

No. 3892-CS

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In the  
SUPREME COURT OF DELAWARE

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CLAIRE C. MARSHALL  
Appellant

v.

CHARLES H. SALIGMAN, PATRICK C. RICHMOND, YVONNE M. CRAIG, MARTIN R.  
ROTHSCHILD, ELAINE A. LASATER, WILLIAM M. LEWIS, GILBERT W. COULSON,  
RACHEL N. LIEBERMAN, TIMOTHY M. STOCKDALE AND CARLOS B. HUELVA AND  
SECURANCE INCORPORATED  
Appellees

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BRIEF FOR THE APPELLEE

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February 16, 2009

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**QUESTION PRESENTED**

1. Under Court of Chancery Rule 21.1 and 12(b)(6), did the Court of Chancery appropriately dismiss a plaintiff-shareholder's derivative action when the complaint makes only conclusory allegations that the directors and officers are personally liable for inadequate oversight of and response to employee fraud.

**STATEMENT OF FACTS**

Claire Marshall (Plaintiff) owns 1000 shares of the stock of Securance, Inc, a health management organization (HMO) incorporated in Delaware. On date, plaintiff initiated a derivative action on behalf of herself and Securance, against seven Directors and three Officers. Del. Ch. Ct. Memorandum Opinion at 2 (January 6, 2009). Plaintiff stockholder did not seek intra-corporate remedies before initiating the suit. The derivative suit arose out of significant losses suffered by Securance because of managerial fraud. The complaint alleges that both the Board of Directors and Senior Officers breached their fiduciary oversight duties. Id. at 3.

Securance contracts individually with each state that it provides Medicaid coverage. Id. at 4. The state and federal governments pay a premium for every Medicaid recipient that enrolls in a Securance managed plan. Id. at 5. Under both its contract terms, and the law, Securance is required to spend 80% of each state's premiums it receives on direct medical services to Medicaid patients, or refund premium revenue to each state for any shortfall below that 80% benchmark. Id. at 5-6. This spent premium revenue amount, which HMO participants such as Securance are required to report, is defined as the company's medical loss ratio. If medical loss ratios exceed 80% in a given year, those losses are absorbed by Securance and cut directly into its profit. Id. at 6. Given such thin profit margins, Securance must efficiently operate so as to maximize company profits within the legally limited 20% premium revenue band. Id. at 6. In 2005, three former Securance senior managers devised a plan to

boost company profits illegally by deliberately overstating medical loss ratios to regulators in Ohio, Pennsylvania, New York and New Jersey. Id. at 6. Through their scheme, Securance improperly retained, and publicly reported as company net income, \$120 million in Medicaid premiums that, by law and under Securance's contracts, should have been refunded to these four states. Id. at 7. Instead, these funds were veiled in an offshore company owned subsidiary; in order to artificially inflate Securance's publicly reported net income for 2005, 2006 and 2007. Id. at 7. As a result of its seemingly strong financials reported from 2005-2007, Securance's stock rose from \$52 in January 2005 to \$110 by December 2007. Id. at 8. An investigation commenced, eventually pinpointing the three culpable Senior Managers as architects of the fraud. Id. at 10. All eventually plead guilty to conspiracy to commit fraud, resigned their positions with Securance and are each now serving two-year prison sentences. Securance's stock meanwhile, dropped to \$37 by June 2008. Id. at 12.

In 2003, the Board approved an Incentive Compensation Plan for Senior Officers, providing bonus compensation based on operating profit yielded by Securance's business units. Id. at 12. In 2004, Securance voluntarily entered into two court-approved consent decrees, in Connecticut and Virginia respectively, for allegations that it had improperly denied medical services to certain members. Id. at 13. Securance nonetheless admitted to no wrongdoing and paid limited damages to each state. Id. at 13.

**STANDARD OF REVIEW**

The Court of Chancery's ruling the plaintiff shareholder's complaint fails to allege particularized facts demonstrating that the Securance Board of Directors and Senior Officers face a substantial risk of liability presents a question of law subject to de novo review. *Beam ex rel. Martha Steward Living Omnimedia, Inc v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004).

## ARGUMENT

**I. PLAINTIFF'S DERIVATIVE ACTION MUST BE DISMISSED UNDER DELAWARE CHANCERY COURT RULE 23.1 FOR FAILURE TO DEMAND AND FOR FAILURE TO PRESENT FACTS EXCUSING DEMAND AS FUTILE.**

- A. Court of Chancery Rule 23.1 restricts derivative litigation by requiring factually specific allegations showing that the Board of Directors faces a substantial likelihood of liability, thereby preventing an independent and disinterested business decision on the demand.**

Court of Chancery Rule 23.1 imposes threshold requirements on a shareholder seeking to initiate derivative litigation on the behalf of a Delaware corporation. *Stone v. Ritter*, 911 A.2d 362, 367 (Del. 2006). Specifically, the shareholder's complaint must "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors [or] the reasons for the plaintiff's failure to obtain the action or for not making the effort." *Ch. Ct. R. 23.1*. Plaintiff failed to bring her demands before the Board of Directors prior to initiating the derivative action. (Sup. Ct. Order 15.) This is undisputed in the complaint.

A plaintiff shareholder that fails to demand can only proceed with derivative litigation if demand is excused. *Stone*, 911 A.2d at 367. Demand is excused only if the plaintiff satisfies the second prong of Rule 23.1 by explaining why she did not first exhaust intra-corporate remedies, and why that failure should be excused. Demand is only excused if the complaint shows that demand would be futile.

As a threshold requirement for derivative action, demand futility erects a substantial hurdle for shareholders. It places a burden of pleading on to the shareholder to "demonstrate that the prerequisites

of the Rule have been satisfied." *Stotland v. GAF Corp.*, 1983 WL 21371, at \*4 (Del. Ch.). Additionally, pleadings must "comply with the stringent requirements of factual particularity that differ substantially from the permissive notice pleadings." *Brehm v. Eisner*, 746 A.2d. 244, 254 (Dell. 2000).

A stringent demand futility test reflects Delaware's approach to derivative action. Delaware courts uniformly hold that "[t]he decision to bring a lawsuit or to refrain from litigating a claim on behalf of a corporation is a decision concerning the management of the corporation." *Spiegel v. Buntrock*, 571 A.2d 767, 773 (Del. 1990). "[B]y its very nature derivative action impinges on managerial freedom of directors." *Brehm*, 746 A.2d. 244. Thus, derivative action is an extreme remedy and allowed when a shareholder meets the stringent standards.

The rigorous burdens of production and pleading and the nature of derivative action show that Delaware courts to not evaluate demand futility under Rule 23.1 lightly, or as a formality. It is a gatekeeper requiring the sareholder to exhaust their intra-corporate remedies before bringing derivative actions. It is a defense against strike suits and rushed litigation by disgruntled shareholders. *Rattner v. Bidzos*, 2003 WL 22284323, at \*9 (Del.Ch.). It requires that derivative action be dismissed when the shareholder's complaint does not live up to its demanding standards.

The applicable test for demand futility varies with the plaintiff's theory of liability. A derivative suit can allege facts supporting two different theories. One is when a plaintiff initiates

a derivative suit to challenge a specific business decision of the board. See *Aronson v. Lewis*, 473 A.2d 805 (Del, 1984). For instance, a suit could be brought to challenge a compensation plan or severance package. *Brehm*, 746 A.2d at 244. However, a derivative action can also allege that the directors breached their fiduciary duties to the corporation by failure to act or respond as required. *In Re Caremark Int'l Inc. Derivative Litigation*, 698 A.2d 959, 967 (Del. Ch. 1995). An example of this is breach of fiduciary duties through failure to fulfill oversight obligations, commonly referred to as a Caremark claim. *Id.* A Caremark claim liability is "possibly the most difficult theory" in Delaware corporate law.

Both theories of liability apply their own test. When the suit challenges a business decision, the court applies the *Aronson* test. See *Aronson*, 473 A.2d 805. *Aronson* held that, "under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Id.* at 814. However, in the case of a Caremark claim, there is no business decision that can be evaluated against the business judgment rule. In this situation, the test expressed in *Rales* should be applied. *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993). Under *Rales*, demand futility should be measured against only the first prong of *Aronson*. *Id.* Therefore, demand futility requires that the complaint allege particularized facts that created a reasonable doubt that "the board of directors could have properly

exercised its independent and disinterested business judgment in responding to a demand." *Id.*

For the court to excuse plaintiff's failure to demand, the complaint must, under the *Rales* standard, allege specific facts "that the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." *Id.* *Rales* is the required standard to evaluate the demand futility of plaintiff's complaint because it does not challenge a specific business decision. *Id.* Rather, plaintiff's complaint is based only in allegations that the directors breached their fiduciary duties through failure to act and oversee corporate systems. (Sup. Ct. Order 14.) With no specific decision to evaluate under the business judgment rule, *Rales* must be applied in place of *Aronson*. *Rales*, 634 A.2d at 934.

The *Rales* test does not represent a less stringent standard for demand futility than that of *Aronson*. While the *Rales* court did not accept defendant director's request for a more demanding standard, the test ultimately applied by the court maintains the rigorous nature of the *Aronson* test. *Rales* considers demand futility under the single prong of *Aronson* because the second prong of *Aronson* is not logically applicable in the absence of a specific business decision. *Id.* Furthermore, *Rales* is the test for the very demand Caremark claim. *Caremark*, 698 A.2d at 967.

The court's application of *Rales* is limited to the allegations in the pleading. *Stone*, 911 A.2d at 367. *Rales* specifically contemplates plaintiff-shareholder's claim against Securance that

personal director liability can create a reasonable doubt of the Board's independence and disinterest. *Rales*, 634 A.2d at 936. The *Rales* court also recognized some additional claims that could form a basis for reasonable doubt of independence and disinterest, such as dominance of the board by one or several key directors. *Id.* However, the burden to introduce facts remains squarely on the plaintiff, and conclusory allegation of a reasonable doubt cannot be created without specific supporting factual allegations. *In re General Motors Shareholder Litig.*, 2006 WL 722198 at \*3 (Del. Ch.).

In the present case, plaintiff has advanced only a single theory: Directors face a substantial likelihood of personal liability, which creates a reasonable doubt that the Board could make an independent and disinterest business decision on a shareholder demand. As the sole theory advanced, reasonable doubt relies entirely on the complaint's ability to show a significant likelihood that the Board will be held personally liable for failure to fulfill oversight responsibilities. Logically, the inverse is true as well. If the complaint does not show a significant likelihood of director personal liability, it fails to create any doubt of Board independence and disinterest, and must be dismissed for failure to demand.

**B. Plaintiff Complaint fails to allege particularized facts showing that the members of the Securance Board of Directors face a substantial likelihood of liability.**

Plaintiff claims that the Securance Board of Directors "breached their fiduciary duty of loyalty by failing to act in good faith to fulfill their oversight responsibilities. Because Securance had oversight systems in place, the appropriate question for the court is

whether the directors consciously failed to ensure the function of the oversight systems. *Stone*, 911 A.2d at

Plaintiff supports the Caremark claim through allegations of 'red flags' that should have put the Board on notice of failures of Securance's oversight systems. Primary among the so-called 'red flags' are two consent decrees enacted against Securance in 2004. Plaintiff alleges that these consent decrees provided notice to Securance that their oversight systems were insufficient. Additionally, plaintiff claims that a compensation system rewarding profit increases, Securance's operation in a heavily regulated sector, and the increased profits of Securance all should have placed the board on notice.

Plaintiff's complaint fails to make particularized factual allegations showing that the Securance Board of Directors failed to fulfill their oversight responsibilities. The complaint fails to show a conscious failure to monitor oversight systems. Alleged 'red flags' lack particularized facts, are too far removed from oversight liability, or require a level of Board oversight not supported in Delaware law. Thus, the complaint provides no basis for holding that directors face a significant likelihood of liability. The court should affirm the Court of Chancery's dismissal of plaintiff's derivative suit for failure to demand.

- 1. Plaintiff's Caremark claim makes no particularized factual allegations showing that the Board of Directors consciously failed to monitor oversight systems.**

Plaintiff asserts demand is excused because the Securance Board of Directors faces a substantial likelihood of personal liability

because the Defendants breached their fiduciary duty of loyalty by failing to act in good faith to fulfill their oversight responsibilities. Plaintiff's pleading accurately states the requirements to establish oversight liability, specifically the showing of director bad faith conduct. *Stone*, 911 A.2d at 370. Bad faith is required to establish the breach of the duty of loyalty required in turn to find director oversight liability. *Id.*

Plaintiff's complaint fails to meet the demanding standard of bad faith established in *Stone*. The *Stone* 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 or oversee its operation thus disabling themselves from being informed of risks or problems requiring their attention. *Id.*

The question posed by this test is whether the "directors fail[ed] to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities." *Id.*

The Court of Chancery court correctly determined that part (a) of *Stone*'s two-prong standards is inapplicable. Oversight liability under part (a) requires the directors "utterly failed to implement" oversight systems. *Id.* This language does suggest the court must evaluate reasonableness of the oversight system. As the Court of Chancery correctly held, "Plaintiff's complaint in this case admits to the existence of some form of regulatory compliance program at Securance as early as 2004 (well before the fraud committed by the Senior Managers on which plaintiff's oversight claims are based)." Regardless of the design or function of the oversight system, part (a)

is inapplicable, and oversight liability can only be established under part (b) requirement of conscious failure to monitor the oversight system.

Should the Court, contrary to *Stone* and the Court of Chancery's holding, choose to evaluate the reasonableness of Securance's oversight systems under part (a), the plaintiff's complaint still lacks specific facts enabling to court to make this evaluation. Plaintiff's complaint asserts only that Securance had an oversight system in the form of a board level audit committee, and that this committee handled compliance matters. Beyond this, the complaint is devoid of factual allegations on the operation of the audit committee, how frequently it met, or how the alleged failures of oversight set the stage of the managerial fraud.

Plaintiff's failure to make specific factual allegations challenging the reasonableness of oversight systems prevents the court from finding any likelihood of oversight liability. Plaintiff's complaint is very similar to the complaint evaluated in *Guttman v. Huang*. 823 A.2d 492 (Del. Ch. 2003).

In *Guttman*, the court properly faulted the complaint for not detailing how the Board's audit committee was designed or operated. 823 A.2d at 507. Recognizing that its hands were bound, the court held, "it is impossible to tell anything about the financial compliance systems," and so there was no factual basis with which to allege director oversight liability. *Id.* Plaintiff's complaint similarly relies on conclusory allegations without specific factual

support, and therefore provides absolutely no basis to conclude that the Directors failed to fulfill their oversight obligations.

Plaintiff might argue that, applied in this manner, *Guttman* imposes an impossibly strict test. Delaware courts reject this argument. While the standard imposes a rigorous burden on a shareholder, it can be satisfied when a plaintiff shareholder makes allegations with factual particularity. *In re Abbott Laboratories Deriv. Shareholders Litig.*, 325 F.3d 795, 802 (7<sup>th</sup> Cir. 2003). Under *Abbott*, plaintiff shareholder was able to excuse demand through oversight liability by making particularized factual allegations showing how the director's failed to fulfill their oversight obligations. *Id.* at 809. In the instant case, the plaintiff's complaint simply does not rise to this standard of pleading.

Oversight liability is better evaluated under part (b) of the Stone test, which requires that the director's "consciously failed to monitor" the oversight systems. *Stone*, 911 A.2d at 370. Plaintiff's complaint fails to meet this standard through its failure to make specific factual allegations that could support and inference that directors were conscious of the inadequacies of Securance's oversight systems, and failed to act.

*Abbott* is further illustrative of the extent to which the plaintiff's complaint fails to make specific factual allegations. 325 F.3d 795, 802. In *Abbot*, the court addressed a derivative suit in response to harm resulting from Abbot Laboratories long term violations of FDA regulations. 325 F.3d 795, 801. The shareholder's complaint alleged that the Board of Directors received warning letters

over a six year period, specifically addressing the violations. *Id.* It also alleged that the directors met with FDA officials to discuss the violations and that ongoing violations were well known and discussed in the media. *Id.* While *Abbott* predates the *Stone* decision, it is representative of the level of factual particularity required to infer that directors consciously failed to monitor oversight systems.

In light of what the court held to be sufficient factual particularity in *Abbott*, Plaintiff's allegations are inadequate. The plaintiff makes no factual allegations of direct notice or a paper trail of the Medicaid fraud in Ohio, Pennsylvania, New York and New Jersey. While Securance's stock values increased as a result of the ongoing managerial fraud, the fraudulent scheme was stopped relatively soon after outside suspicion grew. Because the complaint lacks factual allegations enabling an inference that the Board consciously failed to monitor the oversight systems, part (b) of the *Stone* test has not been satisfied. Thus, the plaintiff's complaint fails to show any likelihood of director personal liability, and excuse of demand is not warranted.

The Court of Chancery appropriately limited the *Stone* test to a conscious failure to monitor oversight systems. Plaintiff asserts liability can be based in a conscious or a reckless disregard for oversight liability. Such a standard would conflict directly with the language of part (b) of the *Stone* test. Furthermore, it is not supported by Delaware precedent underlying *Stone*, specifically that liability requires that the "directors were conscious of the fact that

they were not doing their jobs." *Guttman*, 823 A.2d at 506. Finally, a recklessness standard does not reflect the modern heightened standard of bad faith requiring that "the fiduciary intentionally fail to act in the face of a known duty to act." *In re Walt Disney Co., Deriv. Litig.*, 906 A.2d 27, 67 (Del. 2006).

**2. The 2004 Consent Decrees in Connecticut and Virginia are insufficient notice of inadequate oversight systems.**

The consent decree 'red flags' should be evaluated under the same standard as any other allegation that the Securance Board of Directors failed to fulfill their oversight responsibilities. Plaintiff introduces the consent decrees in an attempt to show that Directors consciously failed to monitor and update the oversight systems. These so-called 'red flag' are simply additional allegations of oversight liability through bad faith.

The 2004 consent decrees are too small and far removed from Medicaid fraud to show any likelihood of director oversight liability. First, the consent decrees took place in Connecticut and Virginia, while the later fraud was in Ohio, Pennsylvania, New York and New Jersey. This is particularly meaningful because Securance's service contracts were with individual states. Refunds for fees in excess of the medical loss ratios were to be distributed on a state to state basis. The compartmentalized nature of Securance's business strongly implies that failures of oversight cannot be carried over as broad failures of oversight.

Additionally, the consent decrees dealt with conduct fundamentally different than the large scale fraud at the heart of

plaintiff's derivative action. As "[red] flags are only useful when they are either waived in one's face or displayed so that they are visible to the careful observer," the conduct resulting in the consent decrees does not carry enough force to oblige the Board of Directors to overhaul the oversight systems. *In re Citigroup Inc. Shareholders Litig.*, 2003 WL 21384599, at \*2 (Del. Ch.).

This is especially true when the actual 'red flag' violations are as small as the 2004 consent decrees. As the Court of Chancery correctly noted, the actual fines against Securance represented a minimal fraction of Securance's profit. Furthermore, the negotiated settlement did not reference Securance culpability. While plaintiff asserts liability from the director's failure to revamp the oversight system, a closer look at the consent decrees undercuts completely that the consent decrees requires an extensive, as well as costly, overhaul.

Therefore, the consent decrees do not carry sufficient evidentiary weight that the directors face a substantial likelihood of oversight liability.

**3. Securance's creation of the Incentive Compensation Plan and response to the 2005-2007 stock increase are not red flags requiring board action.**

Neither the Incentive Compensation Plan nor the increase in Securance's market capitalization between 2005 and 2007 are the type of employee wrongdoing that generally constitutes "red flags."

Plaintiff's claim on the Incentive Compensation Plan lacks particularized factual allegations supporting the inference that the Plan contributed to the managerial fraud. Instead, plaintiff makes

the conclusory allegation that the plan created an environment suited to fraud. The court does not need to accept this conclusory allegation as true. *General Motors*, 2006 WL 722198 at \*3. Furthermore, without specified suspicion of wrongdoing, 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." *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. Ch. 1963).

The same logic applies to Securance's increased market capitalization. Market gains, without additional facts absent in the complaint, do not provide a specified suspicion of wrongdoing. Directors have no duty to investigate where there is no basis for suspicion. *Id.*

Thus, neither of these alleged 'red flags' lend support to plaintiff's oversight liability claim. Plaintiff's inability to show a substantial likelihood of oversight liability means that excuse of Rule 23.1 demand as futile is not warranted. Plaintiff's derivative action therefore must be dismissed under Rule 23.1 for failure to demand.

**C. The Court of Chancery correctly dismissed the complaint against Securance Officers under Rules 12(b)(6) and 23.1.**

**1. Officer liability is irrelevant if demand futility against the Directors has not been satisfied.**

The issue of Officer liability is immaterial in this matter, because a derivative lawsuit only concerns the question of whether Directors should bring a claim. Pre-suit demands cannot be excused when a shareholder decides to sue derivatively on the corporation's

behalf. The question of bringing the suit against the Officers is under the purview of the Directors, who are capable of acting independently. *Kaplan v. Peat*, 529 A.2d 254, 259 (Del. Ch. 1987). Plaintiff has not sufficiently established a reasonable doubt that the board of directors could have properly exercised independent and disinterested business judgment in responding to a demand. *Rales*, 634 A.2d at 933. Thus, in failing to make pre-lawsuit demands of neither the Directors, nor the Officers, Plaintiff has not complied with what is deemed to be an essential prerequisite to a shareholder's entitlement to sue derivatively on the corporation's behalf. *Kaplan*, 529 A.2d at 259.

The decision as to whether (and in what manner) a corporation should pursue a corporate claim is typically reserved for the board of directors. *Id.* According to *Hawes v. Oakland*, a shareholder is permitted in her own name to litigate against the corporation only if she shows to the satisfaction of the court that she has exhausted all other available means to obtain, within the corporation itself, the redress of her grievances. *Hawes v. Oakland*, 104 U.S. 450, 460-461 (U.S. 1882). She must make an earnest effort with the managing body of the corporation, to induce remedial action on its part, and this must be made apparent to the court. *Hawes*, 104 U.S. at 461. If she fails with the directors, she must show that she has made an honest effort to obtain action by the shareholders as a body, in the matter of which she complains. 104 U.S. at 461. Her efforts to induce such action both on the part of the directors and on behalf of the shareholders, and the cause of failure in these efforts are to be

stated with particularity. *Id.* In complying with the stringent requirements of factual particularity, these allegations of demand futility should differ substantially from the permissive notice pleadings governed solely by Chancery Rule 8(a). *Brehm*, 746 A.2d at 254.

In this case, plaintiff failed to make an earnest, let alone a simulated effort to induce remedial action on the part of the managing body of the corporation. Furthermore, the record shows no attempt to consult the other shareholders to ascertain their opinions as to what action, if any, to pursue against the Officer Defendants. *Hawes*, 104 U.S. at 461.

To avoid potential abuse of such suits, the U.S. Supreme Court established these requirements that a shareholder would have to satisfy in order to proceed derivatively in the federal courts. *Kaplan*, 529 A.2d at 258. These requirements have carried forward into what now stands as Rule 23.1 of the Federal Rules of Civil Procedure (*Kaplan* at 258). Chancery Rule 23.1 is modeled after, and is virtually identical to Federal Rule 23.1, and Plaintiff cannot ignore such requirements. 529 A.2d at 258. Plaintiff's allegation that a shareholder's demand would have been futile is legally insufficient because Plaintiff has not allowed the Board to determine whether the demand is wrongful. *Id.* at 257.

**2. Officers have the same standing as Directors to raise the demand futility defense under Delaware Chancery Court Rule 23.1.**

Chancery Court Rule 23.1 demand requirement bears directly on the question of who should have standing to challenge a Plaintiff's

failure to abide by that requirement. *Kaplan*, 529 A.2d at 259. *Kaplan* holds that in a derivative action, a defendant other than the corporation should have standing to challenge the plaintiff stockholder's failure to comply with the demand requirement of Rule 23.1. 529 A.2d at 258.

The rule itself requires that plaintiff's complaint allege with particularity, her desired action from the directors, or her reasons for failure to obtain the action or for not making the effort to do so. *Stone*, 911 A.2d at 367. The Court cannot ignore the inherent interest that any defendant would have in being able to challenge a Plaintiff's capacity to sue him. *Kaplan*, 529 A.2d at 259. This concern is reflected in Chancery Rule 9(a), which permits defendants (without distinction) to challenge a Plaintiff's capacity to sue. *Id.* The policy underlying the requirement of a demand is best furthered not by a narrow one, but by a broad concept of standing, to raise the defense of failure to comply with Rule 23.1. *Id.* Therefore, in such a derivative suit, it is only proper that the Officers should be entitled the same latitude of standing to challenge as the Directors, and should not be precluded from also raising a Rule 23.1 defense against Plaintiff's conclusory allegations.

**3. Officer oversight liability should be evaluated under the business judgment rule typically applied to Directors.**

There is widespread consensus among courts and legal commentators on the policy justifications for the deferential judicial treatment of Directors under the business judgment rule. 60 *Bus. Law.* 865 at 3. While the standard of liability for non-director officers remains

relatively unexplored in Delaware case law, both courts and scholars have consistently agreed that sound public policy supports the holding of Corporate Officers to the same duty of care and business judgment standards as Corporate Directors. 60 Bus. Law. 865 at 3. Furthermore, there are many noteworthy limitations on judicial competence to evaluate the business conduct of Corporate Officers and Directors.

First, Scholars agree that the business judgment rule encompasses a relaxed standard of judicial review of care. 60 Bus. Law. 865 at 9. Judicial evaluation of care in preparing for, making and carrying out a business decision presents the same problems of hindsight bias and institutional comparative disadvantage that would apply if courts were called upon to evaluate the substantive soundness of business decisions. 60 Bus. Law. 865 at 9. Thus, if concerns about hindsight bias and institutional competence warrant application of business judgment rule deference to director action, they equally justify such deference to the action of corporate officers. 60 Bus. Law. 865 at 9.

Second, as this case points out, in shareholder derivative proceedings asserting that a breach of the duty of care has resulted in significant corporate harm, it is common to find both directors and officers named together as defendants. 60 Bus. Law. 865 at 9. Given the typical involvement of both directors and officers, and the typical overlap of their roles and communications, it is likely to be extremely complex for a court, let alone a jury, to sort out when and where any given defendant is acting (or failing to act) in a distinct capacity as a director or officer. 60 Bus. Law. 865 at 10. This case is no different. While the defendants are Officers, it was the

exercise of their discretion as Corporate Officers of Securance that gave rise to Plaintiff's claim of failed oversight liability and to which the business judgment rule applies in this instance. Rosenfield v. Metals Selling Corp., 643 A.2d 1253, 1261 (Conn. 1994).

Third, the introduction of a recklessness or negligence standard of liability for officers would make the task of the trier of fact even more painfully complex and uncertain, thereby both exacerbating the risks of hindsight bias and threatening to deprive director action of the protection to which it should be entitled under the business judgment rule. 60 Bus. Law. 865 at 10.

As the Chancery Court opinion accurately states, it is the Board that is empowered to decide what action to take, if any, in the exercise of its own business judgment. Thus, it can choose whether to cause Securance to bring claims against the Officers, or handle it internally in a non-litigation context. *Kaplan*, 529 A.2d at 259. *Paramount Communications* supports this notion, holding that neither the courts nor the stockholders should interfere with the managerial decisions of the Directors. *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 42 (Del. 1994). Rather, it is the business judgment rule that embodies the deference to which such decisions are entitled. *Id.*

These policies that have given rise to the application of the business judgment rule to directors, apply with equal force to the actions of officers within their delegated discretionary authority. 60 Bus. Law. 865 at 12. This is well documented, in that 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. 60 Bus. Law. 865 at 5. Thus, cases decided across the country have been virtually unanimous in their willingness to apply the business judgment rule to Corporate Officers. 60 Bus. Law. 865 at 5.

**4. Plaintiff shareholder's complaint fails to show a substantial likelihood of Officer liability.**

The issue here is whether Plaintiff has established that Officers are liable for failing to conduct adequate oversight. *Stone* holds that in order for Plaintiff's derivative complaint to withstand a motion to dismiss, she must demonstrate that the board sustained a systematic failure to attempt to assure reasonable information and reporting. *Stone*, 911 A.2d at 372. This control deficiency to oversee system operations, thereby disabling the board from being informed of risks or problems requiring attention, would establish the lack of good faith that is a necessary condition of liability. *Id.* This test for Director liability, a lack of good faith as evidenced by a systematic failure of a director to exercise reasonable oversight, is quite high. *Id.* There is no case law that justifies why this test shouldn't be equally as high for Corporate Officers.

*Stone* also holds that the obligation to act in good faith does not establish an independent fiduciary duty equivalent to the duties of care and loyalty. *Id.* at 370. Only the two latter duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. *Id.* The imposition of liability requires a showing that the Directors knew that they were not discharging their fiduciary obligations. *Id.* Where Directors fail to act in the face of a known duty to act, thereby demonstrating a

conscious disregard for their responsibilities; they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith. *Id.* This particular failure on the part of the Directors did not occur.

Likewise with respect to the Officer Defendants, there was no conscious disregard for their responsibilities, as alleged by the Plaintiff. The Officers had no previous meaningful basis to suspect deception on the part of the former Senior Officers. Under this consideration, the Officers cannot be charged with wrongdoing simply for assuming the integrity of their employees and the honesty of their dealings on the company's behalf. *Caremark*, 698 A.2d at 969. Furthermore, similar to the Directors' duty, the Officers' duty to act in good faith to be informed cannot be thought to require them to possess detailed information about all aspects of the operation of the enterprise. *Id.* at 971. Such a requirement would be inconsistent with the scale and scope of efficient organization size in this technological age. *Id.*

#### **CONCLUSION**

For the foregoing reasons, Directors and Senior Officers of Securance, Inc. request that the court dismiss plaintiff's derivative action for failure plead facts excusing demand under Court of Chancery Rule 23.1 and 12(b)(6).