

In the
Supreme Court of Delaware

CLARE C. MARSHALL,
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,
Appellees

- and -

SECURANCE INCORPORATED,
Appellee.

No. 27, 2009

BRIEF FOR THE APPELLEE

Filed by Team N, Counsel for Appellee

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QUESTIONS PRESENTED

Whether the Supreme Court should continue to require that shareholder derivative complaints allege particularized facts of "conscious failure to monitor" in order to show a substantial likelihood of personal liability for breach of fiduciary duty of oversight, thereby creating a reasonable doubt that the Board of Directors could have properly exercised independent and disinterested business judgment thus justifying excusal of demand as futile?

Whether the Supreme Court should continue to extend the business judgment rule to officers in a corporation in accordance with case precedent to ensure that officers receive the same level of protection as directors in order to prevent an increase in director responsibility, prevent a potential increase in liability for officers, and prevent compromising the business judgment of officers?

STATEMENT OF THE CASE

Securance is a well-regarded, for-profit managed health care Delaware corporation that is traded on the New York Stock Exchange with 42 million shares of stock outstanding and deals in the Medicaid and Medicare industries operating in eighteen different states across the nation. (R. at 3, 4.) Securance works under government contract in an industry that struggles to make a thin profit margin because it is bound to follow a complex "medical loss ratio" formula, where 80% of the premiums it receives must be spent on direct medical care (or Securance must refund the difference) leaving only 20% maximum to cover both administrative costs and profit. (R. at 6.) Clare Marshall (herein after referred to as "Appellant") owns a small amount of stock in Securance and has filed a suit alleging a breach of fiduciary duty at the board level for failure to fulfill oversight responsibilities. (R at 3, 14.) The board (herein after referred to as "Directors") consists of seven members Charles H. Saligman, Patrick C. Richmond, Yvonne M. Craig, Martin R. Rothschild, Elaine A. Lasater, William M. Lewis and Gilbert W. Coulson. (R. at 4.) Three of the seven members,

Saligman, Richmond and Craig, are the Company's most senior officers. *Id.* Appellant has also alleged that Securance's officers Rachel N. Lieberman, Timothy M. Stockdale and Carlos B. Huelva (herein after referred to as "Officers") breached their fiduciary duty of oversight. *Id.* The Officers are the senior most officers of the company who do not also have positions on the board, though share many of the same responsibilities and have the same compensation plan as directors. (R. at 4, 12.)

Both Appellant's claims arise out of fraud committed by three former Securance senior managers who falsified documents to boost profits, although none of the parties addressed in the current suit were involved in the fraud. (R. at 9.) The Directors had no knowledge of the fraud but Appellant's claim arises by alleging that there were "red flags" that the Directors should have recognized, constituting an intentional failure to monitor, however the Directors had in place an auditing committee and a regulatory compliance program at Securance as early as 2004, well before the fraud. (R. at 14.) Appellant points to consent decrees resulting from regulation issues in 2004 as "red flags," however, there was no adjudication or admission of any issue of fact or law and the total amount of the fines constituted only \$200,000. (R. at 13, 25.) Appellant bases the oversight claim on the drastic earning growth experienced between 2005 and 2007, however the Medicaid program was merely one aspect of Securance's business operations. (R. at 4, 25.) The Appellant concedes that these facts were only brought to the attention of the Directors after they convened a special meeting to investigate the fraud committed by the

senior managers following a federal search warrant on March 12, 2008.
(R. at 11.)

The connection Appellant alleges for support of her claim against the Officers is that two of the officers supervised the departments the managers who committed fraud worked in. (R. at 8.) The third officer had no day-to-day supervisory role with any of the senior managers who were found guilty of fraud at all and the only connection is that he supposedly worked closely with the managers in their preparation of the reports. *Id.* In their plea agreements for fraud the managers claimed they acted with express or implied support of the Securance's senior officers however they did not name a single senior officer by name or position nor were any senior officers ever charged with any crime. (R. at 10.)

The lower court dismissed the claim because Appellant failed to point to any specific facts that demonstrate the Directors or the Officers *knowingly* and *intentionally* failed to monitor the activities of the managers. (R. at 11-12.) The lower court held, under Court of Chancery Rule 23.1 the plaintiff must do far more than offer sweeping conclusions of law and fact. (R. at 18.)

STANDARD OF REVIEW

The decision of the Delaware Court of Chancery to dismiss the Appellant's derivative complaint in its entirety, pursuant to Court of Chancery Rule 23.1 for failure to adequately allege demand futility and Court of Chancery Rule 12(b)(6) for failure to state a claim will be reviewed *de novo* and plenary because the issues presented are

questions of law rather than fact. (R. at 28, 29.); DEL. CT. CH. R.23.1; DEL. CT. CH. 12(b)(6).

ARGUMENT

I. THE DELAWARE SUPREME COURT SHOULD AFFIRM THE LOWER COURT'S DECISION BECAUSE APPELLANT HAS FAILED TO ALLEGE THE REQUIRED PARTICULARIZED FACTS OF A "CONSCIOUS FAILURE TO MONITOR" THAT WOULD SHOW A SUBSTANTIAL LIKELIHOOD THE DIRECTOR'S ARE PERSONALLY LIABLE FOR BREACHING THEIR OVERSIGHT DUTY, THEREBY FAILING TO CREATE REASONABLE DOUBT OF THE BOARD OF DIRECTOR'S ABILITY TO EXERCISE INDEPENDENCE AND DISINTERESTED JUDGEMENT, WHICH IS REQUIRED TO EXCUSE DEMAND AS FUTILE.

This case deals with upholding the long standing tradition of ensuring the prevention of government encroachment in the complex world of corporate governance. This is precisely why in the State of Delaware, under Court of Chancery Rule 23.1, a complaint brought by one or more shareholders to enforce a right of a corporation, must allege, among other things, "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. CT. CH. R.23.1. When the subject of a derivative suit is not a business decision of the board of directors but rather an alleged violation of the Board's oversight duties, the *Rales* test applies. *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993) (holding a court should not apply the *Arsonson* test for demand futility where there was no business decision which is being challenged). The *Rales* test requires that the Plaintiff allege particularized facts establishing a reason to doubt that "the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." *Id.* at 934. Satisfying the *Rales* test

turns on whether a Plaintiff has alleged facts showing a substantial likelihood of liability for breach of fiduciary duty of oversight by directors. *Id.* at 936; *See also Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984). The Delaware Supreme Court should affirm the lower court's ruling for the following two reasons. First, in applying the test of liability for director oversight claims the court should continue to exclusively use the "conscious failure to monitor" formulation as the standard to determine "bad faith" and apply a practical construction of the term "red flags" because they are consistent with Delaware case law. Second, strong policy concerns for maintaining successful corporate governance require the use of the "conscious failure to monitor" formulation as well as practical construction of the term "red flags."

A. This Court Should Continue To Use The "Conscious Failure To Monitor" Formulation To Determine "Bad Faith" And Apply A Practical Construction Of The Term "Red Flags" Because Such Standards Are Consistent With Delaware Case Law In Determining Director Oversight Liability.

1. The "conscious failure to monitor" formulation to determine "bad faith" should be used because it is consistent with Delaware case law.

The Delaware Supreme Court should continue using the carefully developed substantive test set forth in *Stone v. Ritter* using "conscious disregard" as a predicate to finding liability in director oversight cases. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). In 1996, the *Caremark* court created new precedent by holding directors could face personal liability for failing to take steps to assure compliance with laws, however, the *Caremark* court clarified that lack of good faith is a "necessary condition" to finding liability where a

claim of "directorial liability for a corporate loss is predicated upon ignorance of liability creating activities." *In re Caremark Int'l Inc.*, 698 A.2d 959, 971 (Del. Ch. 1996). The court explained that "only a sustained or systematic failure of the board to exercise oversight" will establish lack of good faith. *Id.* (emphasis added). For example, "where the fiduciary *intentionally* fails to act in the face of a known duty to act, demonstrating a *conscious disregard* for his duties" a lack of good faith can be shown. *In re Walt Disney Co.*, 906 A.2d 27, 66-67 (Del. 2006) (emphasis added). The court in *Stone* clarified the *Caremark* test for director liability in oversight claims using the "conscious disregard" requirement for bad faith set out in *Disney*. See *Stone v. Ritter*, 911 A.2d at 362; See generally *In re Walt Disney Co.*, 906 A.2d at 66-67; See generally *In re Caremark Int'l Inc.*, 698 A.2d at 971. The *Stone* court held that in order to find director oversight liability, the court must find that either "directors utterly failed to implement any reporting or information system or controls, or having implemented such a system or controls, *consciously failed* to monitor its operations thus disabling themselves from being informed of risks or problems requiring their attention." *Stone v. Ritter*, 911 A.2d at 370 (emphasis added); See generally *In re Caremark Int'l Inc.*, 698 A.2d at 971.

In the instant case, the Appellant alleges no facts that would establish the Directors "consciously failed" to monitor its operations. Although the fraud caused by the Senior Managers resulted in millions in criminal penalties, refunds, and capitalization loss, the Appellant fails to point to any specific facts that demonstrate

the Directors *knowingly* and *intentionally* failed to monitor the activities of the managers. (R. at 11-12.) At best, the Appellant has merely alleged a "reckless" failure by the directors in their oversight obligations which Delaware courts have not used in proving bad faith in oversight cases. Appellant alleges the senior managers, in their plea agreements, confirmed they were supported by the company's "senior officers," however, by failing to state specific facts such as names of officers, the number of senior officers involved, or how many, if any, were members of the board of directors, the Appellant fails to allege "conscious failure" on the part of any of the Directors of Securance, and thereby fails to allege bad faith. (R. at 10.) The Directors' lack of knowledge about the fraud committed over a three year span cannot be inflated to imply intentional failure to monitor. (R. at 7.) On the contrary, the facts allege that the Directors had in place an auditing committee and a form of regulatory compliance program at Securance as early as 2004. (R. at 14.) Similar to the *Stone* case, the Appellant, with the benefit of hindsight, attempts to equate a bad outcome with bad faith of the directors. *Stone v. Ritter*, 911 A.2d at 373. The Appellant's allegation that bad faith can be proven by "recklessness" would, as noted by Chancellor Siegel, "conflate the careful distinction between bad faith and gross negligence" set forth in *Stone*. (R. at 21.)

2. A practical construction of the term "red flags" should be used because it is consistent with the "conscious failure to monitor" formulation and existing corporate law.

This court should interpret the meaning of the term "red flag" in a manner that is consistent with the "conscious failure" formulation

set forth by the Delaware Supreme Court and failure to do so would imply bad faith when there is none present. Although case law has not defined the term "red flag", Chancellor Siegal in his opinion defined the term to mean "specific facts of actual or probable employee misconduct" known subjectively by the directors," which if ignored, would infer a conscious indifference to oversight responsibility. (R. at. 24.) In *Graham*, the court stated "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 v. Allis Chalmers Mtg. Co.*, 188 A.2d 125, 130 (Del. 1963) (holding that consent decrees involving allegations of price fixing which occurred more than twenty years earlier were insignificantly remote to the current antitrust problems). Where an internal reporting and compliance system has been implemented, "directors will be potentially liable for breach of their oversight duty only if they ignore red flags that actually come to their attention, warning of compliance problems." *Forsythe v. Esc Fund Mgmt. Co.*, 2007 WL 2982247, at *7 (Del. Ch. October 9, 2007) (explaining that unless red flags surface, corporate officers and employees are exercising their delegated corporate powers in the best interest of the corporation). 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) (*quoting* *In re Citigroup Inc.*, 2003 WL 21384599, at *2 (Del. Ch. June 5, 2003)).

In the instant case, although the Appellant alleges the existence of red flags warning of the wrongdoing by the three senior managers,

she fails to point to facts alleging knowledge of the ongoing fraud by any of the seven board members. She alleges that the Directors *should* have noticed the red flags thereby supporting her assertion that "recklessness" should be the standard for finding bad faith, however, as the court in *Wood* carefully explained, red flags are "only useful when they are either waved in one's face or displayed so that they are visible." *Wood*, 953 A.2d at 143. The alleged "red flags" were neither "waved" in any of the Directors' faces nor visibly displayed, and therefore cannot imply bad faith. The alleged red flags, as Appellant concedes, were only brought to the attention of the Directors after they convened a special meeting to investigate the fraud following the federal search warrant executed on March 12, 2008. (R. at 11.)

Appellant also points to the 2004 consent decrees as "red flags," however, because both decrees were stipulated without "adjudication or admission of any issue of fact or law," they cannot be amounted to red flags of wrongdoing. (R. at 13.) Similar to the consent decrees in *Graham*, which occurred years before the antitrust problems, here, the consent decrees occurred four years before fraudulent activities of the senior managers. (R. at 13.); See *Graham*, 188 A.2d at 130.

Additionally, the events leading to the consent decrees in 2004 only amounted to an insignificant \$200,000 in combined fines, which compared to the total earnings of \$49 million, are insubstantial to constitute a red flag for the board of directors. (R. at 25.) Further, the existence of the Incentive Compensation Plan should not be amounted to a red flag as Appellant alleges because many large corporations have similar plans in place to motivate their directors,

officers, and managers. (R. at 12.) If incentive compensation plans were to be labeled as red flags, directors of corporations, small and large, would find themselves at risk of personal liability because compensation plans are widespread in the corporate world. Appellant's assertion that the Directors failed to keep a critical eye on the company's drastic earning improvement between 2005 and 2007 does not put the Directors on notice of actual or possible misconduct by management. (R. at 25.) The company's significant growth during a three year period could have been perceived as a result of non-suspect factors such as growth in the industry or economy. The Medicaid program was merely one aspect of Securance's business operations, so the significant growth could have resulted from the Medical sector of Securance. (R. at 4.) If drastic improvements in a company's stock portfolio were to be labeled as a "red flag," directors would be more at risk of potential liability. Additionally, Appellant can only allege that certain unidentified senior officers "expressly or impliedly" supported the fraudulent activities of the three senior managers and these groundless accusations come nowhere near the standard needed to demonstrate *knowledge*. (R. at 10.) Thus, although there was significant manager misconduct alleged, the Appellant fails to allege specific facts that the directors consciously "knew" of the senior managers' misconduct or allege the existence of "red flags," which are essential requirements in director oversight liability cases.

- B. Strong Public Concerns For Maintaining Successful Corporate Governance Require The Use Of The "Conscious Failure To Monitor" Formulation As Well As Practical Construction Of The Term "Red Flags."

1. "Conscious failure" formulation should be used because it serves public policy and is consistent with main themes of corporate governance.

Public policy in the realm of corporate law dictates maintaining a demanding test for director oversight liability. Allowing "recklessness," a lower standard than "conscious failure," to be used would result in extraordinary changes to Delaware Corporate governance, which must be prevented at all costs. By lowering the standard of proof, competent individuals who would otherwise be open to serving on the board of directors of companies, would be less likely to take the role for fear of personal liability. See *Air Line Pilots Ass'n Int'l v. UAL Corp.*, 717 F. Supp. 575, 582 (N.D. Ill. 1989); See also Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 Bus. Law. 439, 456 (2005) (discussing the importance of the business judgment rule). A high threshold standard would benefit shareholders as a class by not only making board service by qualified persons more likely, but also encouraging directors to pursue potentially lucrative, but risky endeavors which they otherwise would not consider if the risk of personal liability were higher. See *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996); See also Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 Bus. Law. 439, 456 (2005). Further, implementing a less stringent test for finding liability would be a burden on non-officer directors who are not as involved with the company because they will be required to play an active role in oversight, which in turn, makes board service less attractive. This creates an even greater hardship for non-officer directors who serve

on the board of directors of more than one company. Holding that compliance systems implemented and monitored in good faith but recklessly maintained amount to a breach of fiduciary duty, would result in an inundation of lawsuits in the Delaware Courts. Further, because judges are public officials and not in the corporate business world, allowing them to determine whether directors and officers "recklessly" failed to monitor misconduct would undermine not only Delaware corporate governance based upon the doctrine of judicial restraint, but Laissez-Faire economic philosophy as well. See R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 Bus. Law. 1337, 1337 (1993) (explaining the business judgment rule has always been viewed as a doctrine of judicial restraint). Courts have asserted that they are not business experts, nor are they equipped to second guess actions and/or inactions of businesses. See *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) (recognizing "judges are not business experts"); See generally *Auerbach v. Bennett*, 393 N.E.2d 994, 1000 (N.Y. 1979) (stating courts are ill equipped to evaluate business judgments). With the countless number of industries, each with their own complex business methods, requiring the court to impose a objective standard of what a prudent director in each industry should have done in a given situation would be an impossible task. Delaware courts will simply not be able to understand the specific circumstances confronting a corporation.

In the instant case, application of a less stringent test would be unduly burdensome for companies like Securance, actively do business in eighteen different states across the nation. (R. at 4.)

Further, because Securance can only "maximize the company's percentage of profit with the legally limited 20% band of premium revenue" allotted by the government contracts, the directors and officers must pursue potentially lucrative, but risky endeavors, which they otherwise would not consider if the risk of personal liability were higher with the less stringent test of "recklessness." (R. at 6.) Non-officer directors, such as the four serving on the board of directors of Securance, would become unduly burdened if they were required to play a more active role, for fear of personal liability, in a company working out of eighteen different states. (R. at 3-4.)

2. "Red flags" should be interpreted practically because it serves public policy and is consistent with main themes of corporate governance.

Public policy in the realm of corporate law favors a practical construction of the term "red flags." If insignificant corporate events or plans were labeled as red flags, courts would become inundated with oversight liability cases, especially in Delaware, which is home to more corporations than any other state. The threshold for what can be considered a "red flag" that puts the directors on notice should be kept high. Labeling universal corporate policies such as corporate incentive or motivational plans as red flags will change long standing themes of corporate governance drastically. Directors and officers would find themselves at risk of oversight liability for attempting to motivate their corporate colleagues. Further, courts would be forced to review alleged "red flags" that arose in hindsight to determine whether the directors "knew" and "consciously failed" to monitor misconduct. This is a task which judges are not equipped to

address in the roles as public officials. See *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) (recognizing “judges are not business experts”). It would unsurely result in excessive involvement by courts into the internal affairs of corporations.

In the instant case, labeling drastic improvements in Securance’s stock price as red flags of corporate fraud or misconduct would be illogical because corporations grow drastically for reasons unrelated to misconduct, such as changes in technology. (R. at 25.) If miniscule events such as the ones alleged by Appellant were “red flags” sufficient to put directors on notice, competent individuals otherwise willing to serve as officers or members of a corporations board of directors, will be reluctant to serve, for fear of personal liability. If such events were labeled as red flags to put directors on notice, then thousands of directors across the nation face potential personal liability as compensation plans, like the one implemented by Securance, are found in most corporations. (R. at 12.) Therefore, the court should adopt a practical construction of the term “red flag” setting a high threshold standard.

Thus, the existing “conscious failure” standard should be maintained and a practical construction of “red flags” should be implemented by the court because doing so affords much needed protection for directors in their monitoring responsibilities, serves public policy, and is consistent with main themes of corporate governance.

II. THE DELAWARE SUPREME COURT SHOULD AFFIRM THE LOWER COURT'S DECISION BECAUSE OFFICERS DESERVE THE SAME PROTECTION AS DIRECTORS OR IT WILL INCREASE DIRECTOR RESPONSIBILITY, INCREASE POTENTIAL LIABILITY FOR OFFICERS, COMPROMISE THE BUSINESS JUDGMENT OF OFFICERS AND COMPROMISE CORPORATE BUSINESS.

This case deals with preventing unjust treatment of officers and ensuring they receive the same standard of liability as directors. The *Stone* test that applies to directors should be applied to officers under the same rationale that the business judgment rule afforded to directors has been extended to protect officers. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). The lower court correctly asserted that the "business judgment rule applies with equal force to protect decisions made by non-director corporate officers." (R. at 27.) The Supreme Court of Delaware should affirm the lower court's decision giving directors and officers the same level of liability for the following two reasons. First, the lower court was correct in holding the *Stone* test should apply to officers for the same reasons the business judgment rule has been applied to officers because strong policy concerns makes the application essential to encourage officers to accept business risks, reflect the limits on judicial competence to judge business transactions, and preserve the governing role of the directors. Second, case law in Delaware and elsewhere demonstrates this rule must be adopted to preserve the ability of officers to make reasoned judgments to further corporate business.

A. Strong Policy Concerns Demand The *Stone* Test Be Applied To Officers As Well As Directors Under The Same Rationale That The Business Judgment Rule Has Been Extended To Officers In Order To Protect Sound Business.

The *Stone* test should be applied to the Officers under the same three generally recognized policy considerations that necessitate the

business rule being extended to officers as well as directors:
Encouraging officers to accept business risks; recognizing the
limitations on judicial competence to evaluate business conduct; and
preserving the board's governance role. See Lyman P.Q. Johnson,
Corporate Officers and the Business Judgment Rule, 60 Bus. Law. 439,
456 (2005); Lawrence A. Hamermesh, *Corporate Officers and the Business
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1. The same protection of the business judgment rule must
be extended to cover officers because it is essential
to encourage officers to accept business risks without
being liable for it.

Strong public policy recognizes the importance of encouraging
officers to serve and take risks in the same manner as directors
because "stockholders desire competent officers willing to serve in
that capacity as much as—perhaps more than—they desire competent
directors." Lyman P.Q. Johnson, *Corporate Officers and the Business
Judgment Rule*, 60 Bus. Law. 439, 459 (2005). In addition,
"[s]tockholders seek the same optimizing stance toward risky corporate
investment opportunities from officers as they do from directors." *Id.*
People who oppose extending the rule argue it should not apply to
officers because they stand to gain more in compensation packages,
however, "the scope of potential negligence-based liability for
officers is enormous in comparison to any but the most generous
incentive packages." Lawrence A. Hamermesh, *Corporate Officers and
the Business Judgment Rule: A Reply to Professor Johnson*, 60 Bus. Law.
865, 872 (2005); See *In re Caremark Int'l Inc.*, 698 A.2d 959, 961
(Del. Ch. 1996) (explaining that without the protection of the

business judgment rule officers could be liable for \$250 million in losses). Justification for extending the rule in Delaware is even more essential because "under Delaware law, officers cannot even enjoy the damages insulation afforded to directors under exculpatory charter provisions." Lawrence A. Hamermesh, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 *Bus. Law.* 865, 872 (2005). Furthermore, officer liability insurance will not apply in derivative lawsuits because they "uniformly include an 'insured v. insured' exclusion, denying coverage where the corporation itself initiates the claim against the officer." *Id.* Additionally, when officers implement board policy and exercise delegated corporate authority it is unjust to hold them to a higher standard than directors because "it would shift to officers the burden of legal liability for risk-taking activity that the directors themselves encouraged." *Id.*

In the instant case the policy rationale of encouraging officers to serve and take risks is vital because Securance is a for-profit managed healthcare company with over 42 million shares outstanding, competing in a heavily regulated industry, thus making it essential that officers take risks to make profit for its shareholders. (R. at 3.) In addition, taking risks is essential because Securance is contractually bound to follow a "medical loss ratio" formula, where 80% of the premiums it receives must be spent on direct medical care (or Securance must refund the difference) leaving only 20% maximum to cover both administrative costs and profit. (R. at 6.) With so little margin for profit and "[s]tockholders seek[ing] the same optimizing

stance toward risky corporate investment opportunities from officers as they do from directors" it is essential that Securance's Officers be afforded the same protections. Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 Bus. Law. 439, 459 (2005). Additionally, the argument that officers deserve a higher standard of liability because their incentive packages are greater is irrelevant in the instant case because Securance's compensation plan was the same for both directors and officers. (R. at 12.) This would make subjecting officers to a higher standard of care extremely unfair as the benefits are the same for directors and officers yet the risk is far greater for officers. Especially since Delaware law does not allow damage insulation for officers under exculpatory charter provisions.

2. The business judgment rule should be applied to officers because the judiciary has limited competency to evaluate business conduct.

The court should extend liability protection to officers because courts recognize "their limited ability to evaluate and attach liability to complex business judgments," especially when viewing decisions in hindsight. Lawrence A. Hamermesh, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 Bus. Law. 865, 874 (2005). "The risk of hindsight bias applies with at least equal force to officer decisions" even more than director decisions. *Id.* Officer decisions "arise in complex, fluid situations in which courts and juries suffer from what scholars aptly describe as 'cognitive limitations and informational disadvantage.'" *Id.* In addition, "judicial evaluation of care in 'preparing for, making and carrying out' a business decision presents the same problems of

hindsight bias and institutional comparative disadvantage that would apply if courts were called upon to evaluate the substantive soundness of business decisions." *Id.* at 874. The notion that judges are not experts in business "would seem to carry equal-if not greater-weight for officers as for directors" because "[o]fficers devote more time to company business than do directors." Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 *Bus. Law.* 439, 463 (2005).

In this case, the extension of the business judgment rule is further justified because Securance is in the managed health care industry which the lower court correctly describes as an "industry [that] typically struggle[s] with thin profit margins and relatively low rates of earning growth," so it would be difficult for the judiciary to decide in hindsight what a prudent course of action would be when risks must be taken to make profit. (R. at 6.) The field has an incredibly *complex* "medical loss ratio" that must be followed, so there is a severe risk of hindsight bias because it would be incredibly difficult for the court to discern what constitutes prudent judgment in such a complex field. (R. at 6.)

3. It is necessary to extend the business judgment rule to preserve the board's governance role or officers will always seek board approval to avoid liability.

Officers deserve the same level of liability protection to ensure they can do their jobs without having to constantly seek board approval because "a default rule that would place officers at substantially greater risk of care-based liability than the risk faced by directors *would* impinge upon the board's managerial prerogative, and would therefore frustrate, rather than advance, the policies

underlying the business judgment rule." Lawrence A. Hamermesh, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 Bus. Law. 865, 876 (2005) (emphasis added). In addition, having a disparity in liability "would simply encourage officers to place more decisions in the hands of the board, and to take fewer, and less risky, initiatives on their own, so as to avoid liability." *Id.* The purpose of the business judgment rule is to enable directors and officers to make risky moves that stockholders seek and limiting the rule to directors would make "management of the corporation . . . 'top heavy,' making service on a board of directors even more time-consuming and costly to the corporation and its stockholders," thereby frustrating the purpose of the business judgment rule. *Id.*

In the instant case, failing to extend the liability protection to Officers would create a cumbersome impediment to Securance's operations. With a profit margin of only 20%, "a default rule that would place officers at substantially greater risk of care-based liability than the risk faced by directors *would* impinge upon the board's managerial prerogative" and would make "management of the corporation . . . 'top heavy,' making service on a board of directors even more time-consuming and costly to the corporation and its stockholders." *See Id.*; (R. at 6.) In the current case, Securance's officers would constantly have to go to the board for their approval in order avoid liability, which would likely increase the cost of oversight, thereby making management 'top heavy.' Furthermore, managing the day to day business of a corporation which works out of

eighteen different states scattered across the nation would likely increase overhead costs thereby cutting into the margin of profit, which would result in lower or no payment at all of shareholder dividends. (R. at 4.)

B. The Stone Test Should Apply To Officers Under The Same Rationale That The Business Judgment Rule Has Been Extended To Officers In Substantial Case Law In Delaware And Other States.

1. The Supreme Court has suggested the business judgment rule applies to officers and lower courts have applied Delaware law to protect officers under the rule.

The Delaware Supreme Court has continually asserted that the business judgment rule should apply to officers. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995) (holding "the business judgment rule attaches to protect *corporate officers* and directors) (emphasis added); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (holding that the business judgment rule applies to corporate officers and directors). The Supreme Court in *Kelly v. Bell*, 266 A.2d 878, 878 (Del. 1970) used the terms "directors or officers" interchangeably as they affirmed the lower court's recommendation that the business judgment rule applies to executive officers. See also *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971) (holding the business judgment rule applies to Officers following board action).

Two non-Delaware courts, as well as the U.S. District Court for the District of Delaware have applied Delaware law to Officers. *Stanzaile v. Nachtomi*, 2004 U.S. Dist. LEXIS 7375 (D. Del. Apr. 20, 2004) (holding officer not responsible for losses that result from good faith decision and conclusory allegations of bad faith not enough

to sustain a claim); *Grassmueck v. Barnett*, 2003 WL 22128263 (W.D. Wash. July 7, 2003) (applying Delaware law and protecting officers with the business judgment rule); *Potter v. Pohlard*, 560 N.W.2d 389 (Minn. Ct. App. 1997) (holding an officer protected under business judgment rule even though the officer was considered an agent). The only case applying Delaware law that failed to extend business judgment to officers was the Pennsylvania district court's decision in *Platt v. Richardson*, but many commentators have criticized the decision because the ruling was based on a lack of precedent, yet they did not reference *Kelly* or *Kaplan* which did extend the rule. *Platt v. Richardson*, 1984 WL 159584, at *2 (M.D. Pa. June 6, 1989); *Kelly v. Bell*, 266 A.2d 878 (Del. 1970); *Kaplan v. Centex Corp.*, 284 A.2d 119 (Del. Ch. 1971).

In the instant case, Securance's Officers should be protected because they acted in good faith, and as *Stanzaile* demonstrates conclusory allegations, such as the kind Appellant alleges, are not enough to sustain a claim. *Stanzaile*, 2004 U.S. Dist. LEXIS 7375 at *15; (R. at 28.) In addition, as case law has shown in *Potter*, even if Securance's Officers are considered to owe a heightened agency duty of care, the business judgment rule would supersede it. *Potter*, 560 N.W.2d at 395. Delaware courts have continually favored extending the business judgment rule to officers, and by the same rationale, the *Stone* test should be applied which would result in no liability for the Officers under the "conscious failure to monitor" formulation. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). Under the *Stone* test, the Officers would not be held liable because Appellant has alleged no

evidence of "bad faith" which is required to demonstrate oversight liability. *Id.* As the lower court noted, the "plaintiff must do far more than offer sweeping conclusions of law and fact." (R. at 18.) The Appellant's complaint does not "allege direct participation in the fraud by any of the Officer[s]" and the only connection Appellant alleges for two of the Officers is that they supervised the departments the managers who committed fraud worked in. (R. at 8.) Additionally, the Appellant admits that the last Officers had "no day-to-day supervisory role with any of the senior managers" who were found guilty of fraud and the only connection he had is that he supposedly "work[ed] closely" with the managers in their preparation of the reports. *Stone v. Ritter*, 911 A.2d at 370. Furthermore, the baseless allegations that the managers acted with express or implied support of the Securance's senior officers is completely erroneous because not one of the managers named a single senior officer "by name or position" in their plea agreements nor were any senior officers ever charged with any crime. (R. at 10.) These broad allegations come nowhere near the high threshold needed to meet the demand futility requirement and fail to demonstrate "bad faith" under the *Stone* test. Since the Appellant has failed to meet the heightened burden of pleading to show that Securance is incapable of acting independently to bring an oversight action or handle the matter in a non-litigation setting, the lower court was correct in dismissing the claim.

2. Other state courts applying non-Delaware law have also extended the business judgment rule to officers.

Other states have extended the business judgment rule to protect officers by refusing to differentiate between Officers and Directors.

See *FDIC v. Niblo*, 821 F. Supp. 441 (N.D. Tex. 1993) (extending the business judgment rule to officers and refusing to differentiate between officer and directors for the purpose of the rule); *Estate of Detwiler v. Offenbecher*, 728 F. Supp. 103 (S.D.N.Y. 1989) (extending the business judgment rule to officers by refusing to distinguish between officers and directors under the rule). In *AmeriFirst Bank v. Bomar*, the court reaffirmed the "bad faith" requirement as it applied the business judgment rule to officers. *AmeriFirst Bank v. Bomar*, 757 F. Supp. 1365, 1376-77 (S.D. Fla. 1991) (holding the business judgment rule applied to officers in a public company and the only way to overcome it is recklessness, illegality, and a lack of reasonable care). Even when the courts have held that officers owe an agency duty, they have stated that the business judgment rule supersedes that duty. *Para-Med. Leasing, Inc. v. Hangen*, 739 P.2d 717 (Wash. Ct. App. 1987); See *Omnibank of Mantee v. United So. Bank*, 607 So.2d 76 (Miss. 1992) (holding an officer protected despite their status as agents).

Many courts refuse to distinguish between directors and officers for the purpose of the business judgment rule and with the way Securance is set up that should be even truer. The record states that none of the Officers only supervised the department thus making their role more like directors with control over corporate policy decisions rather than managerial oversight obligations. (R. at 8.) Further, the Directors and Officers both had the same bonus packages. (R. at 12.) The Officers are the most senior officers who do not have positions on the Board so their positions are very similar since they receive comparable pay and have related responsibility which justifies

applying the same rule. (R. at 12.) As case law demonstrates, the *Stone* test should apply in the same manner as the business judgment rule, and the court was correct in dismissing the action under that test.

CONCLUSION

The Delaware Supreme Court should affirm the lower court's decision in order to prevent government encroachment in the complex world of corporate governance and the unjust treatment of officers by ensuring they receive the same standard of liability as directors. Strong public policy concerns for maintaining successful corporate governance and Delaware case law necessitate the use of the *Stone* formulation to determine "bad faith" as well as a practical construction of the term "red flag" in determining oversight liability in derivative suits. Further, strong public policy concerns and case law precedent requires that officers receive the same treatment as directors because failing to do so will increase director responsibility, increase potential officer liability, compromise officer's business judgment and erode the structure of corporate business as a whole. For the foregoing reasons it is essential the Delaware Supreme Court uphold the lower court's judgment or risk putting the corporate business world in jeopardy.

Respectfully Submitted,

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