

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,  
Appellee

- and -

SECURANCE INCORPORATED,  
Appellee

No. 24, 2008

---

BRIEF FOR THE APPELLEE

---

Filed by O, Counsel for Appellee

February 17, 2009

TABLE OF CONTENTS

TABLE OF CONTENTS.....	i
TABLE OF CITATIONS.....	iii
NATURE OF PROCEEDINGS.....	1
SUMMARY OF ARGUMENT.....	2
STATEMENT OF FACTS.....	5
ARGUMENT.....	11
I. THE COURT OF CHANCERY CORRECTLY DISMISSED THE COMPLAINT UNDER RULE 23.1 WHERE APPELLANT NEITHER MADE PRE-SUIT DEMAND NOR PLED PARTICULARIZED FACTS ADEQUATE TO RAISE A REASONABLE DOUBT THAT THE DIRECTOR DEFENDANTS WERE DISINTERESTED AND INDEPENDENT.....	11
A. Questions Presented.....	12
B. Scope of Review.....	12
C. Merits of the Argument.....	12
1. The Court of Chancery correctly articulated and applied the Rales test in granting Defendants’ motion to dismiss the Complaint, in its entirety, pursuant to Court of Chancery Rule 23.1 where Appellant failed to make demand and failed to allege particularized facts sufficient to excuse demand.....	14
a. There were no red flags indicating the system of controls was inadequate or inefficient..	17
2. The Court of Chancery correctly articulated and applied the Rales test in granting Officer Defendants’ motion to dismiss Count II of the Complaint pursuant to Court of Chancery Rule 23.1 where Plaintiff failed to include Director Defendants Saligman, Richmond and Craig in Count II and failed to allege any facts which raise a reasonable doubt that other Director Defendants were disinterested or independent such that demand is excused.....	18
II. THIS COURT SHOULD AFFIRM CHANCELLOR SEIGEL’S DECISION GRANTING OFFICER DEFENDANTS’ 12(b)(6) MOTION TO DISMISS COUNT II OF THE COMPLAINT WHERE THE COURT OF CHANCERY CORRECTLY FORMULATED AND APPLIED THE RALES TEST FOR OVERSIGHT LIABILITY.....	20
A. Questions Presented.....	20
B. Standard of Review.....	20
C. Merits of Argument.....	21
1. Chancellor Seigel applied sound reasoning in determining that the Stone standard for director oversight liability applies with equal force to corporate officers.....	22
2. Chancellor Seigel’s 12(b)(6) ruling should be upheld where under either a knowing or less deferential standard Count II of the Complaint fails	

to state a claim for fiduciary oversight liability..	24
CONCLUSION.....	25

**TABLE OF CITATIONS**

**CASES:**

<u>Aronson v. Lewis</u> , 473 A.2d 805 (Del. 1984).....	12, 13
<u>Beam ex. rel. Martha Stewart Living Omnimedia, Inc. v. Stewart</u> , 845 A.2d 1040 (Del. 2004).....	12-14
<u>Brehm v. Eisner</u> , 746 A.2d 244 (Del. 2000).....	11, 12
<u>Dunlap v. State Farm Fire &amp; Cas. Co.</u> , 878 A.2d 434 (Del. 2005).....	20
<u>Feldman v. Citaia</u> , 951 A.2d 727 (Del. 2008).....	20
<u>Forsythe v. ESC Fund Mgt. Co.</u> , 2007 WL 2982247 at *1 (Del. Ch. 2007).....	16
<u>Gantler v. Stephens</u> , No. 132, 2008, 2009 WL 18828 at *1 (Del. 2009).....	22
<u>Grobow v. Perot</u> , 539 A.2d 180 (Del. 1988).....	15
<u>In re Abbott Labs, Deriv. S'holders Litig.</u> , 325 F.3d 795 (7th Cir. 2003).....	19
<u>In re Caremark Int'l. Inc. Deriv. Litig.</u> , 698 A.2d 959 (Del. Ch. Ct. 1996).....	21-23
<u>In re Citigroup Inc. S'holders Litig.</u> , 2003 WL 21384599, at *1 (Del. Ch. Ct.).....	17
<u>In re General Motors (Hughes) S'holder Litig.</u> , 897 A.2d 162 (Del. ....)	21
<u>In re Fed. Nat'l. Mortgage Ass'n. Sec., Deriv., &amp; "ERISA" Litig.</u> , 503 F.Supp.2d. 9 (D.C. Dist. Ct., 2007).....	23
<u>In re MIPS Tech. Deriv. Litig.</u> , 542 F.Supp.2d 968 (N.D.C.A., 2008).....	24
<u>Pogostin v. Rice</u> , 480 A.2d 619 (Del. 1984).....	12
<u>Public Employees' Retirement Associaton of CO v. Deloitte &amp; Touche</u> , 551 F.3d 305 (4th Cir. 2009).....	16
<u>Rales v. Blasband</u> , 634 A.2d 927 (Del. 1993).....	11-16
<u>Rattner v. Bidzos</u> , No. Civ.A. 19700, 2003 WL 22284323 at *1 (Del. Ch. 2003).....	15
<u>Smith v. Van Gorkom</u> , 488 A.2d 858, 872 (Del. 1985).....	17
<u>Stone v. Ritter</u> , 911 A.2d 362, 367 (Del. 2006).....	14-17, 24
<u>VLIW Tech., LLC v. Hewlett-Packard Co.</u> , 840 A.2d 606 (Del. 2003).....	20
<u>White v. Panic</u> , 783 A.2d 543 (Del. 2001).....	11, 12, 25
<u>Wood v. Baum</u> , 953 A.2d 136, 143 (Del. 2008).....	17

**PERIODICALS:**

<u>Lyman P.Q. Johnson, Corporate Officers and the Business Judgment Rule</u> , 60 Bus. Law 439, 455-56 (2005).....	24
--	----

**RULES/STATUTES:**

8 Del. C. §102(b) (7).....	16
Ch. Ct. R. 12(b) (6).....	23, 24
Ch. Ct. R. 23.1.....	11, 12, 18
Del. Code Ann. tit. 8, § 141(a) (2006).....	12

## NATURE OF PROCEEDINGS

Ms. Clare C. Marshall plaintiff below-appellant (the "Appellant"), filed Derivative Complaint (the "Complaint"), Civil Action No. 3892-CS, in the Court of Chancery in and for New Castle County on Jul 3, 2008.

The Complaint named Securance Incorporated ("Securance") as nominal defendant and its seven-member board of directors (the "Director Defendants" or the "Board") and three non-director, senior officers (the "Officer Defendants" ) as defendants (collectively, the "Defendants"). (Compl. ¶ 1). The Complaint alleged that Defendants breached their fiduciary duty of loyalty by failing to act in good faith to fulfill their oversight responsibilities. Id. at ¶ 2.

Plaintiff failed to make pre-suit demand upon the Board. Id. at ¶ 46. The Defendants motioned to dismiss the Complaint pursuant to Court of Chancery Rule 23.1 for failure to adequately plead that pre-suit demand is excused in this case. Alternatively, the Defendants motioned to dismiss claims against Officer Defendants in Count II of the Complaint for failure to state a claim pursuant to Court of Chancery Rule 12(b)(6). The case was submitted to the Court of Chancery on November 5, 2008 and decided on January 6, 2009. The Court of Chancery (Siegel, C.) granted both motions to dismiss. (Mem. Op. at 28-29). On January 16, 2009, Appellant filed Notice of Appeal, No. 27, 2009, challenging the Court of Chancery's decision.

## SUMMARY OF ARGUMENT

The Appellant seeks to pursue a derivative claim on behalf of the Securance and its shareholders. Before she may do so, however, Appellant must meet the high pleading standard required by Court of Chancery Rule 23.1. Under Rule 23.1, Appellant must plead with factual particularity either that she made demand and it was wrongfully refused or that pre-suit demand is excused.

Appellant failed to make pre-suit demand. Thus, Appellant must satisfy the Rales test to survive Defendants' Rule 23.1 motion to dismiss. Under Rales, Appellant must allege with factual particularity sufficient to create a reasonable doubt that a majority of Securance's board of directors were disinterested or independent such that they could not have objectively considered demand, if Appellant had made one. According to her Complaint, Appellant maintains that demand is excused under Rales because the board of directors faced a substantial likelihood of liability for Counts I and II of the Complaint.

Count I alleges that the Director Defendants, all of whom constitute Securance's entire seven-member board, breached their fiduciary duty by failing in good faith to meet their oversight responsibilities. While, Count I names all of the Director Defendants, it only amounts to a mere threat of liability. While heavy with conclusory statements, the Complaint offers few particular facts. Moreover, the particular facts alleged in the Complaint do not support a reasonable inference that the Director Defendants breach their

fiduciary duty of loyalty to fulfill in good faith their oversight responsibilities.

With respect to Count II, the Complaint also fails to meet the Rule 23.1 pleading standard. Count II alleges that the Officer Defendants breached their fiduciary duty of oversight. The analysis here is whether the Director Defendants, none of whom are named in Count II, could have exercised their independent business judgment on a shareholder's demand that Securance litigate Count II. Where none of the Director Defendants are named in Count II, they face a very remote chance of liability, particularly given the sparse factual allegations contained within.

The Complaint still fails even if the Director Defendants, who also serve as officers, are said to be interested or dependent. Rales requires that the Appellant disqualify a majority of the Securance board of directors. The Securance board has seven members, only three of which serve concurrently as officers. Thus, Appellant would have to plead with factual particularity allegations sufficient to raise a reasonable doubt regarding the disinterest or independents of at least one other director. Appellant alleges no such factual allegations.

Thus, this Court should affirm the Court of Chancery's decision granting Defendants' motion to dismiss pursuant to Rule 23.1 for failure to plead that demand is excused in this case.

In the alternative, the Officer Defendants filed a Rule 12(b)(6) motion to dismiss Count II for failure to state a claim. While it is not certain whether the Rales test applies with equal force to the Officer Defendants, the Court of Chancery used sound reasoning to

reach that conclusion. The Court of Chancery based its decision on two precepts: (1) the business judgment rule applies equally to corporate officers as it does to directors and (2) the Rales test is the inverse of the business judgment rule. From these, the Court of Chancery logically reasoned that the Rales test applies with equal force to the Officer Defendants.

The Court of Chancery reasoning and conclusion is supported by Delaware case law and is supported by sensible policy considerations. This court should, therefore, adopt the Chancery Courts formulation of the Rales test as applied to the Officer Defendants.

Notwithstanding this Court's decision on the deference granted the Officer Directors via the Rales test, the Complaint fails to state facts sufficient to satisfy the pleading requirements under Rule 12(b)(6). Defendants concede that the Rule 12(b)(6) pleading standard is not as high as that under Rule 23.1. Rule 12(b)(6) essentially amounts to a notice standard. In spite of this very low standard, the factual allegations alleged in Count II of the Complaint, including all reasonable inferences flowing there from, fail to state a claim upon which relief may be granted.

Thus, this Court should affirm the Court of Chancery's decision to grant Officer Defendants' motion to dismiss pursuant to Rule 12(b)(5) for failure to state a claim.

## STATEMENT OF FACTS

Appellant purportedly owns 1,000 shares of Securance common stock. (Compl. ¶ 3). The Director Defendants are individual directors who together constitute Securance's seven-member board of directors. Id. at ¶ 4. Director Defendant Charles H. Saligman is also Chairman and Chief Executive Officer. Id. at ¶ 5. Director Defendant Patrick C. Richmond is also Chief Financial Officer. Id. Director Defendant Yvonne M. Craig is also Executive Vice President. Id. Martin R. Rothschild, Elaine A. Lasater, William M. Lewis, and Gilbert W. Coulson are the remaining Director Defendants. Id. at ¶ 5.

The Officer Defendants are three non-director, senior officers of Securance. Id. at ¶ 6. Rachel N. Lieberman is Chief Operating Officer. Id. at ¶ 6(a). Timothy M. Stockdale is chief legal officer, holding the titles General Counsel and Chief Compliance Officer. Id. at ¶ 6(b). Carlos B. Huelva is Securance's Chief Accounting Officer. Id. at ¶ 6(c). For their services, Officer Defendants Lieberman, Stockdale and Huelva earned, respectively, \$2.8, \$2.6 and \$2.5 million in salary and bonuses in fiscal year 2008. Id. at ¶ 6(a)-(c).

Securance is an approved health maintenance organization ("HMO"). Id. at ¶ 11. Securance is traded on the New York Stock Exchange with 42 million shares of common stock outstanding. Id. at ¶ 7. Securance became publicly traded in an initial public offering in 2002. Id. By January of 2008, Securance had contracts with 18 states - located primarily in the Mid-Atlantic and Midwestern regions of the United States - to manage and provide health care coverage to Medicare and Medicaid patients in those states. Id. at ¶ 13. Securance also had

contracts with Ohio, Pennsylvania, New York, and New Jersey. Id. No aspects of Securance's Medicare services are at issue in the Complaint. (Mem. Op. at 4).

Under the Medicaid program, individual states contract with Securance to manage and provide health coverage to Medicaid patients. (Compl. ¶ 11). For each Medicaid patient enrolled with Securance, the state and federal governments pay Securance a premium per-member or per-capita. Id. In turn, Securance enters into contracts with individual health care providers who service the healthcare needs of Securance's enrollees. Id. at ¶ 12. Many of these contracts require Securance to pay providers on a fee-for-service basis. Id.

Under each state contract, Securance is required to report to each state the amount of money it spends on direct medical care through a metric known as "medical loss ratio". Id. at ¶ 14. The medical loss ratio reflects the percentage of premiums actually spent on medical services for covered Medicaid patients. Id. By the law of each state and by contract terms with each state, Securance is required to either (a) spend 80% of the premiums it receives on direct medical services for Medicaid enrollees or (b) refund any premium revenue below the 80% benchmark. Id. at ¶ 15. Prior to 2008, Securance's board of directors oversaw compliance with this requirement through its audit committee. Id. at ¶ 34.

Securance, like all other HMOs, is limited to the 20% band of premium revenue generated by its Medicaid operations. Id. at ¶ 16. Thus, Securance, like all other HMOs, must prudently manage medical claims and control administrative costs and overhead in order to

maximize its profits. The board of directors, acting on the recommendation of its compensation committee, sought to encourage prudent management through its Senior Officer Performance Compensation Plan ("Performance Plan") adopted shortly after the 2002 initial public offering. Id. at ¶ 38. The Performance Plan provided bonus compensation based on the profits yielded by each of Securance's business segments. Id. The Performance Plan applied to senior corporate executives including the Officer Defendants and Director Defendants Saligman, Richmond and Craig. Id.

In 2004, Connecticut and Virginia state investigators examined allegations that Securance offered improper, financial incentives and bonuses to its health care providers. Id. at ¶ 40. Securance initially disputed these allegations, but eventually entered into court approved consent decrees with each state. Id. at ¶ 42. Under each decree, Securance promised to comply with applicable law and pay \$100,000 to each state. Id. at ¶ 42. Nevertheless, each consent decree stipulated that the decree is entered into "without adjudication or admission of any issue of fact or law." Id. The consent decrees did not involve allegations of fraud or false overstatement of medical loss ratios. Id. at ¶ 43. Further, the decrees did not involve any formal admission of wrongdoing. Id. No change to Securance's compliance system resulted from the consent decrees.

Securance appeared to flourish after the 2003 initial public offering. Corresponding with its rapid expansion, Securance reported net income growth in consecutive years: \$49 million in 2004, \$88

million in 2005, \$95 million in 2006, and \$104 million in 2007. Id. at ¶ 25. Securance's stock price rose from its \$42 initial public offering price per share to \$52 in January of 2005 and its height of \$110 per share on December 14, 2007. Id.

Beginning in 2008, analysts began noticing disparities in Securance's medical loss ratios reported in its state regulatory filings versus its SEC filings. Id. at ¶ 27. Specifically, disparities were noticed between Securance's medical loss ratios as reported in its state regulatory filings and its SEC filings. Id. On February 4, 2008, Goldman Sachs issued a report which suggested that Securance was using its reinsurer to hide profits from the states but report them to investors. Id. Thereafter, the report appeared on wire services and in various print and online publications. Id.

Responding to these publications, the Medicaid Fraud Control Units for Ohio, Pennsylvania, New York and New Jersey commenced a joint investigation of Securance. Id. at ¶ 28. On March 12, 2008, approximately one month after the suggested activity by analysts was published representatives of three state Medicaid agencies participated in the execution of a federal search warrant of Securance's headquarters. Id. Laptop computers, BlackBerrys, disks and boxes of documents were seized in this search. Id.

As part of the investigation, investigators questioned three Securance managers who shared responsibility for reporting Securance's state Medicaid reports: Gregory J. Devlin, Finance Manger; Susan E. Larner, Vice President-Operations; and Robert S. Hooper, Vice President-Accounting (collectively, the "Managers"). Id. at ¶ 30. On

May 16, 2008, the Managers each pled guilty in the U.S. District Court for the Eastern District of Pennsylvania to one count of conspiracy to commit Medicaid fraud in violation of 18 U.S.C. § 1349. Id. The Managers each immediately resigned their positions at Securance and were sentenced to two years in prison. Id. In their plea agreements, each of the Managers stated that they acted with the express or implied support of Securance's senior officers, although none of the plea agreements identify these "senior officers" by name or position. Id. at ¶ 31.

The investigation revealed details of the fraud perpetrated by the Managers. Beginning in 2005 through 2007, the Managers developed and implemented a covert scheme to increase Securance's profits. Under this scheme, the Managers overstated Securance's medical loss ratios in reports to Ohio, Pennsylvania, New York and New Jersey. Id. at ¶ 18. Thereby, the Managers avoided Securance's legal and contractual state refund obligations. Id. at ¶ 21. Instead, the Managers arranged to transfer the unspent, Medicaid premiums to Total Reinsurance under the guise of purchasing reinsurance. Id. at ¶ 22. Total Reinsurance is a Cayman Island subsidiary of Securance. Id. As a wholly-owned subsidiary of Securance, Total Reinsurance's financials are incorporated into Securance's consolidated financial statements. Id. at ¶ 24.

On March 15, 2008, following the search of Securance's headquarters, the Board convened a special meeting. Id. at ¶ 32. There, the Board authorized and directed the auditing committee to retain independent outside counsel and to work with independent

counsel to investigate and negotiate a possible settlement of all claims arising from the Managers' fraud. Id.

On June 3, 2008, pursuant to a negotiated plea agreement, Securance pled guilty in the U.S. District Court for the Eastern District of Pennsylvania to one count of mail fraud in violation of 18 U.S.C. § 1341 and stipulated to an order imposing \$400 million in criminal penalties distributed to each of the four states affected by the Managers' fraud. Id. at ¶ 33. Additionally, Securance is disqualified from doing business for three years in these four states. Id. Securance was required to refund the amounts wrongfully withheld by the Managers, a total of \$120 million. Id. Finally, Securance agreed to establish a new compliance committee that is separate from the Board's audit committee. Id. at ¶ 34. None of the 14 other states with whom Securance has Medicaid contracts reported fraudulent activity. Id. at ¶ 35.

Upon recommendation of the audit committee and in consultation with Securance's outside auditor and outside legal counsel, the Board determined that Securance's net income for 2005, 2006 and 2007 had been overstated by the amount wrongfully withheld by the Managers. Id. at ¶ 36. On June 3, 2008 Securance announced restated earnings for this period. Id. Earnings were restated as follows: \$53 million for 2005, \$55 million for 2006, and \$59 million for 2007. Id. On June 5, 2008, the Securance stock price fell to \$37 per share. Id. at ¶ 37.

The Complaint followed on March 8, 2008. None of the Defendants are alleged to have directly participated in the fraud. The Complaint does not allege that the Managers structurally reported to or

otherwise had interactions with any of the Director Defendants. The Complaint only alleges that (1) non-director Officer Defendant Lieberman supervised the department wherein Devlin and Larner worked and (2) non-director Officer Defendant Huelva supervised the department wherein Hooper worked. Id. at ¶ 31. Non-director Officer Defendant Stockdale did not directly supervise the Managers. Id. The Complaint alleges that Officer Defendant Stockdale worked with the Managers in preparation of Securance's Medicaid reports. Id.

## **ARGUMENT**

### **I. THE COURT OF CHANCERY CORRECTLY DISMISSED THE COMPLAINT UNDER RULE 23.1 WHERE APPELLANT NEITHER MADE PRE-SUIT DEMAND NOR PLED PARTICULARIZED FACTS ADEQUATE TO RAISE A REASONABLE DOUBT THAT THE DIRECTOR DEFENDANTS WERE DISINTERESTED AND INDEPENDENT.**

#### **A. QUESTIONS PRESENTED**

This appeal presents two questions for review by this Court. The first question presented is whether the Court of Chancery correctly articulated and applied the Rales test in granting Defendants' motion to dismiss the Complaint, in its entirety, pursuant to Court of Chancery Rule 23.1 where Plaintiff failed to make demand and failed to allege particularized facts which raise a reasonable doubt that the Director Defendants were disinterested or independent such that demand is excused.

The second question presented is whether the Court of Chancery correctly articulated and applied the Rales test in granting Officer Defendants' motion to dismiss Count II of the Complaint pursuant to Court of Chancery Rule 23.1 where Appellant failed to include Director Defendants Saligman, Richmond and Craig in Count II or allege any

facts which raise a reasonable doubt that the any of the other Director Defendants were disinterested or independent such that demand is excused.

#### **B. SCOPE OF REVIEW**

This Court reviews *de novo* a Court of Chancery's decision dismissing a derivative suit under Rule 23.1. White v. Panic, 783 A.2d 543, 549 (Del.2001). The scope of review is plenary. Brehm v. Eisner, 746 A.2d 244, 253 (Del.2000). While the Court should draw all reasonable inferences in the plaintiff's favor, such reasonable inferences must logically flow from particularized facts alleged by the Appellant. White, 783 A.2d at 549. Likewise, inferences that are not objectively reasonable cannot be drawn in Appellant's favor. Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1048 (Del.2004).

#### **C. MERITS OF THE ARGUMENT**

The business and affairs of every corporation organized under the Delaware General Corporation Law is managed by or under the direction of a board of directors. Del.Code Ann. tit. 8, § 141(a) (2006). See Rales v. Blasband, 634 A.2d 927, 932 (Del.1993). Thus, "by its very nature [a] derivative action impinges on the managerial freedom of directors." Pogostin v. Rice, 480 A.2d 619, 624 (Del.1984). Therefore, a stockholder's right to prosecute a derivative suit is limited. Aronson v. Lewis, 473 A.2d 805, 811 (Del.1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del.2000).

Court of Chancery Rule 23.1 constitutes the procedural embodiment of this substantive principle of Delaware corporate law. Rales, 634

A.2d at 932. Rule 23.1 requires that the complaint in a derivative action “allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors ... or [plaintiff’s reasons] for not making the effort.” Ch. Ct. R. 23.1.

Appellant made no demand upon the Securance board. Rather, Appellant argues that demand is excused because such demand would be futile. Delaware law has two standards for excusing demand. Compare Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) with Rales v. Blasband, 634 A.2d 927, 933-34 (Del.1993). Nevertheless, it is well established □ in which context each standard applies. In Rales, this Court explained: “where directors are sued derivatively because they have failed to do something (such as a failure to oversee subordinates), demand should not be excused automatically in the absence of allegations demonstrating why the board is incapable of considering a demand.” Id. at 934 n. 9. Appellant’s oversight claim is consistent with the contexts considered by this Court in Rales.

Under Rales, this Court “must determine whether or not the particularized factual allegations [found in Appellant’s 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.” Id. A director is presumed to be faithful to the corporation and able to objectively consider demand. Beam, 845 A.2d at 1048. Appellant must show, with particularity, why that presumption is overcome with respect to a majority of the board. Id. The inquiry into a board’s

ability to consider a demand is context-dependent and fact-specific. Id. at 1049-50.

A director's interest may be shown by demonstrating a potential personal benefit or detriment to the director as a result of the decision. Rales, at 936. On the other hand, a director's independence must be measured by whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences. Id. (quoting Aronson 473 A.2d at 816).

Appellant attempted to satisfy the Rales test by alleging that the Director Defendants face a "substantial likelihood of enormous personal liability" from the claims alleged in the Complaint. Defendants acknowledge that Rales requires an analysis of whether the director is disinterested in the underlying transaction and if the director is otherwise independent. Beam, at 1050. The Complaint, nevertheless, fails on all grounds to raise any reasonable doubt regard the Director Defendants' objectivity.

**1. THE COURT OF CHANCERY CORRECTLY ARTICULATED AND APPLIED THE RALES TEST IN GRANTING DEFENDANTS' MOTION TO DISMISS THE COMPLAINT PURSUANT TO RULE 23.1.**

This Court should hold the Director Defendants and Officer Defendants to a substantial likelihood of liability standard because it follows previous decisions of the Delaware Supreme Court. The applicable standard to excuse demand in the absence of a business decision is the Rales test. Stone v. Ritter, 911 A.2d 362, 367 (Del., 2006) (quoting Rales v. Blasband, 634 A.2d 927 (Del., 1993)). With the Rales 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. The Rales test is satisfied by showing that the defendant directors will face a substantial likelihood of liability that would render them personally interested concerning whether to pursue the claims put forth in the complaint. Id. If the directors are interested or dependent, demand by the stockholders is excused. Stone, 911 A.2d at 367.

Appellants in their complaint claim that the applicable standard is whether the Director Defendants will be “potentially personally liable,” based on a sentence near the end of the Stone decision. Id. at 372. There are no other cases or indications from Delaware courts that this is the applicable standard. Therefore, the applicable standard in this case is the same one spelled out by this Court in Rales and Stone: the substantial likelihood of liability test.

The purpose of the Rales test is to determine if the directors are disinterested and independent from the matter. Rales, 634 A.2d at 934. A director is interested when he appears on both sides of a transaction or will receive a personal financial benefit not equally shared by the stockholders, from a transaction. Rattner v. Bidzos, No. Civ.A. 19700, 2003 WL 22284323 (Del. Ch., Sept. 30, 2003), Rales, 634 A.2d at 936. Interest also arises when a corporate decision will have a detrimental impact on a specific director, but not on the stockholders or corporation. Rales, 634 A.2d at 936. For directors

to be dependent, they would have to be dominated or controlled by an individual or entity interested in the matter. Grobow v. Perot, 539 A.2d 180, 189 (Del., 1988). If a Director Defendant is found to be disinterested and independent from the matter, they have passed the Rales test and demand futility will not be excused. Rales, 634 A.2d at 934.

To create a reasonable doubt as to the director's disinterest, stockholders must allege specific facts establishing that the potential for liability is not a mere threat, but, rather, rises to a substantial likelihood. Forsythe v. ESC Fund Mgmt. Co., 2007 WL 2982247 at \*5 (Del. Ch. 2007) (quoting Rales, 634 A.2d at 936). A complaint must go further than simply demonstrate that Director Defendants should have done more; they must show that the directors were "either knowingly complicit in the fraud, or so reckless in their duties as to be oblivious to malfeasance that was readily apparent." Public Employees' Retirement Association of Colorado v. Deloitte & Touche, 551 F.3d 305, 314 (4th Cir., Jan 5, 2009).

In Stone, shareholders brought a derivative action and Chancery Court Rule 23.1 and the Rales test applied because there was a concern about the director defendants' disinterest and independence. Stone, 911 A.2d at 362-67. The court in Stone said that the complaint was not alleged with the particularity required by the Rales test. Id. at 373. "With the benefit of hindsight, the... complaint seeks to equate a bad outcome with bad faith." Id. Similarly, in the present case, the Appellee did not state the facts with the required particularity. They have attempted to equate a bad outcome with bad faith by the directors

and stated the facts without any causal link between the facts and the outcome. Therefore, the Appellee has not stated the facts with sufficient particularity.

**a. THERE WERE NO RED FLAGS INDICATING THE INTERNAL CONTROLS WERE INADEQUATE OR INSUFFICIENT.**

Events that create a cause for suspicion are “red flags” to directors and corporations that irregular activity is occurring within the company. However, according to Delaware law, red flags are only useful to determine if directors should have realized suspicious activity was occurring when the flags are “waived in one’s face or displayed so that they are visual to the casual observer.” Wood v. Baum, 953 A.2d 136, 143 (Del. 2008) (citing In re Citigroup Inc. S’holders Litig., 2003 WL 21384599, at \*2 (Del. Ch. Ct.)). If the red flags are waived in the board of directors’ faces or apparent to the careful observer and the directors who should look into the suspicious activity do nothing, the disregard could be bad faith by the directors and indicate that they were not disinterested or independent from the suspicious activity. Wood, 953 A.2d at 141-43. In the absence of red flags, directors’ good faith must be determined by their actions to assure reasonable information and reporting systems exists. See Stone v. Ritter, 911 A.2d 362 (Del., 2006).

In Wood v. Baum, a stockholder sued the board of directors regarding accounting and reporting controls and Chancery Court Rule 23.1 applied. Wood, 953 A.2d at 139. The court stated that there were no cognizable red flags because none had been waived in the director’s face or visible to the careful observer. Wood, 953 A.2d at 143 (quoting In re Citigroup Inc. S’holders Litig., 2003 WL 21384599,

at \*2 (Del. Ch. Ct.)). Likewise, in the present case, there were no red flags, alleged by the Appellee, which should have alerted the Director Defendants to any problems.

Acting with a critical eye does not apply in this situation. Directors are expected to act with a critical eye when representing the financial interests of others, such as the stockholders. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985). It is part of exercising an informed business judgment, which falls under the duty of care, rather than the duty of loyalty. Id. However, the Director Defendants are charged with a breach of the duty of loyalty, not the duty of care. Therefore, the critical eye issue is irrelevant in this case. In short, there pleadings are not particularized enough to support the assumption of any red flags in this case.

**2. THE COURT OF CHANCERY CORRECTLY ARTICULATED AND APPLIED THE RALES TEST IN GRANTING OFFICER DEFENDANTS' MOTION TO DISMISS COUNT II OF THE COMPLAINT.**

Defendants concede that the Chancery Court did not fully analyze the Director Defendants under the Rales standard with respect to Count II. Nevertheless, the error is not reversible. Even under a full Rales analysis, the Complaint fails to meet the Rule 23.1 pleading requirement.

Defendants note that Count II, wherein the Appellant alleges that the "Office Defendants" breached their oversight responsibilities, omits to name any of the Director Defendants, including Saligman, Richmond, and Craig who also serve as officers. As a result, Appellant fails to allege that any of the Director Defendants faced liability with respect to Count II.

If this Court forgives Appellant's mistake, Saligman, Richmond and Craig may be said to have an interest in Count II. They are only a minority of the board; there are seven members total on the board. For the Complaint to survive the Rule 23.1 motion, Appellant is required to show a majority of the board was interested or dependant. Thus, Appellant would be required to show that the particularized factual allegations in Count II create a substantial likelihood that at least one of the four outside directors was dependant or interested. Here too, the Complaint lacks the necessary particularized factual allegations to raise a reasonable doubt about any of the four outside directors.

In re Abbott Labs. Deriv. S'holders Litig., 325 F.3d 795 (7th Cir. 2003) is instructive. Abbott Labs, a medical device seller, was subject to the heavy regulatory requirements imposed on it by the Food and Drug Administration ("FDA") and Abbott Labs viability depended on its compliance. Id. at 799. Nevertheless, the FDA notified Abbott Labs' board, or at least one board member, on four occasions to notify the board that the company was failing to comply with FDA regulations. In Abbott Labs, the Court determined that "given the extensive paper trail in Abbott concerning violations and the inferred awareness" of the directors, one could reasonably infer that there was a sustained and systemic failure of the board's oversight. Id. at 809. The paper trail and factual allegations showed that the directors knew of the violations of law, and did not take any steps to prevent or remedy the situation. Id.

Here, there is no similar line of particular factual allegations that the outside Director Defendants knew or should have known of any violations of law, or ignored reports making them aware of any violations of law. There is no allegation that the Officer Defendants delivered reports to the Director Defendants which detailed the Manager's wrongdoing, or that the outside Director Defendants knew of such reports and consciously disregarded them. The only alleged facts regarding the Officer Defendants are that two senior officers oversaw the departments wherein the Senior Managers orchestrated their clandestine scheme.

**II. This Court should affirm Chancellor Seigel's decision granting Officer Defendants' 12(b)(6) motion to dismiss Count II of the Complaint where the Court of Chancery correctly formulated and applied the Rales test for oversight liability.**

**A. Questions Presented**

The appeal from the Court of Chancery's Rule 12(b)(6) ruling to dismiss Count II of the Complaint presents two questions. The first is an issue of first impression for this Court: whether the Rales standard for director oversight liability applies with equal force to corporate officers *qua* officers. The Second question presented is whether Chancellor Seigel correctly applied the Rales and Rule 12(b)(6) pleading standards in granting Officer Defendants' motion to dismiss.

**B. Standard of Review**

This Court reviews *de novo* a decision to grant a Court of Chancery Rule 12(b)(6) motion to dismiss, to "determine whether the trial judge erred as a matter of law in formulating or applying legal precepts." Feldman v. Citaia, 951 A.2d 727, 730-31 (Del.2008)

(quoting Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 438 (Del.2005)). Dismissal is appropriate only if it appears “with reasonable certainty that, under any set of facts that could be proven to support the claims asserted, the plaintiff would not be entitled to relief.” Feldman, 951 A.2d at 731 (quoting VLIW Tech., LLC v. Hewlett-Packard Co., 840 A.2d 606, 610-611 (Del.2003)).

In reviewing a motion to dismiss, this Court views the complaint in the light most favorable to the non-moving party, accepting as true its well-pled allegations and drawing all reasonable inferences that logically flow from those allegations. Feldman, 951 A.2d at 731. This Court does not, however, blindly accept conclusory allegations unsupported by specific facts, nor does it draw unreasonable inferences in the plaintiffs’ favor. In re General Motors (Hughes) S’holder Litig., 897 A.2d 162, 168 (Del.2006).

### **C. Merits of Argument**

In granting Officer Defendants’ 12(b)(6) motion to dismiss Count II of the Complaint, the Court of Chancery reasoned that the Rales standard carries equal weight when applied to the Officer Defendants—requiring a conscious failure to monitor Securance’s operations. Applying this standard to the non-conclusory facts alleged in the Complaint, and all reasonable inferences logically flowing there from, the Court of Chancery found Count II of the Complaint insufficient to satisfy the 12(b)(6) pleading standard.

**1. Chancellor Seigel applied sound reasoning in determining that the Rales standard for director oversight liability applies with equal force to corporate officers.**

In deciding that the Rales test applies to Officer Defendants with equal force as it does to the Director Defendants, the Court of Chancery reasoned: (1) the business judgment rule applies with equal force to non-director, senior officers and (2) the Rales test affords directors equal protection as that afforded them under the business judgment rule. From these precepts, Chancellor Seigel logically concluded that the Rales test applies with equal force to non-director, senior officers. Because the precepts upon which the Court of Chancery's conclusion rests are correct, her conclusion is also correct. Moreover, her conclusion is supported by Chancellor Allen's discussion in Caremark. In re Caremark Int'l. Inc. Deriv. Litig., 698 A.2d 959, 968-72 (Del. Ch. Ct. 1996). Therefore, this Court should affirm Chancellor Seigel's formulation of the Rales test as applied to the Officer Defendants.

In Gantler v. Stephens, shareholders of a bank holding company brought an action against corporate directors and officers alleging breach of their fiduciary duties. The defendants filed a 12(b)(6) motion to dismiss which was granted. On appeal, this Court considered the nature of the officer defendants' fiduciary duties to the corporation and its shareholders. This Court observed, "[i]n the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. .... We now explicitly so hold." Gantler v. Stephens, No. 132, 2008, 2009 WL

188828 at \*9 (Del. 2009). Consequently, this Court applied the business judgment rule with equal force in reviewing the challenged actions of the officer defendants in Gantler. Therefore, the Court of Chancery's first premise is correct.

In In re Caremark, Chancellor Allen began his analysis of the alleged oversight claims reflecting, "director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts." Caremark, 698 A.2d at 967. According to Chancellor Allen, these contexts are liability flowing from a board decision and board inaction. In the case of board decision-making, the business judgment rule attaches and corporate directors and officers are liable only where their conduct is grossly negligent. Chancellor Allen clearly intended to establish a "demanding test of liability" that would afford directors a comparable degree of protection in the oversight context that would otherwise arise from the business judgment rule in cases involving a board's decision-making. Caremark, 698 A.2d at 971. Therefore, Chancellor Ceigel's second premise is correct.

Chancellor Seigel's conclusion that the Rales standard applies with equal force to officers as it does to directors is unquestionably supported by Chancellor Allen's discussion in Caremark. In Graham v. Allis Chalmers Mfg. Co., Chancellor Allen stated, "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 (Del.Ch.,1996) (citation omitted) (emphasis added).

The high standard for officer oversight liability is supported by sensible policy considerations. Similarly to directors, this test also makes officer “service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors.” Id. at 971. A legal rule holding officers too readily liable for corporate losses, as forwarded by Appellant, will deter qualified persons from serving as officers. This case plainly illustrates the gravity of this concern. Officer Defendant Lieberman earned \$2.8 million, Stockdale earned \$2.6 million, and Huelva earned 2.5 million in fiscal year 2008. These earnings are extraordinarily minimal in comparison to the \$3 billion in market capitalization and \$520 million in fines and penalties for which Appellant alleges the Officer Defendants jointly and severally liable.

In Stone, as previously stated, this Court suggests another policy concern is to prevent hindsight bias. Stone, 911 A.2d at 373(citations omitted). As Professor Johnson noted, such “hindsight bias” unfairly “assigns an erroneously high probability of occurrence to a probabilistic event simply because it ended up occurring.” Lyman P.Q. Johnson, Corporate Officers and the Business Judgment Rule, 60 BUSLAW 439, 456–57 (2005)(discussing underlying policies of the business judgment rule).

**2. Chancellor Seigel’s 12(b)(6) ruling should be upheld where under either a knowing or less deferential standard Count II of the Complaint fails to state a claim for fiduciary oversight liability.**

Notwithstanding this Court’s decision regarding the standard to be applied for the Officer Defendants under the Stone test, Count II of the Complaint fails to allege facts sufficient to state a claim

upon which relief may be granted. The Managers perpetrated a clandestine scheme designed to go undetected by state Medicaid investigators, Medicaid industry analyst, the Securities Exchange Commission, the Directors Defendants and the Officer Defendants. The Managers' well planned and executed fraud succeeded for some time before anyone grew suspicious.

#### **CONCLUSION**

For the forgoing reasons, Defendants ask this Court to affirm the Court of Chancery's decision to grant Defendants' motions to dismiss the Complaint in its entirety pursuant to Court of Chancery Rules 23.1 for failure to adequately plead demand futility.

Furthermore, because this case, with respect to the Chancery Court's 23.1 rulings, does not present any novel legal issues and does not require this Court to clarify or to chance Delaware jurisprudence relating to the pleading requirements under Rule 23.1, the general rule against permitting plaintiffs to amend their complaint after a dismissal and an unsuccessful appeal applies. Accordingly, Defendants request that this Court affirm the judgment of the Court of Chancery dismissing the complaint with prejudice. White, 783 A.2d at 547.

Officer Defendants respectfully request that this Court affirm the Chancery Court's decision to dismiss Count II of the Complaint pursuant to Rule 12(b)(6) for failure to state a claim. Defendants respectfully request 30 minutes to be heard orally.

Respectfully submitted,

---

0