
In the
SUPREME COURT 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.

On Appeal from the Court of Chancery of the State of Delaware

BRIEF FOR APPELLEES

Team M

February 17, 2009

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NATURE OF THE PROCEEDINGS

On July 3, 2008, Plaintiff, Below-Appellant, Clare C. Marshall ("Plaintiff" or "Appellant") filed a Complaint on her own behalf and derivatively on behalf of Securance Incorporated ("Securance" or "Company"). Defendants, Below-Appellees ("Defendants" or "Appellees"), are the Securance Board of Directors ("Board") and three non-director senior officers. Appellant alleges that Defendants caused Securance financial harm by consciously or recklessly failing to fulfill their fiduciary duties.

On January 6, 2009, Chancellor Siegel of the Delaware Court of Chancery issued a Memorandum Opinion ("R") granting Defendants' motion to dismiss the derivative suit. The court found that Plaintiff's claim that the directors breached their fiduciary duties by failing to exercise their oversight responsibilities was not supported by particularized facts regarding the behavior of either the director or officer Defendants. Thus, in the absence of particularized facts, Plaintiffs were required to make demand on the Board of Directors. Because pre-suit demand was not excused, Plaintiff's failure to do so was fatal to the Complaint. Plaintiff appeals this decision to the Supreme Court of Delaware.

SUMMARY OF THE ARGUMENT

This Court should affirm the decision of the Court of Chancery dismissing Plaintiff's derivative suit as a result of Plaintiff's failure to plead particularized facts in the Complaint.

The suit was properly dismissed pursuant to Court of Chancery Rule 12(b)(6) because Plaintiff failed to allege particularized facts to support her breach of fiduciary duty claim and thus cannot establish the requisite elements for liability. Plaintiff failed to show that Defendants acted without good faith. Additionally, Plaintiff's allegations do not demonstrate that Defendants engaged in a sustained or systemic failure to exercise oversight. Furthermore, Plaintiff's allegations do not sufficiently support the existence of red flags, again failing to establish liability.

Moreover, the Complaint was properly dismissed because pursuant to Court of Chancery Rule 23.1, a Plaintiff must either make demand on the board of directors or plead particularized facts which establish demand excusal. Plaintiff failed to do either. As such, pre-suit demand was not excused, and Plaintiff's claim was properly dismissed.

STATEMENT OF FACTS

Securance is a publicly traded Delaware corporation engaged in providing managed health care services exclusively to Medicaid and Medicare recipients. (Compl. ¶ 7). Securance operates in 18 states under heavy regulation by both state and federal governments. (Compl. ¶ 7, 14). As a result of the stringent guidelines governing the industry, managed health care companies like Securance struggle with thin profit margins and relatively low rates of earnings growth. (Compl. ¶ 16).

Since its initial public offering in 2002, Securance's Board of Directors has been independent and disinterested. (Compl. ¶ 4). Three of the seven Board members also serve as the corporation's top executives. (Compl. ¶ 5). In 2003, the Board of Directors adopted a senior officer compensation plan. (Compl. ¶ 38). The Board approved this plan, relying on the recommendation of its compensation committee. (Compl. ¶ 38). In 2004, as a byproduct of the pervasively regulatory environment in which Securance operates, the Company was required to pay nominal fines to two of the states where it conducts business. (Compl. ¶ 42). These events in 2004 did not involve allegations of fraud, nor did they involve any admission of wrongdoing. (Compl. ¶ 42). A system of compliance, including the Board's audit committee, was in place during this time period. (Compl. ¶ 34, 43).

From 2004 through 2008, Securance's stock price rose solidly as the Company recognized increased profits. (Compl. ¶ 25). During this time period, Securance was described by analysts as a top performer in

its industry. (Compl. ¶ 26). In May 2008, three Securance managers admitted they falsified Medicaid data to state regulators in four states over a three year period, beginning in 2005. (Compl. ¶ 20). As a result of the actions of these three employees, Securance, acting on the advice of its outside auditor and outside legal counsel, immediately announced that it would restate earnings for the prior three years and make full restitution to the states affected by the actions of its employees. (Compl. ¶ 36-7). These three employees immediately resigned their position with Securance and subsequently pled guilty to conspiracy to commit Medicaid fraud. (Compl. ¶ 30). Each is currently serving two-year prison sentences. (Compl. ¶ 30). The isolated actions of these employees did not tarnish Securance's ongoing relationship with other states. None of the other fourteen states to whom Securance presently provides managed health care services indicated a desire to disqualify the Company from doing business within those jurisdictions. (Compl. ¶ 35).

During the time the fraud occurred, a system of compliance was in place. (Compl. ¶ 34). Following the disclosure of the activities that gave rise to the imposition of fines, Securance proactively established a compliance committee with the purpose of assisting the already established audit committee in handling Company compliance matters. (Compl. ¶ 34).

QUESTIONS PRESENTED

1) Whether the lower court was correct in dismissing Plaintiff's claim, since it failed to allege particularized facts which would justify an inference that Defendants consciously breached their fiduciary duty of oversight?

2) Whether the lower court properly granted Defendants' motion to dismiss pursuant to Court of Chancery Rule 23.1, where pre-suit demand to the Board of Directors was required under the *Rales* test?

ARGUMENT

I. THE COURT OF CHANCERY PROPERLY GRANTED DEFENDANTS' MOTION TO DISMISS THE DERIVATIVE LAWSUIT BECAUSE PLAINTIFF FAILED TO ALLEGE PARTICULARIZED FACTS THAT THE DIRECTOR OR OFFICER DEFENDANTS BREACHED THEIR FIDUCIARY DUTIES.

A. Scope of Review.

This Court should affirm the dismissal of Plaintiff's derivative lawsuit under Court of Chancery Rule 12(b)(6) for failure to state a claim upon which relief can be granted. Del. Ch. Ct. R. 12(b)(6). This Court reviews *de novo* a dismissal by the Court of Chancery of a complaint under Rule 12(b)(6). See *In re Santa Fe Pac. Corp. Shareholder Litig.*, 669 A.2d 59, 70 (Del. 1995). Similar to the role of the trial court, this Court "must determine whether it appears with reasonable certainty that, under any set of facts that could be proven to support the claims asserted, the plaintiffs would not be entitled to relief." *McMullin v. Beran*, 765 A.2d 910, 916 (Del. 2000) (citing *In re Tri-Star Pictures*, 634 A.2d 319, 326 (Del. 1993)). Here, even when viewing the pleaded facts in the light most favorable to Plaintiff, the allegations do not support an inference that Plaintiff would be entitled to relief. As such, this Court should affirm the Court of Chancery's dismissal of Plaintiff's Complaint.

B. Plaintiff's Complaint Fails to Allege the Director Defendants Engaged in a Sustained or Systemic Failure to Exercise Oversight, and Therefore Fails to Establish the Lack of Good Faith Necessary for Liability.

In this case, Plaintiff's allegation that the director Defendants breached their fiduciary duty of oversight is unsupported by facts pled in the Complaint. In the landmark *Caremark* decision, Chancellor Allen posited that the lack of good faith necessary to establish

liability can be shown "where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation." *In re Caremark Int'l*, 698 A.2d 959, 971 (Del. Ch. 1996). Plaintiff's Complaint fails to allege specific facts which justify a reasonable inference that the director Defendants consciously failed to discharge their oversight responsibilities. This Court "need not blindly accept as true all allegations, nor must [it] draw all inferences from them in plaintiffs' favor unless they are reasonable inferences." *White v. Panic*, 783 A.2d 543, 549 (Del. 2001) (citing *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988)). Plaintiff's claims for breach of the duty of oversight cannot succeed because the Complaint fails to show that the directors consciously disregarded their fiduciary obligations.

In *Caremark*, the court made it more difficult for plaintiffs to establish bad faith on the part of directors in the oversight context. The court found that, "[o]nly a sustained or systemic failure of the board to exercise oversight - such as an utter failure to attempt to assure a reasonable information and reporting system exists [sic] -- will establish the lack of good faith that is a necessary condition to liability." *Caremark*, 698 A.2d at 971. The Supreme Court of Delaware affirmed the standard for director oversight liability set forth by Chancellor Allen in *Caremark*. The court stated, "[w]e hold that *Caremark* articulates the necessary conditions for assessing director oversight liability." *Stone v. Ritter*, 911 A.2d 362, 365 (Del. 2006). The burden of pleading and proving a lack of good faith as evidenced by sustained or systemic failure of a director to exercise reasonable

oversight, often referred to as a "Caremark claim," is a very onerous task for Plaintiffs. See *Teachers' Ret. Sys. v. Aidinoff*, 900 A.2d 654, 668 (Del. Ch. 2006). In *Caremark*, Chancellor Allen described the difficulty of establishing director liability for oversight as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." *Caremark*, A.2d at 967.

Here, Plaintiff's Complaint must be dismissed for failure to allege with particularity that the director Defendants failed to exercise oversight. An independent and disinterested board has been in place since the outset of the Company's initial public offering, which predates any of the alleged instances of lack of oversight. (Compl. ¶ 4). The record is clear, and Plaintiff does not challenge the fact, that a compliance system has been in place during each of these alleged instances. (*Id.* at ¶ 34, 38, 44). Thus, Plaintiff's Complaint must be dismissed because it does not properly allege facts to establish a *Caremark* claim.

In *Stone v. Ritter*, the Delaware Supreme Court interpreted the language of *Caremark* to hold that the necessary conditions predicate for director oversight liability are "(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system of controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risk or problems requiring their attention." *Stone*, 911 A.2d at 370. As recognized by the Court of Chancery, part (a) of the *Stone* two-part approach is inapplicable in the case at bar because Plaintiff's recognized the existence of regulatory programs at

Securance. (R. 20). As such, Plaintiff's claims must be reviewed solely under part (b) of *Stone*.

A *Caremark* breach of the duty of oversight claim "premises liability on a showing that the directors were conscious of the fact that they were not doing their jobs." *Guttman v. Jen-Hsun Huang*, 823 A.2d 492, 506 (Del. Ch. 2003). Plaintiff alleges without particularity that the directors exhibited "conscious or recklessly indifferent failure. . . to fulfill their fiduciary duties." (Compl. ¶ 1). Relatedly, Plaintiff alleges that the directors were "supinely content with the status quo. . . [which] set the stage for the financial catastrophe that foreseeably followed." (*Id.* at ¶ 44). These allegations, even when considered in the light most favorable to Plaintiff, fail to allege any facts that would overcome the arduous pleading standard in order to establish director liability for oversight as set forth in *Caremark*. Moreover, Plaintiff does not proffer any evidence to suggest that the director Defendants were consciously shirking their fiduciary responsibilities in bad faith.

Plaintiff's allegations of oversight are conclusory statements that fail to show a conscious failure to monitor. Principally, Plaintiff unsuccessfully attempts to show that the fraud committed by three Securance managers was condoned by the Board. (R. 17). This Court should not accept Plaintiff's attempt to characterize the inability to detect the fraud committed by three deceitful Securance employees as acquiescence by the Board. *Id.* As the Delaware Supreme Court noted, "[a]bsent cause for suspicion[,] there is no duty upon the directors to install and operate a corporate system of espionage

to ferret out wrongdoing which they have no reason to suspect exists.” *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963). More recently, in the oft-cited *Caremark* decision, it was stated that the holding of *Graham* could more narrowly be construed to mean that “absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company’s behalf.” *Caremark*, 698 A.2d at 969. Plaintiff’s claim must be dismissed because it does not establish that Defendant directors consciously failed to detect the fraud.

Here, it is evident that the Securance Board cannot be held liable for oversight as a result of the fraudulent behavior of three employees. Plaintiff acknowledged that a compliance system was in place prior to the outset of the fraud. (Compl. ¶ 44). Additionally, at the time the fraud was committed, an audit committee existed. (*Id.* at ¶ 32). The very existence of the audit committee, coupled with Securance’s retention of an outside auditor, are enough for Plaintiff’s oversight claim to fail under the demanding standards set forth in *Caremark* and its progeny. (*Id.* at ¶ 36). See *Ash v. McCall*, 2000 Del. Ch. LEXIS 144 n.57 (Del. Ch. 2000) (the existence of an audit committee, together with the retention of an outside auditor to conduct annual audits of the company’s financial reporting, is some evidence that a monitoring and compliance system was in place). Even if this Court were to find that the directors did not actually implement an adequate system of financial controls, Plaintiff’s Complaint should nonetheless be dismissed because it alleges solely

conclusory statements that fail to properly assert that the directors neglected their oversight responsibilities. See *Desimone v. Barrows*, 924 A.2d 908, 940 (Del. Ch. 2007) (noting that Delaware courts routinely reject conclusory allegations that because illegal activity occurred, internal controls must have been deficient, and the board must have known so). Thus, even when making all reasonable inferences in favor of Plaintiff, a sustained or systemic failure of the Securance directors to exercise oversight has not been established.

C. Plaintiff's Baseless Allegations of Purported Instances in Which the Director Defendants Failed to Exercise Oversight do Not Rise to the Level of Red Flags.

Absent facts presented to a board of directors that support an inference of a sustained or systemic failure of internal controls, this Court has suggested that there can be no board of director liability for failure to exercise oversight. *Stone*, 911 A.2d at 370. Such a lack of oversight will be evidenced by "red flags," that is, "facts showing that the board ever was aware that. . . internal controls were inadequate, [and] that these inadequacies would result in illegal activity. . ." *Id.* (citing *Stone v. Ritter*, 2006 Del. Ch. LEXIS 20, C.A. No. 1570-N (Del. Ch. 2006)).

While this Court has never explicitly adopted a definition of the type of warning sign that would rise to the level of a red flag, the federal court for the Southern District of New York held that in order to be considered a red flag, "[p]laintiff must allege that facts which come to a defendant's attention would place a reasonable party in defendant's position on notice of wrongdoing." *In re Refco, Inc. Sec. Litig.*, 503 F. Supp. 2d 611, 649 (S.D.N.Y. 2007) (citing *In re Van Der*

Moolen Holding N.V. Sec. Litig., 405 F. Supp. 2d 388, 406 (S.D.N.Y. 2005)). Moreover, this Court has more narrowly stated that "red flags are only useful when they are either waved in one's face or displayed so that they are visible to the careful observer." *Wood v. Baum*, 953 A.2d 136, 143 (Del. 2008) (citing *In re Citigroup, Inc. S'holders Litig.*, 2003 Del. Ch. LEXIS 61, at *2). The court's language in *Wood* implies that a reasonableness test is appropriate to determine the existence of red flags in this jurisdiction. The Court of Chancery properly determined that Plaintiff's allegations against the director Defendants for the creation of an incentive compensation plan, as well as the trivial fines paid for two regulatory violations, do not amount to red flags.

1. The Profit-Based Incentive Compensation Plan for Senior Executives Did Not Amount to a Red Flag.

The Securance Board of Directors' approval of the profits-based incentive compensation plan for senior executives is protected by the business judgment rule. *Grimes v. Donald*, 673 A.2d 1207, 1215 (Del. 1996). This Court has stated that when "an independent and informed board, acting in good faith, determines that the services of a particular individual warrant large amounts of money. . . the board has made a business judgment. That judgment normally will receive the protection of the business judgment rule." *Id.* Here, the majority of the Securance Board was independent and disinterested at the time the plan was adopted. (Compl. ¶ 4-5). The Board was well "informed" when it adopted the incentive plan, because it was acting on the recommendation of its compensation committee. (*Id.* at ¶ 38). These facts are sufficient to establish that the plan was adopted in good

faith. Therefore, the Board's approval of the incentive compensation plan is protected by the business judgment rule, and as a result, the Court of Chancery correctly determined it did not amount to a red flag.

2. The Consent Decrees with Connecticut and Virginia Did Not Amount to Red Flags.

Plaintiff's allegations that the nominal consent decrees entered into with Connecticut and Virginia served as a red flag that the Company's compliance system was inadequate are misguided. (Compl. ¶ 43). This Court previously stated that a director's good faith exercise of his oversight responsibility may not prevent the corporation from incurring significant financial liability. *Stone*, 911 A.2d at 373. Additionally, in *Caremark*, Chancellor Allen opined that "no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation's compliance with the law." *Caremark*, 698 A.2d at 970. Furthermore, it would be illogical to require directors to be fully apprised of the inner workings of a large corporation. *Id.* at 971. "Such a requirement would simple [sic] be inconsistent with the scale and scope of efficient organization size in this technological age." *Id.*

Here, consent decrees were entered into in 2004 with Connecticut and Virginia, two of the 18 states where Securance conducts business. (Compl. ¶ 13, 42). These consent decrees did not constitute red flags because they did not involve either allegations of fraud or any formal

admission of wrongdoing, which would have served to put the Board on notice of a possible flaw in the existing system of compliance. (*Id.* at ¶ 43). Additionally, the fines paid to the states are insignificant in the grand scheme of Securance's bottom line. These fines represented a mere 0.0014% of Securance's overall revenue for 2004. (R. 25). As such, the consent decrees and subsequent fines are nothing more than a byproduct of the heavy regulatory market in which Securance operates. (Compl. ¶ 44). Thus, the consent decrees do not reach the level of red flags to implicate liability for failure to exercise oversight.

The Court of Chancery was correct in its determination that neither the adoption of the profits-based incentive compensation plan nor the 2004 consent decrees rise to the level of red flags. (*Id.* at ¶ 24-5). This Court has previously held that "directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong." *Graham*, 188 A.2d at 130. In *Graham*, the court refused to hold the directors liable in a derivative action in which the corporation had lost large sums of money for violations of anti-trust laws. *Id.* The court reasoned that there were no grounds for suspicion by the directors. *Id.*

Applying a reasonableness test to the facts of the case at bar, it is apparent that the purported red flags do not support an inference of conscious indifference to oversight responsibility. "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" *Stone*, 911 A.2d at 373 (citing *Caremark*, 698 A.2d at 971) (internal quotations omitted). Plaintiff acknowledges that a system of compliance has been in place at Securance since before 2004. (Compl. ¶ 44). Furthermore, Securance consistently maintained an audit and a compensation committee, and in 2008 established a compliance committee. (*Id.* at ¶ 34, 38). As such, this Court should affirm the dismissal of Plaintiff's Complaint because the directors have exercised their oversight responsibilities in good faith.

D. Plaintiff is Precluded from Collecting Monetary Damages from the Director Defendants Because Securance's Certificate of Incorporation Contains a Valid Exculpatory Provision Pursuant to § 102(b)(7) of the Delaware General Corporation Law.

Plaintiff's claim must be dismissed because the Securance certificate of incorporation contains a valid exculpatory provision. (R. 20, n.18). A valid exculpatory provision precludes Plaintiffs from collecting monetary damages for breaches of the duty of care, so long as the director acted in good faith without knowingly violating the law and without obtaining any improper personal benefits. *Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001). When a complaint contains allegations of breaches of both the duty of due care and the duty of loyalty, and fails on its face to properly invoke the loyalty claims, the court is left only with the due care claims, for which the defense of a 102(b)(7) provision is appropriate. *Id.* at 1094. Here, the allegations pleaded in the Plaintiff's Complaint fail to rise to the level of particularized facts which could reasonably infer a breach of the duty of loyalty. Thus, the exculpatory

provision, adopted by Securance, precludes Plaintiff from collecting money damages under any surviving duty of care claims.

E. Decisions Made by the Non-Director Officer Defendants are Entitled to a Presumption of the Business Judgment Rule.

The Court of Chancery correctly determined that the business judgment rule applies with equal force to the non-director officer Defendants. (R. 27). This Court has stated that absent a showing that a fiduciary duty has been breached, "the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments." *Cede & Co. v. Technicolor*, 634 A.2d 345, 361 (Del. 1993). Furthermore, scholars have argued "that the policy rationales underlying the development and application of the business judgment rule to corporate directors similarly justify application of the rule to non-director officers." Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 Bus. Law. 865, 865 (2005). However, Hamermesh and Sparks qualify this assertion by adding that it "should not apply to conduct of officers outside the scope of their delegated authority." *Id.*

In the case at bar, the Securance non-director officers were acting well within the scope of their delegated authority. Although high-level managers perpetrated the fraud, these individuals have all been criminally sanctioned for their behavior. (Compl. ¶ 30). The non-director officers took no part in the fraud; thus, they were

acting within the scope of their delegated authority, and as such, their actions are protected by the business judgment rule.

Both the American Law Institute and the ABA Committee on Corporate Laws endorse this line of reasoning. Am. Law Inst., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 cmt. a (1994) ("Sound public policy points in the direction of holding officers to the same duty of care and business judgment standards as directors, as does the little case authority that exists on the applicability of the business judgment standard to officers, and the views of most commentators support this position."). Although the Delaware Supreme Court has yet to definitively determine the standard for officers, there is little question that officers should be held to the same standards as directors for purposes of application of the business judgment rule. For these reasons, Plaintiff's Complaint should also be dismissed, for failure to state a claim, against the officer Defendants.

II. THE COURT OF CHANCERY PROPERLY GRANTED DEFENDANTS' MOTION TO DISMISS THE DERIVATIVE LAWSUIT BECAUSE PLAINTIFF FAILED TO MEET THE REQUIREMENT OF PRE-SUIT DEMAND UNDER RULE 23.1 AND THE RALES TEST.

A. Scope of Review.

This Court should affirm the lower court's dismissal of Plaintiff's derivative lawsuit under Court of Chancery Rule 23.1 for failure to make demand. This Court reviews *de novo* a dismissal by the Court of Chancery of a complaint under Rule 23.1. *Wood v. Baum*, 953 A.2d at 140 (citing *Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000)). The scope of the review is plenary. *Id.* While the court should make

all reasonable inferences in favor of the Plaintiff, these inferences must flow logically from the alleged particularized fact. See *Beam v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004) Thus, “[c]onclusory allegations are not considered as expressly pleaded facts or factual inferences.” *Id.* (quoting *White v. Panic*, 783 A.2d at 549). Even when construing all reasonable inferences in favor of Plaintiff, the allegations in the Complaint are conclusory. As such, this Court should affirm the Court of Chancery’s dismissal of Plaintiff’s Complaint.

B. Plaintiff’s Complaint Fails to Demonstrate That Adequate Demand Was Made on the Board Pursuant to Rule 23.1.

Delaware Court of Chancery Rule 23.1 regulates derivative actions by shareholders to enforce a right of a corporation. The derivative suit is a powerful mechanism of corporate governance because it allows a party with standing to assert a cause of action on behalf of the entire corporation. See *Levine v. Smith*, 591 A.2d 194, 200 (Del. 1991). However, this power is not without limitation. Delaware Court of Chancery Rule 23.1 states that a complaint in a derivative action must “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.” Del. Ch. Ct. R. 23.1.

Under Delaware law, the board of directors is responsible for managing the business and affairs of a corporation. 8 *Del. C.* § 141(a). “Because a derivative action, by its very nature, impinges on the managerial freedom of directors, Chancery Rule 23.1 operates as a

threshold to insure that plaintiffs exhaust intracorporate remedies and protect against strike suits.” *Postorivo v. AG Paintball Holdings, Inc.*, 2008 WL 553205, at *4 (Del. Ch. 2008). As a result, courts strictly construe the requirements of Rule 23.1. See *Growbow*, 539 A.2d 180.

When a plaintiff does not make demand on the board, the complaint must allege particularized facts that would establish demand excusal. See *Brehm*, 746 A.2d at 254. In *Brehm*, this Court elaborated on the standard by requiring that such allegations of demand futility “must comply with the stringent requirements of factual particularity that differ substantially from the permissive notice pleadings” that are required in other situations. *Id.* In other words, the plaintiff in a derivative action has two options: give the board of directors the opportunity to exercise its substantive rights or demonstrate through particularized facts that the board is unable to do so and demand would be futile. See *Braddock v. Zimmerman*, 906 A.2d 776, 784 (Del. 2006).

As concluded by the lower court, Plaintiff “has not alleged particularized facts.” (R. 2) It is well established that the burden to plead particularized facts “clearly falls upon plaintiffs claiming demand futility.” *Grobow v. Perot*, 539 A.2d at 187. *Grobow* further clarifies that “upon a motion to dismiss, only well-pleaded allegations of fact must be accepted as true; conclusory allegations of fact or law not supported by allegations of specific fact may not be taken as true.” *Id.* at 187. Hence, Plaintiff is solely responsible for well-pleaded particularized allegations.

In the Complaint, Plaintiff states that demand would have been futile because “[d]irector Defendants face a substantial likelihood of enormous personal liability on the claims asserted in this complaint and as such the Director Defendants are personally interested in the outcome of the decision on whether to pursue such claims.” (Compl. ¶ 46) However, the Delaware Supreme Court has found that there is no basis for an oversight claim holding the directors personally liable when employees have ultimately caused the underlying problem. See *Stone v. Ritter*, 911 A.2d 362. Thus, in this case, where employees caused the underlying problem, the allegation that personal liability excuses demand is conclusory and does not meet the pleading requirements of Rule 23.1.

Compliance with Rule 23.1 is considered an “essential prerequisite” of a derivative suit initiated by a shareholder on behalf of a corporation. *Kaplan v. Peat, Marwick, Mitchell & Co.*, 529 A.2d 254, 258 (Del. Ch. 1987). Demand on the board, or pleading particularized facts that would excuse demand, is considered the “foundation of the shareholder’s right to sue derivatively.” *Id.* at 261. On appeal in *Kaplan*, this Court noted that “[w]hen deciding a motion to dismiss for failure to make a demand under Chancery Rule 23.1 the record before the court must be restricted to the allegations of the complaint.” *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 727-28 (Del. 1988).

Plaintiff’s failure to meet this prerequisite of demand under Rule 23.1 is fatal to Plaintiff’s claim. Because the court may look only to the allegations made in the Complaint, and those allegations

are conclusory, the motion must be dismissed. Even assuming, *arguendo*, that Plaintiff could meet the pleading burden, the motion for dismissal would still be granted because Plaintiff's claim could not meet the standards of the *Rales* test, which is dispositive in determining when particularized facts excuse the requirement of demand. Thus, even assuming the existence of particularized facts, pre-suit demand would not be excused.

C. Plaintiff's Complaint Failed to Meet the Standard of Demand Futility Pursuant to the *Rales* Test.

The Delaware Supreme Court recognizes two tests for demand futility, commonly known as the *Aronson* test and the *Rales* test. *Postorivo*, 2008 WL 553205, at *5. "Both tests spring from the concept that a court should not intervene in a board's decision to refuse a shareholder demand, unless the shareholder raises the troubling inference that the board's refusal would not be a good faith exercise of business judgment." *Id.* The *Aronson* test is employed when the plaintiff is challenging a specific action that the board has taken. *Id.* Where, as here, the subject of a derivative suit is not a business decision by the board of directors, the Supreme Court of Delaware applies the test in *Rales v. Blasband*, 634 A.2d 927 (Del. 1993).

The *Rales* test is applicable in derivative suits regarding a violation of the board's oversight duties. *Wood*, 953 A.2d at 140. Under this test, a court must determine "whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its

independent and disinterested business judgment in responding to a demand." *Rales*, 634 A.2d at 934. In order to succeed, a derivative suit "must focus intensely upon individual director's conflicts of interest or particular transactions that are beyond the bounds of business judgment." *In re info USA, Inc. S'holders Litig.*, 2007 WL 2419611, at *12 (Del. Ch. 2007). In other words, a court need not focus on the actions or failures to act; rather, a court ensures that the board made the business judgment with a disinterested and independent mindset. *Id.* It is not the merits of a decision, but the motivations fueling the decision, that interest a court. *Id.*

Rales is instructive in determining both interest and independence in decisions by the board of directors. *Rales*, 634 A.2d at 936. Directorial interest is present under two circumstances. First, if a director will receive a greater financial benefit than the shareholders from a certain transaction, the director is interested. *Id.* Second, if the decision would have a personal materially negative impact, the director is considered interested. *Id.* If either of these situations is present, a director will not be considered disinterested because there are potential adverse personal consequences. *Id.* In the case of *Securance*, none of the directors personally benefited from the fraud that boosted Company profits. To the contrary, the benefit was spread throughout the Company and amongst the shareholders. Thus, no director interest was present.

Although there is no director interest, independence must still be examined. "Independence is a fact-specific determination made in the context of a particular case. The court must make that

determination by answering the inquiries: independent from whom and independent for what purpose?" *Beam*, 845 A.2d at 1049-50. Here again, Plaintiff must plead particularized facts that the directors are not independent, and no such particularized facts were provided in the Complaint.

Even assuming, *arguendo*, that the directors who are also officers of the Company ("inside" directors) cannot be considered independent, this argument fails. In *Beam*, this Court found that only when there is a majority of independent directors could demand be considered futile. *Id.* at 1046. In this case, there are four "outside" directors and only three "inside" directors, meaning that the majority is independent. Thus, it can be concluded that the directors of Securance are both disinterested and independent under the *Rales* test.

Given that the particularized factual allegations of the Complaint did not create a reasonable doubt that the Board of Directors was unable to exercise its independent and disinterested business judgment in responding to a demand, the Complaint fails the *Rales* test, and the motion to dismiss must be granted.

CONCLUSION

For the foregoing reasons, Appellees respectfully request that the decision of the Chancery Court be affirmed.

APPENDIX

Delaware Court of Chancery Rules and General Corporations Law

Del. Ch. Ct. R. 12(b) (6)

Failure to state a claim upon which relief can be granted.

Del. Ch. Ct. R. 23.1 Derivative actions by shareholders.

In a derivative action brought by 1 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. The action shall not be dismissed or compromised without the approval of the Court, and notice by mail, publication or otherwise of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the Court directs; except that if the dismissal is to be without prejudice or with prejudice to the plaintiff only, then such dismissal shall be ordered without notice thereof if there is a showing that no compensation in any form has passed directly or indirectly from any of the defendants to the plaintiff or plaintiff's attorney and that no promise to give any such compensation has been made.

8 Del. C. § 102(b) (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.

8 Del. C. § 141(a)

The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.