

IN THE SUPREME COURT
OF THE STATE OF DELAWARE

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.)
_____)

Case No. 3892-CS
CD-ROM Version To Be Filed
On Appeal From:
Chancery Court

APPELLEES' ANSWERING BRIEF

Team P
Counsel for the Appellees

Dated: February 17, 2009

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I. NATURE OF THE PROCEEDINGS

This is an appeal by the Plaintiff from a decision of the Court of Chancery dismissing Plaintiff's derivative complaint. The complaint asserts an oversight liability claim against seven board members and three senior officers of Securance Incorporated ("Securance"), a Delaware corporation. Plaintiff, Clare C. Marshall, filed this derivative claim in response to a fraudulent action carried out by former senior managers which resulted in payment of fines by Securance. The lower court based its January 6, 2009 decision on Plaintiff's failure to plead with particularity that demand upon the board would have been futile. (Del. Ch. Ct. R. 23.1.)

Plaintiff is attempting to hold directors and officers of Securance liable for failing to monitor the company's regulatory systems. (*In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del.Ch. 1996).) To successfully plead demand futility Plaintiff must show a substantial likelihood of personal liability on behalf of the directors. (*Stone v. Ritter*, 911 A.2d 362 (Del. 2006).) Thus, the trial court analyzed the claim to determine whether the Directors and/or Officers consciously failed to perform oversight duties. The Chancery Court found that there was a regulatory system in place, and further, the Directors did not consciously disregard their oversight duties or face any "red flags," thus failing to plead a substantial likelihood of liability. (Mem. Op. 25, Jan. 6, 2009.)

In its analysis, the Chancery Court explained that the oversight test should be used to evaluate officer liability, even though it had

never been applied to officers before. (Op. 28.) However, the Court stated that the Plaintiff did not state a claim upon which relief could be granted and dismissed the claim against the Officers under Chancery Court Rule 12(b)(6). (Op. 28.)

Upon dismissal of the complaint, the Plaintiff filed a Notice of Appeal on January 16, 2009. This is the answering brief of all the Defendants-Appellees.

II. SUMMARY OF THE ARGUMENTS

1. The Court of Chancery correctly determined that demand on the Defendants would not have been futile. The Defendants did not face a substantial likelihood of liability that would render them personally interested in the decision to bring a claim on behalf of Securance pursuant to the Plaintiff's demand. The Court of Chancery made this determination after properly finding that the Plaintiff failed to allege with particularity, sufficient facts which showed both a conscious failure to perform oversight duties and intentional disregard of "red flags."
2. The Court of Chancery correctly determined that oversight liability did not apply to officers of a corporation in light of current legislation. If oversight liability does exist for officers, then the appropriate test will be the same used for directors. The Court of Chancery found that while the Plaintiff failed to show a substantial likelihood of liability, the Plaintiff also failed to state a claim.

III. STATEMENT OF FACTS

Clare Marshall ("Plaintiff") is a shareholder of Defendant Securance, Incorporated ("Securance"). (Mem. Op. 1, Jan. 6, 2009) Plaintiff brought a derivative action on behalf of Securance against Securance's seven member board of directors ("Directors") and three senior officers ("Officers"). While some directors are also officers, the three senior Officers here are not also directors. (Op. 1-2.)

Securance is a publicly traded Delaware corporation headquartered in Frederick, Maryland and has over 42 million shares of common stock outstanding. (Op. 3.) Securance does business as a for-profit managed care services company serving Medicaid and Medicare patients in over 18 states. (Op. 4-5) The initial public offering of Securance stock began at \$42 per share in 2002 and reached an historic high of \$110 per share in December 2007. This resulted in a market capitalization of \$4.6 billion. (Op. 3-4.) Securance reports to each state the amount of money it spends on direct medical care through a metric known as the "medical loss ratio." (Op. 6.)

In early 2005, three former senior managers of Securance falsified medical expense reports to certain state regulators. (Op. 6.) All three managers shared complete responsibility for deliberately overstating the medical loss ratios in an attempt to increase Securance's profits. (Op. 6.) Each manager pled guilty to conspiracy and voluntarily resigned their positions with Securance and now all are serving prison sentences. (Op. 7-8.) The derivative complaint in

this case does not allege that these managers structurally reported to or otherwise had interaction with any members of the Board. (Op. 8.)

Early in 2008, analysts noted disparities in Securance's medical loss ratios which caused the State and Federal authorities to begin an investigation. (Op. 9.) A federal search warrant was executed for Securance's headquarters and investigators focused on the three managers who previously pled guilty to falsifying reports. Each of those managers subsequently resigned as stated prior. (Op. 10.)

On March 15, 2008, the Securance Board held a special meeting at which it initiated the audit committee and directed it to have independent outside counsel investigate and resolve all issues regarding the reporting of medical loss ratios. (Op. 10-11.) In response to the investigation, Securance entered into a plea agreement for mail fraud resulting in penalties and fines. (Op. 11.) Securance further established a new independent compliance committee which has been more engaged and proactive going forward. (Op. 11.)

The Securance Board approved a Performance Compensation Plan (the "Incentive Compensation Plan") in 2003. (Op. 12.) This plan provided for bonus compensation based on the operating profit yielded by each of Securance's business segments. (Op. 13.)

During early 2004, Securance was accused of systematically denying certain medical services to the enrollees. (Op. 13.) It was alleged that Securance offered improper financial incentives and bonuses to doctors. (Op. 13.) In response, Securance entered into court approved consent decrees with each state to comply with applicable law and paid fines to each state. (Op. 13.)

IV. LEGAL ARGUMENTS

A. The Lower Court Appropriately Determined That The Plaintiff Failed To Plead With Particularity That The Directors Faced A "Substantial Likelihood Of Liability" That Would Render Demand Futile.

1. Question Presented

Did the Court of Chancery properly determine that the plaintiff failed to satisfy the demand requirements set forth under Rule 23.1?

2. Scope Of Review: De Novo

This Court reviews de novo a decision of the Court of Chancery to dismiss a derivative suit under Rule 23.1. *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004). Allegations of demand futility under Rule 23.1 "must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed solely by Chancery Rule 8(a)." *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000). "A court 'is not...required to accept as true conclusory allegations' without specific supporting factual allegations." *In re General Motors (Hughes) S'holder Litig.*, 897 A.2d 162, 168 (Del. 2006).

3. Merits Of Argument

a. A Demand On The Directors Is Futile When The Directors Face A Substantial Likelihood Of Personal Liability For Oversight Failure And This Test Is Not Altered By The Use Of The Word "Potential" In *Stone V. Ritter*.

When making a determination of whether or not demand on directors is futile in a derivative action, the court will look to state law. *Kamen v. Kemper Fin. Serv., Inc.*, 500 U.S. 90, 97 (1991). Delaware Chancery Court Rule 23.1 identifies the need for demand in stating

that any "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." Many times demand will have to overcome the business judgment rule, which protects the business decisions made by directors and officers. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del.Ch. 1996). However, in the absence of a business decision, the applicable standard for determining demand futility is explicated in *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

In *Stone*, the Shareholders brought a derivative action on behalf of AmSouth Bancorporation ("AmSouth") against the directors for oversight failure. *Id.* at 365. The Shareholders alleged that the directors of AmSouth breached their fiduciary duty of good faith by failing to implement the required monitoring, reporting, or information controls under the Bank Secrecy Act. *Id.* Although AmSouth maintained a program to monitor the Bank Secrecy Act compliance, the court found the program was not adequate to prevent violations giving rise to fines and civil penalties. *Id.*

To determine oversight liability, the *Stone* court expanded the demand futility rule set forth in *Rales v. Blasband*, 634 A.2d 927 (Del. 1993). *Rales* stated the standard for determining demand futility in the absence of a business decision. *Id.* The *Stone* court found determination of the *Rales* test turns on whether the complaint alleges particularized facts to show that the defendant directors "'face a substantial likelihood of liability' that renders them

'personally interested in the outcome of the decision on whether to pursue the claim asserted in the complaint.'" *Stone*, 911 A.2d at 367, quoting *Rales*, 634 A.2d at 934.

The Plaintiff erroneously asserts that the "substantial likelihood" test will be met if the Directors are "potentially personally liable." (Op. 17.) However, this argument is flawed. Plaintiff misread the *Stone* opinion which stated that a plaintiff must show that "directors face a substantial likelihood of liability" and said later in the opinion that plaintiff must show the "directors' potential personal liability" *Stone*, 911 A.2d at 367. This use of the latter terminology was intended only to make reference to the previously stated "substantial likelihood" test without altering the high burden. Accordingly, the lower Court stated in its opinion that the "potentially" language in no way altered or weakened the "substantial likelihood" test. (Op. 18.)

Therefore, this Court should apply the stringent substantial likelihood test in determining demand futility in this case. At the same time, the Plaintiff failed to state with particularity reasons as to why demand was futile. Thus, this Court should affirm the dismissal. (Op. 18.)

b. The Chancery Court Properly Determined That The Directors Did Not Face A Substantial Likelihood Of Oversight Liability.

The Delaware Supreme Court in *Stone* stated that one of two necessary conditions must be shown to exist before director oversight liability can be established. *Stone*, 911 A.2d at 370. In that case the court stated:

We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information systems or controls; or (b) having implemented such a system or controls, consciously failed to monitor its operations thus disabling themselves from being informed of the risks or problems requiring their attention. *Id.*

Only the second prong of this oversight liability test applies here because Plaintiff admits in the complaint the existence of an implemented regulatory compliance program put in place by Securance in 2004. (Compl. 23:52, Jul. 3, 2008.) However, the complaint consistently alleges that the Directors consciously or *recklessly* failed to perform their oversight duties. The law of Delaware and the Chancery Court's opinion in this case, reject Plaintiff's erroneous assertion that "reckless failure" can establish the requisite culpability demanded by the second prong of the oversight liability test. Further, the Plaintiff's allegation that the Defendants "consciously failed" to monitor the regulatory systems, must also fail, because "red flags" did not exist and were not plead with particularity.

i) The "Conscious Failure" Language Requires Intentional Conduct To Impose Oversight Liability For Which Reckless Conduct Will Not Suffice.

The lower court correctly determined that the second prong of the oversight liability test governs when attempting to determine whether the Defendants' faced a substantial likelihood of liability. Further, the Chancery Court properly determined that "conscious failure" requires intentional conduct. However, facts constituting a "conscious failure" were not pled with sufficient particularity, for

three reasons. First, precedential cases require a showing of lack of good faith as a condition to oversight liability. Second, the "conscious failure" standard was intended to incorporate the definition of lack of good faith, from *In re the Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006), which required conduct to be intentional. Third, since a showing of a lack of good faith requires intentional conduct, any lesser level of culpability, such as recklessness, will not suffice.

In *Stone*, the Court articulated very clearly that there is an important distinction between the terms "conscious" and "reckless" in the oversight liability context. In fact, this distinction is essential to the fundamental function of this test and is readily apparent after one has an understanding of the purpose of the "conscious failure" language. That language was purposely included to require a showing of intentional conduct which lacks good faith.

1) The "Conscious Failure" Language Was Deliberately Included In The Oversight Test To Require A Showing Of Conduct Lacking Good Faith.

The oversight liability standard stated in *Stone* draws heavily on the concept of a director's failure to act in good faith. *Stone*, 911 A.2d at 369. The Court in *Caremark* stated that the showing of a lack of good faith is a necessary condition to oversight liability. *Caremark*, 698 A.2d at 971. As a requirement of the second prong of the *Stone* Court's oversight test, the "conscious failure" language has been deliberately included to encompass the requisite bad faith or lack of good faith condition to oversight liability. It originated in the *Disney* Court's definition of bad faith when describing an example

of bad faith as "a failure to act in good faith may be shown where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." *Disney*, 906 A.2d at 67. Ultimately, the *Stone* Court included the "conscious failure" language when it restated the oversight test from *Caremark* by using its own recent definition of bad faith described in *Disney*.

The Court in *Disney* went to great lengths to define bad faith conduct and ultimately stated that conduct lacking good faith is bad faith conduct when it articulated:

Section 102(b)(7) expressly denies money damage exculpation for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law". By its very terms that provision distinguishes between "intentional misconduct" and a "knowing violation of the law" on the one hand, and "acts... not in good faith", on the other. Because the statute exculpates directors for conduct only amounting to gross negligence, the statutory denial for "acts...not in good faith" must encompass the intermediate category of misconduct captured by the Chancellors definition of bad faith. *Disney*, 906 A.2d at 67, noting 8 Del.C. § 102(b)(7).

The *Disney* Court drew the conclusion that the Delaware Legislature intended that "acts not in good faith" be placed in the same category as bad faith conduct. Further, the Court explained that 102(b)(7) only exculpates directors for acts done in good faith even when those acts are performed in a grossly negligent manner. On the other hand, directors who act in bad faith or who fail to act in good faith are not exculpated from personal liability. For these reasons, acts which lack good faith are considered to be within the *Disney* definition of bad faith. This single category of non-exculpatory conduct in 102(b)(7) was defined by the *Disney* Court to require intentional

conduct, as distinguished from conduct which can be exculpated even when done with gross negligence.

This distinction has been created to ensure that directors act in good faith and in the best interest of the corporation, as well as to ensure an adequate level of protection for directors to perform their duties without the threat of being constantly second guessed.

2) Lack Of Good Faith Requires Intentional Conduct.

The *Stone* court provided three examples of conduct that were described in *Disney* as establishing a failure to act in good faith. One of those examples is applicable here to clarify the level of culpability demanded by the "conscious failure" language in the second prong of the oversight test. The language in the *Disney* Court's three examples of "lack of good faith" all use the word intentional. *Disney*, 906 A.2d at 67.

One example provides that a director has failed to act in good faith "where a fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." *Id.*; *Stone*, 911 A.2d at 368. The *Stone* court stated that this type of conduct is a necessary condition for oversight liability. This means that the imposition of liability requires a showing that the directors intentionally failed to discharge their fiduciary obligations of oversight in the face of "red flags" which give rise to that duty.

Therefore, directors who fail to act in good faith demonstrate a conscious or intentional disregard for their responsibilities. *Stone*, 911 A.2d at 370. This is the same level of culpability which is demanded in the second prong of the oversight liability test. Such a

high level of culpability was intended to include the element of intentional conduct. To meet this test, oversight complaints must allege particular facts showing that a board is guilty of some sort of "intentional dereliction of duty" or "conscious disregard" of duty, neither of which have been shown here.

3) Reckless Conduct Will Not Establish The Required Level Of Culpability.

In this case the Chancery Court acknowledged the importance of maintaining the distinction between intentional conduct and gross negligence while emphasizing the need to reject any conflation of the two. (Op. 20.) Conduct lacking good faith or done in bad faith requires intentional conduct, not mere gross negligence. This important distinction is fundamental to the law of fiduciary duties. The *Stone* Court carefully stated "that a failure to act in good faith requires conduct that is qualitatively different from and more culpable than, the conduct giving rise to a fiduciary duty of care (i.e. gross negligence)." *Stone*, 911 A.2d at 368. This distinction is important because a fiduciary duty of care can be breached by a grossly negligent act, despite the fact it was done *in good faith*. In contrast, the fiduciary duty of loyalty may only be breached when an action *lacks good faith*. *Id.* The fiduciary duty of loyalty may not be breached by a mere showing of gross negligence. *Id.*

The failure to oversee is a breach of the fiduciary duty of loyalty. *Id.* "It follows that because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark*, is essential to establish director oversight liability; the fiduciary duty violated by that

conduct is the duty of loyalty." *Stone*, 911 A.2d at 370. Allowing a reckless standard to establish lack of good faith will prevent a clear distinction between conduct that constitutes a breach of the fiduciary duty of care, which can be exculpated, and a breach of the fiduciary duty of loyalty, which may not be exculpated.

Gross negligence means "reckless indifference to or a deliberate disregard." *Tomczak v. Morton Thiokol, Inc.*, 1990 Del. Ch. LEXIS 47, at *12 (Del. Ch.). Recklessness requires an indifference to whether certain conduct causes a bad result. The reckless standard simply requires a less culpable state of mind than that required for intentional conduct. The Delaware Chancery Court expressed that "for the reasons Caremark well-explained, to hold directors liable for a failure in monitoring, the directors have to have acted with a state of mind consistent with a conscious decision to breach their duty of care." *Desimone v. Barrows*, 924 A.2d 908, 933 (Del.Ch. 2007).

The fact that intent is needed to make a showing of conduct not in good faith, makes clear that nothing less than intentional conduct will suffice to meet this standard including recklessness. Business decisions should be made by the minds of business people not the minds of reasonable people. This is the reason for looking only to whether there was a lack of good faith rather than to the substance of the decision itself. If the reckless standard were used to determine lack of good faith, then the purpose of our well established business judgment rule, which allows business decisions to be protected as long as they are made in good faith, would be defeated. Instead the test

properly requires that conduct must be intentional to constitute a "conscious failure" to oversee.

Whether the Defendants intentionally disregarded their duty to oversee depends on whether that duty arose in the face of "red flags."

ii) Plaintiff Failed To Plead With Particularity That Any "Red Flags" Existed.

The second prong of the oversight test requires a plaintiff to prove that directors failed to act in the face of "red flags".

Under Delaware law, "'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. S'holders Litig.*, 2003 Del. Ch. LEXIS 61, at *2 (Del. Ch.). In *Stone*, the Court found that the plaintiff's derivative complaint failed to allege particularized facts in the face of "red flags." *Stone*, 911 A.2d at 373; see also *Wood*, 953 A.2d 136 (affirming the Court of Chancery that held there were no cognizable "red flags" from which it could be inferred in the alleged complaint); *Citigroup*, 2003 Del. Ch. LEXIS 61 (the Court of Chancery held that plaintiff failed to show any "red flags" in the amended complaint from which the court could infer any of these ever came to the attention of the board).

Discussing red flags, *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) said that "absent 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." The Court concluded that two prior FTC decrees warning of antitrust violations did not give the directors notice of

the possibility of future price fixings. Therefore 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." *Id.* at 128-129.

In the case at bar, the Court of Chancery found no suspicion of any "red flags." The court approached the "red flag" inquiry by asking "whether the complaint alleges specific facts of actual or probable employee misconduct about which the board was in fact subjectively aware, and which if ignored, would support an inference of conscious indifference to oversight responsibility." (Op. 24.)

The first allegation concerning "red flag" oversight responsibility made by Plaintiff concerns the implementation of the Incentive Compensation Plan. (Compl. 18:38.) The Plaintiff states that because of the Incentive Compensation Plan, the Directors and Officers were all aware that they had put in place a system of compensation that provided specific incentives for senior executives to inflate the results of their business segment. (Compl. 18:38.) However, this argument is flawed. The Chancery Court's opinion in this case states that the derivative complaint does not allege that the managers structurally reported to or otherwise had interaction with any members of the Board, nor does the complaint allege direct participation in the fraud by any of the Officers. (Op. 8.) These factual allegations are not sufficient to support an inference that the Directors consciously failed to discharge their oversight responsibilities. The managers had absolutely no contact with any of the Board members, thus the Board could not be subjectively aware of employee misconduct

requiring oversight attention. "Red flags" must show that the board was aware the internal controls were inadequate and that the problems were the result of illegal activity. *Stone*, 911 A.2d at 370. However, the Plaintiffs have failed to prove that the Incentive Compensation Plan resulted in a "red flag" which the Directors should have been aware of.

The Plaintiff's second allegation concerns the 2004 consent decrees, which Plaintiff asserts should have been a "red flag" to the Directors and Officers that the company's compliance systems were inadequate. (Compl. 43:20.) Here, the 2004 consent decrees occurred immediately prior to the year in which the managers started their scheme to commit Medicaid fraud in four other states. However, the Court believed these 2004 consent decrees did not amount to "red flags" for oversight liability. (Op. 25.) The two reasons stated were that both 2004 consent decrees denied any admission of wrongdoing and in the same year the company earned net profits of \$49 million on revenues of 1.4 billion. (Op. 25.) Thus, the combined fines of \$200,000 resulting from these consent decrees were not considered material to the company's operations. Therefore, these immaterial fines would not amount to suspicion by the Directors to start an immediate investigation.

The third allegation states that the Directors committed actionable oversight failure by not acting with a "critical eye" in examining and confirming the company's improving earnings results during the year 2005-2007. (Op. 25.) Once again, these factual allegations do not allege specific facts to put the Directors on notice of actual or

probable employee misconduct. Nowhere in the complaint does the Plaintiff allege that such dramatic improvement to business results were not explained or justified to the Directors by facially valid business reasons. (Op. 25.) The Plaintiff must meet the "conscious failure" standard to establish the necessary conditions predicate for director oversight liability. However, this has not been sufficiently pled.

Plaintiff's complaint fails to allege with particularity specific facts that the Directors face a substantial likelihood of personal liability for oversight failure. Nowhere in the case is there a "red flag" of any kind. Therefore, the dismissal of the complaint must be affirmed under Court of Chancery Rule 23.1 for failure to adequately allege demand futility.

B. This Court Should Affirm The Lower Court's Decision Because The Plaintiff's Claim Of Officer Oversight Liability Has Not Been Recognized Under The Law, However, The Stone Test Should Be Applied In The Event This Court Decides To Recognize Such a Claim

1. Question Presented

Did the Court of Chancery properly hold that officers are not subject to oversight liability, and even if they are, the Stone test would be applied?

2. Scope Of Review: De Novo

This Court reviews de novo a decision of the Court of Chancery to dismiss a complaint under Court of Chancery Rule 12(b)(6). *Wal-Mart Stores, Inc. v. AIG Life Ins. Co.*, 901 A.2d 106, 112 (Del. 2006); *Gantler v. Stephens*, 2009 Del. LEXIS 33, at *6 (Del. Supr.). With such a standard, all inferences will be viewed in a light most favorable to the defendants. *Id.* As discussed below, in adhering to this standard, this Court should affirm the decision of the Court of Chancery.

3. Merits Of Argument

a. The Lower Court's 12(b)(6) Dismissal Was Correct Because No Court Has Subjected Officers To Oversight Liability.

In the event this Court determines that demand upon the board was necessary and not futile, the Court will not have to address this issue. However, if this Court finds that demand was futile, the motion to dismiss pursuant to Court of Chancery Rule 12(b)(6) should nonetheless be granted, because corporate officers have never been subjected to oversight liability. Since there is essentially no case law for this Court to make a determination, any conclusion will need

to be made by examining legislation. *Bartron v. Del. River Joint Toll Bridge Comm'n*, 216 F.2d 717, 719 (3rd Cir. 1954).

The Court must look to the purpose of the corporate form of governance "to earn and pay dividends." *A. P. Smith Mfg. Co. v. Barlow*, 98 A.2d 581, 585 (N.J. 1953). To that end the Delaware Legislature has separated officers and directors within corporations by recognizing those two inherently different bodies in the Delaware General Corporate Law ("DGCL"). "The business and affairs of every corporation...shall be managed by or under the direction of a board of directors." 8 Del.C. § 141(a) (1998). "Every corporation...shall have such officers with such duties as shall be stated in the bylaws or in a resolution of the board of directors." 8 Del.C. § 142(a).

A number of states have adopted the Model Business Corporation Act ("MBCA") which has similar provisions to the DGCL. The MBCA also separates the board of directors from officers. The language of the MBCA has particularly identified the duties of each. For directors, oversight responsibilities include paying attention to policies and practices as well as the effectiveness of internal controls. Model Bus. Corp. Act § 8.01(c) (1979). Additional provisions of the Act place more of the oversight responsibility on directors by providing liability for "a sustained failure of the director to devote attention to ongoing oversight." Model Bus. Corp. Act § 8.31. On the other hand, the MBCA only requires that officers act in good faith, with an emphasis on reasonableness and acting with the best interests of the company in mind. Model Bus. Corp. Act § 8.42(a). The MBCA does not articulate any specific oversight duties for officers, but requires

them to inform their superiors when faced with errors or violations. Model Bus. Corp. Act § 8.42(b).

Additionally, public policy does not warrant liability in the oversight context. Holding officers liable for oversight failure would defeat the purpose of the creation of two independent bodies of management. The corporate form has found it advantageous to utilize a decentralized management. Officers are entrenched in the day-to-day activities of promoting the company's goal of earning a profit for its shareholders. This allows the ability to make crucial decisions for specific areas of the company and design plans for improvement and growth.

In regard to the role officers play in a company, they are closer to the day-to-day action. Some may argue that this should subject the officers to liability for a lack of oversight due to such close interactions. Officers should have a responsibility to oversee their employees, but only in matters that catch their attention. With as many duties as an officer has, it would be inappropriate to hold them liable, as in the instant case, where the structure did not warrant communication that would cause one to recognize violations. (Op. 8.)

When it comes to the Officers, this Court should look to what has been laid out. There is virtually no precedential case law on this point and the legislature, in exercising the power to draft the laws, has decided to leave out any liability for officers in an oversight context, consequently deciding that it would be in the best interest of the shareholders to allow directors and officers to operate as two separate bodies serving two different roles. This Court should

refrain from legislating from the bench and instead should affirm the ruling of the lower court, leaving the legislature to draft the laws it deems necessary.

b. The Correct Test For Oversight Liability, If Applied, For Officers Should Be The Stone Test.

In the event this Court finds that demand was not futile and also denies the Rule 12(b)(6) motion to dismiss, it should still dismiss the claim against the Officers, because the test for oversight liability will be the same as it was for the Directors. While case law is relatively minimal on the subject, the business judgment rule can be used to show how each group is similarly treated. "Although the business judgment rule is usually defined in terms of the role of corporate directors, it is equally applicable to corporate officers exercising their authority." *Rosenfield v. Metals Selling Corp.*, 643 A.2d 1253, 1261 n.16 (Conn. 1994). Cases primarily have dealt with the oversight conduct of directors and have not given much insight as to how to treat similar actions when done by officers, but "the *Caremark* decision itself suggests that the same test [used for directors] would be applicable to officers." *In re World Health Alternatives, Inc.*, 385 B.R. 576, 592 (Bankr.D.Del. 2008).

i) Officers Should Be Entitled To The Business Judgment Rule.

Since 1992 "no court has stated that the business judgment rule does not apply to officers, and quite a number of opinions have held that it does." Hamermesh, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 Bus. Law. 865, 868-869 (2005). The business judgment rule is a presumption made when there is no

self-interest involved, the decision was made on an informed basis, in good faith, and in an honest belief that the decision was in the best interests of the company. *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988). In regard to officers, *Stanziale v. Nachtomi*, 330 B.R. 56, 63 (D.Del. 2004), citing *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1051 (Del. Ch. 1996), stated that a corporate officer would not be legally responsible for losses to the corporation when the decision was made in good faith.

Since officers will be in the thick of decision making for a corporation, where the difference in succeeding and losing can be the smallest of details, it would not be prudent to hold such decision makers liable. However, the Plaintiff will misdirect this Court's attention to the Incentive Compensation Plan in an attempt to not apply the business judgment rule due to their self-interest. (Op. 12.) While the business judgment rule comparison is used primarily to discuss how officers in general should be treated like directors, even in the case at hand the Officers have not violated the protections of the rule. The original violation was committed by the former managers two years after the performance plan was established. (Op. 6.)

This Court should apply the same oversight liability test to officers, as that applied to directors.

ii) The Stone Test Should Be Used In Applying Oversight Liability To Officers As Well.

As discussed above, oversight liability is used in order to make sure corporate officials perform the duties they were put in place to do, essentially providing for an environment that promotes corporate success. In performing those duties, it has been stated, "there is

nothing in any Delaware case which suggests that the fiduciary duty owed is different in the slightest from that owed by directors." *World*, 385 B.R. at 592, citing *In re Greater Southeast Cmty. Hosp. Corp.*, 353 B.R. 324, 339 (Bankr. D.D.Col. 2006).

To restate, the court in *Stone* articulated the test as laid out in *Caremark*, that for oversight liability there needs to be a complete failure to implement a reporting system or that there was a conscious failure to monitor or oversee the system. *Stone*, 911 A.2d at 370. Both of these elements require officers to act in good faith while executing their fiduciary duties. *Id.* at 367. Further, officers should not have to seek out problems, but rather be able to rely on the honesty and integrity of employees. *Graham*, 188 A.2d at 130, citing 8 Del.C. § 141(f)).

In this case, the Officers were involved in the daily operations and trusted that they would receive valid information from their senior managers. The Officers went about their duties in an effort to continue the successful operation of the corporation and generate profits for the shareholders. These actions were taken in good faith.

The Plaintiff will have this Court believe that any relationship between the conspirators and the other senior officers would be enough to give rise to a "red flag". However, while two officers may have been the supervisors of the conspirators (Op. 8.), that does not mean they should expect fraud. Also, the third officer has been said to "work closely" with the conspirators on the reports made to the state agencies. (Op. 8.) This is misleading, because the reports made to the state, by themselves, would not shed any light on criminal

conduct. Not even the state agencies noticed the problem originally. (Op. 9.) It is the Plaintiff's hope to use these facts in an effort to make this Court believe that the Officers did not exercise their duties, but that would be an exaggeration.

For these reasons this Court should use the principles of the business judgment rule when determining officer oversight liability. The Plaintiff has failed to demonstrate that there is a "substantial likelihood of liability" in their pleading and therefore, the summary disposition of the lower court should be affirmed.

V. CONCLUSION

This Court should affirm the dismissal of Plaintiff's derivative complaint against the Directors and Officers under Court of Chancery Rule 23.1. The claim against the Officers should also be dismissed under Court of Chancery Rule 12(b)(6).

Respectfully Submitted,

/s/ Team P
Team P
Counsel for Appellees