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NATURE OF THE PROCEEDINGS

This case comes before the court as an appeal of the Court of Chancery's January 6, 2009 Order granting the defendants motion to dismiss the Complaint pursuant to Court of Chancery Rules 12(b)(6) and 23.1. On January 16, 2009, the Appellant appealed that decision to the Supreme Court of the state of Delaware.

SUMMARY OF THE ARGUMENT

This court should reverse the Court of Chancery's decision to dismiss this case and remand it to be decided on the merits. The facts in this case were sufficient to survive both Motions to Dismiss.

The Complaint alleges sufficient facts to support a claim upon which relief can be granted, so the Court of Chancery erred in granting the Appellees' Rule 12(b)(6) Motion to Dismiss. A claim is deemed insufficient and a motion to dismiss should be granted only when it is clear that a plaintiff would not be entitled to relief based on any set of facts alleged to support the action. In this case, the Appellees ignored numerous red flags, breaching their fiduciary duty of loyalty by failing to attempt, in good faith, to protect Securance's best interests. Based upon the red flags alleged in the Complaint, the Appellees knew or should have known and, therefore, had constructive knowledge of the liability-creating activities being carried out by the corporation's employees. Furthermore, regardless of whether the court applies an "intent" standard or a "gross negligence" standard to impose fiduciary duty, the Appellant has shown a substantial likelihood that a breach occurred. Consequently, the

Appellee has alleged a claim for which relief can be granted, so dismissal under Rule 12(b)(6) is inappropriate.

The Complaint also alleges sufficient facts to establish demand futility, so the Court of Chancery erred in granting the Appellees' Rule 23.1 Motion to Dismiss. Pursuant to this Court's interpretation of Rule 23.1, demand is excused as futile where sufficient facts are alleged to establish a reasonable doubt that the board of directors could consider pre-suit demand with independence and disinterest. As indicated in the previous paragraph, the Complaint alleges sufficient facts to support a claim that the Securance directors breached their fiduciary duty of loyalty in failing to properly oversee the company's employees. The existence of this claim establishes a substantial likelihood that the directors may be held personally liable for the company's resulting losses. Such potential personal liability prevents the directors from impartially considering the merits of the present suit. As a result, demand was futile and the Court of Chancery should never have granted the Defendants' Rule 23.1 Motion to Dismiss.

STATEMENT OF FACTS

Securance, Inc. ("Securance") is a publicly traded, for-profit Delaware health maintenance organization ("HMO") serving Medicaid and Medicare recipients. (Compl. ¶7). The Appellant, Clare Marshall, is, and at all relevant times was, a stockholder of Securance. (Compl. ¶13). The Appellees are, and at all relevant times were, the seven members of Securance's Board of Directors (the "Securance Board"), and the company's three most senior non-director officers. (Compl. ¶13-4)

Under state law and the terms of its Medicaid contracts, Securance's medical loss ratio ("MLR"), which is the percentage of total premiums that the company must spend on direct medical care for its Medicaid enrollees, is eighty percent. (Compl. ¶14-15). If an HMO spends less than its MLR on direct medical care, it must refund to the state the difference between its direct care expenses and the MLR. (Compl. ¶15). If an HMO's MLR exceeds eighty percent, the company must absorb the excess loss. *Id.* The remaining twenty percent of Medicaid premiums provide for each company's overhead and administrative expenses and for profits. (Compl. ¶16). As a result of this regulatory system, for-profit HMOs generally suffer thin profit margins and low rates of earning growth. *Id.*

In 2003, the Securance Board approved an Incentive Compensation Plan which provided bonus compensation to management based on the operating profits of each business segment, thereby creating incentives for senior executives to inflate the results of their business segment. (Compl. ¶38). Additionally, in 2004, Securance entered into consent decrees and paid a \$200,000 in fines to settle allegations that the company had offered improper financial incentives and bonuses to doctors in return for the doctors denying diagnostic and specialist services to Medicaid enrollees, in order to maximize Securance's profits. (Compl. ¶39-42). The Defendants all were aware of the 2003 Incentive Compensation Plan and the 2004 investigations and consent decrees, but none insisted on restructuring or reinvigorating the existing compliance system. (Compl. ¶44).

In 2004, Securance reported only \$49 million in net income on approximately \$1.4 billion in revenue, which is a profit margin of only 3.5%. (Compl. ¶16). Beginning in January 2005, however, profits sky-rocketed. The company reported profits of \$88 million in 2005, nearly double the amount reported in 2004. (Compl. ¶25). The increase continued in 2006, when the company reported net income of \$95 million, and in 2007, when it reported net income of \$104 million. *Id.*

Following this profit surge, a joint investigation by regulators from Ohio, Pennsylvania, New York, and New Jersey revealed that three senior managers at Securance falsified company data during the years 2005, 2006, and 2007. (Compl. ¶19-20). These managers admitted that they overstated the company's MLRs in the four states and retained and reported as profits \$120 million in premium revenues which should have been refunded. (Compl. ¶19). Each of these senior managers reported directly to and worked closely with one or more of the Officer Defendants. *Id.* As part of the settlement agreement resulting from this fraud, Securance agreed to pay \$400 million in fines and to establish a new, more engaged and proactive, compliance committee to overseeing the company's actions in the future. (Compl. ¶34).

ARGUMENT

A. THE COURT OF CHANCERY ERRED IN GRANTING THE RULE 12(B)(6) MOTION TO DISMISS BECAUSE THE FACTS ALLEGED IN THE COMPLAINT WERE SUFFICIENT TO SUPPORT A CLAIM THAT THE DIRECTORS BREACHED THEIR FIDUCIARY DUTY OF LOYALTY.

a. Question Presented

Under Delaware case law requiring that corporate directors act in the best interests of their corporation in order to fulfill their fiduciary duty of loyalty, does a claim for the breach of such duty exist where the Complaint alleges that (i) sufficient red flags existed to provide the directors constructive knowledge that the corporation's employees were engaged in liability-creating fraudulent activities, (ii) the directors took no action to investigate or prevent such activities, and (iii) the corporation suffered significant financial harm as a result of the fraud?

b. Scope of Review

When a court reviews a motion to dismiss under Court of Chancery Rule 12(b)(6), the court must accept the well-pled allegations of the complaint as true and construe the facts and reasonable inferences derived therein in the light most favorable to the plaintiff. *General Motors*, 897 A.2d at 162. Although the court is not bound by a plaintiff's legal assertions of conclusory statements without supporting facts, a motion to dismiss may only be granted when it "appear[s] with a reasonable certainty that a plaintiff would not be entitled to the relief sought under any set of facts which could be proven to support the action." *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1104 (Del. 1985).

c. Merits of Argument

I. THE FACTS ALLEGED IN THE COMPLAINT ARE SUFFICIENT TO ESTABLISH THE EXISTENCE OF "RED FLAGS" WHICH PROVIDED THE DIRECTORS CONSTRUCTIVE KNOWLEDGE THAT ILLEGAL ACTIVITIES WERE BEING CARRIED OUT BY SECURANCE'S EMPLOYEES.

In a suit claiming that a corporation's board of directors breached its fiduciary duty of loyalty by failing to properly oversee the actions of the corporation's employees, courts have held that a cause of action against the individual directors exists where red flags existed to provide the directors with constructive knowledge that employees were undertaking liability-creating actions, but the directors failed to respond appropriately, causing the corporation to suffer financial harm. In *McCall v. Scott*, 239 F.3d 808, 814 (6th Cir. 2001)(citing *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996); *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125, 127 (Del. 1963)), the Sixth Circuit applied Delaware state law to a case substantially similar to the case at bar, holding that stockholders had a cause of action against a corporation's board of directors for breaching their fiduciary duty. In that case, the stockholders brought a derivative action when the corporation's officers, with the constructive knowledge of the directors, devised a scheme to increase revenue profits and perpetuate a management philosophy that provided a strong incentive for employees to commit fraud. The court held that plaintiff's allegations were sufficient to state a claim. *Id.* at 820. The court stated that an oversight liability claim can withstand a Rule 12(b)(6) motion to dismiss where a plaintiff's allegations, taken as a whole, provide "sufficient facts

from which one could infer that the board knew of or recklessly disregarded the allegedly improper policies and practices being systematically followed in [the corporation] facilities nationwide." *Id.* at 823. Specifically, the court focused on the board's failure to take action in the face of questionable audit practices, a New York Times investigation, and federal investigations, as well as its aggressive acquisitions practices. *Id.* at 820.

The red flags that created director liability in *McCall* are very similar to those alleged in the case at bar. First, the Appellees in this case implemented an Incentive Compensation Plan which provided managers with bonus compensation based on the operating profit yielded by each manager's business sector. (Compl. ¶38). As explicitly stated in the Complaint, "the Director Defendants and the Officer Defendants were all well aware that they had put in place a system of compensation that provided specific incentives for senior executives to inflate the results of their business segment." *Id.*

Second, the Appellees in this case should have noticed and been prompted to investigate Securance's reported profits when analysts started questioning whether those profits were being accurately reported. (Compl. ¶27). Although the analysts' speculations prompted an investigation by the FBI and the U.S. Department of Health and Human Services, it didn't inspire the Appellees to investigate the company's profit reporting practices. (Compl. ¶28).

Third, the Appellees were aware of a 2004 investigation by regulators in Connecticut and Virginia, wherein Securance employees were accused of offering incentives and bonuses to doctors who denied

medical services to Securance's impoverished and disabled enrollees in order to boost the company's profits. (Compl. ¶40). The Defendants were also aware that Securance entered into consent decrees and paid \$200,000 in fines as a result of the investigation. (Compl. ¶39-42). Despite this knowledge, the Board failed to implement a better monitoring system to ensure that the Company complied with state laws.

Fourth, the Appellees should have been alerted to the fraud when Securance's net income showed a sudden and dramatic increase between 2004 and 2005. In 2004, the corporation reported earnings of \$49 million. (Compl. ¶16). In 2005, the figure jumped to \$88 million. (Compl. ¶36). Such a huge increase in an HMO's net income over a single year should have been sufficiently unusual to raise serious questions regarding the company's reporting practices, given the strict regulations and limited opportunity for growth in the industry. (Compl. ¶16).

Based upon these particularly alleged facts, the court can easily infer, in a light most favorable to the Appellant, that the Appellees knew or should have known that something unprecedented and suspicious was occurring in the company's profit reports.

Cases where the court held that the facts alleged in the Complaint were not sufficient to state a claim are substantially different from the case at hand. For example, in *Stone v. Ritter*, 911 A.2d 362, 365 (Del. 2006), shareholders of a corporation brought a derivate suit against the directors claiming a breach of the fiduciary duty of loyalty when the directors failed to properly monitor their employees' compliance with the federal Bank Secrecy Act. The court

dismissed the case on the grounds that the stockholders' claims were inadequate to show that the directors had acted in bad faith in carrying out their oversight responsibilities. *Id.* at 373. In contrast to the case at bar, the stockholders in *Stone* conceded that the directors did not know nor had reason to know that violations were taking place because no red flags existed that would have alerted them to the violations. *Id.* at 364. The court held that "in the absence of red flags, good faith in the context of oversight must be measured by the directors' actions to assure a reasonable information and reporting system exists." *Id.* at 373. Once the directors became aware of the legal violations, they implemented new policies and procedures delegating oversight responsibility to certain employees. *Id.*

Here, in contrast, there are several red flags that were known by the Appellees. As indicated before, the Appellees were aware of the 2004 investigations into the improper employee practices to increase profits and the subsequent consent decrees and fines. They were also aware of the Incentive Compensation Plan and the corresponding risk that it would encourage employees to use deceitful tactics to receive bonuses because they implemented it. Additionally, the Appellees were aware of the suspicious jump in earnings between 2004 and 2005 and of the questions analysts were contemplating in relation to that jump.

Despite the existence of all of these red flags, the Appellees never attempted to improve their compliance system. As a result, the facts alleged in the Complaint indicate the existence of a substantial likelihood that the Appellees breached their fiduciary duty of loyalty by their utter failure to implement an information and reporting

system capable of informing them of potential fraudulent activities by employees. Based on these red flags, the Appellant's claim is sufficient to survive a motion to dismiss.

II. THE SECURANCE DIRECTORS BREACHED THEIR FIDUCIARY DUTY OF LOYALTY BY FAILING TO INVESTIGATE OR ACT UPON THE NUMEROUS RED FLAGS, THEREBY ALLOWING THE CORPORATION TO INCUR SUBSTANTIAL FINANCIAL HARM.

Corporate directors and officers owe their corporation and its stockholders a duty of loyalty. They "are not permitted to use their positions of trust and confidence to further their private interests." *Miller v. Foodservice, Inc*, 361 F.Supp.2d 470, 481 (D. Md. 2005)(quoting *Gulf v. Loft*, 5 A.2d 503 (Del. 1939)). The duty of loyalty requires a director or officer "to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it." *Id.* Here, the Defendants failed to fulfill their oversight responsibility, thereby causing Securance millions of dollars in fines and jeopardizing future business ventures.

The *Stone* court recognized that a breach of fiduciary duty occurs "where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." *Id.* (quoting *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d (Del. 2006). Where the directors are accused of disregarding the duty of oversight, that court identified two situations in which a breach of the fiduciary duty of loyalty would occur: (1) where "the director utterly failed to implement any reporting or information system or controls;" or (2) where "having implemented such a system or controls, [the

director] consciously failed to monitor or oversee its operations thus disabling [himself or herself] from being informed of risks or problems requiring their attention." *Stone*, 911 A.2d at 370. This interpretation creates a standard requiring constructive knowledge of liability-creating activities before a director can be held liable for failing to oversee the corporation's employees. The court held that such a failure did not exist in *Stone*, however, finding that the directors acted in good faith and, therefore, did not consciously violate their fiduciary duty of loyalty because they implemented a new and reasonable reporting system after discovering the employee's liability-creating activities. *Id.* at 369.

In contrast to *Stone*, the Appellees in this case failed to act in the face of glaring red flags, thereby breaching their fiduciary duty of loyalty. The Appellees' awareness of the 2004 consent decrees and related fines should have alerted them that the company's compliance systems were inadequate. Additionally, the Appelles should have been aware that the Incentive Compensation Plan implemented by the Appellees in 2003 might motivate officers to falsely inflate the results of their business segments. If extent of this motivation was not apparent to the Appellees in 2003, they should have been aware of the threat of fraudulent income inflation after the 2004 investigations. Yet at no time did the Appellees establish a compliance system that would prevent their employees from doing such fraudulent deeds or identify such actions in time to protect the corporation. The Appelles' failure to restructure or reinvigorate the company's then-existing compliance system constituted an intentional

breach of their fiduciary duty to act in good faith to protect Securance's best interests. (Compl. ¶44).

In contrast to the "intent" standard developed in *Stone*, some courts have used a gross negligent standard to attach liability in oversight liability cases. In *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 127 (Del. 1963), stockholders brought a derivative action against directors and some employees of the corporation who allegedly violated anti-trust laws. The court dismissed the claim stating that the plaintiff failed to show that the defendants had knowledge of the anti-trust violations or any acts that would have put them on notice of the violations. *Id.* at 133. The court held that if the plaintiffs had shown that a director "ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him." *Id.* at 130.

The significant increase in Securances' net income between 2004 and 2005 was an 'obvious danger sign of employee wrongdoing,' as contemplated by the *Graham* court. As described previously, such an increase was an anomaly in the HMO industry and merited serious review by the board. When the directors became aware of suspicious events or activities occurring within their corporation, their fiduciary duty required that they investigate those events or activities. *Id.* Because they failed to do so, the directors can be held liable for any resulting harm to the company. *Id.* While the *Graham* court did state that "absent cause for suspicion there is no duty upon the directors to... ferret out wrongdoing which they have no reason to suspect exists," in this case, the red flags should have created a significant

suspicion on the part of the board, so their duty to investigate is clear. *Id.*

In some circumstances courts have combined the "intent" and "gross negligence" standards to impose oversight liability. In *Caremark*, 698 A.2d at 971, the court identified certain factors a plaintiff would have to demonstrate in order to state of a cause of action for a breach of fiduciary duty based upon oversight failure. Among the factors the court held that the plaintiff needs to show were either "(1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation and (4) that such failure proximately resulted in the losses complained of." *Id.*

The test set forth in *Caremark* is satisfied here. The Appellees clearly should have known that legal violations were occurring due to the numerous red flags that existed. In a blatant breach of their duty of oversight, however, the Appellees in this case made no attempt to investigate the Company's suspicious activities, to discover the violations that were occurring at Securance, or to prevent future violations from occurring. As a result of the Appellees' failure to adequately monitor the corporation's employees, Securance incurred \$400 million in fines, (Compl. ¶133), its market value plunged to a record low of \$37 per share, (Compl. ¶137), it lost \$3 billion in market capitalization, (Compl. ¶12), and it has been banned for three years from doing business in the four states which, together, provided forty percent of the company's annual premium revenue. (Compl. ¶18).

Therefore, the Appellant and the other stockholders have suffered a significant loss as a direct result of the Appellees' failure to satisfy their fiduciary duties.

Regardless of whether this court applies an "intent" test, a "gross negligence" test, or a combination of the two, the Appellant has satisfactorily pled facts sufficient to state a claim that the directors breached their fiduciary duty of loyalty. As a result, the Appellant has established the existence of a case or controversy adequate to overcome a Rule 12(b)(6) motion to dismiss. This court should reverse the Court of Chancery's decision and remand the Appellant's claim to be tried on its merits.

B. THE COURT OF CHANCERY ERRED IN DISMISSING THE APPELLANT'S COMPLAINT FOR FAILURE TO MAKE A DEMAND ON THE BOARD, AS DEMAND IS FUTILE BECAUSE OF THE SUBSTANTIAL LIKLIHOOD THAT THE DIRECTORS ARE PERSONALLY LIABLE FOR THE RELIEF SOUGHT IN THE CLAIM, WHICH PREVENTS THEM FROM CONSIDERING THE CLAIM WITH INDEPENDENCE AND DISINTEREST.

a. Question Presented

Under Delaware case law interpreting the Court of Chancery Rule 23.1 demand requirement in derivative suits, is demand excused as futile when all of the directors face a substantial likelihood of personal liability for the relief sought in the claim?

b. Scope of Review

In order for demand to be excused, Plaintiffs are required to allege in their Complaint particularized facts sufficient to rebut the presumption that the board exercised sound business judgment. *Grobow v. Perot*, 539 A.2d 180, 187-188 (Del. 1988). In meeting this burden, "only well-pleaded allegations of fact must be accepted as true; conclusionary allegations of fact or law not supported by allegations of specific fact may not be taken as true." *Id.*

c. Merits of Argument

Demand on the Securance Board should be excused in this case because it could not have properly exercised independent and disinterested business judgment in responding to demand. Rule 23.1 of the Delaware Court of Chancery Rules requires that, in order for a shareholder plaintiff to bring a derivative suit, the stockholder must demand that the board of directors bring the proposed action on behalf

of the corporation or demonstrate why such demand must be excused as futile. Ch. Ct. R. 23.1. This requirement recognizes that, because a board is empowered by law to manage the business and affairs of its corporation, a stockholder's right to bring a derivative suit is limited to situations where either (1) the directors have wrongfully refused to bring the action demanded by the stockholder, or (2) demand is excused because the directors are incapable of making an impartial decision regarding the demanded litigation. 8 Del.C. §141(a), Ch.Ct.R. 23.1. Here, the failure of the Securance Board to adequately and in good faith monitor the actions of Securance's Senior Managers, in breach of its fiduciary duty to the stockholders, creates director liability for the company's losses resulting from the Managers' scheme to defraud the state Medicaid programs in Ohio, Pennsylvania, New York, and New Jersey ("The Fraud"). As a result of their personal liability, the directors cannot make an impartial decision regarding the demand for litigation, so demand should be excused.

I. DEMAND IS FUTILE BECAUSE THE SECURANCE DIRECTORS ARE INCAPABLE OF MAKING AN INDEPENDENT AND DISINTERESTED DECISION REGARDING WHETHER TO INSTITUTE LITIGATION.

In a derivative suit, demand is excused where a plaintiff alleges particular facts sufficient to establish a reasonable doubt that the board of directors is capable of considering demand in an independent and disinterested manner. *Rales v. Blasband*, 634 A.2d 927 (Del. 1993). The substantive test for determining when demand is excused in Delaware was established in *Rales*, wherein this Court held that, although the challenged board of directors was not directly involved

in a fraudulent transaction arising from the investment practices of its subsidiary, reasonable doubt existed regarding the directors' ability to act in an independent and disinterested manner due to the financial and employment interests of the individual directors. *Id.* at 933. As a result, demand was excused in that case. *Id.*

The holding in *Rales* indicated that, to determine if demand is excused, a court should consider whether "the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that... the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." *Id.* at 934. The key question under the *Rales* test is whether directors are "independent and disinterested." Determination of independence and disinterest requires an analysis of the factual allegations regarding the influences that affected the directors' ability to perform their duties, especially those duties pertaining to the challenged transaction. *Id.* Where a board cannot impartially consider the merits of a demanded suit for risk of being improperly influenced by their own participation in the challenged transaction, the demand requirement is futile and, therefore, excused. *Id.* at 933.

The test for demand excuse established by *Rales* is applicable to the present case because the *Rales* decision, in establishing the test, specifically contemplated its application to situations such as the suit at bar, in which directors are sued individually in a derivative action for failing to properly oversee their subordinates ("Oversight Liability Cases"). *Id.* at 934 n.9. The *Rales* decision stated that demand in Oversight Liability Cases should not be excused

automatically, but that the plaintiff must make sufficient factual allegations to "demonstrat[e] why the board is incapable of considering a demand." *Id.* As thoroughly discussed above in response to and refutation of the 12(b)(6) Motion to Dismiss, the Appellant here has alleged sufficient facts in her Complaint to support a cause of action for the Directors' failure to satisfy their fiduciary duty of loyalty. If assumed to be true, as they must at this stage of the proceedings, these allegations establish a substantial likelihood of liability on the part of the individual directors, which necessarily casts a grave doubt on the ability of the directors to impartially consider whether to bring the present suit on behalf of Securance.

Based upon this potential liability, the Securance Board, like the board in *Rales*, is unable to consider the merits of the derivative suit with independence and disinterest. Although the directors in *Rales* were influenced by their personal financial and employment interests rather than their fiduciary duty based upon a failure to adequately oversee employees, the facts in both cases support allegations that both boards acted improperly and in violation of their fiduciary duties to their corporations' stockholders, casting serious doubt on the ability of the boards to impartially consider the merits of the stockholder complaint. *Id.* at 934. As a result, demand must be excused.

II. THE SECURANCE BOARD'S SUSTAINED FAILURE TO ASSURE THE EXISTENCE OF A REASONABLE INFORMATION AND REPORTING SYSTEM, IN LIGHT OF MULTIPLE RED FLAGS WHICH SHOULD HAVE ALERTED IT TO THE ABSENCE OF SUCH A SYSTEM, CREATES A SUBSTANTIAL LIKELIHOOD THAT THE DIRECTORS MAY BE HELD PERSONALLY LIABLE FOR THE COMPANY'S LOSSES.

Every board of directors has a good faith duty to implement a corporate reporting system that, "in concept and design [is] adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations." *Caremark*, 698 A.2d at 970. In *Caremark*, the Delaware Court of Chancery addressed this duty when a corporate stockholder brought a derivative suit against the corporation's board of directors. The plaintiff in that case maintained that the directors should be held personally liable for approximately \$250 million in fines and reimbursements accruing to the corporation as a result of its employees' alleged legal violations. *Id.* To determine whether or not director liability existed, the court considered the scope of the board's monitoring system as well as the existence, or lack thereof, of red flags which would have alerted the directors of the employees' liability creating activities.

The *Caremark* decision permits a court to find that individual directors are liable for a corporation's losses where the corporation suffers such losses as a result of the board's failure to address employees' liability-creating activities which the directors knew, or should have known, about. In order to be held liable, however, the directors must have engaged in a "a sustained or systematic failure... to exercise oversight." *Id.* at 971. Such a failure of oversight may be

the result of either the directors' lack of good faith in carrying out their monitoring responsibility or their conscientious tolerance of the company's legal violation. *Id.* at 972.

As discussed in more detail in the previous section regarding the Rule 12(b)(6) motion, the *Caremark* standard requires that a stockholder allege sufficient facts to establish (1) that the directors should have known that violations of law were occurring, (2) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (3) that such failure proximately resulted in the losses complained of, in order to state a cause of action imposing director liability for failure to properly oversee employees. *Id.* Essentially, this standard requires a showing that the directors of a company should have known that they were not discharging their fiduciary duty. Applying this analysis to the facts of the *Caremark* record, the court declined to impose personal liability upon the directors, based on the fact that the record "tend[ed] to show an active consideration by Caremark management and its Board,... not... knowing or intentional violation of law." *Id.* at 961. In particular, the court noted that the Caremark Board had a functioning corporate compliance oversight committee which represented a good faith attempt to be informed of relevant facts. *Id.* at 970-971.

In contrast to the Caremark Board, the Securance Board had knowledge of and ignored multiple red flags, from which their knowledge of the Fraud should be inferred. These red flags include: the sudden, unexpected increase in Securance's net income between 2004 and 2005, the publicly reported suspicions of analysts, the structure

of the Incentive Compensation Plan, which tied company profits to manager bonuses, and the 2004 investigations into Securance's reporting practices in Connecticut and Virginia, which resulted in consent decrees and fines. The manifestation of these red flags strongly indicated that substantial issues of business ethics and integrity existed in Securance's financial reporting system. Their existence further provides evidence that, if it had been satisfying its fiduciary duty, the Securance board should have known about the Fraud. In failing to appropriately investigate and act upon this information, the Defendants breached their fiduciary duty of loyalty to Securance and its stockholders, thereby becoming personally liable for the corporation's subsequent losses.

III. PURSUANT TO THE STANDARDS ESTABLISHED IN *RALES* AND *CAREMARK*, DEMAND SHOULD BE EXCUSED IN THIS CASE BECAUSE OF THE SECURANCE BOARD'S INABILITY TO MAKE AN INDEPENDENT AND DISINTERESTED DECISION REGARDING THE PRESENT SUIT BASED UPON THE SUBSTANTIAL LIKELIHOOD OF THE DIRECTORS' PERSONAL LIABILITY.

Where a stockholder alleges specific facts that establish a board of director's liability for damages suffered by its company, the stockholder is excused from making a pre-suit demand on that board. In the case of *Stone*, 911 A.2d at 362, this court combined the "independent and disinterested" standard for demand excuse articulated in *Rales* with the *Caremark* standard for establishing director liability for corporate loss predicated upon ignorance of liability-creating activities within a corporation to determine whether a Rule 23.1 motion to dismiss was appropriate in an Oversight Liability Case. *Id.* at 364. In *Stone*, the court found that the Appellants failed to

satisfy the two tests because their complaint "failed to plead with particularity the facts underlying the [fraud investigation] report's conclusions." *Stone v. Ritter*, 2006 WL 302558 *2 (Del. Ch. Jan. 26, 2006). In so holding, the court emphasized the importance of alleging specific underlying facts required to state a claim, as opposed to merely alleging conclusions based on unstated facts. *Id.* The complaint in *Stone* also failed to allege any red flags to demonstrate that the directors knew or should have known about the liability-creating activities occurring within their corporation. In particular, the facts failed to show that, (i) the board was ever aware that the company's internal monitoring systems were inadequate, (ii) such inadequacies would result in illegal activity, or (iii) the board chose to do nothing about problems it allegedly knew existed. *Id.*

Such is not the case in the present matter. As stated in both of the preceding sections, the Complaint in the case at bar has alleged sufficient particularized facts to support the existence of red flags which provided the Appellees with constructive knowledge of the Fraud. Applying the *Rales* and *Caremark* standards in tandem to the facts alleged in the present case demonstrates that the directors are potentially liable for their failure to prevent or remedy the violations of law which they should have known were occurring and, therefore, it would be impossible to conclude that the directors were sufficiently disinterested and independent to consider the stockholder's demand. As a result, demand should be excused in the case at bar and the suit should be remanded to the Court of Chancery for trial on the merits.

CONCLUSION

For the foregoing reasons, the Appellant asks this Court to reverse the Court of Chancery's decision to dismiss her Complaint and remand the case to that court for trial on its merits.

Respectfully Submitted,

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