
No. 3892-CS

IN THE SUPREME COURT OF THE STATE OF DELAWARE

CLARE C. MARSHALL,

Appellant,

- v. -

**CHARLES H. SALIGMAN, PATRICK C. RICHMOND, YVONNE M. CRAIG, MARTIN
R. ROTHSCHILD, ELAINE A. LASATER, WILLIAM H. LEWIS,
GILBERT W. COULSON, RACHEL N. LIEBERMAN,
TIMOTHY M. STOCKDALE AND CARLOS B. HUELVA,**

Appellees.

ON APPEAL

BRIEF FOR APPELLANT

Team G
Counsel for Appellant
Dated: February 17, 2009

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QUESTIONS PRESENTED

- I. Whether the Plaintiff provided a well-pled complaint, sufficient to withstand a motion to dismiss, when the Plaintiff alleged facts to establish to a reasonable degree of certainty that Defendant Directors and Officers breached their fiduciary duties of care and loyalty, when they failed to act in good faith when overseeing senior managers who were perpetrating a fraud.

- II. Whether the Plaintiff satisfied the demand futility test when she alleged particular facts which established that the Directors were neither independent nor disinterested regarding their failure to oversee senior managers who were perpetrating a fraud against the corporation.

NATURE OF PROCEEDINGS

The Plaintiff in this case, Clare C. Marshall, is a shareholder of nominal defendant, Securance Incorporated (“Securance”). On July 3, 2008, Marshall brought a derivative action in the Delaware Court of Chancery on behalf of Securance against its seven-member board of directors (the “Board” or the “Director Defendants”) and three of the Company’s senior officers (the “Officer Defendants”), all collectively referred to as (the “Defendants”). None of the Officers are members of the Board. Marshall’s Complaint alleges that the Director Defendants and the Officer Defendants are personally liable to Securance for monetary losses because they breached their fiduciary duties. (See Complaint (“Compl.”) and Memorandum Opinion (“Opinion”). Marshall also alleges the Defendants breached their fiduciary duty of loyalty by failing to discharge in good faith their oversight responsibilities as either directors or senior officers of Securance. (See Compl. and Opinion).

On November 5, 2008, all Defendants, including Securance, submitted a motion to dismiss the complaint pursuant to Delaware Chancery Court Rule 23.1 for failure to allege with adequate particularity that pre-suit demand is excused as futile in this case. (See Opinion). Similarly, on November 5, 2008, the Officer Defendants submitted a motion to dismiss the complaint under Court of Chancery Rule 12(b)(6) for failure to state a claim. (See Opinion). The Court of Chancery issued a Memorandum Opinion on January 6, 2009, granting Defendants’ motion to dismiss for failure to allege demand futility under Court of Chancery Rule 23.1. (See Opinion at 16). The Court of Chancery also granted the Officer Defendants’ motion to dismiss for failure to state a claim pursuant to Court of Chancery Rule 12(b)(6). (See Opinion at 16). Plaintiff filed a timely Notice of Appeal on January 16, 2009. (See Notice of Appeal).

SUMMARY OF ARGUMENT

This stockholder derivative case presents a current and significant question of Delaware corporation law. The question before this Court is whether Plaintiff provided a well-pled complaint, sufficient to survive a motion to dismiss, when she pled facts establishing that the Defendant Directors and Officers breached their fiduciary duties of care and loyalty, and whether the Directors were neither independent nor disinterested, making a demand against the Board futile.

Directors have a duty to act with the amount of care that a reasonable person would use in similar circumstances and a duty of loyalty to the corporation. Directors have a duty to monitor corporate performance in good faith. In this case, the facts alleged in Plaintiff's Complaint are sufficient to show that the Directors acted in bad faith, and therefore, breached their fiduciary duties. The Directors failed to use good faith to ensure that their reporting system was providing them with accurate information. Moreover, there were several "red flags" that should have warned the Board that its compliance system was inadequate. Specifically, the 2004 corporate scandal, the discrepancies between the SEC and state regulatory filings, and the Goldman Sachs report, which correctly speculated that a fraud was being committed.

Furthermore, the business judgment rule in Delaware should not be applicable to officers. The business judgment rule establishes that corporate directors are generally immune from liability for the corporate decisions they make. However, Delaware courts have never given the protection of the business judgment rule to non-director officers. Officer Defendants should not be shielded from liability based on the business judgment rule because Delaware case law does not establish a precedent for such a holding and public policy dictates that courts should hold

officers to a more vigorous standard because they are more intimately involved in the day-to-day operations of the corporation.

Presented with the opportunity to resolve these questions, this Court should now provide a proper remedy for stockholders who bring derivative actions by finding the Directors and Officers liable for breaching their fiduciary duties of loyalty and care and that demand futility has been met.

STATEMENT OF FACTS

Securance is a Delaware corporation that provides managed healthcare services for Medicare and Medicaid recipients. (Compl. ¶ 7.) Securance is a public company, traded on the New York Stock Exchange, with 42 million shares of common stock outstanding. *Id.* Plaintiff, Clare Marshall, owns 1,000 shares of common stock and brings this derivative lawsuit against the Directors and Officers of Securance for failing to oversee Senior Managers, who perpetrated a fraud. (Compl. ¶ 2.)

Securance receives funding from the federal and state governments to provide healthcare to states' Medicaid and Medicare recipients. (Compl. ¶ 11.) The state and federal governments pay Securance a premium for every patient they treat. *Id.* Securance is contractually required to spend at least eighty percent of the government funds it receives directly on patient care. (Compl. ¶¶ 14,15.) If they spend less than eighty percent of the money on patient services, Securance is required, by contract and law, to reimburse the state governments the difference. *Id.* Securance Senior Managers, with the expressed or implicit support of Senior Officers, devised a scheme to send funds that they should have reimbursed, to an offshore Securance subsidiary, in order to report and retain larger profits. (Compl. ¶ 19.) This fraud cost Ohio, Pennsylvania, New York and New Jersey \$120 million in Medicaid premiums. (Compl. ¶ 24.) While Securance committed

this fraud, its stock price rose from \$52 a share in January of 2005, to a historic high of \$110 per share in December of 2008. (Compl. ¶ 25.)

While Securance was committing this fraud, its SEC reports varied greatly from its state regulatory filings, and overstated Securance's profits. (Compl. ¶ 27.) A May 10, 2006 Credit Suisse report stated, "Securance's first quarter (2006) results qualify as the best in the Medicaid space." (Compl. ¶ 26.) Similarly, an August 4, 2007 CIBC World Markets report stated, "Securance's second quarter (2007) earnings handily beat expectations and should dispel any investor concern surrounding Securance, following disappointing results from several of its Medicaid peers." *Id.*

However, the fraud did not go unnoticed forever. Goldman Sachs analyst Thadeus Gipp issued a report on February 4, 2008, suggesting that Securance was shifting profits to its Cayman Islands reinsurance subsidiary to give state regulators the impression that the Company's profits were slim. (Compl. ¶ 27.) Wire services picked up this report and distributed it widely into various print and online business publications. *Id.*

The Federal Bureau of Investigations and the Department of Health and Human Services investigated the fraud, and after negotiations, the Company pled guilty to mail fraud. (Compl. ¶ 28.) After this settlement, Securance's stock price fell to a historic low of \$37 per share. (Compl. ¶ 37.) This drop represented a \$3 billion loss in market capitalization. *Id.*

In early 2004, prior to the Senior Managers' fraud, state investigators in Connecticut and Virginia examined claims that Securance was denying certain medical services to its indigent and disabled members to boost profits. (Compl. ¶ 40.) Officials also investigated claims that Securance had offered improper financial incentives and bonuses for doctors to deny services to members, so that Securance could make a larger profit. *Id.* These events, along with the

discrepancies between the SEC and state filings, and the Goldman Sachs report, should have been red flags to the Board and Officer Defendants that Securance's compliance systems were inadequate.

ARGUMENT

Shareholders of corporations rely on directors and officers to run a business efficiently, and to maximize their investment. In return for shareholder capital, corporate directors and officers owe the shareholders a duty of loyalty and care. *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 969 (Del. Ch. 1996); *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). This responsibility includes a duty to oversee corporate performance. *Id.* The Defendant Directors and Officers in this case breached their duties of loyalty and care when they failed to properly oversee Senior Managers who were perpetrating a fraud. The Plaintiff has filed a Complaint with well-pled facts and inferences establishing that the Officers and Directors breached their fiduciary duties of loyalty and care. Therefore, this court should reverse the decision of the Chancery Court.¹

¹ In order for a plaintiff to survive a motion to dismiss in a shareholder derivative lawsuit, she must satisfy the procedural issue of demand futility. Typically, a legal analysis commences with the issue of demand futility; however, the demand futility argument is predicated on establishing that the directors faced a "substantial likelihood of liability that renders them personally interested in the outcome of the decision on whether to pursue the claims asserted in the complaint." *Stone*, 911 A.2d at 368. For this reason, Plaintiff will first address the Directors' breach of the duty of their fiduciary duties, thereby establishing their "substantial likelihood of liability" and satisfying demand futility.

I. DEFENDANT DIRECTORS AND OFFICERS BREACHED THEIR FIDUCIARY DUTIES WHEN THEY FAILED TO PROPERLY OVERSEE SENIOR MANAGERS, WHO WERE PERPETRATING A FRAUD, AND THEREFORE, THIS COURT SHOULD REVERSE THE MOTION TO DISMISS.

A. The Standard of Review is *De Novo*.

The Delaware Supreme Court reviews Chancery Court decisions granting motions to dismiss *de novo*, to determine “whether the trial judge erred as a matter of law in formulating or applying legal precepts.” *Feldman v. Cutaita*, 951 A.2d 727, 730-31 (Del. 2008). The Chancery Court’s dismissal is only appropriate if it appears “with reasonable certainty that under any set of facts that could be proven to support the claims asserted, the plaintiff would not be entitled to relief.” *Feldman*, 951 A.2d at 731. This court should review all facts and reasonable inferences from those facts in the complaint in the light most favorable to the Plaintiff. *Id.* at 731.

B. Defendant Directors Breached Their Duty of Care When They Acted in Bad Faith, and Failed to Oversee Senior Managers.

Directors have a duty to act with the amount of care that a reasonable person would use in similar circumstances. *See Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). However, decisions of directors are protected by the business judgment rule, which presumes their decisions are made in accordance with their fiduciary duties. *Gimbel v. Signal Cos.*, 316 A.2d 599, 608 (Del. Ch. 1974). Courts will not review decisions of directors who, (1) acted in good faith; (2) used the amount of care that a reasonable person in a similar circumstance would have used; and (3) acted in a manner the director reasonably believed was in the best interest of the corporation. *See e.g. Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971); *Robinson v. Pittsburgh Oil Refinery Corp.*, 126 A.2d 46 (Del. Ch. 1926). As this court previously held, a court “will not substitute its own notions of what is or is not sound business judgment” if “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 interests of the company.” *Aronson*, 473 A.2d at 812; *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971). The party challenging the director’s decision has the burden to rebut this presumption. *Aronson*, 473 A.2d at 812. A plaintiff must show that the directors failed to act in good faith or with the appropriate amount of care to overcome the business judgment rule. Delaware courts have determined that a director must act with “gross negligence” to breach the duty of care. *In re Walt Disney Co. Deriv. Litig. (Disney V)*, 907 A.2d 693, 755 (Del. Ch. 2005), *aff’d* 906 A.2d 27 (Del. 2006).

Delaware statutes allow further insulation of directors by allowing corporations to drastically reduce or eliminate a director’s duty of care. 8 DEL. CODE ANN. tit 8, § 102(b)(7). A Delaware corporation may include a provision in its certificate of incorporation that eliminates or limits the personal liability of a director. *Id.*

There is no indication in the complaint that Securance has a §102(b)(7) provision, and when considering a motion to dismiss, the court is limited to the “four corners of the complaint.” *In re Tyson Food, Inc.*, 919 A.2d 563, 586 (Del. Ch. 2007). However, even if Securance has a 102(b)(7) provision, the Directors are still liable breaching their duty of care. A corporation may not reduce the director’s duty of care, or shield them from liability, if they fail to act in good faith. 8 DEL. CODE ANN. tit 8, § 102(b)(7)(ii). As the Chancery Court in this case noted in footnote 18 of its opinion, “if the plaintiff can adequately plead the existence of bad faith requisite to such a claim, then damages for such lack of good faith may not be exculpated as a matter of law.” (Opinion at 20, n.18).

In this case, the facts alleged in the Complaint are sufficient to show that the Directors acted in bad faith, and therefore, breached their duty of care.

Directors have a duty to monitor corporate performance in good faith. *Caremark*, 698 A.2d at 971. In *Caremark*, this Court held that in order to establish that directors breached their duty of care, by failing to adequately monitor corporate performance, plaintiff must “show either (1) that the directors knew, or (2) should have known that violations of the law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the loss complained of.” *Id.* *Caremark* also holds 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.” *Id.* at 969, (quoting *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 188 (Del. 1963).

However, directors do have a duty to use good faith to ensure that they have designed, implemented and maintained a system to ensure that the directors receives accurate, appropriate information in a timely manner. *Stone*, 911 A.2d at 368. This court held in *Caremark* that failing to monitor corporate performance is a breach of the duty of care when there is a “sustained or systematic failure of the board to exercise oversight.” 698 A.2d at 971.

In this case, the Directors failed to use good faith to ensure that their reporting system was providing them with accurate information, and therefore, breached their duty of care. The Directors’ failure to heed warnings that indicated there were problems with the reporting system provides evidence of a breach of the duty of care. The Defendant Directors’ systematically failed to ensure that Senior Managers provided accurate information to the Board, allowing these Senior Managers to commit fraud that cost Securance more than \$3 billion in market capitalization. If the Directors had fulfilled their duty to oversee the Senior Managers, they could have prevented the fraud. (Opinion at 18).

This failure is even more egregious in light of the “red flags” that should have warned the Board that their compliance system was inadequate. While *Graham* holds that directors do not have a “duty of espionage absent cause for suspicion,” in this case there *was* cause for suspicion. Specifically, the 2004 corporate scandal, the discrepancies between the SEC and state regulatory filings, and the Goldman Sachs report, which correctly speculated that a fraud was being committed.

The first “red flag” that should have alerted the Board that there was a problem with the reporting of corporate information was the 2004 regulatory scandal in Virginia and Connecticut. (Compl. ¶ 40.) In 2004, Securance was involved in a scandal where it allegedly paid bonuses to doctors to deny services to patients, thus increasing Securance’s profits. *Id.* While this scandal did not involve fraud, it should have alerted the Board to the reporting problems Securance was facing. Despite the “substantial issues of business ethics and integrity” raised by this scandal, the Board failed to take any action. (Compl. ¶ 44.) The Board’s conscious disregard is evidence of a “sustained and systematic” failure that set the stage for the Senior Managers to perpetrate their fraud.

Additionally, the Directors had other warning that the corporation was not providing them accurate and appropriate information. Securance’s SEC reports varied greatly from its state regulatory filings. (Compl. ¶ 27.) While the record is silent to whether the Directors read these reports and actively ignored the differences, or if they failed to establish a system where these reports were provided to the Board, in either case, the Board’s failure to react to this “red flag” establishes their breach of the duty of care.

Finally, the Directors even failed to take any action after Goldman Sachs issued a widely distributed report, speculating (rightly so), that Securance was committing fraud. (Compl. ¶ 27.)

The Goldman Sachs report correctly hypothesized that Securance was shifting profits to its Cayman Island subsidiary to give the impression that its profits were slim. *Id.* However, even after this accusatory report, the Board did nothing.

The Board's callous disregard for risk is precisely the type of "systematic failure of the board to exercise oversight" that *Caremark* determined was a breach of good faith. It is an example of the "deliberate indifference" that the *Disney* court called "the epitome of faithless conduct." Defendant Directors knew that they had a reporting system that was so poorly designed it contributed to a scandal that cost Securance hundreds of thousands of dollars; they knew, or should have known, there was a dramatic difference between the company's SEC filings and its state regulatory filings, and yet, they failed to take any action.

C. Defendant Directors Breached the Duty of Loyalty by Acting in Bad Faith When They failed to Oversee the Senior Managers.

A director who acts in bad faith while monitoring corporate performance violates the duty of loyalty, as well as the duty of care. *Stone*, 911 A.2d at 362. A director cannot act in good faith towards the corporation unless she acts with a good faith belief that her actions are in the best interest of the corporation. *Id.* at 370. In *Stone*, the court applied *Caremark* and held that directors may breach their duty of loyalty for a failure to oversee the corporation when; (a) directors fail to implement a reporting or information system; *or* (b) the directors consciously failed to monitor or oversee such a system, if it was in place. *Id.* The court concluded, "[w]here 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 duty in good faith." *Id.* Additionally, in *Disney*, this Court held that a director who had a "conscious disregard for one's responsibilities" established that she acted in "bad faith." *Disney*, 907 A.2d at 755, *aff'd* 906 A.2d 27 (Del. 2006). This Court also held, "deliberate

indifference and inaction in the face of a duty to act is ... conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.” *Id.*

While the court in *Stone* ultimately held the directors were not liable for a breach of the duty of loyalty, it based its decision heavily on the fact that there were no “red flags” to show that the directors were ever aware that the internal controls were insufficient. *Id.*

The facts of our case are diametrically opposed to the facts in *Stone*. As previously explained in great detail, the Directors had not only been warned by a 2004 scandal that the general corporate reporting structure was not appropriate, but also by discrepancies in their SEC and state regulatory filings, and a very specific Goldman Sachs report that speculated a precise, and correct, theory of wrongdoing. (Compl. ¶¶ 27, 40.)

The Defendant Directors had a duty to be active monitors of corporate performance. They breached that duty when they were aware of a corporate scandal in 2004, which cost the corporation hundreds of thousands of dollars, and failed to take action. (Compl. ¶¶ 40-42.) Moreover, despite discrepancies between SEC and state regulatory findings the Board took no actions to audit the reporting system. (Compl. ¶ 44.) Finally, the Board failed to take action even when Goldman Sachs alleged specific acts of fraud in a widely distributed report. (Compl. ¶ 27.) This failure to act constitutes a “sustained or systematic failure of the board to exercise oversight” and, therefore, the Directors breached their duty of good faith. The Board’s failure to act exemplifies the “conscious disregard” for responsibility that *Disney* calls the epitome of “faithless conduct.” This Court should find that Plaintiff has provided well-pled facts and inferences to establish that it is reasonable that the Directors breached their duty of loyalty and, therefore, should reverse the decision of the Chancery Court.

II. OFFICER DEFENDANTS BREACHED THE DUTY OF LOYALTY BY FAILING TO OVERSEE THE SENIOR MANAGERS, AND THEREFORE, THIS COURT SHOULD REVERSE THE CHANCERY COURT DECISION.

A. Court of Chancery Rule 12(b)(6).

The Officer Defendants in this case moved to dismiss Plaintiff's Complaint for failure to state a claim under Court of Chancery Rule 12(b)(6). (Opinion at 16). Plaintiff's Complaint states a claim under Court of Chancery Rule 12(b)(6), as she has met her burden of pleading to show that the Board was incapable of acting independently or disinterestedly on a demand to bring the oversight claims in this case. Dismissal is only appropriate if the "plaintiff would not be entitled to recover under any reasonable conceivable set of circumstances susceptible to proof." *Ryan v. Gifford*, 918 A.2d 341, 357 (Del. Ch. 2007).²

Here, Plaintiff is entitled to relief because the Officer Defendants breached their duty of loyalty by failing to properly oversee the Senior Managers who perpetrated this fraud. Therefore, this Court should reverse the Chancery Court decision to dismiss the Complaint.

Corporate officers owe the same fiduciary duties of care and loyalty as directors. *Gantler v. Stephens*, --- A.2d ----, 2009 WL 188828, *9 (Del. Supr. Jan. 27, 2009). While officers and directors have the same fiduciary duties, the consequences for a breach are not the same. *Id.*, n.9. Delaware does not allow a corporation to reduce the standard of care for an officer through a §102(b)(7) provision. *Id.* Thus, the Officers are liable for simple negligence. *Disney*, 906 A.2d at 53.

This court has never offered the protection of the business judgment rule to non-director officers. See Lyman Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW 439, 440 (2005). The Chancery Court in this case acknowledged that Delaware caselaw has not

² The issue of whether the officers breached their fiduciary duties is reviewed *de novo*. *Feldman*, 951 A.2d at 727.

protected non-director officers under the protection of the business judgment rule. (Opinion at 26-27). Despite the lack of authority, the Chancery Court reduced the standard of care for corporate officers.

There are two reasons why this Court should not shield the Officer Defendants from liability based on the business judgment rule. First, Delaware caselaw does not establish a precedent for such a holding. Second, public policy dictates that courts should hold officers to a more rigorous standard.

B. Delaware Case Law does not Extend the Business Judgment Rule to Corporate Officers, and Therefore, This Court Should Not Insulate the Officers from Liability.

This Court has never applied the business judgment rule to non-director officers. Johnson, *supra*, at 443. The Chancery Court in this case recognized that Delaware law has never considered whether a court should hold non-director officers to the *Stone* test, or have a lower burden to prove a breach of fiduciary duty. (Opinion at 26-27).

None of the Delaware cases that appear to state that the business judgment rule should apply to corporate officers are analogous to this case. For example, in *Kelly v. Bell*, this Court stated that, “the directors or officers were not necessarily liable to the corporation ... provided they exercised honest business judgment.” 266 A.2d 878, 879 (Del. 1970). However, despite this strong rhetoric, the plaintiff in *Kelly* sought damages only from the corporate directors, not officers and, therefore, is not applicable to the present case.

Despite ambiguous statements from Delaware courts on the issue of officer liability, two non-Delaware courts have applied Delaware law to conclude that the business judgment rule does not, and should not, apply to corporate officers. In *Platt v. Richardson*, for example, the U.S. District Court in Pennsylvania held that the business judgment rule “applies only to

directors of a corporation and not officers.” CIV. No. 88-0144, 1989 WL 159584 (M.D. Pa. June 6, 1989). Additionally, in 1997, the Minnesota Court of Appeals decision, applied Delaware law to hold that an officer’s responsibilities might be more extensive than those of a director. *Potter v. Pohland*, 560 N.W.2d 389, 391-92 (Minn. Ct. App. 1997).

Because Delaware law does not create a precedent establishing that the business judgment rule applies to corporate officers, this court should hold that the Plaintiff has presented a well-pled complaint, sufficient to establish reasonable circumstances under which the Officers are liable, and therefore, reverse the Chancery Court’s motion to dismiss.

C. It is in the Best Interest of Public Policy for This Court to Find that the Business Judgment Rule Does Not Protect Corporate Officers.

The value of the business judgment rule for directors is well established in corporate law. Scholars agree that the business judgment rule encourages individuals to serve as directors by lessening the risk of liability for decisions that, in hindsight, proved unwise. Johnson, *supra*, at 455-56; Aaron D. Jones, *Corporate Officer Wrongdoing and the Fiduciary Duties of Corporate Officers Under Delaware Law*, 44 AB. BUS. L.J. 475, 486 (2007). While there is some disagreement as to the reach of the business judgment rule, scholars generally agree that such protection for directors is required to create an efficient and effective market. *Id.*

However, holding corporate officers to a more stringent general negligence standard would further public policy concerns. There are three reasons why officers should not receive the heightened protection that the business judgment rule offers. First, officers are closer to the day-to-day activities of the corporation, and are in a better position to manage the corporation than the board. Additionally, failure to hold corporate officers liable for negligent acts creates devastating consequences. Finally, the Officers in this case were acting as agents of the corporation, and therefore, they owe agency duties.

1. Officers are involved in the day-to-day operations of the corporation, and therefore, should not receive the protection of the business judgment rule.

Many rationales have been proffered to justify the business judgment rule for corporate directors. For example, it is generally accepted that the business judgment rule encourages directors to serve on boards and promotes calculated risk-taking on behalf of the corporation. Jones, *supra*, at 482. The pool of corporate directors willing to serve would shrink considerably if directors were subject to liability by courts analyzing corporate decision with the benefit of hindsight.

Officers, however, should shoulder a greater burden. Unlike directors, they are full-time employees, who are significantly more knowledgeable of the day-to-day operations of the corporation. Johnson, *supra*, at 456. While directors rely on the corporation to deliver them information at formal, quarterly meetings, officers are present at the corporation everyday, and able to observe the operations of the corporation. They have “access to considerably more and better information” and have the ability to discipline other employees to prevent wide-scale fraud by dealing with problems while they are small. *Id.*

In this case, the Senior Managers who committed fraud reported directly to two of the Officers, and the third Officer worked closely on the SEC and state regulatory filings. (Compl. ¶ 31.) These Officers were responsible for supervising the work of the Senior Managers who committed a fraud that cost Securance \$3 billion, and the Officers failed to do anything to stop it.

Additionally, this Court should also consider the economic theory of “the least cost avoider.” Applying that theory to this case, it is clear the Officers were in a much better position than the Directors (or anyone else) to end the fraud. As previously stated, two of the supervisors directly oversaw the Senior Managers who committed the fraud, and the other worked closely on

the state reports, and therefore, they should have known about, and put an end to, the fraud.
(Compl. ¶ 31.)

The Delaware Supreme Court should send a message to officers across the country. This Court should hold corporate officers to a general negligence standard, and not give them the protection of the business judgment rule and its gross negligence threshold. There is little doubt that the Officers were negligent under the standard negligence definition. A reasonable officer would check the work of employees reporting to him to make sure they were not committing fraud, especially in light of the aforementioned “red flags.” General negligence is the standard for duty of care not only for all of the other Securance employees, but also for virtually all other professions across the country. Johnson, *supra*, at 460. The harm that is caused by giving protection to corporate officers who are acting negligently far outweighs any value from extending the business judgment rule to corporate officers.

2. Protecting corporate officers from liability leads to devastating results.

This Court does not need to look far to see the devastating effect of courts failing to hold corporate officers responsible for their actions. The lack of appropriate corporate governance played a key role in the subprime crisis. Nobel Prize winning economist, Joseph Stiglitz, said that American CEOs manage corporations for their own benefit, and not the betterment of shareholders. *Talk of the Nation: Economist Explain How to Save Capitalism*, 2008 WLNR 22815991 (NPR radio broadcast, Oct. 20, 2008). He asserts that “CEOs reported high profits, gave big bonuses, big stock options, but in fact, there were huge risks buried off-balance sheet and those chickens have now come home to roost.” *Id.* Another Nobel Prize winning economist, Paul Krugman, believes that, “the subprime crisis and credit crunch are, in an important sense, the result of our failure to effectively reform corporate governance after the last set of scandals.”

Paul Krugman, *Banks Gone Wild*, N.Y. TIMES, Nov. 23, 2007, at A37, available at <http://www.nytimes.com/2007/11/23/opinion/23krugman.html>.

Insulating corporate officers has a price. Officers often have compensation plans tied to corporate performance. Johnson, *supra*, at 459-60. While this seems logical, when coupled with the protection of the business judgment rule, it leads officers to take huge risks. As Stiglitz stated, these risks are often designed for the benefit of the CEO and not the long-term health of the corporation and its shareholders. *Talk of the Nation*, (Oct. 20, 2008). Essentially, CEOs are asked to flip a coin when they take unnecessary risks: heads, the company makes short term profit and the CEO's salary skyrockets; tails, the risk proves fatal to the company, the CEO faces no liability for negligent decisions, and walks away with a golden parachute. *Disney*, 906 A.2d at 34. The CEOs have nothing to lose by flipping that coin because the law insulates them from liability while the shareholders carry the burden of their risks.

Ultimately, this latest scourge of corporate misconduct is likely to cast federal light upon Delaware corporate law. This is no time for further indulgence of corporate misconduct.

3. The corporate officers were acting as agents of the corporation, and therefore, the business judgment rule should not apply.

In this case, the Officers were agents of Securance. An agent acts on behalf of a principle, and subject to her control. Restatement (Third) of Agency § 1.01 (2006). Officers “derive their authority and ability to act on behalf of the company from agency law.” Jones, *supra* at 481. Agents have a duty to the principal to “act with the care, competence, and diligence normally exercised by agents in similar circumstances.” *Estate of Carpenter v. Dinneen*, No. 1804, 2008 WL 859309, at *12 (Del. Ch. Mar. 26, 2008).

Delaware courts have only applied the business judgment rule to officers who were also serving in a director capacity, not in an agency capacity. Johnson, *supra* at 440. In this case, the

Officers were *not* acting in a director's role, but rather as agents of the board. (Compl. ¶ 2.) This Court should reserve the protection of the business judgment rule for individuals who are setting corporate strategy, not implementing the directives of the board. In this case, the Officers were agents, and therefore, the Court should not grant them the protection of the business judgment rule.

Failing to reign in negligent corporate officers will continue to allow officers to make decisions in a consequence-free world, where shareholders are the only ones who feel the pain of an officer's negligent decision. For the aforementioned reasons, this Court should reverse the Chancery Court decision.

III. PLAINTIFF ALLEGES WITH ADEQUATE PARTICULARITY THAT PRE-SUIT DEMAND IS EXCUSED AS FUTILE, AND THEREFORE, THE CHANCERY COURT INCORRECTLY DISMISSED THE CASE.

A. Chancery Court Rule 23.1.

The Defendants have moved to dismiss Plaintiff's Complaint under Delaware Court of Chancery Rule 23.1 for failure to allege with adequate particularity that pre-suit demand is excused as futile in this case. (Opinion at 16). The Defendants contend that Plaintiff, in her Complaint, does not allege with adequate particularity that the Board, or for that matter that the Officer Defendants, failed to exercise proper oversight regarding Securance's compliance with state Medicaid law (and the Company's contractual obligations) on reporting medical loss ratios and refunding premiums. (Opinion at 16). Plaintiff alleges that the Director Defendants, if asked to authorize suit against themselves, would have prevented a majority of the Board from exercising disinterested and independent business judgment in deciding the merits of, and whether to pursue, her claims. Plaintiff has pled particularized facts which support her case.

The right of a stockholder to prosecute a derivative suit is limited to situations where either the stockholder has demanded the directors have wrongfully refused to do so, or where demand is excused because the directors are incapable of making an impartial decision regarding whether to institute such litigation. *Stone*, 911 A.2d at 366-67. Accordingly, Delaware Court of Chancery Rule 23.1 requires that the complaint in a derivative action “allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or the reasons for the plaintiff’s failure to obtain the action or for not making the effort.” *Id.* at 367; Ch. Ct. R. 23.1. The demand requirement in Court of Chancery Rule 23.1 is an acknowledgement that a shareholder’s prosecution of a derivative action necessarily impinges upon the power and autonomy of a board of directors to manage the affairs of the corporation, including whether or not to pursue a cause of action belonging to a corporation. *Rattner v. Bidzos*, No. Civ.A. 19700, 2003 WL 22284323 at *7 (Del. Ch. 2003).

Allegations of demand futility under Rule 23.1 “must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed by Chancery Rule 8(a)”. *Stone*, 911 A.2d at 367; citing *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000). The complaint must allege with particularity the reasons for demand excusal. *Id.* In determining whether a derivative plaintiff has satisfied Court of Chancery Rule 23.1, review is confined to the well-pled allegations of the complaint. *Id.* All well-pled allegations of fact in the complaint must be accepted as true, and all reasonable inferences from non-conclusory allegations contained in the complaint must be drawn in favor of the plaintiff. *Id.*; *Grobot v. Perot*, 539 A.2d 180, 187 (Del. 1988).

B. The *Rales* Demand Futility Test is Satisfied.

The applicable standard for determining demand futility is the *Rales* test as set forth in *Stone v. Ritter. Rales v. Blasband*, 634 A.2d 927 (Del. 1993); *See Stone*, 911 A.2d at 362. Under *Rales*, a court must determine whether the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. *Id.* If the court finds that a reasonable doubt exists, demand is excused. *Id.* In this case, a decision by the Board to bring suit against the Directors could have had potentially significant financial consequences for the Directors. Pre-suit demand on the Directors should be excused in this case because the Directors were in the possession of facts about material adverse changes in Securance's business. Therefore, the Plaintiff has met the elements of the demand futility test in this case.

1. The Directors had an interest and were dependent on that interest.

In order to determine whether the Board could have impartially considered a demand at the time the Plaintiff filed her Complaint, it is necessary to examine what would have occurred if the Plaintiff would have issued a stockholder demand letter.

The Director Defendants included seven members of the Board. Three of the seven Board members were also the Company's most senior officers. (Opinion at 3). The three Officer Defendants are the most senior officers of Securance who do not also have positions on the Board. *Id.* The Officer Defendants supervised the departments in which the Senior Managers who committed fraud worked. *Id.* at 8.

If Marshall would have issued a demand letter, the Board would have been obligated to determine whether the charges of wrongdoing should have been investigated and, if

substantiated, become the subject of legal action. *Rales*, 634 A.2d at 937. Plaintiff would not have been afforded a proper investigation as the Senior Managers reported to the Officer Defendants who oversaw the day-to-day operations of Securance. The Board of Directors, upon reviewing this information, would not have been inclined to initiate a lawsuit against themselves.

In this case the Directors would be personally interested in a decision of the Board in response to a demand that would address alleged wrongdoing as alleged by Marshall in her Complaint.

There must be “a reasonable doubt that the board was disinterested.” *Siegman v. Tri-Star Pictures, Inc.*, CIV. A. No. 9477, 1989 WL 48746 at *11 (Del. 1989). Reasonable doubt is based on the allegations contained in the complaint. *Id.* A director is considered interested where he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders. *Rales*, 634 A.2d at 937; citing *Aronson*, 473 A.2d at 812. Directorial interest also exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and stockholders. *Id.* The benefit need not be financial. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993). Directors are interested when they “receive a substantial benefit from a supporting transaction.” *Id.* A substantial likelihood of personal liability prevents a director from impartially considering a demand. *Id.* 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. *Rales*, 634 A.2d at 937. This Court reaffirmed this rule in *Brehm*, 746.A2d at 254.

In this case, a decision by the Board to bring suit against the Directors could have had potentially significant financial consequences for the Directors, thus creating a personal interest. Therefore, the Plaintiff has met the first element of the demand futility test in her Complaint.

2. The Directors were not sufficiently independent to make an impartial decision.

The Directors in this case not only had an interest in the outcome of a potential demand made by the Plaintiff, but they also were not sufficiently independent to make an impartial decision in the matter.

“Independence means that a director’s decision is based on the corporate merits of the subject before the Board rather than extraneous considerations or influences.” *Rales*, 634 A.2d at 937; citing *Aronson*, 473 A.2d at 816. To establish a lack of independence, a stockholder must show that the Directors are “controlled” or “beholden” to the interested directors, or influenced by the interested directors that the “independent” director’s discretion is compromised. *Rales*, 634 A.2d at 937; *Texlon Corp. v. Meyerson*, 802 A.2d 257, 264 (Del. 2002). A director is controlled or beholden when he has:

direct or indirect unilateral power to decide whether the director continues to receive a benefit upon which the director is so dependent or is of such subjective material importance that its threatened loss might create a reason to question whether the director is able to consider the corporate merits of the challenged transaction objectively.

Texlon, 802 A.2d at 264.

In *Rales*, this Court reasoned that even considering that the directors could be presumptively disinterested, they were not sufficiently independent to make an impartial decision. *Rales*, 634 A.2d at 937. This Court further held that the stockholder’s amended complaint alleged particularized facts raising a reasonable doubt that members of the board were capable of acting independently of the directors. *Id.* Thus, plaintiff still met the first element of the *Rales* test.

In this case, the Director Defendants included seven members of the Board. Three of the seven Board members were also the Company's most senior officers. (Opinion at 3). The three Officer Defendants are the most senior officers of Securance who do not also have positions on the Board. *Id.* The Officer Defendants supervised the departments in which the Senior Managers who committed fraud worked. *Id.* at 8. The Director and Officer Defendants are significantly intertwined. The Officer Defendants are involved in the day-to-day operations of Securance, reporting to the Board of Directors.

Therefore, the Directors had a substantial financial interest in maintaining profits for Securance in knowledge of the creation of a compensation plan for the Senior Managers. Thus, there is a reasonable doubt that the Directors were able to consider impartially an action contrary to their own interests.

C. It is in the Best Interest of Public Policy to Find that Plaintiff Satisfied Chancery Court Rule 23.1.

By statute, corporate directors possess the authority to pursue a lawsuit on behalf of the corporation. 8 DEL. CODE ANN. tit 8, § 141(a)(2008). Shareholders are required to make a demand on the board of directors before bringing a derivative action on behalf of the corporation. Del. Ch. Ct. R. 23.1. A demand requests that the board rectify the challenged decision. *Id.* However, this means that a shareholder typically must exhaust all available means to obtain relief through the corporation before filing a lawsuit on behalf of the corporation. Ann M. Scarlett, *Confusion and Unpredictability in Shareholder Derivative Litigation: The Delaware Courts Response to Recent Corporate Scandals*, 60 FLA. L. REV. 589, 596 (July 2008).

Therefore, upon receiving a shareholder demand, a board of directors can take one of three courses of action: (1) accept the demand and prosecute the claim itself, (2) resolve the matter internally, or (3) reject the demand. Lisa M. Fairfax, *Spare the Rod, Spoil the Director?*

Revitalizing Directors' Fiduciary Duty Through Legal Liability, 42 HOUS. L. REV. 393, 408 (2005). Boards typically reject these demands. *Id.* If a shareholder wins and demand is excused, the lawsuit continues. Scarlett, *supra*, at 596; citing Fairfax, *supra*, at 408. However, if the board rejects the demand, the shareholder must prove that the board wrongly rejected the demand. *Id.* The shareholder then is in the same position as if the shareholder, before filing the suit, had made a demand that the board rejected. *Id.*

As the *Guth* court stated, “corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests.” *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939). The court further enunciated that corporate officers and directors have the duty to protect the interests of the corporation but also to refrain from doing anything that would harm the corporation or to deprive it of profit or advantage. *Id.*

CONCLUSION

For the foregoing reasons, Marshall respectfully requests that the Court reverse the decision of the Delaware Court of Chancery and hold that the Directors and Officers breached their fiduciary duties and that Marshall’s Complaint alleges with adequate particularity that pre-suit demand is excused as futile in this case.