IN THE

Supreme Court of the State of Delaware

No. 3892-CS, 2009

CLARE C. MARSHALL,	)	
	)	Court Below:
Plaintiff	)	Court of Chancery
	)	Of the State of Delaware
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,	)	
	)	
- and -	)	
	)	
SECURANCE INCORPORATED,	)	
	)	
Nominal Defendant.	)	

Brief for Appellant
Clare C. Marshall

Team E
Attorneys for
Plaintiff Below-Appellant
Clare C. Marshall

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NATURE OF PROCEEDINGS

This Court is asked to reverse the Court of Chancery order granting Securance's motion to dismiss for failure to adequately allege demand futility and for failure to state a claim under Court of Chancery Rules 23.1 and 12(b)(6) respectively. (R. 1, 29.) This derivative action was initiated by a shareholder who has held Securance's stock at all relevant times, and involves allegations that the Board of Directors and senior executives breached their fiduciary duty of loyalty by failing to monitor Securance while senior managers executed a massive fraud in the Company's Medicaid division. (R. 2-3.)

The Court of Chancery granted the Defendants' motions to dismiss on 23.1 and 12(b)(6) grounds. The court held that the facts failed to plead with specificity that demand was excused, and thus the motion to dismiss on Rule 23.1 was granted. Additionally, and in the alternative, the court held that the Complaint failed to state a claim against the Officer Defendants and granted the 12(b)(6) motion to dismiss.

SUMMARY OF ARGUMENT

1. The Court of Chancery incorrectly granted the motion to dismiss for failure to make demand under Court of Chancery Rule 23.1. Demand is futile because the Directors are not disinterested or independent, because they face a substantial likelihood of liability from the derivative action. The Board consciously disregarded a series of red flags that, when taken together, indicated there was a problem with Securance's internal controls. In addition, the Board faces a substantial likelihood of liability because of their sustained and systematic failure to assure that Securance had a reasonable system of internal controls.

2. Officers and directors have the same fiduciary duties under Delaware law. The facts specifically allege that the Officer defendants' failure to monitor corporate employees and activities amounts to a breach of loyalty. The Board is unable to make a disinterested business decision as to the Officers because they have a personal stake in the outcome of any suit against the Officers. As such, a reasonable doubt exists about the Board's ability to make an independent business decision about the Officers and demand is excused.

STATEMENT OF FACTS

Securance is a Delaware corporation traded on the NYSE that provides medical services to members pursuant to contracts with eighteen states in the Mid-Atlantic and Midwest. (R. 5,7.) Securance must spend 80% of premiums on medical care or refund the difference to the states, which leaves the company with only 20% of receipts for profit and non-medical expenses. (R. 8.) Companies in this highly regulated environment operate with low growth rates and narrow profit margins. (R. 9.) Securance's profit margin was only 3.5% in 2004, based on $49 million of income on $1.4 billion of revenue. (R. 9.)

In 2003, Securance's Board approved the Incentive Compensation Plan that provides bonuses for senior executives based on operating profit. (R. 19.) In 2004, investigators in two states examined claims that Securance systematically denied medical services to indigent patients and offered doctors incentives to deny expensive medical services in order to boost profits. (R. 19.) As part of consent decrees signed to resolve the allegations, Securance paid fines of $200,000 and promised to comply with the law. (R. 20.)

In 2005, Securance began overstating its medical expenses in four states that accounted for 40% of the company's revenues and traditionally received refunds. (R. 10-11.) Securance transferred the unspent premiums to its wholly-owned Cayman Islands subsidiary, Total Reinsurance, Ltd., seemingly to buy reinsurance. (R. 11.) Securance's profits were inflated by the amount of premiums fraudulently withheld from the states, because Total Re was included

in Securance's consolidated financial statements. (R. 12.) Securance's net income surged 80% in the first year of the fraud alone. (R. 9, 17.) While the fraud was committed, over 41% of Securance's net income was attributable to the fraud. (R. 17.)

On February 4, 2008, an analyst noticed disparities between information filed with the SEC and state regulators that suggested Securance used Total Re to hide profits. (R. 13-14.) The analyst's report was circulated nationally by newswire, and prompted federal agents to execute a search warrant of Securance's headquarters in early March. (R. 14.) On March 15, the Board held a special meeting to authorize the audit committee to obtain outside counsel to settle all lawsuits resulting from the fraud. (R. 16.)

Three senior managers pled guilty to the fraud and entered into plea agreements which confirmed that they acted with the consent of Securance's senior officers. (R. 15.) Securance pled guilty to mail fraud and entered into a plea agreement whereby the Company must pay $400 million in criminal fines, return $120 million of fraudulently withheld refunds, and cannot do business in four states for three years. (R. 16.) Securance agreed to establish a new and separate compliance committee going forward, but did not force its Officers to return the portion of their bonuses attributable to fraudulently inflated earnings. (R. 17.) On June 3, Securance restated earnings to reflect $120 million or 42% of earnings that was not actually earned. (R. 17.) Two days later, shares of Securance closed at a record low of $37, which marked a $3+ billion loss in market capitalization from the stock's price of $110 in 2007. (R. 18.)

ARGUMENT

A. Questions Presented

The questions presented are whether (1) the allegations in the complaint sufficiently raised a reasonable doubt as to a majority of the Directors disinterestedness or independence so that demand upon the Board of Directors would be excused, (2) the complaint states a claim against the Officer Defendants, and (3) the Board is entitled to make a business judgment with respect to the Officers.

B. Scope of Review

This Court's review of the decision of the Court of Chancery is de novo and plenary. *Brehm v. Eisner,* 746 A.2d 244, 253 (Del. 2000). With respect to a 12(b)(6) motion, "a plaintiff need only plead so as to give notice of the claim; even vague allegations, so long as they give the opposing party notice of the claim, are well-pleaded," and thus survive an officer's motion to dismiss. *McPadden v. Sidhu*, 2008 WL 4017052, at *6 (Del. Ch.) (citing *In re Gen. Motors (Hughes) S'holder Litig.*, 897 A.2d 162, 168 (Del. 2006)); *See also Gantler v. Stephens*, 2009 WL 188828, at *5 (Del.).

C. Merits of Argument

Where the subject of a derivative suit is not a business decision of the board, demand is excused as futile when the allegations in the complaint raise a reasonable doubt that, as of the time the complaint is filed, the majority of the board of directors could have exercised its independent and disinterested judgment in responding to a demand. *Rales v. Blasband*, 624 A.2d 927, 934 (Del. 1993). Plaintiffs do not have to plead facts that would be sufficient to support a judicial

finding of demand futility to establish a reasonable doubt regarding the directors' judgment. *Grobow v. Perot*, 539 A.2d 180, 186 (Del. 1988). In addition, the determination of whether there is reasonable doubt is made in light of all of the relevant facts taken as a whole. *Harris v. Carter*, 582 A.2d 222, 229 (Del. Ch. 1990).

A director is interested when a corporate decision will not affect the corporation or shareholders, but may cause a material detriment to the director. *Rales*, 624 A.2d at 936. An example of such a situation is when the decision to bring a derivative suit would result in personal liability for the directors. *Id.* Although a "mere threat" of liability is insufficient, demand will be excused as futile when the directors face a "substantial likelihood" of liability. *Id.*

I. THE COURT OF CHANCERY ERRED IN HOLDING THAT DEMAND WAS NOT EXCUSED, BECAUSE A MAJORITY OF THE BOARD WAS INTERESTED AT THE TIME OF FILING BECAUSE THEY FACE A SUBSTANTIAL LIKELIHOOD OF PERSONAL LIABILITY.

Directors face a substantial likelihood of liability when particularized allegations show that the directors breached their fiduciary duty of loyalty by failing to act in good faith to fulfill their oversight responsibilities. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). Under Delaware law, "Boards are expected to erect mechanisms designed to bring misconduct to their attention, and to investigate in good faith when warnings appear." *Shaev v. Armstrong*, 2006 WL 4762860 at *6 (Del. Ch.). The duration and magnitude of the alleged misconduct are relevant to determine whether directors face a substantial likelihood of liability. *McCall v. Scott*, 239 F.3d 808, 823 (6th Cir. 2001).

If directors are ignorant of the liability creating activity within the corporation, only a systematic failure to exercise oversight, such as "an utter failure to attempt to assure a reasonable information and reporting system exists," will render a substantial likelihood of liability. *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996). However, even if a reasonable system of controls exists, directors face a substantial likelihood of liability when they "disable themselves from being informed of risks and problems requiring their attention." *Stone*, 911 A.2d at 370. "Red flags" that indicate a corporation's internal controls are not functioning properly may demonstrate that directors consciously failed to monitor operations and are therefore subject to a substantial likelihood of liability. *See Stone*, 911 A.2d at 373.

1. The directors face a substantial likelihood of personal liability because they consciously failed to monitor operations despite multiple red flags that indicated deficient internal controls.

The demand requirement is excused because the Directors of Securance are not independent or disinterested. The Directors face a substantial likelihood of personal liability because they consciously disregarded their duty to monitor the Corporation. The existence of multiple red flags that were clearly visible to the Board demonstrates that the Directors did not act in good faith to fulfill their duty to monitor operations.

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." *Wood v. Baum*, 953 A.2d 136, 143 (Del. 2008), quoting *In re Citigroup*

Inc. S'holders Litig., 2003 WL 21384599, at *2 (Del. Ch.). Although each red flag alone may be insufficient to show that a board consciously disregarded its duty to monitor the company, it is the totality of the red flags together that must be considered when determining if directors face a substantial likelihood of liability. *McCall*, 239 F.3d at 823; *Harris v. Carter*, 582 A.2d at 229. Therefore, directors face a substantial likelihood of liability when they fail to act despite the existence of red flags that are visible to the careful observer and, when taken as a whole, suggest a problem with internal controls.

A series of red flags indicating weakness in a corporation's internal controls is sufficient to show that directors face a substantial likelihood of liability and are therefore interested for the purpose of excusing demand under Delaware law. *McCall*, 239 F.3d at 823. In *McCall*, shareholders of a Delaware health care management corporation brought a derivative lawsuit against the corporation's directors and officers for a breach of the duties of care and loyalty. *Id.* at 813. Senior managers allegedly schemed to fraudulently increase revenue and profits by improper billing and cost reporting, and by offering financial incentives to physicians to increase referrals. *Id.* at 814. The shareholders asserted that the directors' failure to act in light of the fraudulent activities was the equivalent of a conscious decision not to act. *Id.* at 816.

In support of this argument, the shareholders pointed to various red flags within the Company such as audits, lawsuits, and both

federal and media investigations, that warned of the ongoing fraudulent activity. *Id.* at 820. Audits indicated that hospitals would bill for conditions with the highest reimbursement codes more frequently after being acquired by the corporation and consistently billed more cases with these higher codes than other hospitals. *Id.* at 820, 823. As a result, the corporation was investigated for questionable billing, cost reporting and marketing practices, and paid $475,000 and refunded $1.1 million for questionable expenditures. *Id.* at 821. In addition, a physician filed a *qui tam* action alleging that the corporation used financial arrangements to induce doctors to refer patients to the corporation, and engaged in fraudulent billing for unnecessary services. *Id.* at 822. In late March 2007, the New York Times published several articles which claimed that there was a government investigation into the corporation's billing practices. *Id.* at 833. The company took two weeks to evaluate the articles before taking any action. *Id.* at 833. In March of 2007, federal agents executed a search warrants on one of the corporation's offices to locate evidence relating to billing. *Id.* at 822.

The *McCall* court held that the particularized allegations, taken as a whole and drawn in the plaintiff's favor, were sufficient to raise a reasonable doubt as to the disinterestedness of the majority of the corporation's directors due to their substantial likelihood of liability. *Id.* at 821. The court cited the magnitude and duration of the alleged wrongdoing as relevant in its determination. *Id.* at 823. Although the payments relating to the questionable reimbursements alone may not have indicated a corporate-wide fraud, considering the

company received hundreds of millions of dollars in reimbursements, the court reasoned that the directors should have been sensitive to any circumstances that prompted an investigation into the company's practices. *Id.* at 821. Although the *qui tam* lawsuit was eventually settled, the court explained that it was still a relevant factor to determine if the board acted in good faith by not investigating further. *Id.* at 822. Although, the court agreed with the district court that it may have been reasonable for the corporation to take two weeks to evaluate the New York Times' articles before taking any action, the court noted that the district court had erroneously viewed the search of the corporation's office in isolation. *Id.* at 823.

A board of directors does not consciously fail to monitor a corporation when the only red flags alleged are those that are unlikely to come to the board's attention. *Citigroup*, 2003 WL 21384599, at *2. In *Citigroup*, shareholders brought a brought a derivative action against Citigroup's directors for failing to exercise reasonable control and supervision over its operations due to a wholly-owned subsidiary's transactions with Enron Corporation. *Id.* at *1. The shareholders alleged that internal corporate memoranda and e-mails circulated amongst Citigroup's subsidiaries were red flags that should have put the board of directors on notice of deficient internal controls. *Id.* at 2. The Court of Chancery held that the red flags did not put the directors on notice because there was no evidence to show that the red flags ever came to the attention of the board. *Id.*

In the case at bar, Securance's regulatory trouble was a red flag to the Board of Directors that internal controls were not functioning properly to bring important information to their attention. Like the health care company in *McCall* that was forced to pay fines and make reimbursements for questionable practices, Securance paid fines to Connecticut and Virginia for allegedly systematically denying service to members in order to boost profits. (R. 20.) Although in both instances the amount of the fines was minor considering each company's revenue, the significance of the regulatory trouble is not merely the resulting penalty, but the fact that the alleged violations demonstrated an obvious and systematic failure of internal controls in the precise business segment that is the subject of the derivative action. In the case of Securance, the alleged violations involved its Medicaid division and an attempt to improperly manipulate its direct medical expenses for the purpose of obtaining a higher profit. (R. 19.) Unlike the health care company in *McCall* that merely billed government agencies for its services, Securance can only operate by virtue of its contracts with state governments. (R. 7.) Therefore, the alleged regulatory problems were even more serious because Securance jeopardized its relationship with two important sources of revenue.

In addition, the Incentive Compensation Plan was a red flag to the Board of Directors that senior managers had an incentive to fraudulently bolster Securance's profits. Unlike the directors in *Citigroup* that may not have been aware of any red flags, Securance's directors voted to enact the Incentive Compensation Plan. (R. 18).

In addition, all of the Defendant Directors were members of the Board at the time the Compensation Plan was enacted. (R. 3.) The executive Directors had an incentive to turn a blind eye to the fraud because they stood to benefit directly from bonuses under the Incentive Compensation Plan. (R. 19.) Although it is unclear from the record exactly how much of the Defendants' salaries were attributable to bonuses, the six executive Defendants' salaries alone totaled $21.9 million in 2008. (R. 4-5.) Assuming bonuses from the Incentive Compensation Plan comprised a large part of this compensation, these Defendant's would have been sensitive to any change in net income, either favorable or unfavorable. Although the plan would most likely not be a red flag by itself, the Directors should have examined Securance's unlikely financial explosion more closely considering they had put an incentive compensation structure in place.

Additionally, the increase in medical loss ratios in the four defrauded states was a red flag to Securance's directors. Securance's employees referred to these states as a "band of gold," because they generated approximately 40% of Securance's annual premium revenue (R. 7.) Unlike billing codes in *McCall* that may not have been of concern to the Board, the medical loss ratio is a benchmark that is crucial to Securance's profitability and visible to careful observers. Considering these states consistently had medical loss ratios near 75%, the increase would have been a cause for concern because any increase above 80% would have cut into profitability. (R. 7.) The increase in direct medical costs in the states that were most important to Securance's business could not have been overlooked.

The analyst's report and the federal investigations were a red flag to the Board that there was a problem with internal controls. Because the report was disseminated across the country by newswire, it is logical to assume the Board knew of its existence. (R. 14.) After the report was released, the Board sat passively while a federal investigation and search of the Company's headquarters ensued. (R. 14.) Unlike the two weeks it took the Board to act after news articles suggested the company was involved in illegal practices in *McCall*, Securance's Directors took well over a month to take any action. (R. 14.) When the Directors finally acted, they did not address the weakness in internal controls, but merely convened a special meeting to contemplate a settlement of potential litigation. (R. 16.) The fact that these red flags occurred after much of the damage had presumably occurred is irrelevant for the purpose of showing that the board did not act in good faith, as demonstrated by the relevance of the red flags in *McCall*.

Furthermore, Total Reinsurance's sudden rise to enormous profitability was an obvious red flag, and the Board's failure to investigate was in conscious disregard of their duty to monitor the Corporation. Although an increase in profitability would not normally be considered a red flag, in this case the improvement was so spectacular and unlikely that it demanded a thorough explanation. During the first year of the fraud, Securance's net income soared nearly 80% from $49 million in 2004 to $88 million in 2005. (R. 9, 17.) Because of the structure of the fraud, $35 million of this $39 million increase in net income was attributed directly to its wholly

owned Cayman Island subsidiary, Total Reinsurance, Ltd. (R. 12.) There is no evidence that Securance planned to drastically restructure its business model in favor of providing reinsurance. Unlike the red flags in *Citigroup* that were merely memos and e-mails circulated within a subsidiary, the explosion of Total Re could not have been missed by the Directors. Even a cursory look at the Corporation's financial statements would have shown that the increase in profits was attributed to the growth of the Cayman Island subsidiary.

Despite this, the Defendants may sight the Court of Chancery's reasoning that, "the complaint contains no allegations that such dramatic improvement to business results were not explained or justified to the Board by facially valid business reasons." Marshall v. Securance, Del. Ch. No. 3892-CS, slip. Op. at 25. This rationale is flawed for three reasons. First, at the pleading stage it is not necessary for the complaint to address every potential explanation that may refute the allegations contained therein. The burden is on the defendants to refute the well-pled, particularized allegations. Second, because the Shareholder, Clare Marshall, is not a member of the Board of Directors, it is impossible for her to prove the nonoccurrence of an event that may or may not have happened. Finally, even if the Board was given an explanation that attributed the improvement in business results to valid business reasons, the explanation still may not absolve the Board of liability. The source of the explanation, when it was given, and whether it was repeated would be relevant to determine if the Board adequately fulfilled its duty to oversee the Corporation under the circumstances. Discovery is

necessary to ascertain if such an explanation was given, and if so, what credibility it should be
of the Directors face a substantial likelihood of liability.

The Board of Directors consciously disregarded multiple red flags that were waved in their faces and visible to a careful observer, therefore they face a substantial likelihood of liability that renders demand futile.

2. Alternatively, the board faces a substantial likelihood of personal liability based on their sustained and systematic failure to assure the Corporation had a reasonable information and reporting system.

Delaware law has evolved considerably with respect to the duty of oversight by a corporation's fiduciaries. *See Graham v. Allis-Chamlers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) (holding that "absent cause for suspicion, there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."); *but see In re Caremark Int'l Inc. Deriv. Litig.,* 698 A.2d 959, 971 (Del. Ch. 1996) (holding that a board would be liable for "a sustained or systematic failure . . . to exercise oversight-such as an utter failure to attempt to assure a *reasonable* information and reporting system exists...." (emphasis added)). Although not explicitly stated, the case law indicates that "any" system of monitoring is insufficient and that a board has an obligation to establish a "reasonable" information and reporting system, and this Court should expressly hold so now. *See In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996); *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

(a) The Board of directors is required to implement a reasonable reporting and monitoring system.

The seminal case in the area of corporate oversight was *Caremark,* where the directors were charged with knowingly violating the law or failing to oversee the corporation's activities to such an extent that it amounted to a breach of a fiduciary duty. 698 A.2d at 971. The court in *Caremark* interpreted the *Graham* opinion to hold that a board could not satisfy their fiduciary duties "without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to [allow]. . . informed judgments concerning both the corporation's compliance with law and its business performance." *Id.* at 970. The court noted that for a system to be reasonable, it must ensure that "information will come to [the board's] attention *in a timely manner as a matter of ordinary operations.*" *Id* at 970 (emphasis added). This line of reasoning was affirmed in this Court's decision in the *Disney* case. *In re Walt Disney Co. Deriv. Litig.,* 906 A.2d 27 (Del. 2006).

The Defendants may argue that this Court's decision in *Stone v. Ritter* allows directors to avoid oversight liability by implementing *any* system of reporting. 911 A.2d 362. This argument fails because this Court in *Stone* analyzed at length why the reporting system under review was reasonable. *Id.* at 371. In holding that the system was reasonable, this Court noted that an independent audit of the system by KPMG described in detail the extensive controls in place. *Id.* This Court went on to explain each control individually. *Id.* If the standard was in fact "any" system, there would have been no need for

this Court to address the reasonableness of the system. In addition, public policy requires that the standard be a reasonable system to protect shareholders. Otherwise, directors could knowingly put an inadequate system in place that will fail to detect wrongdoing, even when monitored.

(b) The Board failed to implement a reasonable system.

However, unlike in *Stone*, where the plaintiffs specifically conceded that there were no "red flags," the Directors in this case faced several such warnings and made no attempts to ensure the reporting system was reasonable. (R. 18-21.) Furthermore, the present case is also distinguishable, because in *Stone* this Court based its decision in large part on the independent report by KPMG which established that the system was in fact reasonable. *See Stone v. Ritter*, 911 A.2d at 372, (noting that "[t]he KPMG Report-which the plaintiffs explicitly incorporated by reference into their derivative complaint-refutes the assertion that the directors 'never took the necessary steps ... to ensure that a reasonable BSA compliance and reporting system existed.' ").

Additionally, not only did the Defendant's reporting system fail to detect the fraud "in a timely manner as a matter of ordinary operations," as the *Caremark* court held was necessary, but even after the numerous "red flags" previously discussed, there was no effort to modify the current system or implement a new one. 698 A.2d at 970. For example, in *Graham* the only potential red flag to put the directors on notice was a series of twenty year old consent decrees,

whereas the Directors in this case had a plethora of warnings. (R. 18-21.) First, in this case the consent decrees occurred in 2004, only a few years before the most recent fraud, and afterwards the directors made no changes to their reporting system. (R. 20-21.) Since no changes were made, the fraud that began shortly thereafter was not detected by the Board. However, eventually the fraud became so obvious that an analyst at Goldman Sachs was able to detect it solely by looking at publicly available financials. (R. 13-14.) Even a cursory comparison of the SEC filings and the state regulatory filings would have revealed the discrepancies, and that is all the analyst who broke the story did. *Id.* The Directors, who are privy to sensitive corporate knowledge and financial data, should have realized that they failed to implement a system after this event, and yet no changes were made to the system yet again. (R. 13-15.) In fact, the board did not even meet regarding the matter. *Id.* The fraud was so pervasive at this point to have triggered the suspicions of the federal authorities, and this resulted in the search warrant that was executed on Securance's corporate headquarters. (R. 13-14.) This search warrant directly led to the guilty pleas of both the Corporation and the former senior managers in this case. (R. 13-14.)

These "red flags," in essence, completely distinguish this case from *Graham* as well because this Court specifically noted that only "*absent cause for suspicion*" does no duty exist to install a "system of corporate espionage to ferret out wrongdoing." 188 A.2d at 130 (emphasis added). It was not until three days after the warrant was executed that the Board met for the first time on the matter. (R. 14,

16.) At this point, the damage was done: the fraud resulted in a corporate guilty plea, $520 million in fines and refunds, over $3 billion in losses in market capitalization, and the loss of access to critical markets for Securance for the next three years. (R. 16.) Despite all this, the *sole* action taken by the Board was to create a new compliance committee, staffed by members from the same group of directors who failed to implement a reasonable system prior to all the losses. *See* R. 17. This, clearly, is "too little, too late."

However, the Defendants may argue that the Board's creation of a new compliance committee is a legitimate response to the fraud in this case and satisfies the Board's duty to oversee the Corporation going forward. Even if this were true, the Board breached its duty of loyalty to the Corporation when it failed to implement a reasonable system *prior* to the massive losses and fraud that occurred in this case. Public policy, and indeed common sense, require that in order for directors to discharge their duties, the reasonable system must be implemented prior to illicit or fraudulent activity, and not after the fact. This policy shields directors who do in fact have a reasonable system in place that simply fails to detect wrongdoing through misfortune, but in cases such as this one, it holds directors liable for failing to implement a reasonable system from the beginning.

As such, the Board breached its duty of loyalty by failing to implement a reasonable reporting system. This Court should reverse for the foregoing reasons.

II. THE COURT OF CHANCERY ERRED BECAUSE A CLAIM EXISTS AGAINST THE OFFICERS AND DEMAND IS EXCUSED.

In light of this Court's decision in *Gantler*, the total failure to monitor direct subordinates by officers amounts to a breach of the duty of loyalty. Additionally, the well-pled facts in this case demonstrate that the board is unable to make a disinterested decision as to whether to bring suit against the officer defendants.

1. The Officers have a fiduciary duty of loyalty to the Corporation and they breached it.

This Court conclusively established that officers have the same fiduciary duties as directors in *Gantler v. Stephens.* 2009 WL 188828 (Del.). In that case, this Court held officers who failed to respond to a due diligence request liable for a breach of loyalty under a 12(b)(6) standard. *Id.* at *10. This Court went on to note that no reasonable factual inference could be disregarded, or discounted by possible contrary inferences. *Id.* Furthermore, the law of Delaware has consistently been that a failure to act in good faith amounts to a breach of the fiduciary duty of loyalty. *In re Walt Disney Co. Deriv. Litig.,* 906 A.2d 27, 67 (Del.2006); *Guttman v. Huang,* 823 A.2d 492, 506 n. 34 (Del. Ch. 2003). Therefore, a failure to monitor the Corporation's activities and employees in good faith would result in a breach of loyalty for the Officers.

In the present case, the Officers were in a position, through the compensation package and the conscious disregard of fraud, to secure improper benefits for themselves at the expense of the remaining shareholders. (R. 9, 18-19.) The complaint specifically alleges that the Officers failed to fulfill their oversight responsibilities, and this directly resulted in the massive losses. (R. 25-26.)

Additionally, the Officers were not merely high level managers of the company. These Officers were the Chief Operating Officer, Chief Compliance Officer, and Chief Accounting Officer. (R. 4-5.) This is of particular importance because these three Officers, in any corporation, are expected to ensure that operations run smoothly and legally, that compliance measures are taken to prevent violations of law, and that proper accounting procedures are in effect. (R. 4-5.) Specifically, this Court is required to "[accept] as true . . . well-pled allegations and [draw] all reasonable inferences that logically flow from those allegations." *Feldman v. Cutaia,* 951 A.2d 727, 31 (Del.2008). In early 2005, when the Vice President of Operations, the Vice President of Accounting, and the Finance manager all conspired to illegally increase company profits, it is only logical to infer that the Officer defendants at best consciously failed in their fiduciary duties (R. 5). This is all the more true in this particular case, where two of the Officer Defendants directly supervised the departments of two of the senior managers who pled guilty, and the other Officers "worked closely with each of [the senior managers] in their preparation of the Company's Medicaid reports to state agencies." Opinion page 8. Furthermore, when the senior managers pled guilty to conspiracy to commit Medicaid fraud, they confirmed that "they were not rogue employees, but acted with the express or implied support of the Company's senior officers." (R. 15.)

However, the Defendants may claim, though the point is far from settled amongst scholars, that the Officer's actions are also entitled to the protections of the business judgment rule. Marshall v.

Securance, Del. Ch. No. 3892-CS, slip. Op. at 27, n. 28. Assuming arguendo that the business judgment rule applies, such application is only possible to specific business decisions, and not to broad, systemic lack of oversight as is alleged in this case (R.9). *See* Lawrence A. Hammermesh & Gilchrist Sparks, III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 Bus. Law. 865, 876 (2005). Also, even those who argue in favor of the business judgment rule's application to officers advocate for it not to apply in situations where the officer acts in contravention to the board's directives. *Id.* Thus, any suggestion that the business judgment rule applied to the complaint's allegations of fraud would be a tacit admission that the board supported the actions. *Id.* If this were true the business judgment rule would apply, but the Board would implicate itself for liability purposes. *Id.* If the Board claimed such actions were against the Board's directives, the business judgment rule would not apply. *Id.* Lastly, the well-pled facts state that the Officer defendants breached their duty of loyalty by consciously disregarding the fraudulent overstatement of earnings and the fraudulent retention of $120 million in premiums, which amounts to a breach of loyalty. (R. 9, 16.) However, even if this Court finds only a breach of care, the plaintiffs are entitled to proceed because that alone is sufficient to rebut the business judgment rule, and the Corporation's 102(b)(7) provision only exculpates *directors* from breaches of care claims. *McPadden*, 2008 WL 4017052 at *10; 8 Del. C. § 102(b)(7); Opinion Below p. 20 n.18.

For the foregoing reasons, the Officers of Securance breached their fiduciary duties to the Corporation and the Board is unable to make a disinterested decision with respect to the Plaintiff's derivative suit.

2. There is a reasonable doubt as to the Board's independence, because the Board could not make a disinterested decision.

This Court established in *Aronson* that, in order to be independent and claim the protection of the business judgment rule, "directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." 473 A.2d at 813. In that case, this Court held that allegations that a board's approval of a compensation package amounted to corporate waste were insufficient to render the board interested in the decision of whether to allow a derivative suit on the matter. *Id.* This Court specifically noted that the complaint failed to establish a claim given the broad latitude directors have with respect to the corporate waste doctrine. *Id.* at 817. Most recently in *Gantler*, this Court held that because the directors in that case were in a position to structure a transaction "in a way that benefits his or her interests differently from the interest of the unaffiliated stockholders," the directors were interested as to that transaction. 2009 WL 188828 at *8.

In the present case, the Board is also directly interested because the Board's likelihood of liability would be increased by a decision to sue the Officers since the facts allege both groups

jointly condoned the fraud in this case. (R. 9.) Additionally, because the Board has a direct financial interest in whether allegations of fraudulent conduct by the Officers are confirmed, a reasonable doubt exists about their ability to exercise a business judgment regarding this derivative suit because the decision bears on potential personal liability for the Board. *See Rales*, 634 A.2d at 936. The complaint specifically alleges that the federal search warrant executed on Securance's headquarters established that the fraud "permeated the Company's operations," (R. 14), and thus it is a logical to infer that this permeation could have reached all the way to the Board. Any suit against the Officers could implicate the Board further. Furthermore, unlike the board in *Aronson* whose only alleged interest in the transaction was providing compensation to one of the board's own directors, Securance's audit committee was the entity that handled the Company's guilty plea (R. 5, 16). *See Aronson v. Lewis,* 473 A.2d 805, 810-11 (Del. 1984). This audit committee, which by virtue of Securance's NYSE listing was staffed by non-officer defendants, authorized a settlement agreement that included a guilty plea to a federal crime, $400 million in criminal penalties, and an additional $120 million refund in wrongfully withheld premiums. *See* NYSE Listed Company Manual, *www.nyse.com/lcm/lcm_section.html; R. 16*. The NYSE rules also require that all members of the audit committee be financially literate, "meet to review and discuss the company's annual audited financial statements and quarterly financial statements with management . . . discuss the listed company's earnings press

releases, as well as financial information and earnings guidance provided to analysts and rating agencies." *Id.* at §§ 303a.07(b), (c).

The propriety of such a settlement, especially when all of the Officer defendants and three of the seven Board members were *not* required to disgorge their own overinflated salaries in connection with these illegally withheld premiums, is definitely in question and creates a reasonable doubt about the Board's business judgment with respect to their fulfillment of the Officers' fiduciary duties. *See Rales v. Blasband*, 634 A.2d at 936.

Despite this, the Defendants may contend that the Board is still entitled to exercise its business judgment, notwithstanding the allegations against it, because the actions of the Officers are separate and distinct from that of the Board. However, the Board has already made decisions that bear directly on future board and officer liability, such as the negotiation of the plea agreements with the federal and state authorities regarding the alleged fraud within the company. This is especially true given the allegation that both the Board and the Officer defendants consciously or recklessly condoned a scheme to defraud state Medicaid organizations. (R. 9.)

As such, the Board is unable to make a disinterested decision with respect to the derivative suit, and demand is excused.

Conclusion

For the foregoing reasons, the Petitioner respectfully requests that this Court reverse the Court of Chancery's decision.