

IN THE SUPREME COURT OF THE STATE OF DELAWARE

CLAIRE C. MARSHALL, )  
 )  
 Plaintiffs Below- )  
 Appellants, )  
 )  
 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, )

No. 27, 2009

OPENING BRIEF OF APPELLANT  
CLAIRE C. MARSHALL

Filed by Team D,  
Counsel for the Appellant

February 16, 2009

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### **NATURE OF PROCEEDINGS**

On July 3, 2008, Plaintiff, a shareholder holding 1000 shares of Securance stock, filed this derivative complaint. Plaintiff brought this derivative suit on behalf of Nominal-Defendant Securance, Inc. (the "Company"), against the Company's seven-member board of directors (the "Director Defendants") as well as against three of the Company's non-director senior officers (the "Officer Defendants").

On January 6, 2009, the Court of Chancery granted the Defendants' motion to dismiss the derivative complaint in its entirety pursuant to Court of Chancery Rule 23.1 for failure to adequately allege demand futility. The Court of Chancery also granted the motion to dismiss the claims against the Officer Defendants pursuant to Court of Chancery Rule 12(b)(6) for failure to state a claim. On January 16, 2009, the Plaintiff appealed and this Court accepted certification.

### **SUMMARY OF THE ARGUMENT**

This court should reverse the Court of Chancery's finding that Plaintiff failed to adequately plead particularized facts, which support an excuse of demand under Court of Chancery Rule 23.1. Demand shall be excused where Plaintiff alleges with particularity his reasons for not serving demand on the board, namely, that the directors are interested. Such interest is shown in a Caremark case where directors face a substantial likelihood of success on the merits. Plaintiff Marshall pleads particularized facts that are critical to a Caremark claim; facts suggesting serious irregularities within the company and the Board's choice to ignore them.

By only examining Plaintiff's allegations under the Caremark analysis, the Court of Chancery ignored a recent holding in this Court suggesting an alternative standard in the presence of red flags. Plaintiff here has particularly alleged clear red flags. Where clear red flags are present, it should be the policy of this court to hold that directors are not justified in further relying on clearly inadequate monitoring systems.

Should this Court find that Plaintiff's allegations do not amount to red flags, the Caremark standard is then applicable. Under this "good faith" standard, the Court should still excuse demand. The totality of the facts, each a yellow flag, amounts to a single red flag waving in the faces of the Defendants. The Defendants either should have been aware of the fraudulent violations, or alternatively were aware and consciously chose to disregard them. The Defendants failed in discharging their fiduciary duties in good faith and consequently face a substantial likelihood of success on the merits.

Further, this Court should reverse the Court of Chancery's finding that the Plaintiff failed to state a claim for which relief can be granted because the Defendants did breach their fiduciary duty of loyalty by failing to exercise their oversight responsibilities.

In deciding a 12(b)(6) motion to dismiss this Court should give Plaintiff Marshall the benefit of well-pled, non-conclusory facts which support a finding that Defendants breached their fiduciary duty of loyalty by failing to monitor Securance's operations.

Additionally, this Court recently explicitly confirmed that Officers have the same fiduciary duties as Directors. Because

Securance had a monitoring system in place which waved red-flags in the face of the Officer Defendants their conscious disregard of such red-flags equates to a breach in their fiduciary duty of care.

Finally, Plaintiff Marshall argues that public policy dictates that the business judgment rule should not apply to corporate officers because it encourages unnecessary risks and provides improper incentives, particularly in a highly regulated, low-margin industry such as the one in which Securance operates. In the alternative if this Court finds that the business judgment rule should apply to the Officer Defendants, their actions are still not shielded by the business judgment rule because they failed to satisfy either of the two prongs required to invoke the rule's protection.

## STATEMENT OF THE FACTS

Securance is a for-profit managed care company serving Medicaid and Medicare patients in various state markets. (Mem. Op. 1-3). State and Federal governments pay securance a premium for every Medicaid recipient that enrolls in one of Securance's managed plans. (Compl. ¶. 11). In turn, Securance enters into contracts with individual health care providers to service Securance enrollees. (Compl. ¶. 12). The Company must file annual state reports detailing the amount it spends on direct medical care, which is known as a "medical loss ratio." (Compl. ¶. 14). This ratio reflects the percentage of premiums Securance spends on medical services for Medicaid patients it serves. (Mem. Op. 5). According to state Medicaid regulations the Company must either: (1) spend 80% of the premiums it receives from each state on direct medical services; or (2) refund premiums to each state for any shortfall below 80%. (Mem. Op. 5). If medical loss ratios exceed 80%, the Company absorbs these losses. (Mem. Op. 6).

In 2004, state investigators in Connecticut and Virginia examined claims that Securance was systematically denying certain medical services to its Medicaid patients in order to increase profits. (Compl. ¶. 40). After originally denying these claims Securance entered into consent decrees promising to comply with the applicable state laws. (Compl. ¶. 42.)

In 2005, Securance created a wholly-owned offshore subsidiary in Grand Cayman, Total Reinsurance ("Total Re"). (Compl. ¶. 22). Simultaneously, Securance began reporting a perfect loss ratio of 80% in four key states responsible for 40% of the Company's total profit,

and continued to do so through 2007. (Compl. ¶. 18). The Company typically incurred loss ratios between 74% and 76% in its key states (New York, New Jersey, Ohio and Pennsylvania). (Compl. ¶. 21). From 2005 through 2007 Securance was able to report a perfect 80% loss ratio because Senior Managers fraudulently funneled \$120 million through Total Re as "direct medical costs." (Compl. ¶. 20). These Senior Managers pled guilty to conspiracy to falsify data, resigned, and are now serving two-year prison sentences. (Compl. ¶. 30).

In 2004, Securance reported \$49 million in profits on \$1.4 billion in revenues (a %3.5 margin). (Compl. ¶. 16). HMOs typically operate at low margins, yet from 2005-2007 Securance reported profits of \$88 million, \$95 million and \$104 million respectively. (Compl. ¶. 25). These increased profits reflected Securance's fraudulent practices, which were concealed by two separate financial reports. (Compl. ¶. 27). A 2008 Goldman Sachs report exposed that Securance appeared to be shifting profits to Total Re to give state regulators the impression that profits were slim. (Compl. ¶. 27).

A month after the report FBI representatives of the state Medicaid agencies executed a federal search warrant at Securance's headquarters. (Compl. ¶. 28). Shortly there after the Board convened and decided to enter into plea agreements (Compl. ¶. 32). Securance pled guilty to one count of mail fraud and stipulated to an order imposing \$400 million in criminal penalties and additionally requiring the restitution of \$120 million in funds Securance wrongfully withheld. (Compl. ¶. 33). Securance is also barred from doing business in these jurisdictions for three years. (Compl. ¶. 33).

## ARGUMENT

I. THIS COURT SHOULD REVERSE THE CHANCERY'S COURT DISMISSAL OF THE DERIVATIVE COLAINT UNDER RULE 23.1 BECAUSE PLAINTIFF, STOCKHOLDER MARSHALL, PLED PARTICULARIZED FACTS THAT DEMONSTRATE THE DEFENDANTS COULD NOT HAVE PROPERLY EXCERCISED THEIR INDEPENDENT AND DISINTERESTED BUSINESS JUDGMENT IN RESPONDING TO A DEMAND BECAUSE THEY FACE A SUBSTANTIAL LIKELIHOOD OF PERSONAL LIABILITY.

### A. QUESTION PRESENTED

Did the Court of Chancery err in holding that Plaintiff failed to allege with adequate particularity that pre-suit demand was excused as futile in this case when Plaintiff pled specific facts that demonstrated that Defendants were aware or should have been aware of serious irregularities and that Defendants' failure to act breached their fiduciary duties?

### B. STANDARD AND SCOPE OF REVIEW

The standard of review is de novo when reviewing the decisions of the Court of Chancery applying Rule 23.1. "In a Rule 23.1 determination of pleading sufficiency, the Court of Chancery, like this Court, is merely reading the English language of a pleading and applying to that pleading statutes, case law and Rule 23.1 requirements. To that extent, our scope of review is analogous to that accorded a ruling under Rule 12(b)(6)." Brehm v. Eisner, 746 A.2d 244, 253-254 (Del. 2000).

### C. MERITS OF THE ARGUMENT

1. Plaintiff pled sufficient facts from which this Court should reasonably infer that Defendants either knew of indications of fraudulent activities and failed to act, or failed to implement internal controls in good faith.

The Court of Chancery Rule 23.1 requires the plaintiff in a derivative action to allege with particularity the reasons for not

serving demand on the board of directors ("board"). Del. Ch. Ct. R. 23.1. In Guttman v. Huang, the Court of Chancery stated that the kind of fact pleading critical to a failure to monitor claim (a "Caremark claim") includes the board's notice of serious irregularities, that is, facts suggesting "red or yellow flags," and the board's choice to ignore them. 823 A.2d 492, 507 (Del. Ch. 2003).

Precedent suggests that in addressing the particularity of the plaintiff's allegations, this Court should make all reasonable inferences that logically flow from the alleged facts. White v. Panic, A.2d 543, 549 (Del. 2001); Brehm v. Eisner, 746 A.2d 244, 253 (Del. 2000). Additionally, a pleader may rely on factual statements in the media as some of the tools from which he intends to derive the particularized facts. Brehm, 746 A.2d at 249.

In Wood v. Baum, this Court found the plaintiff's allegations were not particularized where allegations of failure to monitor hinged almost exclusively on the board's execution of financial statements. 953 A.2d 136, 142 (Del. 2008). The court noted that the execution of financial reports, "without more, is insufficient to create an inference that the directors had actual or constructive notice of illegality." Id. Similarly, in Guttman, where the plaintiff's Caremark claim relied solely upon a former executive's employment complaint filed with the company's human resources department, the Court of Chancery found that the plaintiff's allegations failed to meet the heightened pleading standard. Guttman, 823 A.2d at 507.

Here, Plaintiff Marshall's factual allegations are extensively more particular than the facts alleged in either Wood or Guttman. In

Wood, the mere allegation that directors approved financial statements and were thus aware of fraudulent accounting was, without more, not enough. 953 A.2d at 142. In this case in addition to director approval, this Court can reasonably infer that Director and Officer Defendants Saligman and Richmond had extensive knowledge of the financial statements given their Sarbanes-Oxley Act obligations. 15 U.S.C. § 7241 (Supp. II 2002). Additionally, Officer Defendants Craig, Lieberman, Stockdale and Carlos each had intimate knowledge of the workings of the corporation, legal compliance issues, financial statements, and Securance's use of Total Re. (Compl. ¶. 5,6). Astonishingly, these officers worked on and approved two sets of financial reports, one to the SEC and investors, and another to state Medicaid regulators, each showing substantial differences in profits. (Compl. ¶. 5,6).

Under the court's analysis in Guttman, Plaintiff Marshall pleads specific instances of red and yellow flags sufficient to meet the particularized pleading standard. Unlike the plaintiff in Guttman who relied on a single internal employment complaint filed by a former executive, Plaintiff Marshall, alleged numerous specific red and yellow flags. Marshall's complaint alleged the following red and yellow flags: (1) the 2004 consent decrees (Compl. ¶. 40-43); (2) the peculiar incorporation of Total Re in Grand Cayman (Compl. ¶. 22); (3) the substantial increases in profits in a low-margin industry (Compl. ¶ 16, 25); (4) the fact that the medical loss ratio for Ohio, Pennsylvania, New York, and New Jersey was a perfect 80% for 2005, 2006, and 2007 (Compl. ¶. 21); (5) the execution of separate and

different financial and regulatory reports (Compl. ¶. 27); (6) the Goldman Sachs report suggesting a fraudulent use of Total Re (Compl. ¶. 27); and (7) the use of an aggressive profit motive scheme in what is, again, a low-profit-margin industry. (Compl. ¶ 38).

Under the limited facts pled in both Wood and Guttman the courts properly refused to draw unreasonable inferences and conclusions about the directors' knowledge. Here, the red and yellow flags necessitate the reasonable inference that the Defendants, through their intimate role in the company, knew that the internal controls were flawed or corrupt well before the 2008 events.

2. **The Court of Chancery's decision to dismiss Plaintiff Marshall's complaint under Rule 23.1 should be reversed because an improper standard was applied despite the presence of two clear "red flags."**

The court shall excuse demand where the particularized allegations of the stockholder create reasonable doubt that a board of directors could have properly exercised its independent and disinterested business judgment in response to a demand. Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993). This test is satisfied where a plaintiff demonstrates a substantial likelihood of success on the merits. Id.

This Court recently affirmed that lack of good faith conduct is a necessary condition for director liability in a failure to monitor case. Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006). However, good faith conduct in the oversight liability<sup>1</sup> context is applicable only in the absence of red flags. Id. at 373. The Stone test does not

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<sup>1</sup> The Stone Court refers to liability for failure to monitor as "oversight liability."

directly apply to a case in which there are specific factual allegations of "red flags." (Mem. Op. 24). Although not precisely defined, the Stone Court suggests a three prong test to determine whether "red flags" exist: (1) facts showing a board was ever aware that internal controls were inadequate; (2) that these inadequacies would result in illegal activity; and (3) that the board chose to do nothing about problems it knew existed. Stone 911 A.2d at 370.

The first "red flag" to the Defendants was the incorporation of Total Re, an offshore reinsurance company unrelated to the normal business of an HMO. (Compl. ¶ 22). The Defendants were not only well aware of Total Re, but had to approve its incorporation as a wholly owned subsidiary. While the Board is not involved in the Company's day-to-day operations, the creation of a wholly-owned subsidiary is of particular interest when \$120 million dollars was parked there over a three year period. (Mem. Op. 7).

Directors must be knowledgeable of the particular business in which they engage including its financial and regulatory records. 15 U.S.C. § 7241 (Supp. II 2002). HMOs neither need to reinsure nor have assets or liabilities that need reinsuring. Reinsurance is used by insurers to spread the risk of loss especially for insurers of catastrophic damage. Diaconis, Joseph S., PLI Order No. A4-4479, Reinsurance Litigation and Arbitration, Introductory Comments and Basic Over View of Reinsurance. Given the security of contracting with state and federal regulatory agencies, Securance has no such risk of fatal loss.

Assuming Securance employs competent directors, the incorporation of Total Re is a "red flag." Even outside financial analysts noticed inconsistencies in Securance's two sets of books. (Compl. ¶. 27). On February 4, 2008, a Goldman Sachs report suggested that Securance was shifting profits to Total Re to give state Medicaid regulators the impression that profits were thin. (Compl. ¶. 27). The report was promptly picked up by the wire services and published in numerous business publications. (Compl. ¶. 27).

The second red flag present in this case is the 2004 consent decrees. In Graham v. Allis-Chalmers Mfg., Co., this Court looked at "red flags" in the context of consent decrees. 188 A.2d 125 (Del. 1963). In 1937, Allis-Chalmers Mfg. Co. entered into consent decrees with nine others enjoining agreements to fix uniform prices on electrical equipment. Id. at 129. The decrees recited that they were consented to solely for the purpose of avoiding the expense of litigation. Id. In 1959, new allegations of anti-trust violations surfaced, Allis-Chalmers internally investigated the claims and eventually suffered losses as a result of a price-fixing scheme. Id. The plaintiff argued that the 1937 decrees put the board on notice, yet this Court held the decrees were too remote given the time gap and fact that only 3 directors were even aware of the decrees. Id.

Here, the Chancery Court places emphasis on the lack of admission of liability, yet examining the reasoning behind consent decrees reveals this emphasis is misplaced. (Mem. Op. 25). Consent decrees are settlements; they do not serve the law because they typically contain no admission of liability. Mengler, Thomas M., Consent Decree

Paradigms: Models Without Meaning, 29 BCLR 291, 331 (March, 1988). Liability carries a possibility of great loss of business reputation, particularly in cases involving public welfare. Attaching liability to consent decrees removes one of the two fundamental incentives of settling. Id.

The 2004 Consent Decrees constitute "red flags" under this Court's three prong test in Stone. In 2004 state investigators alleged Securance systematically denied certain medical services to indigent and disabled members and used improper financial incentives and bonuses to persuade doctors to deny specialist services, both in an attempt to boost profits. Securance entered into two decrees promising to comply with applicable laws and consented to pay a fine of \$100,000 in each state. Illegal activities were very likely occurring within the Company, the current internal controls obviously did not catch these activities, and the Board chose to do nothing.

Securance's reaction to the allegations and the awareness of the Board were acutely different from Graham. In response to FTC allegations in 1937, Allis-Chalmers conducted internal investigations and reviewed implicated departments to ensure compliance and satisfy themselves that no misconduct had occurred. Securance neither conducted internal investigations nor took any steps to satisfy themselves that misconduct had not occurred. Furthermore, Securance entered into consent decrees just one year prior to the Medicaid fraud scheme and all seven directors served during both the 2004, and 2008 investigations.

The Court of Chancery opines that the \$200,000 fine is insignificant in contrast to the \$49 in million profits and \$1.4 billion in revenues. Following this line of thought will set a dangerous precedent: where consent decree fines are immaterial, a company may rely on present internal controls despite their obvious inadequacies and the possibility of future fines. Consent decrees entered into by large corporations will always be immaterial in terms of profits and revenues. The key factor is not the amount of the fine; but rather it is the fact that a fine is deemed necessary because of the system's inability to deliver timely, accurate information to the Defendants.

It should be the policy of this Court to hold that whenever directors know or should have known that their monitoring system has failed, they are not justified to further rely on that system. By failing to even attempt to enhance or alter internal controls following serious allegations of Medicaid regulatory violations in 2004, Securance has done just this; continued to rely on a clearly inadequate system at the expense of the Stockholders and the American taxpayers.

**3. Alternatively, the Defendants breached their fiduciary duty of loyalty by consciously failing to assure a reasonable reporting and information system exists in good faith.**

Absent blatant red flags, good faith in the context of oversight must be measured by the directors' actions "to assure a reasonable information and reporting system exists." Stone, 911 A.2d at 373. An adequate information and reporting system exists where the system provides the board with timely, accurate information sufficient to

allow the board to reach informed judgments concerning the corporation's compliance with law. In re Caremark Intl. Inc. Derivative Litigation, 698 A.2d 959, 970 (Del. Ch. 1996); Stone, 911 A.2d at 369. Internal controls cannot remove all possibility that corporations will violate laws, or that directors may be misled. Caremark, 698 A.2d at 970. However, emphasis is not placed on detection or results, but rather the good faith belief that the monitoring system is adequate. Id.

In In re Walt Disney Co. Derivative Litig., this Court established a partial list of acts demonstrating good faith, most importantly, failure to act in the face of a known duty to act. 906 A.2d at 67. In Stone, this court found that "a sustained or systematic failure of the board to exercise oversight, such as an utter failure to attempt to assure a reasonable information and reporting system exists" demonstrates bad faith. 911 A.2d at 369.

In Caremark, the Court of Chancery held that the Caremark directors had not breached their fiduciary because the information systems in place represented a good faith attempt to be informed of relevant facts. 698 A.2d at 971. In 1991 and 1992, the Office of the Inspector General ("OIG") and the DOJ began investigations into Caremark's payment of physicians' fees for monitoring patients under Medicaid and Medicare, violations under the Anti-Referral Payments Act. Id. at 962. Caremark at all times denied any wrongdoing, yet immediately following the investigation, Caremark ceased payment of such fees, revised internal compliance guides, restructured management, implemented policy requiring approval for new contractual

relationships, employed outside auditors to assess potential liability and mandated local branch officers to seek approval from the home office for all contractual disbursements. Id. at 963.

Securance, through indolence or ineptitude, utterly failed to act. Caremark, facing allegations almost identical to those alleged against Securance in 2004, responded swiftly and thoroughly, completely overhauling their internal compliance systems, and instituted changes despite an independent audit finding they would likely incur no liability. Securance relied on their own assurance that they had done nothing wrong.

Yet making a simple comparison to Caremark is inadequate because the facts here, taken together, are simply more severe than the single allegation made against Caremark. HMOs typically operate at a low profit-margin, yet the directors either failed to note or failed to adequately address a 100 percent increase in profits. Further, a simple contrast of the SEC reports with the Medicaid filings would reveal a discrepancy of some \$40 million plus dollars in profit per year, quite material for a company with only \$49 million in profits in 2004. Six of the defendants worked closely with some aspect of both of these filings, their intimate dealings with these obvious discrepancies reveals knowledge of or a conscious disregard towards the fraudulent activity.

The following factors are at a minimum yellow flags, meaning that they should have alerted the Defendants of the need to investigate in order to fulfill their fiduciary duties. (1) The 2004 consent decrees; (2) the unnecessary incorporation of an offshore Total Re in Grand

Cayman; (3) the substantial increases in profits in a low-margin industry; (4) the fact that the medical loss ratio for Ohio, Pennsylvania, New York, and New Jersey was a perfect 80% for 2005, 2006, and 2007; (5) the execution of separate and different financial and regulatory reports; (6) the Goldman Sachs report suggesting a fraudulent use of Total Re; and (7) the use of an aggressive profit motive scheme in what is, again, a low-profit-margin industry. (RECORD CITE). Clearly "something is rotten in the State of Denmark."<sup>2</sup> The totality of seven yellow flags is a clear red flag waving in the faces of the Defendants.

Good faith in the context of oversight liability is measured by directors' actions; Caremark as a corporation set the standard and Securance clearly missed the mark. The failure to act under these circumstances cannot be interpreted as good faith. Given the breadth and weight of the allegations, the only reasonable inference is that the Defendants should have been aware of the fraudulent violations, or alternatively were aware and consciously chose to disregard them.

**II. THE COURT OF CHANCERY IMPROPERLY DISMISSED THIS CASE PURSUANT TO RULE 12(b) (6) FOR FAILURE TO STATE A CLAIM FOR WHICH RELIEF CAN BE GRANTED BECAUSE DEFENDANTS BREACHED THEIR FIDUCIARY DUTIES IN FAILING TO ACT IN GOOD FAITH TO FULFILL THEIR OVERSIGHT RESPONSIBILITIES AND MONETARY RELIEF CAN BE GRANTED.**

**A. Question Presented**

Did the Court of Chancery err in holding that Plaintiff Marshall failed to state a claim for which relief can be granted when the facts alleged demonstrate that the Defendants breached their fiduciary duties to the Company and the stockholders and damages are available?

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<sup>2</sup> Shakespeare, William. Hamlet. (I. iv. 87-91) .

## **B. Standard and Scope of Review**

This Court reviews de novo the Court of Chancery's grant of a motion to dismiss for failure to state a claim. Wal-Mart Stores, Inc. v. AIG Life Insur. Co., 901 A.2d 106, 112 (Del. 2006). A Rule 12(b)(6) dismissal "will be upheld only if it appears from the well-pleaded allegations of the complaint that plaintiffs would not be entitled to relief under any set of facts that could be proven to support the claim asserted." *Id.* The Court must consider the "facts alleged in the complaint ... as true" and view "all inferences ... in the light most favorable to the non-moving party." *Id.*

## **C. Merits of the Argument**

- 1. The pleading requirement to overcome a 12(b)(6) motion is met because the Plaintiff's complaint showed a breach of the fiduciary duty of loyalty by failing to monitor Securance's operations, a duty owed to the stockholders.**

Plaintiff Marshall's complaint meets the requirement to overcome a 12(b)(6) motion to dismiss. In considering a 12(b)(6) motion to dismiss, the following standards are applicable: (1) all well-pleaded factual allegations are accepted as true; (2) even vague allegations are "well-pleaded" if they give the opposing party notice of the claim; (3) the court should draw all reasonable inferences in favor of the non-moving party. Savor, Inc. v. FMR Corp., 812 A.2d 894 (Del. 2002).

According to Savor this Court should consider the "various factual permutations reasonably possible within the framework of the Plaintiff's allegations." *Id.* Dismissal under Rule 12(b)(6) is inappropriate unless the court determines that the "plaintiff would

not be entitled to recover under any reasonably conceivable set of circumstances susceptible of proof." Id.

Here, the Court of Chancery did not give the Plaintiff the benefit of well-pled, non-conclusory facts and thus erred in finding that the grave injury suffered by the Plaintiff and all of Securance's stockholders was not due to a breach in the fiduciary duty of oversight by the Defendants. Additionally, Plaintiff Marshall provided the Defendants with notice of the claim that alleged that the Defendants owe to Securance and its stockholders fiduciary duties of loyalty which includes the duty of oversight over the company. A breach of the fiduciary duty of oversight may be shown either by an affirmative wrongful act or a director or officer's failure to act. Caremark, 698 A.2d at 969.

The Defendants' failure to provide oversight over Securance left the Company and its stockholder vulnerable to the massive fraud scheme. This fraudulent scheme resulted in \$520 million out-of-pocket losses, a \$3 billion loss in market value, and untold substantial harm to the Company's reputation. (Compl. ¶. 2).

**2. The Plaintiff overcame the 12(b)(6) motion because the Officer Defendants have the same fiduciary duties as the Directors and neglected those duties by failing to provide effective oversight.**

This Court explicitly held that "Officers of Delaware corporations, like Directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of Officers are the same of Directors." Gantler v. Stephens, 2009 WL 188828 (Del. 2009). This recent holding in Gantler supports the finding from In re World Health Alternatives. 385 B.R. 576, 591 (Bankr.Ct. 2008). There, Judge

Walsh, stated that as an Officer of the company, the Defendant<sup>3</sup> was in a "top management" position and as such "had a duty to know or should have known of these corporate wrong doings and reported such breaches of fiduciary duties by the management." Id.

Given the fact that officers and directors have the same fiduciary duties, this Court should apply the standard for directors elaborated in Disney in order to determine whether the Officer Defendants have breached their fiduciary duties. Disney, 906 A.2d 27 (Del. 2006). Disney states that when a director intentionally fails to act in the face of a known duty to act he breaches not only his duty of loyalty, but also his duty of good faith. Id. In Stone this court affirmed that one of two conditions must be present for director oversight liability: (1) the directors utterly failed to implement any reporting or information system or controls; or (2) having implemented such a system or controls, consciously failed to monitor or oversee its operations thereby disabling "themselves from being informed of risks or problems requiring their attention." 911 A.2d 370.

The Caremark court held that board-created information and reporting systems must be "reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance." 698 A.2d at 970. When there is a known duty to act, a director's failure to act

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<sup>3</sup> In re World Healthcare, the court held that two officer-defendants, one vice president of operations and the other the general counsel, have the same fiduciary duties as directors.

demonstrates a conscious disregard for their responsibilities and by failing to discharge that fiduciary obligation in good faith, a breach of their duty of loyalty. Guttman v. Huang, 823 A.2d 492, 506 (Del.Ch.2003). Directors breach their fiduciary duty of oversight when they fail to take appropriate steps to properly inform themselves of the ongoing operations of the company.

Here, the second prong of the Caremark test is applicable in that Securance had a monitoring system in place but the Defendants consciously disregarded information that amounted collectively to a "red flag" indicating that this monitoring system was inadequate. (Compl. ¶ 36-37.). Due to the nature of Securance's business the company must report to each state the amount of money it spends on direct medical care through a "medical loss ratio." (Mem. Op. 6). The Officer Defendants were aware or should have been aware of Securance's medical loss ratio reports which provided information. (Compl. ¶. 31). One of the first yellow flags brought to the attention of the Defendants was the fact that Securance typically incurred medical loss ratios between 74% to 76% in Ohio, Pennsylvania, New York and New Jersey. (Compl. ¶. 21). However, from 2005 through 2007 while the fraudulent scheme was in place, a consistently perfect 80% medical loss ratio in Securance's four key states remarkably went undetected. (Mem. Op. 7).

Secondly, once the scheme was launched in early 2005, Securance's income almost doubled from \$49 million in 2004 to \$88 million in 2005. (Compl. ¶. 25). With the scheme continuing into 2006 and 2007, the Company sustained this artificially high level of performance,

reporting net income of \$95 million in 2007 and \$104 million in 2008. (Compl. ¶. 25). While medical costs do increase every year, the increases are typically small and Securance's margins have traditionally been approximately 3.5%. (Compl. ¶. 16). Such increases in medical costs simply cannot account for Securance's meteoric rise in profits.

Unlike Stone where the plaintiffs agreed that the directors neither "knew [n]or should have known that violations of law were occurring," the Officer Defendants in this case were aware, or should have been aware, of the clear red flags. As such, the Officer Defendants had actual knowledge of, or chose to ignore these warnings that revealed suspicious activities. The Officer Defendants consciously failed to monitor Securance's compliance with applicable law. As a result of the Officer Defendants' failure to monitor, Securance has suffered irreparable damage to its reputation, serious monetary fines, and an untold loss of possible future Medicaid business.

- 3. Public policy dictates that the business judgment rule should not apply to corporate officers because it encourages unnecessary risks and provides improper incentives, particularly in a highly regulated, low-margin industry such as the HMO industry.**

The business judgment rule provides directors with "liability protection to induce risk taking because their relatively small stockholdings and lack of incentive compensation give them little of the 'upside' gains on investment projects." Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996). It is in the

interest of companies to encourage directors to take appropriate risks while being protected under the business judgment rule.

In contrast an officer's compensation is usually based on a highly incentivized model. A significant portion of an officer's pay is often directly related to their job performance. Officers, unlike directors, stand to reap substantial rewards for taking risks under this model. Application of the business judgment rule to corporate officers would encourage unnecessary risk taking and would incentivize them to breach their fiduciary duties because they would be afforded greater protection from personal liability.

Here, as a result of the "Senior Officer Compensation Plan" the Senior Officers were greatly motivated to increase profits at any cost. (Mem. Op. 13). Adopted in 2003 upon recommendation of the Board's compensation committee, the plan provided senior corporate executive bonuses based on the operating profit yielded by each of Securance's business divisions. (Mem. Op. 13). While profit based incentive plans are common, implementing them in a highly regulated, low-margin industry such as the HMO industry exacerbates the existing incentives to circumvent regulation and creates the need for greater oversight. Thus applying the business judgment rule in this environment skews the risk/reward ratio for officers by limiting risks yet maximizing rewards. See generally Lyman P. Q. Johnson, Corporate Officers and the Business Judgment Rule, 60 BUS. LAW. 439 (2005).

4. **Alternatively, if this Court applies the business judgment rule to the Officer Defendants, their actions are not protected under the business judgment rule because they do not satisfy either of the two prongs required to invoke the protection of the rule.**

The "business judgment standard"<sup>4</sup> is one in which there is:

"a presumption that in making a business decision the Directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company."

Gantler, 2009 WL 188828 at 7.

Whether the decision of an Officer is protected by the business judgment rule is a two-prong analysis. Id. First, the question as to whether the decision was reached in the "good faith pursuit of a legitimate corporate interest" must be asked. Secondly, the court should inquire as to whether such a decision was executed post-advisement. Id.

The Officer Defendants will likely argue that the business judgment rule protects their decisions. However, under the two pronged analysis used by this court in Gantler the Officer Defendants' decision not to look into red-flags as part of their oversight duty is not protected by the business judgment rule.

First, the Officers' failure to monitor despite the many red and yellow flags was simply not a "good faith pursuit of a legitimate corporate interest." Id. The Officers' lack of oversight facilitated the fraud that eventually took place and led to Securance's catastrophic legal and financial consequences. In their plea agreements, the Senior Managers confirmed that they were not rogue

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<sup>4</sup> This Court in Gantler uses the term "business judgment standard" in place of the traditional term "business judgment rule." Hereinafter it shall be called the business judgment rule.

employees, but that they acted with the "express or implied support of the Company's senior Officers." (Compl. ¶. 31). Because the Officer Defendants managed the day-to-day business operations and supervised each of the now incarcerated Senior Managers, the Officer Defendants were either aware or should have been aware of the Senior Managers' activities and thus their failure to act could not have been in good faith.

Furthermore, the second prong of the business judgment rule test was not satisfied because the Officer Defendants failed to seek advisement prior to making their decision not to take affirmative action in the face of numerous red and yellow flags. The Defendants failed to provide information as to the type of advisement that they sought or the processes used in making their decision to ignore the significant red and yellow flags that were brought to their attention.

In Gantler this Court held that facts which showed disloyalty of three of the officers were enough to rebut the business judgment presumption. 2009 WL 188828 at 9. The Court held that it is enough to assert facts that provide merely a "sufficient basis" to conclude that a defendant acted contrary to his fiduciary duties so that the business judgment standard no longer applies. Id. A complaint creating an inference that officers assisted corporate directors in sabotaging due diligence, which resulted in the withdrawal of a merger bid, provided a "sufficient basis" for this Court to conclude that the officers breached their fiduciary duty of loyalty. Id.

Here, like in Gantler the complaint alleged facts which provide a sufficient basis to find that the Officer Defendants breached they

fiduciary duty of loyalty. The now incarcerated Senior Managers stated in their plea agreements that they acted in "express or implied support of the Company's senior officers." (Compl. ¶. 31). The numerous red and yellow flags, along with the statements in the plea agreement support, at the very least, an "inference" of breach of the fiduciary duty of loyalty. Like the plaintiff in Gantler, Plaintiff Marshall's allegations effectively rebut the application of the business judgment rule to the Officer Defendants and overcome the Officer Defendants' 12(b)(6) motion to dismiss.

#### **Conclusion**

For the foregoing reasons, Plaintiff respectfully requests that the Court of Chancery's order dismissing this case for failure to adequately allege demand futility per Court of Chancery Rule 23.1 and for failure to state a claim for which relief can be granted pursuant to Court of Chancery Rule 12(b)(6) be reversed and the case remanded.

Respectfully Submitted,

Team D