

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 )

No. 27, 2009

Court Below: Court of  
Chancery of the State of  
Delaware

C.A. No. 3892-CS

APPELLEES' ANSWERING BRIEF

Team R  
Counsel for Defendants Below-  
Appellees

DATED: February 17, 2009

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### **NATURE OF PROCEEDINGS**

On July 3, 2008, Clare C. Marshall instituted a stockholder derivative action on behalf of Securance Incorporated. The Complaint alleged that Securance's Board of Directors and three of its non-director senior officers failed to fulfill their fiduciary duty to Securance and its shareholders. The Defendants filed motions to dismiss for failure to allege demand futility as required by Court of Chancery Rule 23.1 and failure to state a claim on which relief can be granted under Court of Chancery Rule 12(b)(6). On January 6, 2009, the Court of Chancery granted the Directors' motion to dismiss pursuant to Rule 23.1 and the officer's motion to dismiss pursuant to both Rule 23.1 and Rule 12(b)(6). Ten days later, on January 16, 2009, Clare C. Marshall filed a Notice of Appeal with this Court challenging the motions to dismiss granted by Chancellor Seigel pursuant to Rules 23.1 and 12(b)(6).

### **SUMMARY OF ARGUMENT**

1. Under Delaware law, it is a well-settled principle that the authority to make decisions for a corporation rests with its board of directors. Thus, pursuit of an action on behalf of Securance against its directors and officers is left to the board of directors.

2. Stockholders wishing to compel a corporation to pursue a cause of action must make demand on the board. Demand on the board is a requisite action unless the stockholder can show that demand was futile. Proving demand futility requires particularized factual allegations. Plaintiff has failed to make such particularized allegations.

3. Demand may be excused when directors are either disinterested or independent. A key test of in determining the lack of disinterest or independence requires particularized factual allegations showing that the directors face a substantial likelihood of liability. Plaintiff's Complaint fails to allege facts leading to a substantial likelihood of liability for the Directors.

4. In the context of oversight liability, demand may be excused if the directors consciously ignored and failed to monitor reporting systems. However, Plaintiff has failed to plead any facts showing that the Directors did not monitor the controls set in place.

5. Even in circumstances where a plaintiff is unable to prove that the director's knew they were failing to monitor, a plaintiff can allege that "red flags" should have alerted them to the problem. The Complaint only mentions two possible red flags. Neither the incentive-based compensation nor the prior no-fault settlement amount to legally recognized red flags in the oversight context.

6. Although director fiduciary duties have been extended to corporate officers, Delaware law has yet to recognize oversight liability on behalf of officers. Thus, Plaintiff's allegations against the Officer Defendant's should be dismissed for failure to state a claim.

7. Even if Plaintiff has stated a claim against the Officers, the Complaint should still be dismissed because the decision to pursue action against the Officers rests with the directors, not an individual shareholder.

## STATEMENT OF FACTS

Securance is a for-profit health care company that provides managed care services to Medicare and Medicaid recipients in 18 states in the Mid-Atlantic and Midwest regions of the United States. Only the Medicaid component of Securance's business in four states is at issue in this proceeding.

The Medicare and Medicaid programs are regulated at both the state and federal levels. As a provider, Securance must either: (a) spend 80% of the premiums it receives from each state directly on medical services for Medicaid recipients; or (b) refund premium revenue to each state if Securance uses less than 80% of the premiums on medical services.

In March 2008, four of the eighteen states in which Securance offered Medicaid programs commenced a joint investigation of Securance with the Federal Bureau of Investigation (FBI) and the U.S. Department of Health and Human Services (HHS). A federal search warrant was executed at Securance's headquarters. The items seized by investigators filled an entire moving truck and included computers, BlackBerry disks, and numerous boxes of documents containing Securance's corporate records and communications at the highest level for the relevant time period.

After reviewing all of the seized materials, the investigators discovered that three senior managers of Securance had developed and carried out a plan between 2005 and 2007 involving the overstatement of medical loss ratios to state regulators in Ohio, Pennsylvania, New York, and New Jersey. Specifically, instead of reporting medical loss

ratios of 74% to 76% to those four states, the Senior Managers reported loss ratios of 80%. The difference, totaling \$120 million, was reported as used to purchase reinsurance from Total Reinsurance ("TotalRe"), a wholly owned subsidiary of Securance.

The comprehensive investigation conducted by state and federal authorities revealed that the three Senior Managers were the architects of the plan. As a result, the Senior Managers voluntarily resigned their positions, eventually pled guilty to conspiracy to commit Medicaid fraud, and are now serving two-year prison sentences. As part of their plea agreements, the Senior Managers stated that they acted with the express or implied support of the Company's senior officers. However, none of the plea agreements identify these "senior officers" by name or position.

The fourteen other states where Securance offers managed health plans are not threatening to disqualify Securance from Medicaid funding. Still, as a result of the financial loss, Clare Marshall filed a stockholder derivative suit on behalf of Securance and its shareholders. In spite of the extensive corporate information obtained and revealed by investigators, Plaintiff's complaint fails to allege that the three Senior Managers structurally reported to or otherwise had interaction with any members of the board, including the three Directors making up Securance's most senior officers. The complaint also does not allege direct participation in the scheme by any Officer Defendants.

## ARGUMENT

I. **THE COURT OF CHANCERY PROPERLY DISMISSED THE COMPLAINT AGAINST THE DEFENDANT DIRECTORS UNDER RULE 23.1 BECAUSE THE COMPLAINT FAILED TO ALLEGE PARTICULARIZED FACTS DEMONSTRATING THE FUTILITY OF DEMAND.**

### A. Question Presented

Whether the Court of Chancery properly dismissed Plaintiff's derivative complaint pursuant to Court of Chancery Rule 23.1 for the failure to allege particularized facts showing that the Director face a substantial likelihood of liability for breach of their fiduciary duty of loyalty to Securance and are therefore unable to impartially consider demand.

### B. Scope of Review

The Court of Chancery's decision to dismiss Plaintiff's derivative complaint under Rule 23.1 is reviewed de novo by this Court. Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1048 (Del. 2004); Brehm v. Eisner, 746 A.2d 244, 253 (Del. 2000).

### C. Merits of Argument

**1. Demand is not excused under Rule 23.1 because the Complaint does not create a reasonable doubt that a majority of the Board of Directors could have properly exercised its independent and disinterested business judgment in responding to the demand.**

Under Delaware law, demand is excused in the context of claim involving a purported violation of oversight duties only if "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.” Stone v. Ritter, 911 A.2d 362, 366-67 (Del. 2006) (quoting Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993)).

The requisite “reasonable doubt” that a majority of the directors is incapable of considering demand may be demonstrated by showing that the directors face a substantial likelihood of liability. Stone, 911 A.2d at 367. A “mere threat” of personal liability is not sufficient to raise a reasonable doubt as to director disinterest. Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984); see Rales, 634 A.2d at 936. Accordingly, the Court of Chancery correctly rejected Plaintiff’s argument that “potential” liability is sufficient to establish a reasonable doubt as to whether the Directors can impartially consider demand. Opinion at 17-18.

Furthermore, in order to show the necessary “substantial likelihood of liability,” Plaintiff must plead a non-exculpated claim with particularized facts. Guttman v. Huang, 823 A.2d 492, 501 (Del. Ch. 2003); accord Stone, 911 A.2d at 367. As articulated in Stone, directors do not face a substantial likelihood of liability if their conduct constitutes “gross negligence” and the corporation’s certificate of incorporation contains a provision exculpating directors from monetary liability for breach of the duty of care authorized by 8 Del. C. § 102(b)(7); Id. Because Securance’s certificate of incorporation includes such a provision, conduct constituting gross negligence is not enough to establish a substantial likelihood of liability.

Delaware’s formulation of what constitutes a culpable failure of oversight precludes the imposition of liability for conduct that

merely rises to the level of gross negligence. Under Delaware law, gross negligence is conduct that constitutes "reckless indifference or actions that are without the bounds of reason." McPadden v. Sidhu, 2008 WL 4017052, at \*9 (Del.Ch. 2008). Accordingly, gross negligence and recklessness are essentially equivalent. Therefore, Plaintiff's allegations that the Directors acted "recklessly" with respect to any of their fiduciary duties are insufficient as a matter of law to show the requisite substantial likelihood of liability.

Consequently, in order for liability to be imposed on directors for a purported failure to exercise their oversight responsibilities, a plaintiff must make particularized factual allegations showing that a majority of the directors breached their duty of loyalty by failing to act in good faith. Stone, 911 A.2d at 369. A failure to act in good faith requires conduct that is "qualitatively different from, and more culpable than," gross negligence. Stone, 911 A.2d at 369 (citing In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 66 (Del. 2006)). Thus, conduct demonstrating a lack of good faith is a "necessary condition for director oversight liability." Stone, 911 A.2d at 369 (internal quotations omitted).

- a. The Complaint must be dismissed under Rule 23.1 because it does not contain particularized factual allegations demonstrating that the Directors face a substantial likelihood of liability for failing to exercise their oversight responsibilities in good faith.**

Under Delaware law, "the necessary conditions predicate for director oversight liability [are]: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to

monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. Stone, 911 A.2d at 370 (emphasis in original).

Whether or not a reporting or information system exists, the imposition of oversight liability is premised on a showing that the directors acted in bad faith by consciously disregarding their oversight responsibilities. Stone, 911 A.2d at 370. This "requires a showing that the directors knew that they were not discharging their fiduciary obligations." Stone, 911 A.2d at 370 (citing Guttman, 823 A.2d at 506). A conscious disregard for a director's duties may also be shown by particularized factual allegations that the directors intentionally failed to act in the face of a known duty to act. Stone, 911 A.2d at 369 (citing In re Walt Disney Co. Deriv. Litig., 698 A.2d at 67 n. 111). However, "'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.'" Stone, 911 A.2d at 369 (quoting In re Caremark Int'l Deriv. Litig., 698 A.2d 959, 971 (Del. Ch. 1995). In short, director oversight liability is premised on showing with particularized facts that "the directors were conscious of the fact that they were not doing their jobs." Guttman, 823 A.2d at 506.

As the Court of Chancery correctly concluded, only the second part of the Stone formulation is applicable because Plaintiff's complaint explicitly recognizes the existence of a regulatory compliance program at Securance. Opinion at 20, Complaint at ¶ 32 ("compliance matters were handled by the Board's audit committee");

see ¶ 36 (noting presence of outside auditor). Consequently, the issue before the Court is whether Plaintiff's complaint contains particularized allegations of fact that show the Directors consciously failed to exercise their oversight responsibilities in good faith.

**i. Demand was not futile because Plaintiff fails to allege with particularized facts that the Directors knew that they were not discharging their fiduciary obligations.**

The allegations contained in the Complaint are insufficient to show that the Director Defendants consciously failed to discharge their oversight responsibilities in a sustained and systematic manner. Whereas Rule 23.1 requires particularized allegations of fact, Plaintiff has merely presented conclusory assertions that the Delaware courts have long rejected in oversight liability cases as insufficient to excuse demand. See Wood v. Baum, 953 A.2d 136, 143 n. 24 (listing cases in which demand has not been excused due to pleading inadequacies). As a result, Plaintiff's complaint was properly dismissed because it fails to meet the "stringent requirements of factual particularity" of Court of Chancery Rule 23.1. Brehm, 746 A.2d at 254.

To begin with, the Complaint contains no particularized allegations that the Defendant Director's "knew that they were not discharging their fiduciary obligations." Stone, 911 A.2d at 370. Absent from Plaintiff's complaint are any facts describing the actual conduct of the Directors, such as a document, or report by a witness of a meeting or conversation, that would suggest that any of the Directors had any knowledge of the scheme masterminded by the Senior Managers. For example, no where in the Complaint are any

particularized facts describing whether, how or when information regarding the medical loss ratio reporting scheme was presented to the Directors, but that they consciously decided to not take action. See Rattner, 2003 WL 22284323, at \*10 (Del. Ch. 2003) (citing Guttman, A.2d 823 at 498, 503-04). Without such details, Plaintiff's Complaint lacks the particularized facts necessary to impose oversight liability on the Directors.

Instead, it appears that the Plaintiff is attempting to use the status or position of the Directors to charge them with knowledge of corporate activity deep below the surface. Complaint at ¶ 50; see Guttman, 823 A.2d at 507. However, Delaware law on this point is clear: allegations that directors knew of the problems solely because of their position in the corporation, without any facts supporting an inference of actual knowledge, are insufficient to establish oversight liability. In re Sonus Networks, Inc. Deriv. Litig., 499 F.3d 47, 71 (1st Cir. 2007) (applying Delaware law and holding demand was not excused) (citing Guttman, 823 A.2d at 496-98, 507); see Wood v. Baum, 953 A.2d 136, 142-43 (Del. 2008) (even a director's membership on an audit committee was an insufficient basis to infer that they possessed knowledge, or a culpable state of mind, as required for the imposition of oversight liability). Furthermore, a lack of bad faith cannot be shown, merely because the Directors did not know detailed information about all aspects of the operation. Stone, 911 A.2d at 368.

Similarly, Plaintiff alludes that the Directors may have tacitly approved Securance's publicly filed financials or Medicaid reports in four states is insufficient to establish knowledge or lack of good

faith. Wood, 953 A.2d at 142. As Aronson established, and later decisions by Delaware courts confirmed, "board approval of a transaction, even one that later proves to be improper, without more, is an insufficient basis to infer culpable knowledge or bad faith on the part of individual directors." Id. (citing Aronson, 473 A.2d at 814).

Plaintiff's attempt to use the Investigative Report and resulting criminal convictions of the Senior Managers is a similarly insufficient basis for inferring the Defendants' possessed the requisite knowledge. The Complaint contains no particularized allegations of fact regarding the Directors' actual knowledge of the Senior Managers' scheme, despite the truckload of corporate documents and materials seized by federal and state investigators from Securance's headquarters. Complaint at ¶ 28. This is because the investigative reports, including the plea agreements signed by the now incarcerated Senior Managers, fail to raise even the possibility that the Directors had actual knowledge of the Senior Managers' activities or that the Directors share culpability along with those convicted.

Instead, both the Complaint and the investigative reports clearly establish that the Senior Managers' scheme was conducted in a covert manner specifically designed to avoid detection by the oversight and compliance mechanisms that the Directors erected in good faith. Complaint at ¶¶ 19, 25 (the Senior Managers "formed and executed this conspiracy" and "masterminded" the scheme).

The conclusory assertion that the Directors did not adequately supervise the Senior Managers is also insufficient to withstand a

motion to dismiss under Rule 23.1. As a threshold matter, Delaware courts consistently recognize that “[m]ost of the decisions that a corporation, acting through its human agents, makes are, of course, not the subject of director attention.” Stone, 911 A.2d at 372, quoting In Re Caremark Int’l Inc. Deriv. Litig., 698 A.2d at 968. Plaintiff has alleged no particularized facts regarding how or why Directors’ supervision was inadequate, and most importantly, no facts showing that the Directors knew that the supervision they were providing was inadequate, which is necessary to establishing culpable knowledge. For example, Plaintiff has made no allegations whatsoever regarding whether the audit committee or outside auditor detected any improprieties and brought them before the Board, only to have the Board consciously refuse to take action. See Guttman, 823 A.2d at 506-07. Without particularized facts regarding the Board’s supervision of Securance or the practices of the audit committee, the conclusion that supervision of employees was inadequate is untenable.

**ii. Plaintiff’s Complaint fails to plead with adequate particularity that the Directors intentionally failed to act in the face of a known duty to act.**

Additionally, the Complaint fails to plead sufficient facts to show that the Directors intentionally failed to act in the face of a known duty to act. Stone, 911 A.2d at 369 (citing In re Caremark Int’l Inc. Deriv. Litig., 698 A.2d at 970-71) and In re Walt Disney Co. Deriv. Litig., 906 A.2d at 66-67, n. 111). This facet of the oversight liability analysis requires that a plaintiff plead particularized facts showing that the directors knew that the information and reporting controls were deficient, but intentionally

chose not to do anything about it. See Guttman, 823 A.2d at 507 (citing Ash v. McCall, 2000 WL 1370341, at \*15 (Del. Ch. 2000)).

Here, Plaintiff has alleged no facts regarding the actual operation of the audit committee or outside auditor, let alone that they were deficient with respect to the Medicaid reporting requirements and that the Board knew about the deficiencies but chose to not to act. Additionally, Plaintiff makes no particularized allegations of fact regarding how or whether these oversight bodies ignored the Senior Manager's misconduct in a sustained or systematic manner. As a result, the Complaint is devoid of particularized facts that cast doubt on whether the Board exercised a good faith attempt to exercise reasonable oversight. Stone, 911 A.2d at 368, 372 (citing In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d at 970-71).

Instead, Plaintiff's allegations require the Court draw the inference that because the Senior Managers carried out a covert scheme to falsely report Medicaid information to state and federal authorities, the internal controls were deficient and the Directors knew about it, but intentionally chose not to act. Plaintiff's position, however, has been previously rejected: "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, or both . . . ." Stone, 911 A.2d at 373; see Guttman, 823 A.2d at 507 (finding no culpable failure of oversight and noting that a professionally credible outside audit firm exercising a good faith effort may still not be expected to discover accounting irregularities if management's

misconduct is hidden deep below the surface of the financial statements).

Plaintiff attempts to allege that the Directors failed to act in the face of a duty to act when the Complaint alleges that the Directors failed "to act with a critical eye in examining and validating the reasons for the Company's dramatic improvement in earnings performance and soaring stock price." Complaint at ¶ 51. However, this allegation simply amounts to an allegation of a breach of the duty of care. The allegation fails to establish a substantial likelihood of liability for two reasons. First, the Complaint does not plead sufficiently particularized facts showing that the Directors did not carefully view the financial performance of the corporation in violation of a known duty to act. Further, Plaintiff fails to note how the Directors could have been more critical in examining the earnings. Second, the corporate charter of Securance contains the exculpatory clause permitted by § 102(b)(7). Thus, even if Plaintiff could establish a breach of duty in failing to use a "critical eye," the Director Defendant's would be immune from liability.

In sum, Plaintiff's allegations can only be read as an attempt to "equate a bad outcome with bad faith," a conclusory contention that Delaware courts routinely reject: the mere fact that illegal conduct occurred is not sufficient grounds to conclude that internal controls must have been deficient, and that the board knew about it and intentionally failed to take action. Stone, 911 A.2d at 373; Desimone v. Barrows, 924 A.2d 908, 940. As a result, the Complaint was properly dismissed.

- b. The Complaint fails to adequately plead demand excusal because Plaintiff's allegations that certain "red flags" should have put the Directors on notice of alleged oversight inadequacies are insufficient under Delaware law.**

Plaintiff's allegations that the Directors consciously ignored red flags indicating purported inadequacies in Securance's compliance mechanisms are insufficient to establish oversight liability. Stone, 911 A.2d at 365. Under certain circumstances, Delaware law does recognize the possibility of oversight liability if the plaintiff pleads particularized facts showing that a majority of the board of directors knowingly ignored "red flags" that, if heeded, would have alerted them of the Senior Managers' misconduct and that their compliance systems were inadequate. Wood, 953 A.2d at 143; David B. Shaev Profit Sharing Account v. Armstrong, 2006 WL 391931, at \*5 (Del. Ch. 2006); In re Citigroup, Inc. S'holders Litig., 2003 WL 21384599, at \*2 (Del. Ch.), aff'd sub nom Rabinovitz v. Shapiro, 839 A.2d 666 (Del. 2003).

Delaware law has clearly established that "red flags 'are only useful when they are either waved in one's face or displayed so that they are visible to the careful observer.'" Wood, 953 A.2d at 143 (quoting In re Citigroup, Inc. S'holders Litig., 2003 WL 21384599, at \*2 (Del. Ch. 2003)). Furthermore, for the purposes of oversight liability, certain occurrences or events are only red flags if they directly pertain to the underlying misconduct alleged in the complaint. Wood, 953 A.2d at 143; see Guttman, 823 A.2d at 498. For example, allegations of red flags regarding issues unrelated to the underlying alleged wrongdoing are routinely rejected under Delaware

law. Wood, 953 A.2d at 143; In re Sonus Networks, Inc., 499 F.3d at 68 (applying Delaware law and not excusing demand because the alleged red flags were unrelated to the problems the derivative suit relied on; therefore, at most, the directors were on notice of a different problem); cf. In re Abbott Lab. Deriv. S'holder Litig., 325 F.3d 795, 799-800 (7th Cir. 2001) (holding that directors were on notice of the violations of law underlying the complaint because the Food & Drug Administration had sent several warning letters over a six-year period regarding the deficiencies and the board took no action to comply and publicly stated it wouldn't).

Here, however, Plaintiff fails to plead the existence of any events or occurrences that constitute cognizable red flags under Delaware law and fails to make particularized allegations that the red flags were 'waved in the Directors' faces' but they "consciously and in bad faith ignored" them. Wood, 953 A.2d at 143. As a result, the Chancery Court properly rejected Plaintiff's contention that purported red flags put the directors on notice of the inadequate Medicaid reporting compliance system.

**i. The incentive compensation plan is not a legally cognizable red flag.**

The Chancery Court correctly rejected Plaintiff's allegation that the presence of an Incentive Compensation Plan, without more, constitutes a red flag "foretelling likely fraud by employees seeking to achieve illegally earned bonuses." Opinion at 24. The untenability of Plaintiff's allegation is demonstrated through its ramifications: If the mere presence of an incentive payment plan could constitute a red flag in oversight liability cases, then the directors

of every corporation that has such a plan would be continuously exposed to liability. Delaware law, which encourages the participation of qualified individuals on corporate boards, clearly does not support this result. See In re Walt Disney Co. Deriv. Litig., 906 A.2d at 67 (noting that §102(b)(7) evidences an intent to provide significant protection to directors).

Furthermore, as explicitly recognized in Plaintiff's complaint, the Board adopted the incentive compensation plan only after considering a recommendation by the Board's compensation committee. Complaint at ¶ 38. Additionally, the Board had two different oversight mechanisms in place during the relevant timeframe: the audit committee and an outside auditor. Complaint at ¶¶ 32, 36. Contrary to Plaintiff's conclusory assertions, the fact that the incentive compensation plan was adopted after consideration by both the Board and the compensation committee demonstrates that any risks associated with the compensation plan were not consciously ignored. Moreover, the Complaint lacks any particularized facts showing that the Board was presented with information indicating that the entirely above-board benefits to be achieved with an incentive plan were overridden by the potential for employee misconduct, or that the oversight mechanisms in place would be unable to detect abuses. Without these particularized facts, Plaintiff has failed to allege that the incentive compensation plan was a "red flag" that the Board consciously ignored.

**ii. The 2004 Consent Decrees are not red flags.**

The Court of Chancery correctly rejected Plaintiff's allegation that the 2004 Consent Decrees amounted to a "red flag" that should have alerted the board that the compliance systems were inadequate. Opinion at 24; Complaint at ¶¶ 39-44. First, the consent decrees disavowed any admission of wrongdoing; therefore, there was no reason to doubt the adequacy of the compliance mechanisms. Second, the Consent Decrees are wholly unrelated to the alleged problems underlying Plaintiff's complaints and involve conduct totally remote from Securance's medical loss ratio calculations. Therefore, if the consent decrees did constitute a red flag, they were at most a red flag alerting the Board of a different problem. Third, Plaintiff's allegations with respect to the consent decrees are wholly conclusory in the context of the current situation—Plaintiff alleges no facts showing that the Board ignored regulatory issues. Complaint at ¶44 (cursorily asserting that the defendants "consciously or recklessly set the stage for the financial catastrophe" that underlies Plaintiff's contentions). Further, Plaintiff ignores the fact that the alleged improprieties underlying the consent decrees never happened again—proof that the Board was discharging its oversight responsibilities in good faith. Thus, the only reasonable inference that can be drawn from Plaintiff's cursory allegations is that despite no formal admission of wrongdoing and the immaterial nature of the consequences, Securance took successful steps to ensure that this sort of problem wouldn't happen again. Therefore, the 2004 consent decrees

do not constitute legally cognizable red flags signaling the Board of the misconduct underlying this Complaint.

**II. THE COURT OF CHANCERY PROPERLY DISMISSED THE COMPLAINT AGAINST THE DEFENDANT OFFICERS UNDER RULE 12(b)(6) AND 23.1 BECAUSE THE COMPLAINT FAILED TO ALLEGE PARTICULARIZED FACTS STATING A CAUSE OF ACTION IN WHICH RELIEF COULD BE GRANTED OR DEMONSTRATING THE FUTILITY OF DEMAND.**

**A. Question Presented**

Whether the Court of Chancery properly dismissed the derivative complaint against the Officer Defendants pursuant to Rule 23.1 for failure to allege particularized facts showing that the Officer Defendants face a substantial likelihood of liability for breach of their fiduciary duty of loyalty to Securance, or alternatively, pursuant to Rule 12(b)(6) for failure to state a claim.

**B. Scope of Review**

The Court of Chancery's decision to dismiss Plaintiff's derivative complaint under Rule 23.1 is reviewed de novo by this Court. Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1048 (Del. 2004); Brehm v. Eisner, 746 A.2d 244, 253 (Del. 2000).

**C. Merits of Argument**

**1. The Court of Chancery Properly Dismissed the Claim Against Officers Under Court of Chancery Rule 12(b)(6) Because There is No Fiduciary Duty in Regards to Oversight for Officers.**

Like directors, corporate officers also owe the fiduciary duties of care and loyalty to the corporation. Gantler v. Stevens, 2009 WL 188828, at \*9 (Del. 2009). In the context of director fiduciary duties, this Court has previously included

oversight within the duty of loyalty. Stone, 911 A.2d at 370. Later Caremark set forth the standards by which directors can be subject to oversight liability. 698 A.2d at 967. Whether officers can be held liable for an alleged failure to exercise oversight has not been directly addressed by Delaware courts, but the Federal Bankruptcy Court in the District of Delaware determined that, under Delaware law, officers are subject to oversight liability. See Miller v. McDonald, 385 B.R. 576, 592 (Del. 2008). In Miller, the bankruptcy court extended oversight liability to officers because the court interpreted certain statements made by this court as requiring the same duties for officers as directors. Id. He stated: "I believe the Caremark decision itself suggests that the same test would be applicable to officers." Id. (emphasis added).

Despite the Bankruptcy Court's interpretation of Delaware corporate law, there is no oversight duty for officers because Delaware courts have not yet recognized such a duty. Additionally, oversight in its most effective form should: (1) be conducted by those that are not involved in the day-to-day workings of the company and (2) be conducted by a body of directors who are independent. Holding officers liable for oversight failures would contradict Delaware's considered decision to give ultimate control of a corporation to its board of directors. 8 Del. C. § 141(a); Stone, 911 A.2d at 366. The duties of care and loyalty can still be preserved for officers without requiring both officers and directors to be charged with the "task" of oversight.

2. **Demand is not excused under Rule 23.1 because the complaint does not create a reasonable doubt that, as of the time the complaint was filed, a majority of the board of directors could have properly exercised its independent and disinterested business judgment in responding to the demand against the officers.**

The decision to pursue a claim against corporate officers falls within the responsibility of the board of directors. See Rales, 634 A.2d at 932. Whether the directors could impartially consider demand requires an examination of whether the board was disinterested and independent in regards to the claim against non-director officers. See McPadden, 2008 WL 4017052, at \*10. Again, demand is only excused if a majority of the directors are not independent or disinterested. See Rales, 634 A.2d at 930. In this case the plaintiff has failed to make any claims that would lead to such a conclusion.

**a. Plaintiff has failed to show that the majority of the board lacks independence in regards to the officer defendants.**

As previously mentioned, the test for independence requires a showing that the directors can make their decisions without external influence outside the business discussion. Aronson, 473 A.2d at 816. In this case, Plaintiff has failed to allege any facts that would imply any impermissible influence on a majority of the Board members' consideration of whether to pursue litigation. The complaint does not allege any family, financial, or other relationship between a majority of the Directors and Officers beyond the normal business relationships inherent in corporate operations. Because the complaint lacks any attempt to establish such relationships, the board must be considered independent.

**b. Plaintiff has failed to show that a majority of the board is "interested" in regard to the Officer Defendants.**

Plaintiff also fails to establish that the directors are interested under Delaware law. An interested director is one that stands to personally benefit from a board decision disproportionately to the stockholders. Rales, 634 A.2d at 936. Merely being a party to the case will not cause a director to be interested. See Aronson, 473 A.2d at 809, 818. Again, the Complaint fails to allege particularized facts showing that pursuing the claim against the Officers would cause a majority of the Directors to gain or lose anything disproportional to the remaining stockholders. Because of this, a majority of Securance's board is not considered interested.

**c. Plaintiff failed to show that the officers face a substantial likelihood of liability, thus the directors are not interested.**

**i. Duty of Loyalty**

As previously mentioned, interest can also be established if a complaint shows that the officers face a substantial likelihood of liability. Seminaris v. Landa, 662 A.2d 1350, 1355 (Del. Ch. 1995). Considering that a compliance system was in place, Plaintiff attempts to trigger liability under the theory that the Officers failed to monitor the compliance system. Stone, 911 A.2d at 369. Much like the claim against the directors, the Complaint does not attempt to describe the Officers' roles in the preparation or approval of the reports or that officers "consciously disregarded" their

responsibilities to do so. Id. at 370. The allegations in the complaint simply do not rise to the level required to support a violation of good faith.

First, appellant seems to allege that any wrongdoing by the managers would be apparent to the Officers. While on the surface this argument may seem plausible, in reality it is not always the case. The managers that were convicted of fraud went to great lengths to move, hide, and reclassify funds used in the scheme. The Complaint fails to describe the roles that Officer Defendants had in these reports or any failures in the compliance system that allowed the scheme to go unnoticed, much less that the Officers' conduct rose to the level of bad faith.

Second, the only arguments Plaintiff makes that are not mere conclusions of law are that the corporate incentive plan and past settlements constitute red flags that should have put the Officers on notice of some level of manager wrongdoing. As discussed previously in great detail, these events simply do not constitute a red flag in the context of oversight liability – for Securance's Officers or Directors.

Therefore, even though officers might be liable for oversight liability, Plaintiff has not pleaded any particularized facts that could create a substantial likelihood of liability. All the allegations are based on theories and conclusions of law that are unsupported by any particularized facts regarding the behavior, knowledge, or interaction of the Officers with the convicted managers, or anyone for that matter. This is simply not enough to show that the

Officers face a substantial likelihood of liability or that the board was not independent and disinterested when it denied to pursue the action against the officers.

**ii. The Officer Defendants Do Not Face a Substantial Likelihood of Liability for Violating the Duty of Care.**

Unlike corporate directors, officers do not receive protection under the exculpatory clause in the articles of incorporation. 8 Del. C. § 102(b)(7). The Delaware Supreme Court recently adopted the same fiduciary duties of officers as those held by directors, but the court noted "there currently is no statutory provision authorizing comparable exculpation of corporate officers." Gantler, 2009 WL 188828 at \*9 n. 37. This duty of care standard has been described as "gross negligence", "reckless indifference," or a "deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason." McPadden, 2008 WL 4017052. This duty does not require the level of intent that is used to determine violations of the duty of loyalty. See In re Walt Disney Co. Deriv. Litig., 906 A.2d at 64. The Court of Chancery stated that liability for gross negligence requires a factual pleading showing a "wide disparity" between the compliance system used and one that is thought to be reasonable. Guttman, 823 A.2d at 507 n. 39. The Complaint does not even attempt to describe the compliance system in place, nor does it attempt to compare the system to those generally accepted by practice. Even if the compliance system had some flaws, the Complaint fails to identify such flaws. Substantial likelihood of liability for duty of care cannot be established without particularized facts;

therefore, the Complaint does not create a reasonable doubt that the Directors could make an independent and disinterested decision regarding the suit against the Officer Defendants.

In summary, the Complaint does not offer particularized factual allegations that create any reasonable doubt that the directors could make an independent and disinterested decision in considering suit against the Officers. This theme has been repeated in many cases and the courts have often signaled to plaintiffs that they should "use the tools at hand" before filing a claim in a derivative action. See Rattner, 2003 WL 22284323, at \*50. Plaintiff's complaint is a classic example of a claim that is not supported by anything more than mere conclusory allegations.

#### **CONCLUSION**

For the foregoing reasons, this Court should uphold the Court of Chancery's decision to grant a motion to dismiss for inadequate pleading pursuant to Rule 23.1 and Rule 12(b)(6).

Respectfully Submitted,

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Team R  
Counsel for the Appellee