IN THE SUPREME COURT OF THE STATE OF DELAWARE

CLARE C. MARSHALL,
Appellant,

Civil Action
No. 3892-CS

v.

CHARLES H. SALIGMAN,
PATRICK C. RICHMOND, YVONNE M. CRAIG,
MARTIN R. ROTHSCHILD, ELAINE A. LASATER,
WILLIAM M. LEWIS, GILBERT W. COULSON,
RACHEL N. LIEBERMAN, TIMOTHY M. STOCKDALE
AND CARLOS B. HUELVA,
Appellees,
- and -
SECURANCE INC., Nominal Appellee

BRIEF FOR THE APPELLANT

Filed by H, Counsel for Appellant
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Nature of Proceedings

At the heart of this case lies egregious fraud executed by senior management at Securance ("Securance"). Securance provides managed healthcare services to Medicare and Medicaid recipients in 18 states. Senior management launched a scheme to increase net profits illegally by falsely overstating medical loss ratios from 2005-2007, leading to astronomical financial losses.

Clare C. Marshall ("Appellant") filed a complaint ("Complaint") in the Court of Chancery on July 3, 2008 against Charles H. Saligman, Patrick C. Richmond, Yvonne M. Craig, Martin R. Rothschild, Elaine A. Lasater, William M. Lewis, Gilbert W. Coulson ("Director Appellees" or "the Board"); Rachel N. Lieberman, Timothy M. Stockdale, Carlos B. Huelva ("Officer Appellees"); and Nominal Appellee Securance.

Defendants moved to dismiss under Court of Chancery Rule 23.1 for failure to make a pre-suit demand on the Board. Defendants also moved to dismiss under Court of Chancery Rule 12(b)(6) for failure to state a claim upon which relief can be granted. In opposing Defendants' motion, Plaintiff argued that demand was excused because the Complaint set forth particularized allegations showing the Director Defendants faced a substantial likelihood of personal liability for breaching their fiduciary duties. In addition, Plaintiff argued a standard of ordinary negligence should be applied to the Officer Defendants.

The Court of Chancery issued its Memorandum Opinion and Order on January 6, 2009, granting all motions in favor of Defendants and dismissing the Complaint.

Plaintiff appeals from the January 6, 2009 Memorandum and Order.

Summary of Argument

This Court should reverse because the Appellant plead particularized facts stating a claim of oversight liability for Director Appellees and Officer Appellees, making demand futile.

First, Director Appellees were not disinterested in determining whether to pursue litigation for their lack of oversight. Director Appellees violated their duty of loyalty when they acted in bad faith by consciously disregarding numerous red flags. Those red flags alerted or should have alerted the Board of inadequate compliance controls and egregious fraud. Furthermore, the Board's actions intertwined with the actions of Officer Appellees, making Director Appellees not disinterested in determining whether to pursue litigation for Officer Appellees' oversight as well.

This Court should reverse the dismissal under Court of Chancery Rule 12(b)(6) because Officer Appellees acted negligently or in the alternative, in bad faith. This Court should formally adopt a standard of ordinary negligence for officers acting as officers. First, officers, as agents of a corporation, should be held to the same standard as any other agent. Second, precedent needs clarification as to what standard applies to officers acting as officers. Finally, public policy supports a standard of ordinary negligence. Officer Appellees did not act with the care, competence, or diligence of a reasonable officer with their skill and knowledge by failing to prevent fraud from occurring in their departments by senior managers.

In the alternative, this Court should reverse because Officer Appellees acted in bad faith, as the standard is applied to directors. Officer Appellees consciously disregarded their oversight duties in preventing the fraud overall, and under Sarbanes-Oxley, the filing of fraudulent financial statements.

In conclusion, this Court should reverse because Appellant plead particularized facts demonstrating demand was futile by showing Director Appellees faced a substantial likelihood of liability for violating their oversight liabilities. In addition, Appellant plead particularized facts demonstrating a claim against Officer Appellees for acting negligently, or in the alternative, bad faith. Therefore, this Court should reverse on all accounts.

Statement of Facts

In 2008, Securance, a Delaware corporation, paid over $400 Million in criminal penalties, refunded $120 Million to state agencies, and lost more than $3 Billion in market capitalization because of widespread Medicaid fraud. (Compl. ¶¶ 7, 13, 2.) Securance receives premiums from states for Medicaid and Medicare recipients. (*Id.* at 8.) Securance only earns profits on 20% of those premiums, after it deducts its administration costs. (*Id.* at 15-16.) Securance must refund states any remaining premiums not spent on direct medical care. (*Id.* at 15.)

Early 2004, investigators alleged that to boost profits, Securance offered improper financial incentives for doctors who denied needed medical services. (*Id.* at 40.) Without admitting guilt, Securance signed consent agreements to pay $200,000 in fines and promised to comply with applicable law. (*Id.* at 41, 42.) After the alleged misconduct, Director Appellees did not restructure existing compliance programs (*Id.* at 44), or the incentive program ("Compensation Plan") it enacted in 2003, which based bonuses on profit levels (*Id.* at 38).

In early 2005, senior managers devised a scheme sending unspent premiums as direct medical payments to a wholly-owned Cayman Islands subsidiary. (*Id.* At 22-23.) They avoided refunding unspent premiums to the state and later artificially inflated Securance's net income by incorporating the wholly-owned subsidiary's profits in to Securance's financial statements. (*Id.* at 24.) Thus, net income amounted to only $49 Million in 2004, but $88 Million in 2005, and $104 Million by

2008. (*Id.* at 25.) After the fraud surfaced, Securance restated its earnings for 2005-2007, cutting each year's income by almost half: 2005 decreased by $35 Million, 2006 by $40 Million, and 2007 by $45 Million. (*Id.* at 36.)

On February 4, 2008, a Goldman Sachs analyst issued a report uncovering this fraudulent scheme, when he noticed disparities in SEC filings and state regulatory reports. (*Id.* at 27.) Next, on March 12, 2008, a federal search warrant removed enough laptop computers, Blackberrys, disks, and boxes of documents from Securance headquarters to fill an entire moving truck. (*Id.* at 28.)

Three senior managers, Gregory Devlin-Finance Manager, Susan Larner-Vice President Operations, and Robert Hooper-Vice President Accounting, signed consent decrees pleading guilty to conspiracy to commit Medicaid fraud. (*Id.* at 19, 30.) In their plea statements, they stated they acted with the express or implied support of Securance's senior officers. (*Id.* at 31.) Appellee Lieberman supervised Devlin's and Larner's departments and Appellee Huelva supervised Hooper's department. (*Id.*) Further, Appellee Stockdale worked closely with all three in preparing Securance's Medicaid reports to state agencies. (*Id.*) As bonuses increase with profits, Officer Appellees earned over $2.5 Million each in salaries and bonuses in 2008. (*Id.* at 38, 6.)

Appellant owns 1000 shares of Securance common stock (*Id.* at 3), and filed this appeal after the Court of Chancery dismissed her shareholder's derivate suit under Rules 23.1 and 12(b)(6).

Questions Presented

I. Whether directors should face liability for violating their duty of oversight, good faith and loyalty by failing to act and prevent widespread fraud in the face of red flags, making demand futile as the directors would not be disinterested.

II. Whether this Court should formally adopt a standard of ordinary negligence for officers acting as officers, whether officers should face oversight liability for approving or failing to prevent fraud in their own departments by senior managers; or in the alternative, whether officers should face liability for failing to act, and prevent or report widespread fraud in their own departments.

Argument

I. THIS COURT SHOULD REVERSE BECAUSE DEMAND WOULD BE FUTILE WHEN THE DIRECTOR APPELLEES WERE NOT DISINTERESTED AS THEY FACED A SUBSTANTIAL LIKELIHOOD OF PERSONAL LIABILITY.

A. Standard and Scope of Review

This Court reviews Court of Chancery decisions on Rule 23.1 de novo. *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000).

B. Merits: *Director Appellees Faced a Substantial Likelihood of Personal Liability Because They Acted in Bad Faith, Violating Their Duty of Loyalty.*

Appellant plead particularized facts demonstrating that the Director Appellees faced a substantial likelihood of personal liability for violating their duties of oversight, good faith and loyalty. Shareholders most frequently use derivative suits for harm "allegedly resulting from misconduct by its directors." *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993). The board of directors however controls the internal management of corporations. Del. Code Ann. Tit. 8, § 141(a).

Thus, Court of Chancery rule 23.1 requires plaintiffs in derivative suits to demand either "the directors pursue a corporate claim" or show demand is excused where the directors could not make an "impartial decision regarding whether to institute such litigation." *Stone v. Ritter*, 911 A.2d 362, 367 (Del. 2006); *see also* Ch. Ct. R. 23.1. In cases where the alleged misconduct involves a lack of oversight by the board, the shareholder must plead particularized facts demonstrating the board could not have "properly exercised its independent and disinterested business judgment in responding to a demand." *Rales*, 634 A.2d at 934.

In *Rales*, this Court found demand to be futile where a majority of the directors faced a substantial likelihood of personal liability. *Id.* at 936. This Court analyzed how the demand requirement allows the board to maintain internal control of the corporation. *Id.* at 935. First, demand notifies "directors of the nature of the alleged wrongdoing and the identities of the alleged wrongdoers." After notification, the directors "must weigh the alternatives available to [them], including the advisability of implementing internal corrective action and commencing legal proceedings." *Id. citing Weiss v. Temporary Inv. Fund. Inc.*, 692 F.2d 928, 941 (3d Cir. 1982).

Thus, in *Rales*, this Court found that demand would have notified the director defendants of their own alleged breach of fiduciary duty by investing in "junk bonds." *Id.* Further, the Third Circuit previously decided the complaint contained facts creating reasonable doubt as to the business judgment of investing in junk bonds; this finding led to a substantial likelihood of potential liability. *Id.* at 936. Therefore, the directors could not exercise independent judgment when faced with deciding to commence legal proceedings against themselves for breaching their fiduciary duties. *Id.*

Appellant plead facts sufficient to show that the Director Appellees faced a substantial likelihood of personal liability for their lack of oversight. First, Director Appellees violated their duty of loyalty. Director Appellees violated their duty of loyalty by acting in bad faith. Directors act in bad faith when they consciously disregard their duty of oversight in the face of numerous red flags.

First, the duty of loyalty "mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally." *Cede & Co. v. Technicolor, Inc.,* 634 A.2d 345, 361 (Del. 1993). The fiduciary duty of loyalty includes the duty to act in good faith. *Id*. Moreover, a plaintiff must demonstrate a showing of bad faith to establish director oversight liability. *Stone*, 911 A.2d at 369. Therefore, directors may face liability by failing to act in good faith, thus violating the duty of loyalty.

Bad faith includes an "intentional dereliction of duty, a conscious disregard for one's responsibilities." *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 66 (Del. 2006). In the oversight context, directors may fail to act in good faith when they fail to act in the face of red flags alerting to inadequate control systems. *See Graham v. Allis-Chambers Manufacturing Co.*, 188 A.2d. 125 (Del. 1963); *In re Caremark International Inc.*, 698 A.2d 959 (Del.Ch.1996); *Stone*, 911 A.2d 362.

First, in *Graham*, this Court held that directors did not breach their duty of loyalty because they did not know of the anti-trust conduct, or of any facts that should have notified them of such conduct. *Graham*, 188 A.2d at 129. In *Graham*, the company faced liability for anti-trust violations; the plaintiffs alleged the directors should face liability because earlier consent decrees involving anti-trust violations should have put the corporation on notice. *Id.* at 128-29. The directors could have faced liability

through inattention to "obvious danger signs" of wrongdoing. *Id.* at 130. However, only three of the directors knew about the consent decree; further, those who knew investigated and found compliance with the law. *Id.* at 129. Thus, if red flags exist, directors may face liability for inaction relating to employee wrongdoing. *Id.* at 130.

Next, in *Caremark*, the court held that the directors had not violated their oversight duties because they implemented proper compliance systems. *Caremark*, 698 A.2d at 970. Directors satisfy their oversight obligations through implementing a reporting system, which provides timely, accurate information so that the directors ensure compliance with law and financial success. *Id.* at 970. The court reasoned that the supervisory and management role of the board requires relevant and timely information. *Id.* The directors in *Caremark* used several different compliance programs to ensure employees did not violate evolving laws that prohibited payments from hospitals and doctors to refer Medicare patients to the company. *Id.* at 962. These compliance programs included guides on policies and ethics, ongoing education for their sales force on the law, internal auditing controls and external auditing on the internal audit controls. *Id.* at 963.

Finally, in *Stone*, this Court recognized that oversight liability stems from the duty to act in good faith. *Stone*, 911 A.2d at 369. This Court further approved the oversight liability test from *Caremark*:

> the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

Id. at 370. In *Stone*, the corporation paid $10 million in penalties to resolve investigations regarding employees' failure to file suspicious activity forms. *Id.* at 365. These investigations arose after two outside individuals defrauded both outside investors and bank employees. *Id.* The directors however used considerable resources to implement multiple control systems and thus did not violate their oversight duties. *Id.* at 371. Further, the plaintiffs conceded that no red flags existed to alert the directors of the violations. *Id.* at 364. Thus, Delaware law requires directors to act in good faith; directors may fail to act in good faith when red flags exist to alert them that their control systems may not be adequate. *Id.* at 370, 364.

The Director Appellees acted in bad faith violating their duties of oversight and loyalty. The Director Appellees ignored their responsibilities showing the prerequisite conscious disregard required for bad faith when they ignored the growing list of red flags showing the inadequacy of the compliance system, which establishes a violation of their duty of oversight.

First, in 2003, before the fraud at the heart of this case, the Board adopted the Compensation Plan providing bonus compensation to senior executives based upon profits. (Comp. ¶ 38.) Thus, Director Appellees instituted a system that provided direct incentives for

senior executives to inflate profits (*Id.*), as evidenced by the regulatory difficulty in 2004 (*Id.* at 40).

In 2004, investigators asserted that Securance offered improper bonuses and financial incentives to doctors for denying certain services to members to boost profits (*Id.*). Without admitting guilt, Securance entered into consent decrees and paid fines of $200,000. (*Id.* at 42.) After signing these consent decrees, Director Appellees should have known that the current compliance system was inadequate. However, none of the Director Appellees insisted on improving the compliance system. Securance's compliance system consisted solely of its audit committee (*Id.* at 34), unlike in *Caremark* where an extensive compliance system consisted of using several different programs.

Furthermore, all the Director Appellees knew about the 2004 consent decrees (*Id.* at 4, 41), unlike *Graham*, where only three of the directors knew about the consent decree, and they further investigated to ensure compliance with the law. The Director Appellees seemed content with the status quo, and by failing to take action, they consciously or recklessly allowed fraud to occur.

While those events alerted the Director Appellees of an inadequate compliance system, the explosion in net income over the three-year period of fraud should have also caused the Director Appellees to take action, and prevent the fraud. In the first year of the scheme alone, Securance's net income nearly doubled. (*Id.* at 25.) Net income climbed over the next three years to $104 million. (*Id.*) After noticing discrepancies in Securance's state regulatory and SEC filings, a Goldman Sachs analyst discovered the fraud. (*Id.* at 27.)

Securance later restated its earnings from 2005-2007, with an average of $40 Million of overstated income per year. (*Id.* at 36.) Despite the explosion of profits and these discrepancies, Director Appellees never took action.

While Securance possessed a single compliance control, it became apparent through the growing list of red flags that it was inadequate. The Director Appellees consciously failed to monitor Securance's operations: they knew the Compensation Plan created incentives to inflate profits; they knew about the alleged unethical conduct in 2004; they witnessed the explosion of net income, despite the discrepancies between the state regulatory filings and company financial statements. Taken together these red flags indicate problems with the single compliance control; yet the Director Appellees ignored the problem, consciously disregarded their responsibilities, and violated their duties of oversight, good faith, and loyalty.

In sum, this Court should reverse because Appellant plead particularized facts that demonstrate the Director Appellees were not disinterested because they face a substantial likelihood of personal liability for breaching their duties of oversight, good faith, and loyalty. Therefore, demand should be excused as futile and a claim has been stated upon which relief can be granted. Furthermore, the Board could not decide disinterestedly whether to pursue litigation against the Officer Appellees because the Board's actions intertwined so deeply with those of the officers, making demand against the Officer Appellees futile as well.

II. THIS COURT SHOULD REVERSE BECAUSE OFFICER APPELLEES CONDUCT BREACHED THEIR DUTY OF OVERSIGHT UNDER A STANDARD OF ORDINARY NEGLIGENCE OR IN THE ALTERNATIVE BAD FAITH.

A. Standard and Scope of Review

This Court reviews dismissals under Court of Chancery Rule 12(b)(6) de novo. *McMullin v. Bernan*, 765 A.2d 910, 916 (Del. 2000). In addition, courts must assume any well plead allegations as true. *Solomon v. Pathe Communications Corp.*, 672 A.2d 35, 38 (Del. 1996). Courts may only dismiss if they determine with "reasonable certainty" that the plaintiff cannot prevail on any set of well-plead allegations. *Growbow v. Perot*, 539 A.2d 180 (Del. 1988).

B. Merits

This Court should reverse because the Officer Appellees breached their fiduciary obligations to Securance. This Court should reverse and formally adopt a standard of ordinary negligence for oversight liability of officers acting in their capacity as officers. In the alternative, this Court should reverse because the Officer Appellees' conduct violates the duty of bad faith as applied to directors.

1. This Court Should Formally Adopt A Standard of Ordinary Negligence for Officers Acting as Officers.

This Court should adopt a standard of ordinary negligence for officer oversight liability for three reasons. First, officers, as agents of the corporation, should be held to the same standard as any other agent. Next, current precedent creates confusion as to which standard applies to officers acting as officers. Finally, public policy supports a standard of ordinary negligence.

a. *An Officer Qualifies as an Agent of a Corporation.*

Officers, as agents of a corporation, should be held to the same standard as other agents when acting in their capacity as officers. Agency is created when one person (the principal) and another person (the agent) agree that the agent should "act on the principal's behalf" and "subject to the principal's control." Restatement (Third) of Agency § 1.01 (2006). Officers qualify as agents because they agree to act on behalf of the corporation, under the control of the board. *Science Accessories Corp. v. Summagraphics Corp.*, 425 A.2d 957, 962 (Del. 1980) (stating "agency law applies to field of corporate employment").

Because agency entails a fiduciary relationship, agents must "act with care, competence, and diligence normal to agents in similar circumstances." Restatement (Third) of Agency § 8.08 (2006). While specific employment contracts may limit these duties, if an agent possess special skills or knowledge, then he or she must act "with the care, competence, and diligence normally exercised by agents with such skills or knowledge." *Id.* Therefore, officers, as agents, owe corporations duties of care, competence, and diligence based on their skill and knowledge. *Id.*

b. *Ambiguous Precedent Needs Clarification.*

Next, this Court should formally adopt a standard of ordinary negligence because precedent is ambiguous. First, this Court would not have to overturn any precedent because no decisions articulate a clear rule for officers acting as officers. *See Platt v. Richardson*, 1989 WL 149484, *2 (M.D.Pa. 1989) (holding Delaware law only applies the

business judgment rule to directors). More over, formally adopting a standard of ordinary negligence would add clarity to an ambiguous area of Delaware corporate law. *See In re Fleming Packaging Corp.*, 351 B.R. 626, 635 (B.K.C.D.Ill. 2006) (finding Delaware law on officer oversight liability undeveloped).

This Court would not need to overturn any precedent because no formal standard exists for officers acting as officers. *See Kelly v. Bell*, 266 A.2d 878 (Del. 1970); *Kaplan v. Centex Corp.*, 294 A.2d 119 (Del.Ch. 1971). First, in *Kelly*, this Court held the directors were not liable for continuing to make payments on current machinery if Pennsylvania would repeal its personal property taxation because the business judgment rule protected their decision. *Kelly*, 266 at 878-79. Subsequent decisions cite to one particular sentence: "the directors or officers were not necessarily liable to the corporation because they honored the commitment, provided they exercised business judgment in doing so." *Id.* at 879. However, the stockholders only sued the directors. *Id.* at 878. Thus, even though the word "officers" appears in the decision, the decision did not apply the business judgment rule to officers acting as officers.

Next, in *Kaplan*, the stockholder challenged decisions originally made by the officers and later ratified by the directors. *Kaplan*, 284 A.2d at 124-25. The court recognized that the dicta in *Kelly* might suggest that officers also benefit from the business judgment rule when the board ratified the officers' decision. *Id.*

Furthermore, this Court recently alluded to a standard of ordinary negligence for officers acting as officers, but the defendant

was no longer an officer and thus did not owe any duties to the corporation. *Disney*, 906 A.2d at 51. While this Court used the language "no reasonably prudent fiduciary" in discussing the former officer's duties, no standard was formally adopted. *Id.* Thus, this Court should formally adopt the standard it alluded to in *Disney* to clarify Delaware law.

Other jurisdictions struggle in properly applying Delaware law because they misconstrue dicta from *Kelly*, 266 A.2d 878 or *Kaplan*, 294 A.2d 119. *See* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 Bus. Law. 439 (2005); *see also Potter v. Pholad*, 560 N.W.2d 389 (Minn.Ct.App. 1997); *Grassmueck v. Barnett*, 2003 WL 22128263, *3 (W.D.Wash. 2003) (holding "the business judgment rule protects corporate officials"); *Selcke v. Bove*, 629 N.E.2d 747,750 (Ill.App.Ct. 1994) (citing *Kaplan* to find the business judgment rule protects directors and officers).

For example, the Minnesota Court of Appeals attempted to apply Delaware law, finding "cases challenging corporate practices implicate the business judgment rule." *Potter,* 560 N.W.2d at 391-92. The court quoted and analyzed Fletcher's Encyclopedia in footnote 1, stating:

> 'To a great extent, the rules governing liability are the same whether the officer sued is a director or some other officer such as the president, vice president, secretary, ***.' 3 Fletcher, supra § 991. But an officer's duties *may be more expansive* than those of a director since directors may rely on the management decisions and recommendations of officers. See id. We believe that judicial inquiry into *the level of fiduciary duty owed is necessarily affected* by the circumstances under which the dispute arises, including whether the allegedly defective conduct was that of an officer or a director.

Id. (Emphasis added.) The court then applied the same standard of gross negligence to both the directors and officers, despite its finding the level of duty changes between an officer and director. *Id.* at 392-93. However, this case involved two director-officers and one non-director officer. *Id.* at 391. Dual roles may have added to the court's confusion. This Court should formally adopt a standard of ordinary negligence to clear the ambiguity in Delaware law.

c. *Public Policy Supports a Standard of Ordinary Negligence.*

Lastly, public policy supports a standard of ordinary negligence. Recent events throughout the financial world, including Enron and the collapse of financial institutions, led to a public opinion that corporate officers should face more liability for their actions or inaction. Hence, Congress passed the Sarbanes-Oxley Act of 2002, placing more regulation on how directors and officers manage corporations. *See Sarbanes-Oxley Act of 2002*, Pub. L. No. 107-204, 116 Stat. 745; *see also* Lisa M. Fairfax, *The Sarbanes-Oxley Act as Confirmation of Recent Trends in Director and Officer Fiduciary Obligations*, 76 St.John's L. Rev. 953 (Fall 2002).

In particular, an officer must certify in every report filed that the officer reviewed the report to ensure it does not contain any untrue statements and the information included "fairly present[s] in all material aspects the financial condition" of the corporation. 15 U.S.C. § 7241. The signing officer is also required to establish and maintain adequate internal controls to ensure accurate information availability. *Id.*

Likewise, attorneys working for corporations face additional requirements, namely to "report evidence of a material violation of securities law or a breach of fiduciary duty . . .by the company or any agent." 15 U.S.C. § 7245. Attorneys must further report such action up the chain of command until corrective action has occurred. *Id.* The Sarbanes-Oxley Act demonstrates that corporate management has not worked to public satisfaction and officers must face more liability for their actions or lack thereof. *See* Fairfax, 76 St. John's L.Rev. at 953.

This Court should formally adopt a standard of ordinary negligence for officers acting as officers for three reasons. First, officers as agents of a corporation should be held to the same standard as other agents. Second, this Court would help clear ambiguity in Delaware law by adopting a clear standard of ordinary negligence. Finally, public policy supports a standard of ordinary negligence because recent disasters in corporate management require more regulation. This Court should formally adopt a standard of ordinary negligence and hold the Officer Appellees breached their fiduciary duties by acting negligently.

Officer Appellees acted negligently because they did not act with the care, competence and diligence of a reasonable officer with their skills and knowledge. Unlike the shareholder in *Kelly*, Appellant sued non-director officers. (Compl. ¶ 6.) All possessing at least four years experience, Appellee Lieberman served as Chief Operating Officer, Appellee Huelva as Chief Accounting Officer, and Appellee Stockdale as Chief Legal Officer, General Counsel and Chief Compliance

Officer. (*Id.*) Each received compensation amounting to over $2.5 million in 2008 (*Id.)*, due to the Compensation Plan basing bonuses on profits (*Id.* at 38).

Although Officer Appellees possessed several years experience in senior management (*Id.* at 6), they either approved or overlooked a fraudulent scheme from 2005-2007. On March 12, 2008, a federal search warrant removed an entire moving truck filled with laptop computers, BlackBerrys and numerous boxes. (*Id.* at 28.) Then, Gregory Devlin (Finance Department), Susan Larner (Vice-President of Operations), and Robert Hooper (Vice-President of Accounting) plead guilty to conspiracy to commit Medicaid Fraud from 2005-2007. (*Id.* at 30.) Their consent agreement specifically stated that they acted with the express or implied support of senior officers. (*Id.* at 31.)

Appellee Lieberman supervised Devlin and Larner, and Appellee Huelva supervised Hooper. (*Id.*) In addition, Appellee Stockdale worked closely with all three to prepare the profit margin reports for state agencies. (*Id.*) Unlike the officers in *Kaplan*, Officer Appellees here did not make a decision that the board ratified; rather they violated their duties by failing to use the degree of care, competence and diligence of a reasonably prudent officer in overseeing their departments.

In addition, Securance's financial data demonstrates that the Officer Appellees did not act commensurate with a reasonable person with their skills and knowledge. The company's net income nearly doubled from $49 million in 2004 to $88 million in 2005. (*Id.* at 25.) Net income continued to rise to $104 Million in 2008. *Id.* While no one

within seemed to question this explosive increase, a Goldman Sachs analyst discovered the fraud through discrepancies in state regulatory filings and SEC filings. (*Id.* at 27.) These discrepancies required Securance to restate its earnings from 2005-2007, cutting each year's income almost in half. (*Id.* at 36.) This Court should reverse because Officer Appellees failed to provide adequate care, competence and diligence commensurate with an officer with their skill and knowledge, by allowing fraud to occur right under them.

2. *This Court Should Reverse Because Appellee Officers Breached a Standard of Bad Faith as Applied to Directors.*

Even if this Court does not formally adopt a standard of ordinary negligence for officers acting as officers, this Court should still reverse because the Officer Appellees' conduct constitutes bad faith. As articulated fully in section I, acting in bad faith includes "fail[ing] to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." *Disney*, 906 A.2d at 67.

Officer Appellees failed to act in the face of their duties, particularly their duties under Sarbanes-Oxley to review financial statements and to report any actions of fraud. As supervising officers, Appellees Lieberman and Huelva should have stopped the fraud from occurring in the departments they supervised. (Compl. ¶ 31.) Appellee Stockdale specifically worked closely in preparing the state regulatory forms. (*Id.*) As an attorney, he faced a positive duty to report fraud up the chain of command, past the Board if necessary. (*Id.*) Thus, Officer Appellees consciously disregarded their duties as senior officers to oversee the officers directly below them, and to

prevent the filing of fraudulent financial statements to both the SEC and state regulators.

In conclusion, this Court should reverse and formally adopt a standard of ordinary negligence for officers acting as officers. Officers, as agents of a corporation, should be held to the same standard of any other agent. Furthermore, precedent and public policy support a standard of ordinary negligence. In the event this Court does not adopt a standard of ordinary negligence, this Court should still reverse because the Officer Appellees' conduct constituted bad faith when they consciously failed to perform their oversight responsibilities.

CONCLUSION

The Complaint sets forth particularized allegations that create reasonable doubt as to the disinterest of the Director Appellees in evaluating a pre-suit demand against both the Director Appellees and the Officer Appellees. Further, the Complaint sets forth particularized allegations that the Director Appellees and Officer Appellees violated their fiduciary duties. For the foregoing reasons, Appellant respectfully requests that this Court reverse the January 6, 2009 opinion of the Court of Chancery. Appellant requests 30 minutes to be heard orally.

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H-Council of Appellant