

THE SUPREME COURT OF THE STATE OF DELAWARE

No. 27, 2009

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

APPEAL FROM THE COURT OF CHANCERY OF THE STATE OF DELAWARE

BRIEF FOR APPELLANT

Team J
Counsel for Appellant

Filed February 17, 2009

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NATURE OF PROCEEDINGS

This case is on appeal from the Court of Chancery decision granting Defendants' motion to dismiss pursuant to Court of Chancery Rules 23.1 and 12(b)(6). *Marshall v. Saligman*, Del. Ch., No. 3892-CS, at 1, Siegel, Ch. (Jan. 6, 2009).

SUMMARY OF THE ARGUMENT

I. In a derivative action, a shareholder adequately pleads that pre-suit demand is excused for futility where directors cannot exercise an impartial business judgment. Plaintiff Marshall has pleaded facts sufficient to establish the directors are not disinterested because they face a "substantial likelihood" of personal liability and the undue influence of a dominant fiduciary.

II. As agents to the corporation, officers owe a standard of ordinary care to the corporation. Plaintiff Marshall pleaded facts sufficient to give rise to liability on behalf of the non-director Officer Defendants.

III. If applying the standard applicable to directors, a breach of fiduciary duty requires bad faith. Plaintiff Marshall pleaded facts that can establish bad faith on behalf of the non-director Officer Defendants.

STATEMENT OF THE FACTS

Fraudulent acts committed by several of Securance Inc.'s senior managers forced the corporation to pay \$400 million in criminal penalties, \$120 million in refunds to defrauded state agencies, and have erased \$3 billion of its market capitalization. Compl. ¶ 2. Additionally, the company's future earnings will decrease because Securance's plea agreement with federal and state authorities forbids it from doing business for three years in states that have accounted for forty percent of its annual premium revenue. Compl. ¶¶ 10, 16.

The senior managers responsible for the fraud are serving two-year prison sentences. Compl. ¶ 15. In their plea agreements, the senior managers stated that they acted with the support of Securance's senior officers. Compl. ¶ 31. At issue in this case is the Securance board of directors' record of company oversight, the likelihood that the board will bring a claim against Securance senior officers who may have directed the illegal conduct, and the validity of a derivative claim against those officers. Plaintiff-Appellant Clare Marshall is asking this Court to reverse the Court of Chancery's decision.

The senior managers orchestrated their fraud by manipulating the data the company reported to state agencies. Compl. ¶ 20. Securance, a for-profit, managed health care company that provides services to Medicare and Medicaid recipients, has agreements with the states in which it operates to refund premiums to the states if the amount of premium revenue it spends on direct medical costs falls below a certain threshold. Compl. ¶¶ 14, 15. The three implicated senior managers routed unspent Medicaid premiums to a Cayman Islands

subsidiary and then mischaracterized the transferred funds as direct medical costs in filings with state regulators in Ohio, Pennsylvania, New York, and New Jersey. Compl. ¶¶ 22, 23. Securance was then able to report an additional \$120 million in income from 2005 to 2007 that it should have refunded. Compl. ¶ 24.

The senior managers did not identify which Securance senior officers supported their conduct. Compl. ¶ 31. It is undisputed, however, that two of the Officer Defendants in this case supervised the departments of two of the implicated senior managers, and that the third Officer Defendant worked closely with all three of the implicated senior managers in their preparation of the company's Medicaid reports to state agencies. Compl. ¶ 31.

The fraud at issue in this case occurred against a backdrop of other regulatory troubles for Securance. In 2004, state investigators in Connecticut and Virginia examined claims that the company was systematically denying medical services to indigent and disabled enrollees to boost profits. Compl. ¶ 40. After initially denying the allegations, Securance entered into court-approved consent decrees with each state promising to comply with applicable law. Compl. ¶ 41.

Plaintiff Marshall filed this claim following the Medicaid fraud. The court below granted defendants' motion to dismiss the derivative complaint pursuant to Court of Chancery Rules 23.1 and 12(b)(6) for, respectively, failure to adequately plead that pre-suit demand was excused, and failure to state a claim. *Marshall v. Saligman*, Del. Ch., No. 3892-CS, at 1, Siegel, Ch. (Jan. 6, 2009). Plaintiff Marshall appealed and is now asking this Court to reverse.

ARGUMENT

- I. Plaintiff Marshall adequately pleaded demand excused for futility because the Securance directors are personally interested in the outcome of this litigation and a dominant fiduciary prevents the board from exercising impartial business judgment to decide whether to pursue the claim.

Question Presented: Whether a board of directors in the presence of red flags indicating suspicious activity and a dominant fiduciary can exercise impartial business judgment requiring pre-suit demand in a derivative action. Compl. ¶ 41. In the interest of justice, pursuant to Rule 8 of the Supreme Court of Delaware, this Court must consider the possibility that defendant Saligman's influence over the board of directors as a dominant fiduciary nullifies the board's impartiality. Compl. ¶ 5.

Scope of Review: The review of a dismissal of a derivative complaint is *de novo*. *Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008).

In order to bring a derivative suit when a shareholder has not made a demand upon a board of directors to pursue a claim, the shareholder must establish that a pre-suit demand would be futile because of the directors' inability to exercise impartial business judgment. *Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993). When the cause of action for a derivative suit arises out of the directors' failure of oversight rather than a specific business decision, this Court applies the *Rales* standard for pleading demand futility. *Wood*, 953 A.2d at 140. To meet this standard, a plaintiff must "allege particularized facts establishing a reason to doubt that 'the board of directors could have properly exercised its independent disinterested business judgment in responding to a demand.'" *Id.* (quoting *Rales*, 634

A.2d at 934). A plaintiff may raise such a doubt by demonstrating that a "substantial likelihood" of personal liability exists for the board of directors. *Rales*, 634 A.2d at 936. While plaintiffs must generally show that a majority of a board is interested, the presence of a dominant fiduciary can also raise doubts about the disinterestedness of the board of directors. See *Aronson v. Lewis*, 473 A.2d 805, 815-16 (Del. 1984)(overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000)). When a derivative complaint provides reason to doubt the independence of the board of directors in these ways, a plaintiff establishes demand futility under Court of Chancery Rule 23.1.

A. The directors are not disinterested in the claim pursued by Plaintiff Marshall because the directors face a substantial likelihood of personal liability for breach of their fiduciary duties.

The Securance directors face a "substantial likelihood" of personal liability because they breached the fiduciary duty of loyalty to fulfill their oversight responsibilities in good faith. Compl. ¶ 2. In most circumstances, corporate boards cannot be held accountable for assuming the honesty of their employees, and as a result, only a "sustained or systematic failure of the board to exercise oversight" gives rise to the "lack of good faith that is a necessary condition to [oversight] liability." *Stone v. Ritter*, 911 A.2d 362, 368-69 (Del. 2006)(quoting *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 971 (1996)).

In order to assess whether such a failure exists, this Court must find that "(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, disabling themselves from being informed of risks or problems requiring their attention." *Stone*, 911 A.2d at 370. However, the test articulated in *Stone* applies only when "there [are] no 'red flags' before the directors." See *id.* at 364, 373. The application of the *Stone* test by the court below was inappropriate because there are red flags in this case.

1. *In the presence of red flags, a showing that the Securance directors had notice of suspicious activity establishes the lack of good faith required for oversight liability.*

To establish directors' liability for failure of oversight in cases in which a plaintiff alleges the existence of red flags, the plaintiff must show that the directors "knew or should have known that violations of the law were occurring." *Stone*, 911 A.2d at 364. The demanding standard for oversight liability established in *Caremark* and further articulated in *Stone* "is predicated upon [directors'] ignorance of liability creating activities..." *Caremark* 698 A.2d at 971. The presence of a red flag, however, provides a basis for which a board should "suspect deception." *Id.* at 969. Moreover, if "something occurs to put [the directors] on suspicion that something is wrong... and [the warning] goes unheeded," then directors are likely to be liable for a failure of oversight. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

Stone's more rigorous standard is only applicable when the board lacks notice of suspicious activity in the form of red flags. *Stone*, 911 A.2d at 364, 373; *Caremark*, 698 A.3d at 971. Therefore, because of the presence of red flags in this case, Plaintiff Marshall must only show that the Securance directors knew or should have known about

suspicious activity to show a violation of their oversight duties.
Stone, 911 A.2d at 364.

2. *The Securance directors face a substantial likelihood of personal liability because the 2004 consent decrees constituted a red flag of suspicious activity.*

The regulatory charges Securance faced in 2004 in Connecticut and Virginia were a red flag indicating that the directors knew or should have known that suspicious activity was occurring. Compl. ¶¶ 39, 44. Evidence of a red flag that goes unheeded gives rise to an inference that the directors "consciously and in bad faith ignored... improprieties" in breach of their oversight duties. *Wood*, 953 A.2d at 143. A red flag must actually come to the attention of the board to support oversight liability. *In re Citigroup Inc. S'holder Litig.*, 2003 WL 21384599, at *3 (Del. Ch.). When directors have "ignored either willfully or through inattention *obvious danger signs* of employee wrongdoing, the law will place the burden of liability upon [them]." *Allis-Chalmers*, 188 A.2d at 130 (emphasis added).

A consent decree may constitute a red flag giving rise to oversight liability when the directors have actual knowledge of the decree and fail to determine whether the activity it enjoins was actually committed. See *Allis-Chalmers*, 188 A.2d at 129. In *Allis-Chalmers*, the consent decree offered as a red flag involved antitrust violations, but it had occurred more than nineteen years earlier under a different board of directors. *Id.* Moreover, when three of the current directors learned of the consent decrees, they took steps to assure themselves that Allis-Chalmers had not engaged in the antitrust violations alleged. See *id.* As a result, this Court found that such a

dated consent decree could not provide a red flag of suspicious activity to the current Allis-Chalmers board of directors.

In this case, the 2004 consent decrees serve as a red flag giving rise to a likelihood of oversight liability for the Securance board because of the proximity of the consent decrees to the current litigation and the failure of the board to determine whether the activities enjoined by the decrees were actually committed. In 2004, during the tenure of the current board of directors, Connecticut and Virginia began investigating Securance for regulatory compliance problems, including offering improper incentives to doctors to deny needed services to Medicaid patients in order to generate larger profits. Compl. ¶ 40. Securance eventually entered into court-approved consent decrees requiring that Securance comply with regulations and pay \$100,000 to each state. Compl. ¶ 42.

Unlike in *Allis-Chalmers*, the Securance directors had actual knowledge of the consent decrees, which occurred a year prior to the beginning of the regulatory violations at issue in this litigation. In addition, though Securance admitted no wrongdoing, the directors did not, as in *Allis-Chalmers*, attempt to make a determination whether wrongdoing occurred. Moreover, the payment of a fine suggests a greater probability of actual employee misconduct. The failure of the Securance directors to take any action to assure greater oversight of regulatory compliance in the wake of the consent decrees ultimately amounts to a substantial likelihood of oversight liability.

Furthermore, changes in Securance's net profits and stock price following the 2004 consent decrees constituted additional red flags

that should have put Securance's board on notice that the corporation's employees were engaging in illegal activity. Despite a dip in the Medicaid industry between 2005 and 2008, Securance's net income more than doubled, its stock price went from \$52 to \$110 per share, and its performance was lauded as the "top...in the industry." Compl. ¶¶ 25-26. In light of the decrees and the overall state of the Medicaid industry, Securance's relatively sudden success provided the board with another signal to investigate its management's practices for irregular conduct.

The board's failure to effectively increase its oversight in the aftermath of the 2004 consent decrees and subsequent dramatic increase in the company's performance was a breach of the duty of loyalty, and therefore exposes the board to a substantial likelihood of liability. This Court should excuse Plaintiff Marshall's demand as futile because she has "allege[d] particularized facts establishing a reason to doubt that the board of directors could have properly exercised its independent disinterested business judgment in responding to [her] demand." *Rales*, 634 A.2d at 934.

B. The directors are not disinterested in the claims pursued by Plaintiff Marshall because Defendant Saligman is a dominant fiduciary in his role as chairman of the board.

Saligman's influence as a dominant fiduciary nullifies the board's ability to make an impartial business judgment about Plaintiff Marshall's demand. The failure of the court below to consider this influence is a reversible error. To label a director a dominant fiduciary, plaintiffs must first identify the director's relevant personal interests, and then analyze whether his influence over the

board is significant enough to nullify the board's impartial business judgment. *Grobow v. Perot*, 539 A.2d 180, 186 (Del. 1988). Saligman's leadership positions as the chairman of the board and chief executive officer of Securance, combined with his personal liability in the present claim against as an Officer Defendants, create a reasonable doubt that "at the time the complaint was filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to the demand." *Rales*, 634 A.2d at 936. Plaintiff Marshall's demand should be excused as futile because of Saligman's nullification of the board's impartial business judgment.

1. *Defendant Saligman is personally interested in Plaintiff Marshall's claims against the Officer Defendants because of his dual leadership positions as officer and director.*

While labeling a director personally interested is "essentially a discretionary ruling on a predominantly factual issue," there are factors Delaware courts use in their analysis, including asking whether the alleged dominant fiduciary is at risk of personal liability; maintains a position of power over the board (*Rales*, 634 A.2d at 936); gained unique financial benefit from the questionable transactions (*Steiner v. Meyerson*, 1995 WL 441999, *9-10 (Del. Ch.)); or acts as legal or financial advisor to the corporation. *Friedman v. Beningson*, 1995 Del. LEXIS 154, at *12 (Del. Ch.). While these factors do not independently create a reason to doubt a director's independence, a combination of them can. In cases in which several of the factors are present, a shareholder's demand is excused as futile because any exercise of a board's business judgment is nullified for

want of neutrality. *Heineman v. Datapoint Corp.*, 611 A.2d 950, 952 (Del. 1992).

Directors are more likely to lose their independence, and subsequently their ability to make impartial business judgments, when they are also corporate officers. In *Steiner*, the court found that a defendant's position on the board and as CEO of Telxon created a reason to doubt his ability to respond to "the merits of [a] demand letter." *Steiner*, 1995 WL 441999 at *9-10. In holding that the defendant's combined positions made him personally interested, the court echoed *Rales*' reasoning: "an officer/director [is] considered to lack independence if, at the time demand would have been made, the party benefiting from the transaction is in a position to exert considerable influence over the" board. *Rales*, 634 A.2d 936.

Like the defendant in *Steiner*, Saligman's dual positions as chairman and CEO, together with his potential personal liability as an Officer Defendant, provide reason to doubt his impartiality in considering a demand letter from Plaintiff Marshall.

2. Defendant Saligman is a dominant fiduciary because his influence over the board of directors prevents the board from exercising an impartial business judgment.

Once a director's personal interests have been identified, courts must consider the possibility that he has undue influence over the rest of the board. *Rales*, 634 A.2d at 936. In cases of personally interested directors, a board's business judgment is most clearly nullified when a personally interested director is also chairman of the board. *Id.* In *Rales*, the Rales brothers were categorized as personally interested directors because of their imminent personal

liability and independent financial interest in the questioned transactions. *Id.* The Court also held that the brothers' positions as leaders of their respective boards was sufficient to prove they were dominant fiduciaries, nullifying the boards' impartial business judgment. *Id.*

In cases in which a director in a leadership position is interested, those over whom he has direct financial control are also interested. In *Rales*, the Court found that the positions of the Rales brothers as chairman of the board and chairman of the executive committee raised a reasonable doubt regarding the CEO's independence because the Rales brothers signed his paycheck. *Rales*, 634 A.2d 937. The Court found Sherman personally interested, and held that the influence of an interested director over other fiduciaries can destroy those fiduciaries' business judgment. *See id.*

As the chairman of Securance's board, Saligman is both a personally interested director and a dominant fiduciary. Like the Rales brothers' effect on their CEO, Saligman's influence as an interested director renders the remaining officer/director defendants personally interested because Saligman is their boss. As a result of this influence, the number of personally interested directors on Securance's board increases to three, just one shy of a majority.

Saligman's position as chairman of Securance's board also makes his influence over the remaining directors likely. Like the Rales brothers, Saligman's liability and financial interest in the present litigation, combined with his position as the board's chairman, create

a reasonable doubt that the board can exercise its impartial business judgment regarding the officers' liability.

Significant policy interests also favor allowing derivative suits against chairman/CEO defendants to continue without board approval. "More than twenty-five years ago, the Delaware Supreme Court raised the question whether inquiry into independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse. Now...the answer is clear...the inquiry is inadequate." Anthony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. Ill. L. Rev. 237, 293 (2009). In light of continuing corporate scandals, in cases in which a chairman is interested, courts should allow different decision makers to carry the burden of litigation. *Id.* at 240.

The importance of shareholder protection from dominant fiduciary influence supports the implementation of a clear rule excusing the demand requirement when an interested chairman is subject to litigation. As suggested by Delaware precedent and commentators, regardless of claims of independence, boards with potentially liable chairmen are unlikely to be able to exercise impartial business judgment. Saligman's personal liability as an Officer Defendant and his leadership position on Securance's board casts a shadow over the rest of the board. Even if the Court finds that Saligman is disinterested and therefore did not act as a dominant fiduciary, policy favors reversing the court below and allowing the suit to proceed.

II. Plaintiff Marshall pleaded facts sufficient to establish negligence by non-director Officer Defendants to state a claim for breach of their fiduciary duties as agents of Securance.

Question Presented: Whether negligence by the non-director Officer Defendants, as agents of Securance's board of directors, constitutes a breach of their fiduciary duties that gives rise to liability under agency law. In the interest of justice pursuant to Rule 8 of the Supreme Court of Delaware, this Court must clarify the ambiguity as to whether non-director Officer Defendants should be held to an agency standard for breaches of fiduciary duties.

Scope of Review: The review of a dismissal resulting from a Court of Chancery Rule 12(b)(6) motion is *de novo*. *Feldman v. Cutaia*, 951 A.2d 727, 730-31 (Del. 2008). When reviewing a 12(b)(6) motion, a plaintiff is entitled to "the benefit of all reasonable inferences." *Superwire.com, Inc. v. Hampton*, 805 A.2d 904, 908 (Del. Ch. 2002) (internal quotation marks and citation omitted).

Securance's officers breached their duties to Securance by failing to execute their duties with ordinary care, as required by agency law. Delaware law is sparse on the issues of the fiduciary duties of non-director officers and the standard of review that should apply to their actions. Principles of agency law, however, 1) clearly define those duties, and 2) prohibit the same kind of judicial deference to non-director officer actions that courts – via the business judgment rule – apply to the actions of directors. Therefore, Plaintiff Marshall states valid claims against the non-director officers, and the Court must reverse the lower court's dismissal.

A. The non-director officers breached fiduciary duties to Securance established by agency law.

The non-director Officer Defendants breached their fiduciary duties to Securance either by directing the senior managers to engage in criminal conduct or by failing to monitor the senior managers. Admittedly, Delaware courts have never thoroughly explored the duties officers owe to corporations. Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 Wm. & Mary L. Rev. 1597, 1600, 1609-10 (2005). Courts normally group officers and directors together, drawing no distinction between their different roles within the corporation. *See, e.g., Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939); *In re Walt Disney Co.*, 2004 WL 2050138, at *3 (Del. Ch.). Corporate law treatises generally employ the same analysis. *E.g.*, 3 William Meade Fletcher, *Fletcher Cyclopedia of the Law of Private Corporations* §§ 837.50, 991 (rev. vol. 2002).

While commentators disagree about what judicial standard of review should apply to non-director officers, they notably do agree about the source of officers' fiduciary status: agency law. Johnson & Millon, *supra*, at 1601; A. Gilchrist Sparks III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 Bus. Law. 215, 220, 225-26 (1992). Agents have duties, among others, to act loyally in service to the principal, to act with the care, competence, and diligence normally exercised by agents situated similarly, and to act within the scope of authority granted by the principal. Restatement (Third) of Agency §§ 8.01, .08, .09 (2006).

This Court has employed the agent analogy in another context. In *Science Accessories Corp. v. Summagraphics Corp.*, the Court held that three employees had not violated their duty of loyalty to their

corporate employer when they left the corporation to start a competing company. 425 A.2d 957, 964 (Del. 1980). In reaching its conclusion, the Court applied the corporate opportunity doctrine – a test used to determine whether an employee has taken advantage of an opportunity that belonged to the corporation – and noted that the doctrine “is but application of agency fiduciary law in a particular corporate fact setting.” *Id.* While the former employees were not officers, the Court reasoned that the “principles and limitations of agency law carry over into the field of corporate employment so as to apply not only to officers and directors but also to key managerial personnel.” *Id.* at 962. The Court also applied agency principles to hold that the employees had not breached their duty to inform their former employer about the product that their new company was developing. *Id.* at 964.

Applying agency principals in the case at bar, the non-director officers breached their fiduciary duties to Securance by either 1) sanctioning the illegal acts committed by the senior managers, or 2) failing to properly monitor the senior managers.

If the non-officer directors sanctioned the illegal actions of the senior managers, they breached their duty to act within the scope of the agency relationship with the principal – in this case, the corporation as represented by the board of directors – and to refrain from conduct likely to damage the principal’s enterprise. Restatement (Third) of Agency § 8.10 (2006). In their plea agreements, the senior managers stated that they acted with the express or implied support of unidentified senior officers of Securance in their efforts to commit Medicare fraud. Compl. ¶ 31. Two of the non-director officers

supervised the departments in which two of the implicated senior managers worked; and the third non-director officer worked closely with the senior managers in their preparation of the company's Medicaid reports to state agencies. *Id.*

Additional discovery in this case could very well yield the revelation that the Officer Defendants directed the fraud in question. If that is the case, the officers were plainly operating outside of the bounds of the authority bestowed on them by the board, and in doing so, they harmed the company's enterprise by involving it in criminal conduct. At this stage in the litigation, given the senior managers' statements and the need for further investigation, Plaintiff Marshall has pleaded facts sufficient to state a claim against the Officer Defendants for breaching their duties to Securance by directing the senior managers to engage in criminal conduct.

If the non-director officers did not sanction the senior managers' criminal conduct, they still breached their duty to act with the care, normally exercised by agents in similar circumstances. Restatement (Third) of Agency § 8.08 (2006). As mentioned above, the Officer Defendants either supervised the implicated senior managers or worked closely with them. Compl. ¶ 31. Given the Officer Defendants' positions as the company's chief operating officer, chief legal officer, and chief accounting officer, proper monitoring would have uncovered the fraud. Numerous red flags were present: the company's previous regulatory troubles (Compl. § 40), the sudden change in medical loss ratios (Compl. ¶¶ 22, 23), and the dramatic rise in net income. Compl. ¶ 25. Given these red flags, the high-ranking Officer

Defendants' failure to uncover the fraud amounts to a failure to act with the care expected of agents in their positions. At this stage in the litigation, given the obvious breakdown in the company's internal controls, Plaintiff Marshall has pleaded facts sufficient to state a claim against the Officer Defendants for breaching their duties to Securance by failing to properly monitor their subordinates.

Notwithstanding the dearth of material in Delaware case law on officers' duties to the corporation, recognizing their role as agents is critical to a better understanding of the corporate enterprise. To place directors and officers under the same umbrella of fiduciary duties is to misunderstand their unique roles. Johnson & Millon, *supra*, at 1605. Elected by shareholders, directors are vested with the power to manage the affairs of their principal, the corporation. The directors then delegate their managerial authority to agents of the corporation. If the officers, as agents, breach any of the duties that they owe to the corporation, as principal, the board of directors, acting on behalf of the principal, can seek redress from the officers. Grouping directors and officers together improperly collapses the standard corporate governance structure into one broad category of "management." *Id.* at 1626-27.

By either sanctioning the criminal conduct of the senior managers, or by failing to monitor the incarcerated senior managers, the non-director officers breached their fiduciary duties as agents of Securance. Accordingly, Plaintiff Marshall states valid claims against the Officer Defendants.

B. Because of their role as agents of Securance, the non-director Officer Defendants must be held to a negligence standard for

breach of fiduciary duty, rather than the lenient standard afforded directors.

The Court must not shield the non-director Officer Defendants – who have violated an ordinary negligence standard of care derived from agency law – by applying the same deferential standard of review that it applies to the actions of directors.

The lower court correctly noted that Delaware law is silent on the question of whether the *Stone* test for director oversight liability also applies to non-director officers. *Marshall v. Saligman*, Del. Ch., No. 3892-CS, at 26-27, Siegel, Ch. (Jan. 6, 2009). Under the *Stone* test, a plaintiff alleging demand futility in a derivative action must plead facts creating a reasonable doubt that at the time the complaint is filed “the board of directors could have properly exercised its independent and disinterested business judgment in respond to a demand.” *Stone*, 911 A.2d at 367 (quoting *Rales*, 634 A.2d at 934). To establish potential director liability that would compromise the directors’ judgment about whether to pursue an oversight claim in a derivative complaint, a plaintiff must show either that “1) the directors failed to implement internal controls, or 2) the directors consciously failed to monitor the corporation using internal controls previously implemented.” *Stone*, 911 A.2d at 370 (quoting *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003)).

The lower court also correctly noted that the question of the proper test for officer oversight liability is analogous to the question of whether courts should apply the business judgment rule to officers in the same manner in which they apply the rule to directors. *Marshall*, No. 3892-CS, at 27. Delaware courts generally describe the

business judgment rule as a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson*, 473 A.2d at 812. The standard of care required by the rule is a gross negligence standard. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 364 n.31 (Del. 1993). As with the issue of non-director officers' fiduciary duties, Delaware case law is generally silent on the application of the rule to such officers. Commentators disagree on the matter. See, e.g., Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 Bus. Law. 439 (2005); Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 Bus. Law. 865 (2005).

Corporate governance principles militate strongly against applying either the *Stone* test or the deferential, director version of the business judgment rule to non-director officers. Applying the same standard of review to both officers and directors would ignore the agency law principles detailed above, blurring the distinct roles that the two groups play in the corporate structure. Holding non-director officers to a simple negligence standard, on the other hand, would comport with those agency principles and set Delaware law on a path that correctly distinguishes between officers and directors.

The tendency of Delaware courts to group officers and directors together when reviewing corporate decision-making is most clearly on display when they deploy the business judgment rule. This Court, for example, in cases involving *only* directors, regularly states that the

rule applies to both officers and directors. *E.g., Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995); *Cede*, 634 A.2d at 361. But the Court has never held that the rule applies to officers acting only in their capacity as officers. *Johnson, supra*, at 443.

The primary source of support for identically applying the rule to officers and directors is secondary authority. The American Law Institute applies the rule in the same manner to both directors and officers. *Principles of Corporate Governance: Analysis and Recommendations* § 4.01(c) (1994). The Model Business Corporation Act does the same. 2 *Model Bus. Corp. Act Ann.* § 8.42 cmt. (3d ed. Supp. 1998/99). Admittedly, ALI's Principles and the MBCA are highly regarded sources of corporate law. But both reach their conclusions about the business judgment rule without any direct support from Delaware case law. *Johnson, supra*, at 441-43. They instead rely on corporate law treatises, dicta, and language from cases that did not involve non-director officers. *Id.*

The true thrust of the business judgment rule is to prevent courts from retroactively examining the *substance* of a business decision to conclude that a director did not exercise due care. *Id.* at 463. Applying this rationale to officers, the rule would still broadly protect officers' substantive judgment, but it would not relieve them of their duty, derived from agency law, to exercise due care in the execution of their jobs. That officers face the potential for greater liability is an unavoidable byproduct of their status as agents. Officers, unlike directors, work for the corporation full time, are immediately privy to material corporate information, and possess a

level of knowledge of the business that only employees in their positions could possess. *Id.* at 460. Even commentators who oppose applying a different version of the rule to officers acknowledge that application of the rule "to facts that demonstrate greater intimacy with corporate affairs may be more likely to result in liability." Sparks & Hamermesh, *supra*, at 218-19 (citing 2 Model Bus. Corp. Act Ann. § 8.42 cmt. (3d ed. 1985 & Supp. 1990)).

If the non-director officers failed to properly monitor the senior managers, thus breaching the agency duty of care, they must face liability for simple negligence. Using a more deferential standard of review to dismiss the claim, as the lower court did, is inappropriate, and this Court must reverse.

Even if this Court decides that a more deferential standard applies to the non-director officers, Plaintiff Marshall's claim must still survive dismissal. At this stage in the litigation, Plaintiff Marshall has pleaded facts sufficient to state a claim that the non-director officers sanctioned the senior managers' criminal conduct. Compl. ¶ 31. Such conduct is outside of the authority delegated by the board of directors. Restatement (Third) of Agency § 8.10 (2006). On this point, even critics of applying the business judgment rule to officers concede that the rule should not be used to shield officers from liability for acting outside the scope of their delegated authority. Hamermesh & Sparks, *supra*, at 876. In a case such as this, involving officers' potentially criminal conduct, a more deferential standard is not appropriate. This Court must reverse.

III. Plaintiff Marshall pleaded facts sufficient to state a claim against the non-director Officer Defendants for breach of their duty of loyalty by acting in bad faith.

Question Presented: Whether the non-director Officer Defendants breached their duty of loyalty to Securance through actual or implied approval of the Medicaid fraud, or through the conscious dereliction of their duties.

Scope of Review: The review of a dismissal resulting from a Court of Chancery Rule 12(b)(6) motion is *de novo*. *Feldman v. Cutaia*, 951 A.2d 727, 730-31 (Del. 2008). When reviewing a 12(b)(6) motion, a plaintiff is entitled to "the benefit of all reasonable inferences." *Superwire.com, Inc. v. Hampton*, 805 A.2d 904, 908 (Del. Ch. 2002) (internal quotation marks and citation omitted).

The court below erred in holding that the complaint did not allege facts sufficient to sustain a breach of loyalty claim against the Officer Defendants. Under the standards established in *In re Walt Disney Co.*, the non-director officers breached their duty of loyalty to Securance by acting in bad faith, either by directing the senior managers to engage in criminal conduct or by failing to monitor the senior managers. 906 A.2d 27, 64-67 (Del. 2006).

The duty of good faith, included in the larger duty of loyalty, is meant to serve as a "constant reminder...that, regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for mandatory damages for any harm he causes, even if for a reason other than personal pecuniary interest." *Nagy v. Bistricher*, 770 A.2d 43, 48 n.3 (Del. Ch. 2000) (internal quotation marks omitted); *Stone*, 911

A.2d at 370. Because "corporate officers...are not permitted to use their position of trust and confidence to further their private interests," no split in loyalties is permitted: whenever a corporate director or officer places private interests before the interests of the corporation, bad faith is present. *Id.*

As set out in *In re Walt Disney*, a corporate officer acts in bad faith when he or she: 1) takes action with the intent to harm the corporation; or 2) intentionally disregards duties to the corporation, suffers harm as a result. 906 A.2d 64-67. Breaching the duty of loyalty by acting in bad faith deprives officers of the deferential review of the business judgment rule, assuming *arguendo*, that the rule even applies to officers. *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001). If such breaches of duty exist, then the burden shifts to the officer to prove his decisions were entirely fair. *Id.*

The Officer Defendants acted in bad faith toward Securance, and thus lost the benefit of any deferential review by this Court, when they offered "express or implied support" of the senior managers' Medicaid fraud. Compl. ¶ 31. In support of the managers' assertions in their plea agreements, the initial criminal investigation by the states' Medicaid Fraud Control Units produced evidence that the fraud "permeated the Company's operations and could not have been the work of low-level employees." Compl. ¶¶ 28-29. Therefore, it is likely that further discovery would produce more concrete evidence of the officer-defendants' direct involvement in the fraud.

Alternatively, Securance's Officer Defendants breached their duty of good faith by consciously disregarding their fiduciary duties and

willfully turning a blind eye to the actions of the incarcerated managers. By promoting a "profits by any means" attitude, Securance's officers lost sight of their loyalty to Securance and intentionally created a work environment that valued net profits over the company's long-term well-being. Compl. ¶ 17.

After the consent decrees were issued in 2004, Securance's officers were on notice that there was some level of malfeasance and disregard for company policy in the lower ranks of the company. Once the overcharging was uncovered, the Officer Defendants had an increased duty to monitor their employees' actions. Failure to more closely monitor the incarcerated managers was a willful dereliction and breach of the duty of loyalty.

CONCLUSION

For the foregoing reasons, this Court must reverse the decision of the Court of Chancery granting the Defendant's motion to dismiss pursuant to Court of Chancery Rules 23.1 and 12(b)(6).