

In the  
Supreme Court of Delaware

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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.

No. 27, 2009

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APPELLEES' ANSWERING BRIEF

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Submitted by Q,  
Counsel for Appellees

February 17, 2009



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## NATURE OF PROCEEDINGS

Plaintiff below-appellant ("Appellant") is a stockholder of nominal defendant below-appellee Securance Incorporated ("Securance" or "Company"), a Delaware corporation, and she seeks to bring this derivative action on behalf of Securance against the Company's seven member board of directors (the "Board" or the "Directors") as well as against three of the company's senior officers (the "Officers"), none of whom is a member of the Board.

Appellant alleges that the Directors and the Officers (collectively, the "Appellees") are personally liable to the Company for losses incurred as a result of a fraud committed by three of the Company's senior managers ("Senior Managers") because such damages are assertedly the result of a breach of fiduciary duty by each of the Appellees. More specifically, Appellant alleges that the Appellees breached their fiduciary duty of loyalty by failing to discharge in good faith their oversight responsibilities as either directors or officers of the Company.

The Court of Chancery (Siegel, C.) dismissed Appellant's complaint pursuant to Court of Chancery Rules 12(b)(6) and 23.1 for, respectively, failure to state a claim and failure to adequately plead that pre-suit demand is excused in this case. Appellant appeals to the Supreme Court of the State of Delaware from the Order granting Appellees' motion to dismiss.

## SUMMARY OF ARGUMENT

- I. This Court should affirm the Court of Chancery's Order granting Appellees' motion to dismiss. Pre-suit demand may be excused only if a plaintiff (a) pleads particularized facts to show that directors or officers face a substantial likelihood of liability or (b) alleges facts showing a failure by directors to respond to "red flags." Appellant does not allege one particularized fact linking any Director to the Senior Managers' fraud. Filled with conclusory allegations, the complaint should be dismissed for failure to meet the stringent pleading requirements of Chancery Rule 23.1.
- II. Appellant also fails to plead sufficient red flags that would have put the Board or the Officers on notice of the Senior Managers' fraud. Compensation packages are within the Board's business judgment. Further, the 2004 consent decrees involved isolated occurrences unrelated to the future fraud, resulting in only immaterial fines. Because Appellant fails to plead that the Directors or Officers ever admitted any wrongdoing, these consent decrees are insufficient to indicate that the Appellees exercised bad faith in oversight.
- III. Moreover, the complaint should be dismissed with respect to the Officers under Rule 12(b)6 for failure to state a claim. Conclusory allegations need not be blindly accepted by a trial court. Appellant's complaint is devoid of the particularized allegations of fact needed to tie the Officers to any of the alleged wrongdoings. Thus, the complaint should be dismissed.

## STATEMENT OF FACTS

Securance is a Delaware corporation whose stock is traded on the New York Stock Exchange. Compl. ¶ 7. The Company provides managed care services exclusively to Medicaid and Medicare recipients pursuant to government-sponsored health care programs. Id.

State and federal governments pay Securance a premium for every recipient that enrolls in one its managed health care plans. Id. ¶ 11. The Company is required to report to each state the amount of money it spends on direct medical care for its patients through a metric known as the "medical loss ratio." Id. ¶ 14. By law of each state, Securance is required to (a) spend 80% of the premiums it receives from each state on direct medical services for Medicaid patients in its managed care plans or (b) refund premium revenue to each state for any shortfall below that 80% benchmark. Id. ¶ 15.

In early 2005, three former Senior Managers of Securance (none of whom is a defendant in this case) developed a plan to increase Company profits illegally by falsifying medical expense reports to certain state regulators. Id. ¶ 18. From 2005 to 2007, the Senior Managers falsely reported medical loss ratios by causing Securance to transfer unspent Medicaid premiums to ostensibly purchase reinsurance through the Company's wholly-owned Cayman Islands subsidiary, Total Reinsurance ("Total Re"). Id. ¶ 22. The payments to Total Re were sham transactions designed to hide illegal profits. Id. As a result, Securance improperly retained and publicly reported \$120 million in Medicaid premiums that by law should have been refunded. Id. ¶ 20.

As a consequence of the fraud by the Senior Managers, Securance has: suffered criminal liability for fraud; incurred out-of-pocket losses of \$520 million; been disqualified from doing business in four states; and seen the market price of its common stock collapse from a high of \$110 to \$37 per share for a loss of approximately \$3 billion in its market capitalization. Id. ¶¶ 33, 36-37. Each of the Senior Managers is now serving a two-year prison sentence. Id. ¶ 30.

The Senior Managers have not identified one Defendant as being supportive of the fraud. Id. ¶ 31. Furthermore, Plaintiff does not allege that one Defendant had a day-to-day supervisory role with any of the Senior Managers. Id. Plaintiff alleges only that the Officers supervised the departments in which the Senior Managers worked and that one Officer "worked closely" with the Senior Managers. Id.

To support her oversight claims, Appellant relies in part on some prior history. In 2003, the Board adopted a profits-based incentive compensation plan (the "Incentive Compensation Plan") applicable to senior corporate executives. Id. ¶ 38. In 2004, Securance encountered regulatory issues with state officials in Connecticut and Virginia. Id. ¶ 39. Securance initially disputed allegations it denied certain patients some medical benefits but soon entered into court approved consent decrees promising to comply with applicable law. Id. ¶ 41.

At all times relevant to this action, the Board's audit committee handled compliance matters. Id. ¶ 34. In 2008, the Board established a new and separate compliance committee that is expected to be more engaged and proactive going forward. Id.

## ARGUMENT

### (1) QUESTIONS PRESENTED

1. Whether the Court of Chancery was correct in dismissing Appellant's complaint under the Stone test, where Appellant alleges no specific facts to justify a reasonable inference that the harm suffered by Securance resulted from a conscious failure by the Appellees to monitor the Company's operations.
2. Whether the Court of Chancery was correct in dismissing Appellant's complaint, where Appellant fails to plead sufficient red flags to put the Directors and the Officers on notice of the fraud perpetrated by the Senior Managers.
3. Whether the Court of Chancery was correct in applying the Stone test for director oversight liability with equal force to Officers, who deserve the same degree of protection in exercising their managerial oversight responsibilities. In the alternative, whether the complaint alleges specific facts necessary to hold the Officers liable under a less deferential theory of liability when the Officers did not negligently discharge their duty of oversight and did not possess control over the Senior Managers necessary to impose vicarious liability.

### (2) SCOPE OF REVIEW

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 Court of Chancery 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). Although on a motion to dismiss a trial court must accept as true all well-pleaded allegations and reasonable inferences that logically flow from them, Id. at 255, a court "is not . . . required to accept as true conclusory allegations 'without specific supporting factual allegations.'" In re Gen. Motors (Hughes) S'holder Litig., 897 A.2d 162, 168 (Del. 2006)(citation omitted). Moreover, a court "is required to accept only those 'reasonable inferences that logically flow from the face of the complaint' and 'is not required to accept every strained interpretation of the allegations'" proposed by a plaintiff. Id. (citation omitted).

**(3) Merits of Argument**

**I. THE COURT OF CHANCERY PROPERLY DISMISSED THE COMPLAINT BECAUSE IT FAILS TO ADEQUATELY PLEAD THAT PRE-SUIT DEMAND IS EXCUSED IN THIS CASE**

The derivative complaint in this case asserts oversight claims against Securance's directors and officers. Compl. ¶ 2. Under Delaware General Corporation Law, in order for a stockholder to bring a derivative action without first making a demand upon a company's directors, the stockholder's complaint must demonstrate that the directors are incapable of making an impartial business decision regarding whether to institute such litigation. Stone v. Ritter, 911 A.2d 362, 366-67 (Del. 2006). Specifically, in a derivative case based on a board's fiduciary duty of oversight, a complaint must allege

*particularized facts* to show that the directors "face a *substantial likelihood* of liability." Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993)(emphasis added). Such a claim is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment," and the plaintiff therefore has a heavy burden at the initial pleading stage. In re Caremark Intl. Inc. Deriv. Lit., 698 A.2d 959, 967 (Del. Ch. 1996).

In Stone, this Court emphasized lack of good faith as a predicate to director liability in oversight cases. 911 A.2d at 369. Stone further explained the necessary conditions for director oversight liability: "(a) the directors utterly failed to implement any reporting or information system or controls; or (b) 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." Id. at 370. In this case, Appellant admits the existence of a regulatory compliance program at Securance, therefore only part (b) of the Stone test is at issue.

Ultimately, Appellant fails to allege particularized facts to show that the Directors or the Officers face a substantial likelihood of liability for consciously failing to monitor the Company's operations. Accordingly, pre-suit demand should not be excused.

**A. Appellant Fails to Plead Particularized Facts Linking the Senior Managers' Fraud to the Appellees' Conscious Failure to Exercise Oversight**

Appellant asserts that the Directors breached their fiduciary duty of loyalty by failing to act in good faith to fulfill their

oversight responsibilities. Compl. ¶ 2. However, Appellant fails to “raise a reasonable doubt regarding the ability of a *majority* of the Board to exercise properly its business judgment in a decision on a demand had one been made.” Rales, 634 A.2d at 927 (emphasis added).

It is striking that the complaint fails to allege one fact linking any individual Director to the Senior Managers’ fraud. Instead, Appellant relies on one vague and unreliable statement made by the very managers who perpetrated the fraud. Compl. ¶ 19. In their plea agreements, the Senior Managers claimed that they “acted with the express or implied support of the Company’s senior officers.” Compl. ¶ 31. But Appellant admits that the “plea agreements do not specifically identify the . . . officers who supported the Senior Managers.” Compl. ¶ 31. Further, this fact is insufficient even if construed most favorably to Appellant. Since only three of the seven Directors are also Officers, even if the managers claimed all three Officers were supporting the fraud – which is not supported by the complaint – that would still not command a majority of the Board. Compl. ¶¶ 4-5.

No other fact in the complaint suggests that the Board consciously failed to monitor its reporting or information system or controls. Instead, Appellant admits that the Senior Managers “devised” and “masterminded” the fraudulent scheme. Compl. ¶¶ 21, 25. Appellant makes a conclusory statement that this was done “in an environment of profit-by any means necessary that was consciously or recklessly condoned by the supine and acquiescent” Board. Compl. ¶ 17. However, Appellant fails to mention one action by the Board for seven pages and

fifteen paragraphs in the Complaint, notably throughout the entire description of the Senior Managers' fraud.

Although Appellant states that Securance's losses are "directly attributable to [Appellees'] failure to fulfill their fiduciary mandate to . . . oversee the Company's compliance with applicable law," Compl. ¶ 37, Appellant concedes that the Board had an audit committee that dealt with compliance matters. Compl. ¶ 17. As the Caremark Court recognized, "only a sustained or systematic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to liability." 698 A.2d at 971. Appellant fails to plead facts in the complaint to support the notion that the audit committee was not exercising adequate oversight.

Unfortunately for Appellant, the appalling tale of the Senior Managers' greed and deceit is not sufficient to prove that the Directors breached their duty of oversight. Indeed, this Court has recognized that "directors' good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability." Stone, 911 A.2d at 373. Accordingly, this Court should dismiss Appellant's derivative complaint because it fails to allege particularized facts to show that the Directors consciously failed to monitor the Company's operations.

**B. Appellant Incorrectly Alleges that Recklessness is Sufficient to Show Bad Faith. This Court Uses a Conscious Disregard Standard for Oversight Claims.**

The Court of Chancery was correct in rejecting Appellant's allegation that bad faith in the context of oversight liability could be proven by recklessness. Order Granting Appellees' Motion to Dismiss 20-21. This Court has recognized that fiduciary liability is predicated on conscious action, a subjective standard based on the Board's actual knowledge. See Stone, 911 A.2d at 370 ("[I]mposition of liability requires a showing that the directors *knew* they were not discharging their fiduciary obligations.")(citing Caremark, 698 A.2d at 506)(emphasis added). Further, even in the context of red flags, this Court has held that a Board may be liable only if "it chooses to do nothing about problems it allegedly knew existed." Id.

Recklessness, "an extreme departure from the standard of ordinary care," would incorporate an objective component into the test for oversight liability. Pub. Employees' Retire't Assoc. of Colo. v. Deloitte & Touche L.L.P., 2009 U.S. App. Lexis 3, \*22 (4<sup>th</sup> Cir. 2009). The Caremark decision recognized that the objective concept of negligence is not well-suited to judicial review of board attentiveness because subjecting corporate directors to personal liability based on the objective ordinary person standard would make these decisionmakers overly cautious. 698 A.2d at 968-69, n.16; see also Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982)("It is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions."). Although recklessness is more

subjective than negligence, the "ordinary care" component of recklessness would still allow directors to be "second guess[ed] by ill-equipped judges or juries." Caremark, 698 A.2d at 967.

This situation would be unwise because corporate directors and officers often make business decisions based on less than perfect information. Joy, 692 F.2d at 886. For a court to impose a recklessness standard after-the-fact, with the benefit of hindsight would not reflect the corporate reality. Id. Instead, it would allow a court to hold a Board liable for failure to react to a problem it did not know existed. Subjecting officers and directors to greater liability for unsuccessful business decisions is exactly what this Court warned against in Stone. Accordingly, this Court should impose nothing less than the subjective "conscious disregard" standard.

**II. APPELLANT FAILS TO PLEAD SUFFICIENT "RED FLAGS" TO SUPPORT AN INFERENCE THAT THE APPELLEES CONSCIOUSLY DISREGARDED THEIR OVERSIGHT RESPONSIBILITIES**

The Court of Chancery was also correct in rejecting Appellant's allegations of "red flags." For director oversight liability, a red flag is a "fact showing that the board was ever aware that [the company's] internal controls were inadequate, that these inadequacies would result in illegal activity, and that the board chose to do nothing about the problems it allegedly knew existed." Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). Although well-pleaded red flags would make the two-pronged Stone test inapplicable, here Appellant alleges two inadequate red flags: the profit-based Incentive

Compensation Plan and the regulatory trouble in Connecticut and Virginia. Compl. ¶¶ 38-44.

**A. Appellant Mischaracterizes the Incentive Compensation Plan as a "Red Flag." Employee Compensation is within the Board's Business Judgment.**

The Court of Chancery correctly rejected Appellant's assertion that the Incentive Compensation Plan was a red flag foretelling fraud. Order Granting Appellees' Motion to Dismiss 24. The plan provided for bonus compensation based on the profit yielded by each of Securance's business segments. Compl. ¶ 38. Nothing in the pleadings supports Appellant's bootstrap conclusion that the Appellees were "well aware" that the compensation plan provided incentives for senior executives to inflate the results of their business segment. Compl. ¶ 38. Further, to allow this bootstrap argument would contravene a Company's power under Delaware Law to "[a]ppoint such officers and agents as the business of the corporation requires and to pay or otherwise provide for them suitable compensation." DEL. CODE ANN. 8 § 122 (5). As this Court has recognized, the "size and structure of executive compensation are inherently matters of [business] judgment." Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000).

No court has held that the adoption of an incentive compensation plan, standing alone, is a red flag which triggers Stone oversight liability. If such a compensation plan is deemed sufficient for this purpose, nearly every major corporation would have to abolish its compensation plan or immediately implement compliance reforms in order to avoid being held liable for the tortious acts of its employees.

**B. The 2004 Consent Decrees were not Material to the Board's Decisionmaking**

Appellant also fails to recognize that Board decisions are subject to the concept of materiality. See Brehm, 746 A.2d at 260, ("The Board is responsible for considering only material facts that are reasonably available, not those that are immaterial or out of the Board's reasonable reach."). In this context, the term "material" means "relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care." Id. at 259, n.49.

Based on this definition, Appellant fails to plead that the Board ignored a material red flag. Instead, Appellant merely alleges that, as part of each consent decree, Securance consented to pay a fine of \$100,000 to two states. Compl. ¶ 42. In the same year, however, Securance reported \$49 million in net income, Compl. ¶¶ 16, 25, which means that the fines amounted to less than 0.41 percent of Securance's profits the year. Therefore, the 2004 consent decrees were not necessarily of a "magnitude to be important to the directors' decisionmaking." Brehm, 746 A.2d at 259; See also Order Granting Appellees' Motion to Dismiss 25 (noting that the consent decree fines were "hardly material to the Company's operations").

Furthermore, Appellant's own allegations belie the notion that the 2004 consent decrees were material to the Board. Securance operates in eighteen states. Compl. ¶ 13. The fact that Securance encountered regulatory problems in only two states, Connecticut and Virginia, suggests that these incidents were isolated. More importantly, these two states are notably absent from the four states

where the fraud later occurred: Ohio, Pennsylvania, New York, and New Jersey. Compl. ¶ 18. As Appellant alleges, Securance saw these four markets, which accounted for approximately 40% of the Company's annual revenue, as a geographic "band of gold." Compl. ¶ 18. Although Appellant fails to allege what percentage of Securance's profits Connecticut and Virginia make up, Appellant's pleadings indicate that these states are not critical to Securance. Therefore, taken with the fact that the fines were such a small percentage of Securance's total profits, Appellant fails to plead that the 2004 consent decrees were material to the Board's decisionmaking.

**C. Even if the Consent Decrees Were Material, they were Isolated Events Unrelated to the Managers' Fraud. Accordingly, these Past Events did not Provide Sufficient Warning of the Future Illegality.**

In the alternative, if the 2004 consent decrees were material, Appellant fails to demonstrate that the Board was grossly negligent in failing to implement compliance reforms.

Generally, other courts have only found allegations of repeated warnings to be sufficient red flags for the purpose of surviving a motion to dismiss. See McCall v. Scott, 239 F.3d 808, 823 (6th Cir. 2001) (applying Delaware law, noting that "[the] duration of the alleged wrongdoing is relevant in determining whether the failure of the directors to act constitutes a lack of good faith"); In re Abbott Labs Derivative S'holder Litig., 325 F.3d 795, 809 (7th Cir. 2003).

In McCall, the court found plaintiff's pleaded red flags to be sufficient where the allegations included the directors' failure to act in the face of: "audit information, ongoing acquisition practices,

allegations brought against Columbia in a qui tam action, the extensive federal investigation, the New York Times' investigation into Columbia's billing practices, and [prior] inaction by the Board." McCall, 239 F.3d at 820. The McCall court emphasized that the defendant directors' prior experience as managers in health care organizations was a "significant factor" in its decision because Appellees' prior experience should have put them on greater notice to act. Id. at 819. Further, the McCall directors disregarded all of these warnings over a three-year period. Id.

Similarly, in Abbott, plaintiffs alleged that the directors ignored repeated red flags raised by the FDA and media reports over a six-year period of non-compliance. 325 F.3d at 802. There, several of the board members themselves were warned repeatedly of the problems: the chairman received two copies of FDA warning letters; the directors themselves signed SEC forms acknowledging the Company's involvement in proceedings over FDA regulations; and the FDA met at least ten times with Company representatives—including the CEO and other senior officers—regarding these continued violations. Id. at 808. Therefore, Abbott involved "long-term violations which had not been corrected," and there were several facts that made it reasonable to infer that members of the board were aware of the problem. Id. at 806.

In this case, by contrast, Appellant merely alleges one regulatory problem that occurred in two (arguably immaterial) states in 2004. Appellant admits that the regulatory problems in 2004 did not involve any formal admission of wrongdoing or concern the future illegality

committed by the Senior Managers. Compl. ¶ 43. Unlike McCall, Appellant fails to plead any prior experience by any Director or Officer that would put them on heightened notice to act, yet summarily concludes that the regulatory problem "should have been a red flag to the Board and Officer Defendants that the Company's compliance systems were inadequate." Cf. 239 F.3d at 819; Compl. ¶ 43. Appellant does not allege long periods of repeated warnings like in McCall and Abbott. Therefore, this isolated, unrelated incident should not be sufficient to impose liability on the Board.

Although Appellant does allege the existence of a single analyst report suggesting possible fraud and an investigation of Securance, these are not sufficient to allege substantial "duration" of wrongdoings. Compl. ¶¶ 27, 28; McCall, 239 F.3d 808. First, Appellant does not allege these as red flags. Compl. ¶ 38-44. More importantly, however, these actions occurred one month apart from each other, and began just four months before the Senior Managers were arrested. Compl. ¶¶ 27-28, 30. In McCall and Abbott, the warnings were over such an extended period of time that the directors had sufficient time to respond, and therefore were negligent in failing to do so. In this case, however, the interval was so short that even if the Directors had reacted to the analyst's report, they likely would not have had time to correct the fraud.

Although Appellant alleges that all of the Director and Officers "were aware of the 2004 investigations and resulting consent decrees," that is not enough to excuse demand. Compl. ¶ 44. In Graham v. Allis-

Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963), this Court refused to accept three directors' knowledge of two consent decrees enjoining the company from price-fixing as sufficient notice to the Board of the possibility of future illegal price-fixing. Id. at 129. This Court emphasized that the directors believed that the company had not been guilty of price-fixing in the first place. Id. Similarly, Appellant admits in the pleadings that Securance initially disputed these allegations, Compl. ¶ 41, and that each consent decree stipulated that the decrees were entered into "upon the consent and agreement of the parties *without adjudication or admission of any issue of fact or law.*" Compl. ¶ 42 (emphasis added). As in Graham, knowledge of a consent decree alone is not enough to impute notice on the Board of the possibility of future illegal activity, where the Directors never accepted these allegations as true.

Therefore, Appellant fails to allege "an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss." 698 A.2d at 967 (emphasis in original). Although Appellant claims that neither the Directors nor the Officers "insisted on restructuring or reinvigorating the Company's then existing compliance system," nothing in the complaint suggests that the Board did not *consider* the consent decrees.<sup>1</sup> Compl. ¶ 44. Instead, the complaint seems to support the notion that the Board chose not to take any action, either because the Directors believed Securance was not guilty in the first place, or that this

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<sup>1</sup>However, the Board would not be liable even if it failed to consider the decrees because they were immaterial.

immaterial, isolated problem had been resolved. This decision is within the Directors' business judgment. See Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984)("[A] conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule."). Accordingly, these isolated 2004 consent decrees are insufficient to excuse demand.

**III. THE COURT OF CHANCERY PROPERLY DISMISSED THE COMPLAINT WITH RESPECT TO THE OFFICERS BECAUSE THE COMPLAINT FAILS TO STATE A CLAIM FOR FIDUCIARY OVERSIGHT LIABILITY**

As a matter of first impression, this Court should determine that the director oversight liability test adopted in Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006), applies with equal force to senior officers because they deserve the same degree of protection in exercising their managerial oversight responsibilities. Applying the Stone test, Appellant's claims against the Officers should be dismissed for the same reasons previously advanced in Section I of this brief. In the alternative, if this Court determines that the Stone test does not apply, Appellant's claims against the Officers should be dismissed under any other applicable theory of liability.

**A. The Stone Test for Director Oversight Liability Should Apply with Equal Force to Oversight Claims Brought Against Senior Officers**

The fiduciary duties of officers are the same as those of directors. Gantler v. Stephens, 2009 WL 188828 (Del. Supr. 2009). Nevertheless, the Court of Chancery stated that Delaware case law "has yet to explore whether the Stone test for director oversight liability applies with equal force to oversight claims brought against senior

officers." Order Granting Appellees' Motion to Dismiss 27-28. This Court should conclusively determine that the Stone test applies to officers for two reasons. First, the case law that inspired the Stone decision suggests that it should. Second, courts and other authorities have shown a willingness to extend equal liability standards to directors and officers under the comparable business judgment rule.

Stone explicitly approved the test for director oversight claims that was originally developed in In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996). Although Stone is silent as to whether the same standard applies to officers, Caremark indicates that senior officers should be entitled to the same degree of protection as directors in the context of oversight liability. See Caremark, 698 A.2d at 969 ("[A]bsent 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.") (emphasis added). Thus, this Court should adopt Caremark in its entirety and hold directors and officers to the same standard of oversight liability.

In determining whether Stone applies to officers, this Court should also look to the parameters of the business judgment rule. The business judgment rule protects business decisions from being second-guessed by courts unless the decision was reached by a grossly negligent process. See Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000). The business judgment rule is analogous to the Stone test because each requires a high-degree of culpability before a court will find

liability. Respected authorities such as the American Law Institute and the ABA Committee on Corporate Laws support applying the business judgment rule to officers. See 1 American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (1994) § 4.01 cmt. a ("Sound public policy points in the direction of holding officers to the same duty of care and business judgment standards as directors, as does the little case authority that exists on the applicability of the business judgment standard to officers, and the views of most commentators support this position."); ABA Comm. On Corporate Laws, "Changes in the Model Business Corporation Act Pertaining to the Standards of Conduct for Officers; Inspection Rights and Notices-- Final Adoption," 54 BUS. LAW. 1229, 1231 (1999)("[T]he business judgment rule will normally apply to decisions within an officer's discretionary authority.").

Likewise, Delaware courts have arguably held that the business judgment rule applies to both directors and officers.<sup>2</sup> See Kelly v. Bell, 266 A.2d 878, 879 (Del. 1970). In Kelly, a corporation's officers, three of whom were also directors, approved a plan to voluntarily continue paying a county tax on existing company machinery. Id. Shareholders brought suit against the directors seeking reimbursement for these voluntary payments. Id. The Kelly court held "the *directors or officers* were not necessarily liable to the

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<sup>2</sup> Although we submit that Delaware courts have held that the business judgment rule applies to both directors and officers, we concede that all scholars are not in accord on this issue. One commentator claims that Kelly contains only dictum in favor of affording business judgment rule protection to corporate officers. See Lyman P. Q. Johnson, Corporate Officers and the Business Judgment Rule, 60 BUS. LAW. 439, 444 (2005).

corporation because they honored the commitment, provided they exercised honest business judgment in doing so." Id. (emphasis added). Just as the Kelly court applied the business judgment rule to officers, so too should this Court apply the analogous Stone test to officers.

Moreover, a number of policy rationales support the adoption of the Stone test with regard to senior officers. First, deferential treatment from courts encourages officers to serve. If officers are more strictly scrutinized, increasingly fewer will be willing to assume the position. As a result, the lucrative infrastructure currently employed by corporations could be derailed. Second, applying the Stone test to officers will prevent hindsight bias. Courts have a limited ability to determine exactly what information officers should uncover in the corporate realm. Thus, in the absence of the Stone test, courts may have a tendency to look backwards and hold officers liable simply because a wrong has occurred. Finally, in cases like this where some named defendants serve as both officers and directors, applying a different standard of liability to defendants' roles in each position would be impractical.<sup>3</sup> The inevitable overlap of corporate roles would impede a court's ability to ascertain whether a defendant has acted in her capacity as an officer or a director.

Once Stone is applied, Appellant's claims against the Officers should be dismissed for the same reasons previously advanced in section I of this brief.

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<sup>3</sup> Appellees Saligman, Richmond and Craig serve as both officers and directors of Securance. Compl. ¶ 5.

**B. Even Under a Less Deferential Test for Oversight Liability, the Officers did not Breach their Fiduciary Duty because they did not Act Negligently**

In the alternative, if this Court determines that the Stone test does not apply with equal force to officers, the complaint should nonetheless be dismissed. In the absence of Stone, the appropriate standard would be to assess the Officers' liability as agents of Securance.

The Stone test requires bad faith that is more culpable than gross negligence. Stone, 911 A.2d at 369-70. Agents only owe a duty of ordinary care. RESTATEMENT (SECOND) OF AGENCY § 379 (1958). Consequently, simple negligence is a breach of this duty. Boyd v. Blumenthal, 52 A. 330, 331 (Del. 1902). Thus, the key difference between liability under Stone and agent liability is the degree of negligence required.

Regardless of the standard, Appellant fails to allege particularized facts which support an inference that the Officers acted negligently in discharging their fiduciary duty of oversight. The oversight allegations against the Officers relate to the overstated medical expenses reported to state regulators. The Sarbanes-Oxley Act requires the CEO and CFO of a company to sign quarterly and annual reports certifying to the SEC that the company's financial statements are accurate.<sup>4</sup> 15 U.S.C. § 7241 (2002). Here, however, the Officers did not act negligently in certifying the

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<sup>4</sup> Defendant Saligman is CEO of Securance and Defendant Richmond is CFO. Compl. ¶ 5. The Sarbanes-Oxley Act also requires these officers to certify that adequate internal controls are in place. 15 U.S.C. § 7241 (2002). However, as discussed above, the Officers had no reason to believe that compliance reforms were necessary.

company's financial statements because they had no reason to believe the reports were fraudulent.

In order to illustrate this argument, it is important to understand the relationship between Securance, Total Re, the Officers and the Senior Managers. The Senior Managers were responsible for reporting data on Securance's medical loss ratios to state regulators. Compl. ¶ 18. The Senior Managers committed fraud by using unspent Medicaid premiums to ostensibly purchase reinsurance through Securance's wholly-owned subsidiary, Total Re. Id. ¶ 22. From the Officers' perspective, reinsurance was a sensible expense. Medical loss ratios exceeding 80% cut directly into the Company's profit. Id. ¶ 15. Medical loss ratios exceeding 100% resulted in a negative cash flow. Therefore, the Officers had reason to believe that reinsurance provided a means of insulating the company from financial loss.

The Officers had no way of knowing that Total Re was merely "parking" the funds. There is no evidence that the officers had any involvement with Total Re. In fact, it is likely that Total Re operated altogether separately from Securance because of its remote location in the Cayman Islands. Id. ¶ 22. Consequently, the Officers were not negligent in certifying the Company's financial reports.

**C. The Officers are not Vicariously Liable for the Actions of the Senior Managers because the Officers did not have the Power to Control their Fellow Agents**

The doctrine of *respondeat superior* provides the final avenue for attempting to hold the Officers liable. *Respondeat superior* makes an employer vicariously liable for torts committed by an employee or

agent while acting within the scope of employment. RESTATEMENT (THIRD) OF AGENCY: INTRO. (2006). Here, however, the Officers and Senior Managers did not have an employer-employee or principal-agent relationship. Rather, the Officers and Senior Managers were coagents because they served the same principal, Securance.

The standard for coagent liability is as follows:

The doctrine of respondeat superior does not . . . create liability against an agent for the conduct of servants and other agents of the principal . . . even though other agents are subject to his orders . . . . He is, however, subject to liability . . . if he directs or permits tortious conduct by them or fails properly to exercise control over them.

RESTATEMENT (SECOND) OF AGENCY § 358 cmt. a (1958). Appellant does not allege that any individual Appellee directed or permitted the tortious conduct of the Senior Managers.<sup>5</sup> Thus, in order to find the Officers vicariously liable in this case, Appellant must demonstrate that the Officers had the power to control the Senior Managers and failed to properly exercise control over them.

Although the Officers had a duty of oversight, there is no evidence that this duty empowered the Officers to actually control the Senior Managers' day-to-day activities. Appellant alleges only that the Officers supervised the departments in which the Senior Managers worked and that one Appellee - Officer Stockdale - "work[ed] closely" with the Senior Managers. Compl. ¶ 31. Appellant does not allege that the Senior Managers reported to or took orders from the Officers.

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<sup>5</sup> In their plea agreements, the Senior Managers claim that they acted with the express or implied support of the Company's senior officers. Compl. ¶ 31. However, none of the Officers were identified.

Assuming, *arguendo*, that the Officers could control the Senior Managers, there is no evidence that they failed to properly exercise control over them. The Officers could not control what they were unaware of. As previously discussed, the Officers were not negligent in trusting the Senior Managers to comply with state law.

Furthermore, in Delaware, imposing vicarious liability also seems to require some input in the hiring process. In Fields v. Synthetic Ropes, Inc., 215 A.2d 427 (Del. 1965), the Court stated, “[T]he imposition of liability on the employer thus arises . . . because the employer selected an employee who performed the employer's business negligently and caused an injury.” Id. at 432. Here, there is no evidence that the Officers hired or promoted any of the Senior Managers. Since the Officers neither selected the Senior Managers nor failed to properly exercise control over them, they cannot be held vicariously liable for the Senior Managers’ conduct.

#### CONCLUSION

For the foregoing reasons, this Court should affirm the Court of Chancery’s Order granting Appellees’ motion to dismiss the complaint.

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Submitted by Q,  
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