

IN THE SUPREME COURT OF THE STATE OF DELAWARE

CLARE C. MARSHALL,)
)
)
 Plaintiff Below, Appellant)
)
)
 v.)
)
 CHARLES H. SALIGMAN, PATRICK C.)
 RICHMOND, YVONNE M. CRAIG, MARTIN)
 R. ROTHSCHILD, ELAINE A. LASATER,)
 WILLIAM M. LEWIS, GILBERT W.)
 COULSON, RACHEL N. LIEBERMAN,)
 TIMOTHY M. STOCKDALE, AND CARLOS B.)
 HUELVA,)
)
 Defendants Below, Appellees)
)
 and)
)
 SECURANCE INCORPORATED,)
)
)
 Nominal Defendant Below,)
 Appellee.)

No. 27, 2009
CD-ROM Version To Be Filed

Court Below - Chancery
 Court of the State of
 Delaware
 C.A. No. 3892-CS

Appellant's Opening Brief

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Date Filed: February 17, 2009

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NATURE OF PROCEEDINGS

This case is a derivative action alleging breach of the fiduciary duty of loyalty, based on bad faith demonstrated by a sustained and conscious failure of the board of directors and three senior officers to properly monitor the financial accounting and reporting practices of Securance, Inc. The failure resulted in substantial losses to the company and its shareholders including, but not limited to, \$400 million in fines and suspension of business in the four affected markets of Ohio, Pennsylvania, New York, and New Jersey. (Mem. Op. 1.) These four states accounted for 40% of the company's business revenue. (Mem. Op. 1.) Additionally, due to drastic reductions in the market value of Securance stock, the Company has lost approximately \$3 billion dollars in market capitalization. (Mem. Op. 1.)

Plaintiff filed her complaint on July 3, 2008 naming as Defendants the entire board of directors ("Director Defendants" or the "Board") and three additional non-director senior officers ("Officer Defendants") (collectively, the "Defendants"). (Compl. ¶ 1.) Defendant's moved to dismiss the complaint on the grounds that the Plaintiff had failed to allege particularized facts that would excuse demand under Chancery Court Rule 23.1, and had failed to state a claim for which relief could be granted under Rule 12(b)(6). (Mem. Op. 2.)

The Court of Chancery, Chancellor Seigel presiding, granted both motions for the Defendants in an opinion decided January 6, 2009. Plaintiff properly filed a notice of appeal with this Court on January 16, 2009, and respectfully appeals the order of January 6, 2009.

SUMMARY OF ARGUMENT

1. The Chancery Court failed to properly apply the legal standard for determining demand futility in the wake of a sustained failure by the board to properly oversee the activities of the corporation and its officers. Though the facts taken as a whole demonstrated a reasonable doubt that the Board could act with independent and disinterested business judgment, the Chancery Court erroneously found the particularized facts to be conclusory, and lacking the particularized standard to allow all reasonable inferences to be drawn in favor of the Plaintiff. The Chancery Court failed to recognize that the Board had constructive knowledge of repeated improper activity within the corporation. Additionally, the Chancery Court failed to accept the established legal precedent that recklessness, or conscious disregard, against the best interests of the corporation is sufficient to show the bad faith necessary to breach the fiduciary duty of loyalty, and show demand futility.

2. The Chancery Court incorrectly applied the Chancery Rule 12(b)(6) standard for pleading when it dismissed the Plaintiff's complaint. A claim will be dismissed only if it appears that a plaintiff could prevail on no set of facts inferred. The factual allegations in the complaint that the Officer Defendants knew Company compliance policies were faulty, yet still failed to scrutinize inflated reporting figures creates a reasonable inference that the Officer Defendants breached their fiduciary duty of loyalty for oversight liability. This Court should reverse the decision of the Chancery Court, and remand the case for trial on the merits.

STATE OF FACTS

Securance, Inc. ("Securance") provides managed care services to Medicaid and Medicare recipients in the Mid-Atlantic and Midwest regions of the U.S. (Mem. Op. 4.) Securance became a publicly traded corporation in 2002. (Mem. Op. 8.) Shortly after its initial public offering, Securance approved a Senior Officer Performance Compensation Plan applicable to senior corporate executives. (Mem. Op. 12.) The compensation plan provided bonus compensation based on the operating profit yielded by each of Securance's business segments. (Mem. Op. 13.)

In 2004, Securance's lengthy history of regulatory issues began when claims arose that Securance was denying certain services to members to boost profits. (Mem. Op. 13.) Securance entered into consent decrees promising compliance and agreed to pay \$200,000 in fines because of these claims. (Mem. Op. 13.) Securance never proposed or adopted any changes to its compliance system as a result of the consent decrees. (Mem. Op. 14.)

Shortly after the regulatory problems and the issuance of the consent decrees, three former senior managers at Securance - Gregory Devlin, Susan Larner, and Robert Hooper - developed a fraudulent scheme to increase Company profits illegally through false regulatory reporting. (Mem. Op. 6.) In the scheme's first year of operation Securance's profits increased by approximately 80% going from \$49 million in 2004 to \$88million in 2005. (Mem. Op. 12.) In total, the fraudulent scheme caused Securance to overstate earnings by \$120 million in the three years the scheme operated. (Mem. Op. 12.)

In early 2008, a lone analyst at Goldman Sachs noticed that Securance appeared to be shifting profits to deceive state regulators. (Mem. Op. 9.) This report was made public and soon the FBI executed a search warrant at Securance's headquarters. (Mem. Op. 10.) All in all the FBI seized an entire moving truck full of documents, laptops, disks, and other various electronic devices. (Mem. Op. 10.) Investigators soon uncovered the three senior managers who set up the fraudulent scheme. (Mem. Op. 10.) The three senior managers subsequently pled guilty to one count of conspiracy to commit Medicaid fraud. (Mem. Op. 10.)

In their plea agreements, each of the senior managers stated that they acted with the express or implied support of Securance's senior officers. (Mem. Op. 10.) Officer Defendant Lieberman supervised the department in which senior managers Devlin and Lerner worked, Officer Defendant Huelva supervised the department in which senior manager Hooper worked, and Officer Defendant Stockdale worked closely with each of the three senior managers in preparation of Securance's Medicaid reports to state agencies. (Comp. ¶ 31.)

Subsequently on June 3, 2008, Securance pled guilty to one count of mail fraud and stipulated to an order imposing \$400 million in criminal penalties. (Mem. Op. 11.) Securance also established and set up a new compliance committee as a condition of the plea agreement. (Mem. Op. 11.) This action was brought shortly thereafter.

ARGUMENT

I. The question presented is whether the Chancery Court committed reversible error in dismissing the shareholder derivative action on a motion for failure to show that demand was excused under Rule 23.1.

A. Scope of Review

The standard of review of a Chancery Court's decision to dismiss a shareholder derivative suit based on the Plaintiff's failure to allege particularized facts under Rule 23.1 is de novo and plenary. *Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000).

B. Merits of Argument

For the reasons that follow, this Court should reverse the Chancery Court's decision to dismiss the complaint for failing to plead with particularity facts that would excuse demand under Chancery Court Rule 23.1, and remand the case for trial on the merits.

1. The Chancery Court erred by failing to apply the proper legal standard for pleading that demand is futile under Delaware Court of Chancery Rule 23.1.

When a shareholder chooses not to make demand upon a board of directors, the shareholder is required by Chancery Court Rule 23.1 to allege particularized facts showing demand is excused "because the directors are incapable of making an impartial decision regarding such litigation." *Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993). When demand is alleged to be futile because of a particular action taken by the board, Delaware law requires the plaintiff to "allege particularized facts creating a reason to doubt that: '(1) the directors are disinterested and independent, [or that] (2) the challenged transaction was otherwise the product of a valid exercise

of business judgment.'" *Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008) (quoting *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984)). When the derivative suit does not challenge an actual decision by the board (as in the instant case), but rather questions the failure of the board to affirmatively act on a known duty, the *Aronson* test is not applicable. *Rales*, 634 A.2d at 934. In applying the *Rales* test to the facts in this case, the Court must take all well-pleaded factual allegations as true, and all reasonable inferences from those facts must be drawn in favor of the plaintiff. *Brehm*, 746 A.2d at 255.

a. The Rales Test is the standard a plaintiff must plead to excuse demand under Rule 23.1 when the alleged improper act is one of omission.

The *Rales* test focuses only on whether "the board that would be addressing demand can impartially consider its merits without being influenced by improper considerations." *Rales*, 634 A.2d at 934. *Rales* sets the standard for determining demand futility in the wake of a failure by the board to properly execute its oversight duties. *Wood*, 953 A.2d at 140. Therefore, the threshold requirement for excusing demand in the instant case requires the "plaintiff [to] allege particularized facts establishing a reason to doubt that 'the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.'" *Id.* at 140 (quoting *Rales*, 634 A.2d at 934).

b. Pleading facts with particularity under Chancery Rule 23.1 does not require the plaintiff to plead evidence amounting to a reasonable probability of success at trial.

The plaintiff is not required to plead evidence in order to excuse demand, but only rise above the level of notice pleading. *Brehm*, 746 A.2d at 254 (citing *Aronson*, 473 A.2d at 816). This Court has rejected the need for a plaintiff to demonstrate a "reasonable probability of success" in his complaint. *Rales*, 634 A.2d at 934. The *Rales* Court held that such a requirement is an "extremely onerous burden to meet at the pleading stage without the benefit of discovery." *Id.* In the instant case, the entire Board is alleged to be incapable of being disinterested because of the potential for personal financial liability. The threat of personal liability must only go beyond the "mere threat" of liability, and rise only to "a substantial likelihood [that] personal liability exists." *Wood*, 953 A.2d at 141 n.11 (quoting *Aronson*, 473 A.2d at 814). Showing the threat of liability does not equate to the higher standard of reasonable probability that the plaintiff will win the case at trial.

A substantial likelihood of liability exists where there is a reasonable inference of a "sustained or systematic failure of the board to exercise oversight- such as an utter failure to attempt to assure a reasonable information and reporting system exists." *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996). The facts in the instant case show a reasonable inference of sustained failure by the Board to take action in the face of disturbing irregularities. For example, the audit committee of the Securance Board, who was tasked with ensuring regulatory compliance, allowed different financial reporting values to be reported to the Securities and Exchange Commission ("SEC") and the State Medicaid

programs for three years (2005-2007) without any corrective action.
(Compl. ¶ 24.)

This court should find that there is a reasonable inference, drawn in favor of the plaintiff, that the Board continually failed to act in the light of disturbing irregularities. Accepting all factual allegations as true, the inference is sufficient to create a substantial likelihood of liability at the pleading stage, and therefore excuses demand under Rule 23.1.

2. The Chancery Court erred by not holding that reckless disregard of the oversight duties by the Board is legally sufficient to show a bad faith breach of the duty of loyalty.

The Chancery Court committed reversible error in dismissing the instant case by refusing to hold that a board acts in bad faith when it recklessly disregards an affirmative duty to act in the best interest of the corporation. (Mem. Op. 20-21.) This Court has held that scienter, or the fact that an act or omission was committed knowingly, is a predicate for oversight liability. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006); see also *Wood*, 953 A.2d at 141.

Black's Law defines "reckless" as "[c]haracterized by . . . a conscious (and sometimes deliberate) disregard." *Black's Law Dictionary* 596 (Bryan A Garner ed., 3d pocket ed., West 2006). Further, "reckless disregard" is defined as "[c]onscious indifference to the consequences of an act." *Id.* This language comports with this Court's decision in *Stone* that a "conscious failure to monitor" is sufficient to show a bad faith breach of the duty of loyalty. *Stone*, 911 A.2d at 370. A "conscious failure to monitor" is equivalent to

"reckless monitoring," and is therefore legally sufficient to impose liability for a bad faith breach of the duty of loyalty.

- a. **Reasonable Doubt that the Board could have properly exercised its independent and disinterested business judgment in responding to demand can be shown by facts indicating the Board was reckless, and consciously failed to oversee the actions of the corporation.**

To establish reasonable doubt in the absence of action by the board, the plaintiff must show that the directors acted with bad faith to the extent that they "consciously fail to monitor" the activities of the corporation. *Stone*, 911 A.2d at 370. Such an act of bad faith violates the fiduciary duty of loyalty, and subjects directors to personal liability for failing to act in the corporation's best interest. *Id.*

As the Chancery Court noted, the existence of an exculpation clause under 8 Del. C. § 102(b)(7) (2009) is immaterial where bad faith breaches the duty of loyalty. (Mem. Op. 20 n.18.) However, to show bad faith resulting from a failure of oversight, the plaintiff must plead with particularity facts creating an inference that "the board acted with scienter, *i.e.*, that they had actual or *constructive* knowledge that their conduct was legally improper." *Wood*, 953 A.2d at 141 (emphasis added); see also *Stone*, 911 A.2d at 370. Therefore, constructive knowledge by the Board of repeated fraudulent public filings, by members of the corporation, would create reasonable doubt that the Board could act on a shareholder demand with independence and disinterest. The Board would face a substantial likelihood of liability if such allegations were indeed true.

This Court should hold that actual or constructive knowledge by the Board of repeated improper regulatory filings constitutes a sustained failure of oversight. A sustained failure of oversight forms a "conscious failure" to act in a corporation's best interest, and thus breaches the duty of loyalty. *Stone*, 911 A.2d at 370. Conscious failure of oversight makes demand futile under 23.1 because it creates a reasonable doubt that the Board could act independently or disinterested in responding to demand.

b. Particularized facts must be taken as true, and all inferences made in a light most favorable to the plaintiff.

The Chancery Court committed reversible error by not accepting the particularized facts in the complaint as true, and by not making all reasonable inferences in a light most favorable to the plaintiff. *Brehm*, 746 A.2d at 255. The Chancery Court held that the factual allegations in the case at bar were conclusory, and not deserving of a reasonable inference in favor of the plaintiff. *Id.*

Each of the key facts creating reasonable doubt are particularized facts, and not conclusory statements. First, the Securance Board approved a compensation plan in 2003 that provided for bonuses to senior executives, including members of the Board, based on net profits. (Mem. Op. 12-13.) In 2004, Securance entered into consent decrees with the states of Virginia and Connecticut because of investigations into improper company policies; such as the denial of claims meant to "boost profits," and improper financial incentives and bonuses to doctors who denied needed services "so that Securance could make a larger profit." (Mem. Op. 13.) The compensation plan tied to

net profits alone is not a cause for concern. When viewed in the light of subsequent policies enacted to boost profits, and thereby boost compensation, a reasonable inference of self-interest emerges.

Securance agreed to a court approved settlement of \$200,000 in fines while admitting no wrongdoing. (Mem. Op. 13.) The plaintiff does not dispute that a compliance system used by the Board's audit committee existed at this time; only that the Board ignored the consent decrees in 2004, which demonstrated that the compliance system had failed to uncover improper policies causing harm to the corporation. Even after it became clear that the company's information and reporting system had failed, the Chancery Court found that, "[n]o change to [Securance's] compliance system was proposed or adopted as a result of the 2004 consent decrees." (Mem. Op. 14.)

In 2005, Securance reported profits of \$88 million, nearly double the \$49 million reported in 2004. (Mem. Op. 6, 12.) Profits steadily increased to \$95 million in 2006, and \$104 million in 2007. (Mem. Op. 12.) In 2008, a lone analyst, with no access to corporate records beyond those reported in public disclosures, noticed the difference between the amount of money being reported to the Securities and Exchange Commission (SEC), and the amount of money being reported to state Medicaid regulators. (Mem. Op. 9.)

In a regulated industry where profit margins are known to be slim and earnings growth slow (Compl. ¶ 16.), Securance managed to nearly double profits in one year, yet no change was made to the compliance reporting system until the fraud was discovered in 2008. (Mem. Op. 6, 12, 14.) There is a reasonable inference, drawn in favor of the

Plaintiff, that the Board failed to properly monitor the financial accounting and reporting of the Company. The Plaintiff stipulates that there is a reasonable inference, drawn in favor of the Defendant, that there were legitimate reasons for such an apparent lack of oversight. However, in motions to dismiss under Rule 23.1, all reasonable inferences are drawn in favor of the Plaintiff. *Brehm*, 746 A.2d at 255.

The Chancery Court was unable to draw inferences from facts "standing alone," such as the doubling of profits in 2005. (Mem. Op. 25.) However, this line of reasoning is erroneous. Perhaps this fact standing alone is incapable of creating an inference, but there is no requirement that particularized facts stand alone. "Plaintiffs are entitled to *all reasonable factual inferences* that logically flow from the particularized facts alleged." *Brehm*, 746 A.2d at 255 (emphasis added). The alleged facts taken as a whole are what create the reasonable inference of a sustained failure by the Board in the case at bar.

This Court should reverse the Chancery Court's erroneous holding that facts are required to stand alone in order to create an inference of wrongdoing sufficient to disable the Board from exercising its disinterested and independent business judgment.

- c. Constructive knowledge of sustained failures to properly oversee the regulatory requirements of the corporation is sufficient to show a conscious failure to monitor the activities of the corporation.**

In establishing the necessary conditions for oversight liability, the *Caremark* decision dictates that even when a reporting or

information system is in place, the Directors are subject to liability if they "consciously fail to monitor" that system, thus preventing them from being informed of issues that require their attention. *Stone*, 911 A.2d at 370 (citing *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003)). Failing to act when there is a known duty to act demonstrates a "conscious disregard" of the Director's responsibilities, and results in a "breach [of] their duty of loyalty by failing to discharge that fiduciary obligation in good faith." *Id.* at 370 (citing *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (Del.2006); see also *Guttman*, 823 A.2d at 506.)

The Board members assert that they were unaware of the activities of the senior executives involved. However, if the Board did not know that the reports were being manipulated, the alleged facts support that they should have known. Where accounting discrepancies are present, the entire board is held to have the resources, "namely each other," to be aware of the financial reporting. *Saito v. McCall*, 2004 WL 302876, at *15 n.71 (Del. Ch.).

Black's Law defines constructive knowledge as, "[k]nowledge that one using reasonable care or diligence should have, and therefore that is attributed by law to a given person." *Black's Law Dictionary* 404 *supra*. In the notes attached to the definition, *Black's* gives an example of constructive knowledge stating, "the court held that the partners had constructive knowledge of the partnership agreement even though none of them had read it." *Id.* This Court should equally hold that constructive knowledge makes the directors legally responsible for their failure of oversight. This Court should find, in its de

novo review, that the directors had constructive knowledge of the falsified reports being filed by senior managers for three years, and are liable for their inaction.

Securance nearly doubled profits from 2004 to 2005. This unusual achievement followed in the wake of damage to the corporation in 2004 for improper policymaking related to profits. The facts in the analogous cases below are extraordinarily similar. However, the reasonably inferred fact that the Board recklessly disregarded recent history, distinguishes this case from *Caremark*, *Stone*, and *Wood*, where demand was not excused. See *Caremark*, 698 A.2d at 971; see also *Stone*, 911 A.2d at 373; *Wood*, 953 A.2d at 142-43. The Board of Directors in the instant case were on notice from the 2004 consent decrees that their unaltered compliance system had once failed to prevent harm to the corporation. In the aforementioned cases, there were no improper acts that predated the instant complaints that would have given the boards notice. *Id.*

The Chancery Court held that the \$200,000 fine was immaterial to Securance operations, and therefore did not require the Board to consider that information in moving forward. (Mem. Op. 25.) Public policy will likely be implicated in assuming that fraudulent and illegal activity may be disregarded by the board if it does not financially impact a company's operations. However, materiality of facts is a decision for trial, and should not have been considered on a motion to dismiss. *Saito*, 2004 WL 3029876 at *7.

The facts as presented create the inference that the entire Securance Board of directors "consciously failed to monitor" the

activities of the corporation. The Board had constructive knowledge that irregularities within the company were likely the result of improper or even illegal behavior, yet they remained silent until the harm to corporation was unstoppable. Demand futility is possible when plaintiffs allege particularized facts "indicating that directors had actual knowledge of accounting irregularities, or knowledge of facts indicating potential accounting irregularities, and took no action until confronted." *Ash v. McCall*, 2000 WL 1370341, at *16 (Del. Ch.) (holding that a demand calling into question the good faith of an audit committee would disable the entire board from exercising its disinterested and independent business judgment resulting in excusal of demand). The Securance Board, despite the existence of numerous indicators, failed to make changes to their compliance system until forced to do so in their criminal settlement agreement in 2008. (Mem. Op. 14.)

This Court should find that the Board of directors in its entirety, acting with constructive knowledge of repeated regulatory violations, consciously failed to monitor the activities of the corporation, resulting in harm to the corporation. Therefore, this court should reverse the Chancery Court decision to dismiss the instant case under Rule 23.1, and remand the case for trial on the merits.

II. The question presented is whether the Chancery Court committed reversible error when it dismissed the complaint against the Officer Defendants for failure to state a claim pursuant to Chancery Rule 12(b)(6).

A. Scope of Review

This Court's review of a dismissal under Court of Chancery Rule 12(b)(6) is de novo. *Wal-Mart Stores, Inc. v. AIG Life Insur. Co.*, 901 A.2d 106, 112 (Del. 2006). A Rule 12(b)(6) dismissal "will be upheld only if it appears from the well-pleaded allegations of the complaint that plaintiffs would not be entitled to relief under any set of facts that could be proven to support the claim asserted." *Id.* This Court must accept the well-pleaded allegations of the complaint as true and draw all inferences in favor of the plaintiff. *Id.*

B. Merits of Argument

For the reasons that follow, this Court should reverse the Chancery Court's decision to dismiss the complaint for failing to adequately state a claim for relief pursuant to Chancery Rule 12(b)(6) and remand the case for trial on the merits.

1. The Chancery Rule 12(b)(6) standard is extremely liberal and only requires a general notice of the claim asserted.

The standard of review for a Chancery Rule 12(b)(6) motion is as follows:

The court must give the pleader the "benefit of all reasonable inferences that can be drawn from its pleading." Additionally, a motion to dismiss, at such a preliminary stage, requires the court to determine with "reasonable certainty" that a plaintiff could prevail on no set of facts that can be inferred from the pleadings. The complaint itself need "only give general notice of the claim asserted..." consistent with the notice pleading

concept of Chancery Rule 8(a). However, "conclusions will not be accepted as true without specific allegations of fact to support them."

Solomon v. Pathe Communications Corp., 672 A.2d 35, 39 (Del. 1996) (internal citations omitted). The court may also draw inferences from general allegations under the 12(b)(6) standard. *In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563, 582 (Del. Ch. 2007).

The Plaintiff's complaint is bursting with well-pleaded allegations that state a claim for relief against the Officer Defendants for oversight liability. The allegations in the complaint contain specific facts to support the conclusion that the Officer Defendants consciously failed to monitor Securance's operations. Further, when drawing all reasonable inferences in the favor of the plaintiff, it becomes clear that the Complaint adequately states a proper claim. Because the Chancery Rule 12(b)(6) pleading standard has been satisfied, this Court should reverse the Chancery Court's dismissal for failure to state a claim and remand the case for trial on the merits.

The Chancery Court in the case at bar held that the test for oversight liability set forth in *Stone v. Ritter* applies to officers as well as directors. (Mem. Op. 28.) Therefore, in order for a plaintiff to adequately state a claim for relief against officers under the *Stone* test, they must allege that the officers "(a) utterly failed to implement any reporting system or controls; or (b) having implemented such system or controls, consciously failed to monitor its operations." (Mem. Op. 20.) The Court of Chancery held that part (a) of the *Stone* test was inapplicable, and that the Complaint failed to

state a claim against the Officer Defendants for a conscious failure to monitor the Company's operations under the second prong of the *Stone* test. (Mem. Op. 28.)

This Court has yet to decide whether the *Stone* test for director oversight liability applies equally to officers. There are two reasons for this. First, *Stone* was only recently decided in November of 2006, and second, Delaware did not have personal jurisdiction over officers of Delaware corporations until 2004. Usha Rodrigues, *From Loyalty to Conflict: Addressing Fiduciary Duty at the Officer Level*, 61 Fla. L. Rev. 1, 37 (2009). In a recent decision by this Court, it held that officers owe the same fiduciary duties as directors. *Gantler v. Stephens*, 2009 WL 188828 at *9 (Del. Supr.). Therefore, it can be assumed, for purposes of this argument that the *Stone* test for oversight liability does in fact apply to officers.

2. **The well-pleaded allegations in the complaint, that the Officer Defendants failed to improve Securance's compliance and reporting systems following the 2004 consent decrees, supports the inference that the Officer Defendants consciously failed to monitor Securance's operations.**

The fact that the Officer Defendants took no action to correct the problems in Securance's compliance system after the 2004 consent decrees further supports the reasonable inference that they "consciously failed" to monitor Securance's operations. The court must give the pleader the benefit of all reasonable inferences that can be drawn from its pleading. *Solomon*, 672 A.2d at 39. This inference, taken together with the other inferences created by the

well-pleaded allegations of the complaint, adequately states a claim for relief.

Delaware case law has dealt with the "conscious failure" issue on several occasions in the 12(b)(6) context. While these cases do not apply the *Stone* test directly, they are relevant to show when a complaint has adequately alleged conscious failure to perform fiduciary duties at the officer and director level.

Saito sets forth that a complaint alleging conscious failure can overcome a Chancery Rule 12(b)(6) motion to dismiss by alleging that officers or directors failed to rectify faulty Company policies or controls of which they were aware. 2004 WL 3029876. The complaint in *Saito* alleged that the directors of a newly-merged company failed to exercise oversight in monitoring accounting practices or correcting accounting problems within the company. *Id.* at *1. The complaint further alleged that the directors knew about these accounting problems, and that they failed to do anything to rectify these problems for several months. *Id.* at *7. The failure to correct the accounting problems forced the Company to restate earnings, which harmed the Company's stock price. *Id.* at *4. The defendants moved to dismiss the claim on both Chancery Rule 12(b)(6) and 23.1 grounds. *Id.* at *7.

The court held that the complaint adequately stated a claim for director oversight. *Id.* It reasoned that when viewing the facts alleged in the complaint in the light most favorable to the plaintiff, the complaint sufficiently pleaded that the directors knew about the accounting discrepancies and with this knowledge failed to take any

correcting action. *Id.* The court further stated that, “[a]lthough the facts later adduced may prove otherwise, the procedural posture of the case requires me to focus on the plaintiffs’ complaint, and read it generously.” *Id.* (emphasis added).

Comparatively, the 2004 consent decrees, which caused harm to Securance, present a similar situation to the one faced in *Saito*. As in *Saito*, the Plaintiff’s complaint alleges that the Officer Defendant’s failure to take corrective action following the consent decrees, when coupled with the allegations that Officer Defendants failed to examine or verify the 2005 earnings improvements, supports the inference that they failed to exercise oversight. (Mem. Op. 15). The claims that led to the consent decrees involved allegations that Securance provided improper financial incentives to boost profits. (Compl. ¶ 40.) It is undisputed that the Officers had knowledge of the claims surrounding these consent decrees, although there was no admission of wrongdoing. (Mem. Op. 25.) Securance never proposed, much less adopted, any changes to Securance’s compliance system because of these consent decrees. (Mem. Op. 14.)

Further, the *Saito* court’s reasoning that materiality is not an issue to be resolved at the 12(b)(6) dismissal stage, but rather later in the litigation process, directly refutes the Chancery Court’s finding in the case at bar. 2004 WL 3029876 at *7. The Chancery Court in the instant case found that these consent decrees contained no admission of wrongdoing, and the fines from the consent decrees were not material to Securance’s operations. (Mem. Op. 25.) Litigation at the motion to dismiss stage does not concern

materiality, and the Officers were aware that the claims that led to the consent decrees involved claims of wrongdoing. (Mem. Op. 25.)

3. **The well-pleaded allegations in the complaint, stating that the Officer Defendants failed to examine or verify Securance's dramatic earnings improvements, support the inference that the Officer Defendants consciously failed to monitor Securance's operations.**

The fact that the Officer Defendants failed to examine or verify Securance's dramatic earnings improvements supports the inference that the Officer Defendants consciously failed to monitor Securance's operations. This fact does not stand alone however because under the 12(b)(6) standard of review, a motion to dismiss will be granted "only when it appears reasonably certain that plaintiff would not be entitled to the relief requested, even if all the facts as stated in the complaint are true." *Lewis v. Vogelstein*, 699 A.2d 327, 329 (Del. Ch. 1997) (citing *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099 (Del. 1985)).

The Delaware Chancery Court faced a "conscious failure" situation in *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003). The complaint in this case alleged that the Board of Directors breached their fiduciary duties when "they blindly approved" the employment agreement, and non-fault termination agreement for new Disney president Michael Ovitz. *Id.* at 277. Specifically, the complaint stated that the Board never sought or actually reviewed the final employment agreement. *Id.* at 288. The complaint further stated that no record existed to show any Board action affirming or questioning the decision to approve Ovitz's non-fault termination agreement. *Id.* at 284-285.

The *Disney* Court held that the pleading in the complaint was sufficient to survive a Chancery Rule 12(b)(6) motion to dismiss. *Id.* at 290. The court reasoned that all the alleged facts inferred that the Board consciously disregarded their responsibilities. *Id.* In viewing these facts as true, the complaint adequately stated a claim for relief. *Id.*

Similarly, the Plaintiff's complaint states that there is no record showing any action by the Officer Defendants to examine or verify Securance's incredible earnings results. (Mem. Op. 25.) The jump in earnings from 2004 to 2005 was no small leap either. Profits increased by approximately 80% going from \$49 million to \$88 million. (Mem. Op. 23.) This means that to be consistent with yearly profit margins, Securance's revenues would have increased by over \$1 billion.¹ The failure to justify or verify Securance's inordinate earnings, when coupled with other well-pleaded allegations in the complaint, supports the inference that the Officer Defendants consciously failed to monitor Securance's operations. This failure to act is exactly what the complaint in *Disney* stated, and the inferences drawn are almost identical in the two situations. *In re Walt Disney*, 825 A.2d at 284-85, 290.

Moreover, in the Chancery Court's analysis it erroneously held that the allegations in the Plaintiff's complaint did not allege specific facts to put the Board on notice of employee misconduct. The court supported its holding by stating that, "the complaint contains

¹ This is assuming that the company maintained the 3.5% profit margin from 2004.

no allegations that such dramatic improvements to business results were not explained or justified to the Board by facially valid business reasons." (Mem. Op. 25.)

According to the court in *Disney*, the allegations in the Plaintiff's complaint would require nothing further. The complaint in *Disney* merely stated that no record existed showing any Board action affirming or questioning the agreements. *In re Walt Disney*, 825 A.2d at 284-285. The *Disney* court did not require the complaint to allege reasons why the Board might not have taken any action, which is exactly what the Chancery Court in the present case suggested. Further, on a motion to dismiss a Chancery Court is not free to discount reasonable inferences by "weighing it against other, perhaps contrary, inferences that might also be drawn." *Gantler*, 2009 WL 188828 at * 10. The Chancery Court's holding that the Plaintiff's complaint must allege more was in error. Therefore, the inference that the Officer Defendants consciously failed to monitor Securance's operations is supported by the allegations that the Officer Defendants failed to act with a "critical eye" in examining Securance's inordinate earnings.

- 4. The well-pleaded factual allegations, taken as a whole, creates a "set of facts" that can be inferred from the pleadings that would entitle the plaintiff to relief.**

The factual allegations in the Plaintiff's complaint create a reasonable inference that the Officer Defendants breached their fiduciary duty of loyalty. "The court must give the pleader the 'benefit of all reasonable inferences that can be drawn from its

pleading.'" *Solomon*, 672 A.2d at 39. Further, in order to dismiss at this early stage requires "the court to determine with 'reasonable certainty' that a plaintiff could prevail on no set of facts that can be inferred from the pleadings." *Id.*

The "set of facts" that can be inferred from the pleadings is that the Officer Defendants knew about problems with Securance's compliance and reporting systems in the past. Possessing this knowledge, the Officer Defendants failed to sufficiently examine an extraordinary 80% increase in earnings from 2004 to 2005. This "set of facts" is more than adequate to state a claim for conscious failure by the Officer Defendants to monitor Securance's operations.

This failure to monitor inference is created by the allegations that: (1) the Officer Defendants possessed knowledge that there were problems with Securance's reporting and compliance systems in the past; (2) Securance operated in a highly regulated industry with typically slim profit margins; (3) each of the senior managers who pleaded guilty to conspiracy to commit Medicaid fraud reported directly to one or more of the Officer defendants, and (4) the Officer Defendants failed to examine or verify more closely a large boost in profits following these failures in the Company reporting system. (Compl. ¶¶ 16, 31, 43, 58.)

This Court should hold that the Plaintiff's complaint has met the 12(b)(6) pleading standard based on the reasons stated above. This Court should therefore reverse the decision of the Chancery Court, and remand the case for a trial on the merits.

CONCLUSION

Plaintiff's complaint alleges particularized facts sufficient to create a reason to doubt that the Securance Board of Directors could have properly exercised its independent and disinterested business judgment in responding to a demand under Chancery Rule 23.1. Further, the well-pleaded allegations of the complaint adequately state a claim for relief under Chancery Rule 12(b)(6). Accordingly, Plaintiff respectfully requests this Court reverse the Chancery Court and remand the case for trial on the merits.

Team I

/s/

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Date Filed: February 17, 2009

APPENDIX

§ 102. Contents of certificate of incorporation.

(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.

Rule 12. Defenses and objections -- When and how presented -- By pleading or motion -- Motion for judgment on pleadings.

(b) How presented. -- Every defense, in law or fact, to a claim for relief in any pleading, whether a claim, counterclaim, cross-claim or third-party claim, shall be asserted in the responsive pleading thereto if one is required, except that the following defenses may at the option of the pleader be made by motion: (1) Lack of jurisdiction over the subject matter, (2) lack of jurisdiction over the person, (3) improper venue, (4) insufficiency of process, (5) insufficiency of service of process, (6) failure to state a claim upon which relief can be granted, (7) failure to join a party under Rule 19. A motion making any of these defenses shall be made before pleading if a further pleading is permitted. No defense or objection is waived by being joined with 1 or more other defenses or objections in a responsive pleading or motion. If a pleading sets forth a claim for relief to which the adverse party is not required to serve a responsive pleading, the adverse party may assert at the trial any defense in law or fact to that claim for relief. If, on a motion asserting the defense numbered (6) to dismiss for failure of the pleading to state a claim upon which relief can be granted, matters outside the pleading are presented to and not excluded by the Court, the motion shall be treated as one for summary judgment and disposed of as provided in Rule 56, and all parties shall be given reasonable opportunity to present all material made pertinent to such a motion by Rule 56.

Rule 23.1. Derivative actions by shareholders.

(a) In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.