

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

**BRIEF OF APPELLEES,**  
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, CARLOS B. HUELVA,  
& SECURANCE INCORPORATED

Filed by,  T   
Attorneys for **APPELLEES**

February 17, 2009

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## NATURE OF PROCEEDINGS

On July 3, 2008, Clare C. Marshall (Plaintiff below-Appellant) filed a suit on behalf of herself and derivatively on behalf of Securance Inc. against Securance Inc., Director Defendants Charles H. Saligman, Patrick C. Richmond, Yvonne M. Craig, Martin R. Rothschild, Elaine A. Lasater, William M. Lewis, and Gilbert W. Coulson, and Officer Defendants Rachel N. Lieberman, Timothy M. Stockdale, and Carlos B. Huelva (Defendants below-Appellees). (Compl. ¶¶ 1, 4, 6.) On January 6, 2009, Chancellor Siegel of the Court of Chancery of the State of Delaware granted Defendants' Motion to Dismiss the claims pursuant to Court of Chancery Rule 23.1 for failure to adequately allege demand futility. Additionally, the Chancellor dismissed the claims against the Officer Defendants pursuant to Court of Chancery Rule 12(b)(6) for failure to state a claim. *Marshall v. Saligman*, No. Civ. A. 3892-CS, mem. op. at 28-29 (Del. Ch. Jan. 6, 2009).

On Jan. 16, 2009, the Plaintiff appealed the Court of Chancery's grant of Defendant's Motion to Dismiss to the Supreme Court of Delaware. (Notice of Appeal at 2, *Marshall v. Saligman*, No. 27, 2009 (Del. Jan. 16, 2009)). This brief addresses whether the Court of Chancery properly granted Defendants' Motion to Dismiss.

## **SUMMARY OF ARGUMENT**

1. This Court should uphold the Court of Chancery's opinion dismissing the Plaintiff's Complaint pursuant to Court of Chancery Rule 23.1 for failure to adequately allege demand futility and Court of Chancery Rule 12(b)(6) for failure to state a claim.

2. This Court should uphold the Court of Chancery's dismissal for failure to adequately allege demand futility because the Plaintiff did not satisfy the heightened pleading standard of Court of Chancery Rule 23.1, which requires allegations of particularized facts showing a substantial likelihood that a majority of the Director Defendants were personally liable for a conscious failure to ensure Securance's existing compliance system was adequate or to respond to "red flags".

3. The Complaint alleges that Securance had an oversight system in place but lacks particularized facts showing that the Director Defendants consciously disregarded the Senior Manager's fraud.

4. The alleged "red flags" do not satisfy the standard for demand futility because the mere existence of an incentive compensation plan that only applies to Officers and prior history of unrelated regulatory trouble is insufficient to show that the Directors knew the oversight system was inadequate and failed to remedy the problem.

5. The Plaintiff's claims against the Officer Defendants should be dismissed pursuant to Court of Chancery Rule 12(b)(6) for failure to state a claim under the same good faith standard of oversight that applies to directors. Delaware law and public policy support applying the same fiduciary duties and corresponding liabilities to both officers and directors.

## STATEMENT OF FACTS

In 2002, Securance, Inc. (Securance) became a publicly-traded for-profit corporation on the New York Stock Exchange in the highly regulated industry providing managed care services to Medicaid and Medicare recipients. (Compl. ¶¶ 7-16.) In 2003, its seven-member board (the Board), composed of three Senior Officers and four independent Directors, approved a Performance Compensation Plan to tie part of its Senior Officer's income to operating profits. (Compl. ¶¶ 4-5, 38.) In 2004, investigators in two states alleged that Securance employees had offered financial incentives to doctors to encourage them to deny medical care to members as a way to boost profits. (Compl. ¶ 40.) That July, the Board quickly resolved the claims by entering into court approved consent decrees "without adjudication or admission of any issue of fact or law," wherein Securance promised to comply with applicable law, to not offer such incentives to doctors, and to pay each state nominal fines of \$100,000. (Compl. ¶¶ 41-42.)

Securance's profits continually grew, with dramatic growth from 2004 to 2005 sustained thereafter, leading analysts to label the company a top performer in the industry. (Compl. ¶¶ 25-26.) In February 2008, analysts began questioning Securance's medical loss ratios, and in March, four states began an investigation that uncovered fraud perpetrated by three senior managers (the Senior Managers). (Compl. ¶¶ 27-30.) The Senior Managers subsequently pled guilty to shifting \$120 million in Medicaid payments, reported to the states as medical expenses, into a wholly owned subsidiary that claimed the money as profits, thereby inflating Securance's net income and consequently its

stock price. (Compl. ¶¶ 21–24, 30.) Each of their negotiated plea agreements resulted in a two-year prison sentence, resignation, and a statement that the Senior Manager acted with the express or implied support of the Senior Officers, but without identifying any Securance Officer by name or position. (Compl. ¶¶ 30–31.)

Immediately after a search warrant was executed in mid-March as part of the investigation, the Board directed its audit committee to retain outside counsel to examine the situation and work with authorities to negotiate a settlement to all claims. (Compl. ¶¶ 28, 32.) On June 3, 2008, Securance pled guilty to one count of mail fraud and agreed to make restitution to the four states' Medicaid agencies for the wrongfully withheld \$120 million, pay them \$400 million in criminal penalties, and wait three years before re-entering those markets. (Compl. ¶ 33.) The Board established a compliance committee, separate from the audit committee, which previously handled compliance issues, to more proactively ensure compliance with all applicable laws. (Compl. ¶ 34.) In addition, the Board restated earnings for the three years the fraud occurred, leaving modest instead of impressive growth, but resulting in the stock's price tumbling to a third of its high. (Compl. ¶¶ 36–37.)

The Plaintiff brought this shareholder derivative suit against the Directors, three non-director Senior Officers who supervised or worked with the Senior Managers, and Securance, alleging that the Directors and Senior Officers breached their fiduciary duty of loyalty through a lack of good faith in their oversight of Securance and were personally liable for the \$520 million. (Compl. ¶¶ 4–6, 31, 49–59.)

## ARGUMENT

- I. THE PLAINTIFF DID NOT ALLEGE PARTICULARIZED FACTS SHOWING A SUBSTANTIAL LIKELIHOOD THAT A MAJORITY OF THE DIRECTOR DEFENDANTS WERE PERSONALLY LIABLE FOR BREACH OF THEIR DUTY OF OVERSIGHT SUFFICIENT TO EXCUSE DEMAND ON THE BOARD UNDER DELAWARE COURT OF CHANCERY RULE 23.1 BECAUSE THE COMPLAINT INDICATED THAT SECURANCE HAD A SYSTEM OF OVERSIGHT IN PLACE, INCLUDED ONLY CURSORY ALLEGATIONS UNSUPPORTED BY SPECIFIC FACTS THAT THE DIRECTOR DEFENDANTS CONSCIOUSLY FAILED TO OVERSEE THE CORPORATION, AND CHARACTERIZED FACTS AS "RED FLAGS" THAT WERE INSUFFICIENT TO PUT THE BOARD ON NOTICE THAT THE OVERSIGHT SYSTEM WAS INADEQUATE.

### A. Question Presented

Did the plaintiff allege particularized facts sufficient to excuse demand under Court of Chancery Rule 23.1?

### B. Scope of Review

The appropriate standard of review of a Court of Chancery decision to dismiss a derivative suit under Rule 23.1 is *de novo*. *Stone ex rel. AmSouth Bancorp. v. Ritter (Stone II)*, 911 A.2d 362, 371 (Del. 2006).

### C. Merits of Argument

A fundamental principle of Delaware corporate law is that "the management and business affairs of a Delaware corporation [are] entrusted to its directors" as the "duly elected and authorized representatives of stockholders." *Paramount Comm. Inc. v. QVC Network Inc.*, 637 A.2d 34, 41-42 (Del. 1994) (citing 8 Del C. § 141 (2008)). The business judgment rule extends from this principle to shield the decisions of directors from interference by the courts or by stockholders. *Id.* Because derivative suits necessarily impinge on directors' management decisions, stockholders seeking to remedy a perceived wrong against the corporation must first make a demand that the directors pursue the corporate claim or plead why such a demand is

excused. *Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993).

In light of the encroaching nature of derivative suits, Court of Chancery Rule 23.1 allows a judge to excuse demand only when the shareholder's complaint "allege[s] with particularity the efforts . . . made by the plaintiff to obtain the action . . . from the directors [or] the reasons . . . for not making the effort." Ch. Ct. R. 23.1. Under this heightened pleading standard, when a business decision of the board is not at issue, only "particularized facts creating a reasonable doubt that a majority of the Board would be disinterested or independent in making a decision on a demand" will suffice. *Rales*, 634 A.2d at 930. "[A] prolix complaint larded with conclusory language...does not comply with these fundamental pleading mandates." *Brehm v. Eisner*, 726 A.2d 244, 254 (Del. 2000). Here, the well-pleaded facts of the Complaint must demonstrate a "substantial likelihood" of personal liability on the part of a majority of the Securance Director Defendants to show that they were unable to make an impartial decision regarding litigation. *Rales*, 634 A.2d at 936. If demand is not excused, the Board would decide whether to pursue a corporate claim against a Director or Officer. *Id.* at 935.

Directors are shielded from liability in many situations because the law presumes that directors made informed, good faith decisions they considered to be in the best interest of the corporation. See *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 52 (Del. 2006). A failure to act in good faith "may be shown . . . where the fiduciary intentionally fail[ed] to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." *Id.* at 67. In the

context of director oversight liability, where “a showing of bad faith conduct . . . is essential . . . , the fiduciary duty violated by that conduct is the duty of loyalty.” *Stone II*, 911 A.2d at 370.

In *Caremark*, the seminal oversight case, the court held that “only a sustained or systematic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition of liability.” *In re Caremark Int’l Inc. Deriv. Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996). This Court refined *Caremark’s* rule, holding that director oversight liability exists when: “(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 II*, 911 A.2d at 370. Therefore, the Plaintiff must plead particularized facts showing either conscious failure of the Board to assure the effectiveness of its existing compliance system or conscious failure to respond to “red flags” indicating deficiencies in the existing system. *Id.* at 370, 373.

In summary, without “particularized facts showing a substantial likelihood that the Director Defendants are personally liable for breach of their fiduciary duty of oversight” by acting in bad faith, “creat[ing] reasonable doubt that [a majority of] the Board could have properly exercised an independent and disinterested business judgment in responding to a demand,” the Complaint must be dismissed under Rule 23.1 for a failure to plead demand futility. *Marshall v. Saligman*, No. Civ. A. 3892-CS, mem. op. at 19, 16–17 (Del. Ch. Jan. 6, 2009).

1. **The Plaintiff failed to allege particularized facts to show a substantial likelihood that any Director Defendants consciously failed to monitor or oversee Securance's existing compliance system or knowingly disregarded fraud by the Senior Managers.**

When the board is not presented with "red flags" indicating a failure in the corporate compliance system, the proper measure of the directors' good faith assesses whether the directors acted to "assure [that] a reasonable information and reporting system exist[ed, instead of] second-guessing [their actions] after the occurrence of employee conduct that result[ed] in an unintended adverse outcome." *Stone II*, 911 A.2d at 373. Indeed, this Court acknowledged that "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." *Id.*

Conclusory allegations of directors' liability for the illegal activities of company employees through a failure to exercise their duty of oversight in good faith are insufficient absent particularized facts showing directors' actual knowledge of or involvement in the fraudulent acts. *See Desimone v. Barrows*, 924 A.2d 908, 938 (Del. Ch. 2007). In *Desimone*, a shareholder of Sycamore Networks, Inc. brought a derivative suit claiming, among other things, that the directors breached their duty of oversight by failing to catch illegal backdating of stock options granted to certain company employees and officers. *Id.* at 913, 918, 939. The *Desimone* Plaintiff sought to demonstrate demand futility based on the substantial likelihood of directors' personal liability for their involvement in granting the backdated options. *Id.* at 938.

The Court of Chancery noted that the plaintiff's complaint contained "no facts to suggest that any member of the board was involved in the details of the Employee Grants in any way, much less that the board was driving the process by, and dates on, which options were awarded." *Id.* Considering an allegation that the challenged stock option plan was "administered by the Compensation Committee" of the board, the court found it be too "vague and conclusory" to "suggest in any way that the Compensation Committee was involved in or had any knowledge of the backdating." *Id.* Similarly, a bald allegation that Sycamore's CEO, who was also a director, "might have played a role in the backdating of the Employee Grants" absent "particularized factual allegations in support of [the] conjecture that [he] was involved" was found insufficient. *Id.*; see also *Ash v. McCall*, No. Civ. A. 17132, 2000 WL 1370341 (Del. Ch. Sept. 15, 2000) (finding the "mere existence of a statement from [the company's] investor relations department" in response to securities analysts' reports of potential accounting irregularities insufficient "to impute knowledge" of the report to the company's directors).

Likewise, conclusory allegations relying on statements from government investigations indicating a failure of the corporation's existing compliance system are insufficient to show conscious failure of the board to oversee the system absent particularized facts demonstrating the board's actual knowledge of the basis for the government's finding. *Stone v. Ritter (Stone I)*, No. Civ. A. 1570-N, 2006 WL 302558, at \*2 (Del. Ch. Jan. 26, 2006) (letter op.), *aff'd* 911 A.2d 362 (Del. 2006). In *Stone I*, the plaintiff brought a derivative

suit alleging that the directors of AmSouth Bank “breached their fiduciary duties by failing to institute sufficient internal controls.” *Id.* at \*1. The *Stone* plaintiff relied on a federal agency’s report stating that “AmSouth’s [compliance] program lacked adequate board and management oversight.” *Id.* at \*1-2. The Court of Chancery found that this allegation, without particularized facts supporting the government allegations, was “simply conclusory.” *Id.* at \*2.

Here, like in *Desimone*, the Plaintiff’s Complaint fails to establish actual knowledge of or involvement in the fraud by any of the Director Defendants to create a substantial likelihood of personal liability. First, the Plaintiff alleged that the Director Defendants “consciously or recklessly condoned” an environment of “profit-by-any-means-necessary” at Securance. (Compl. ¶ 17.) The Plaintiff also alleged that “[t]he search warrant and resulting inventory” of items seized by government authorities “establish that the fraud at Securance permeated the Company’s operations and could not have been the work of low-level employees.” (Compl. ¶ 29.) Like the “vague allegation” in *Desimone*, which attempted to link the Compensation Committee to the illegal backdating, these allegations lack any particular indication of the requisite actual knowledge or involvement by the Director Defendants in the fraud. These allegations fail as both vague and conclusory, because each one lacks particularized facts necessary to support the implication that a broad-based culture of fraud existed and fails to specifically link any of the Director Defendants to that alleged corporate culture.

Next, the Plaintiff alleged that in early 2008, at least one

securities analyst “issued a report suggesting that Securance appeared to be shifting profits to its Cayman Islands reinsurance subsidiary.” (Compl. ¶ 27.) However, this allegation fails to even match the specificity of *Ash*, where the plaintiff at least linked knowledge of the analyst’s report to a lower-level employee. Here, the Plaintiff merely mentions that the report “found its way into various print and online business publications,” but fails to allege any particularized facts sufficient to impute actual knowledge of the reports to Securance Directors. (Compl. ¶ 27.)

Finally, the Plaintiff points to statements in the Senior Managers’ plea agreements that they “acted with express or implied support of the Company’s senior officers.” (Compl. ¶ 31.) This allegation, like the allegation implicating the CEO in *Desimone* or the government report alleging lack of oversight by the directors in *Stone I*, lacks any particularized facts linking any specific Officer Director to knowledge of or involvement in the fraud. Additionally, this allegation fails to explain why demand would be futile with respect to the non-officer Directors who comprise a majority of the Securance Board. (Compl. ¶¶ 4–5.)

To facilitate a plaintiff’s ability to satisfy the heightened pleading standard of Rule 23.1, Delaware law provides shareholders the right to request access to corporate books and records. *See Brehm*, 746 A.2d at 266–67; *Guttman v. Huang*, 823 A.2d 492, 504 (Del. Ch. 2003). In *Guttman*, the plaintiff sought to raise a *Caremark* claim against corporate directors for failing to properly oversee the preparation of financial statements “to ensure that the resulting statements had

integrity and met legal standards.” *Guttman*, 823 A.2d at 505. The *Guttman* court characterized the complaint as “conclusory” based on its failure to plead, among other things, facts indicating “that the company lacked an audit committee, that the company had an audit committee that met only sporadically and devoted patently inadequate time to its work, [or] that the audit committee had clear notice of serious account irregularities and simply chose to ignore them, or even worse, to encourage their continuation.” *Id.* at 507. The Court of Chancery then opined that the “void could have been filled had the plaintiffs procured pertinent books and records.” *Id.*

Although the Plaintiff here does not indicate whether she availed herself of Securance’s books and records, this Court has emphasized that the existing structure for claims of books and records enables plaintiffs to search for particularized facts necessary to satisfy Rule 23.1’s pleading standard. *Brehm*, 746 A.2d at 266-67. Here, similar to the complaint in *Guttman*, the Plaintiff alleges a failure of the Director Defendants to act with a critical eye in examining and validating Securance’s earnings. (Compl. ¶ 51.) The Plaintiff erroneously relies on such allegations, lacking particularized facts to demonstrate conscious knowledge of failures in the existing oversight system, which have been repeatedly rejected by Delaware courts as vague and conclusory.

2. **The Plaintiff’s alleged “red flags” do not show that the Directors failed to act when faced with known control deficiencies because the Complaint contained no facts indicating that Directors knew that the Senior Officers’ compensation plan caused the Senior Managers to commit fraud or detailing the Directors’ responses to a regulatory investigation in 2004.**

In order for a court to excuse demand in a *Caremark* case against a corporation with an existing oversight system, a plaintiff must allege particularized facts indicating the “board knew that internal controls were inadequate, that the inadequacies could leave room for illegal or materially harmful behavior, and that the board chose to do nothing about the control deficiencies that it knew existed.” *Desimone*, 924 A.2d at 940 (citing *Stone*, 911 A.2d at 373). Even when a plaintiff is able to plead “red flag” facts, it is important to remember that a *Caremark* claim “is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.” *Caremark*, 698 A.2d at 967. Only particularized facts demonstrating that a director knowingly ignored “red flags” indicating oversight deficiencies are “sufficient proof that a director consciously failed to oversee the company.” *David B. Shaev Profit Sharing Account v. Armstrong*, No. Civ. A. 1449-N, 2006 WL 391931 (Del. Ch. Feb. 13, 2006) (citing *Guttman*, 823 A.2d at 501). Moreover, “red flags are only useful when they are either waived [sic] in one’s face or displayed so that they are visible to the careful observer.” *In re Citigroup Inc. S’holders Litig.*, No. 19827, 2003 WL 21384599, at \*2 (Del. Ch. June 5, 2003), *aff’d Rabinovitz v. Shapiro*, 839 A.2d 666 (Del. 2003).

- a. **The Securance profit-based incentive plan for Senior Officers was not a “red flag” putting the Board on notice of an oversight deficiency because the system gave compensation based bonuses to Officers, not Managers, and because the Complaint contains no facts showing that the Officers pressured the Managers to over-perform based on the incentive plan.**

Incentive plans are a common corporate practice promoting efficiency and good stewardship of company resources and are not a

known vehicle for illegality. Delaware case law suggests that the mere existence of an incentive plan is not enough to show that the directors were conscious that the oversight system was deficient, that illegal conduct could go unnoticed, and that the board consciously chose not to remedy the oversight problem. See *Desimone*, 924 A.2d at 940; *In re Countrywide Fin. Corp. Deriv. Litig.*, 554 F. Supp. 2d 1044, 1064 (C.D. Cal. 2008). The Plaintiff's complaint in *Desimone*, alleging that the company's oversight system was "woefully deficient" after the discovery of illegal backdating of stock-options, failed to plead particularized facts showing that the directors were aware that the system was not functioning properly. *Desimone*, 924 A.2d at 939-40. In *Desimone*, the bald allegation that an Internal Memo "indicating that it was apparently fairly widely known within the Company that the internal controls were inadequate" was held insufficient to constitute "a red flag [suggesting] culpable directorial abdication . . . without any supporting facts." *Id.* at 940. The court explained that there was nothing in the complaint showing that the directors ever saw the memo or knew of its contents, and thus the directors had no way of knowing the oversight system was not working. *Id.* Although an incentive stock option plan served as the source of the illegal activity in *Desimone*, the court did not even consider whether the mere existence of such a plan was a "red flag" that should have put the board on notice of the potential for illegal stock-options backdating.

In another case applying the *Caremark* standard, shareholders brought a derivative suit against Countrywide Financial Corp. alleging several claims, including an oversight claim, relating to the issuance

of nontraditional, low-quality mortgages that hurt the company. *Countrywide*, 554 F. Supp. 2d at 1050, 1056. The court dismissed the plaintiff's "red flag" argument that "a predictable consequence of tying compensation incentives solely to loan originations would be to increase pressure to generate lower-quality loans." *Id.* at 1064. The court explained that this argument simply pointed to the policies as a "cause of the lapses in underwriting standards" rather than showing why directors "would have known of those lapses." *Id.* Furthermore, the court noted the absence of facts showing the directors' complicity in underwriting lapses, such as by actually directing "deviations from Company policy by pressuring managers, who in turn pressured underwriters." *Id.*; see also *McCall v. Scott*, 239 F.2d 808, 814 (6th Cir. 2001) (finding that the board breached its duty of oversight when, among other things, the company's "senior management, with Board knowledge, devised schemes to improperly increase revenue and profits, and perpetuated a management philosophy that provided strong incentives for employees to commit fraud.")

Here, like in *Countrywide*, the existence of Securance's profit-based incentive plan for Senior Officers was not a "red flag" that should have made the Board aware of an oversight deficiency it had a duty to fix. The Plaintiff only alleged that the Board approved a profits-based incentive plan that was applicable to Senior Officers. (Compl. ¶ 38.) The Complaint provided no link between the existence of the plan and the conclusory allegation that the Directors were "well aware that they had put in place a system of compensation that provided specific incentives for Senior Officers to inflate the

results of their business segment.” (Compl. ¶ 38.) In addition, unlike in *Desimone*, where the Internal Memo explaining how the incentive plan was being abused would have put the board on notice of an oversight malfunction had the complaint shown that the board knew of the Memo’s contents, here nothing has been alleged to exist that portrays the oversight system as inadequate, much less allegations showing the Board knew of such inadequacy and did nothing about it. Without knowledge of an oversight deficiency, the Board had no duty to act.

Furthermore, in both *Desimone* and *Countrywide*, the compensation incentive plans in question applied to and directly benefited the people who were illegally backdating stock options or giving out low-quality loans that backfired on the company. In contrast, the Securance managers who committed fraud did not benefit from the incentive plan. The Complaint only states that the incentive plan applied to *Senior Officers*, so it is inconceivable that the existence of such a plan would indirectly induce the *Senior Managers* to act illegally and satisfy the *Caremark* requirement that the board had knowledge that the plan would lead to such illegality. (Compl. ¶ 38.)

Moreover, like in *Countrywide*, there is nothing in the Complaint showing that Officers put pressure on the Senior Managers to increase profits that either explicitly or implicitly encouraged the Managers to commit fraud, and there are no indications that the Board was aware of any such conduct existing. Additionally, in stark contrast to the situation in *Scott* where the Senior Managers *with board knowledge* set growth targets “which could not reasonably be attained without violating [the law]” and encouraged fraud by providing cash bonuses to

employees, the Plaintiff here has not alleged any facts that the Board meant for the incentive plan to encourage fraud or had any knowledge that the plan would result in fraud. *Scott*, 239 F.2d at 814.

- b. A regulatory investigation by two states in 2004 into claims that Securance was systematically denying medical services was not a "red flag" putting the Board on notice of an oversight deficiency because the Complaint contained no facts detailing the Directors' responses before, during, or after consent decrees Securance entered into with the states.**

To determine whether the regulatory investigation in 2004 was a "red flag" alleging particularized facts proving Directors were on notice of an oversight deficiency, the court must analyze "the individual Directors' knowledge of and response to misconduct." *In re ITT Corp. Deriv. Litig.*, 588 F. Supp. 2d 502, 507 (S.D.N.Y. 2008). In *ITT*, the plaintiffs filed a derivative suit against the directors for breach of their fiduciary duty of loyalty by "disregard[ing] 'red flag' warnings of misconduct, thereby consciously failing to oversee ITT's operations." *Id.* at 505, 512. The alleged "red flags" included: employee documentation of "longstanding violation of law in 1998," a government investigation in 2001, and a consent agreement between ITT and the government that included "an \$8 million penalty but no admission of wrongdoing." *Id.* at 512.

The court refused to excuse demand because the complaint did not "make the critical connection between [the 'red flag'] events and the individual directors." *Id.* at 512-13. Though the consent decree would seemingly have "put the Directors on notice as to possible misconduct at ITT," the court explained that without the complaint detailing how the individual directors responded to the consent decree or other

allegations, it could not "say whether the Directors failed to act or if the actions they took were inappropriate in light of the information they received." *Id.* at 513; see also *Guttman*, 823 A.2d at 506-07 (2003) (dismissing a breach of oversight claim because the complaint lacked specific contentions that the audit committee "met only sporadically and devoted patently inadequate time to its work" or knowingly ignored or encouraged the accounting irregularities).

Here, the Plaintiff alleges that in 2004 Securance was offering improper financial incentives to doctors to increase its profits by denying medical services to its Medicaid members. (Compl. ¶ 40.) Securance initially disputed the allegations but then quickly entered into consent decrees where, like in *ITT*, Securance did not admit to any wrongdoing and promised to comply with applicable law. (Compl. ¶¶ 41-42.) Based on this information alone, the Plaintiff makes the conclusory claim that the Director and Officer Defendants failed by not insisting on restructuring or reinvigorating the company's compliance system, leading to the present fraud. (Compl. ¶ 44.) What is lacking in the Complaint, like in *ITT*, are any details about the Directors' responses to the regulators' allegations, whether the compliance system uncovered wrongdoing, how the consent decrees were arrived at, etc. Similar to the *Guttman* complaint's lack of specific allegations of the audit committee's failures, the Plaintiff's Complaint contains no allegations that the Board failed to hold meetings to discuss the compliance system as it related to the 2004 investigations, or whether changes were considered but not accepted. As explained in *ITT*, without specifically alleging how Securance's

Directors responded or failed to respond, a court will not conclude that the Directors knowingly failed to reform an oversight system that may or may not have been broken.

Moreover, the Complaint explicitly states that Securance promised in the consent decrees that it would no longer “offer incentives or bonuses to doctors for the purpose of limiting the Company’s medical loss ratios.” (Compl. ¶ 40.) These promises imply that Securance reconsidered some of its policies, contradicting the Plaintiff’s allegation that the Defendants were “supinely content with the status quo.” (Compl. ¶ 44.) The Directors may have even implemented small, non-structural changes in the compliance system intended to more closely monitor lower-level employees who contracted with doctors. However, it is unlikely that increased low-level oversight would have caught the Senior Managers’ fraud. As this Court opined in *Stone II*, the Plaintiff, “with the benefit of hindsight . . . seeks to equate a bad outcome with bad faith.” *Stone II*, 911 A.2d at 373.

In short, without particularized facts showing how the Board responded to the 2004 investigations and consent decrees, the Complaint fails to suggest culpable abdication by the Directors of their duty of oversight. Where, as here, the Plaintiff fails to plead demand futility, it is the responsibility of the Board to “weigh the alternatives available to it, including the advisability of implementing internal corrective actions” or pursuing a corporate claim against individual officers or directors. *Rales*, 634 A.2d at 935.

II. THE PLAINTIFF FAILED TO STATE A CLAIM THAT THE NON-DIRECTOR OFFICER DEFENDANTS BREACHED THEIR DUTY OF OVERSIGHT UNDER DELAWARE COURT OF CHANCERY RULE 12(B) (6) BECAUSE THE COMPLAINT LACKS SPECIFIC, FACTUAL ALLEGATIONS SHOWING THAT THE OFFICER DEFENDANTS CONSCIOUSLY FAILED TO MONITOR SECURANCE'S COMPLIANCE SYSTEM.

**B. Question Presented**

Did the plaintiff allege specific facts sufficient to state a claim under Court of Chancery Rule 12(b) (6)?

**B. Scope of Review**

The appropriate standard of review of a Court of Chancery decision to grant a motion to dismiss under Rule 12(b) (6) is *de novo*. *Feldman v. Cutaia*, 951 A.2d 727, 730 (Del. 2008).

**C. Merits of Argument**

1. **The proper standard to determine liability of the Officer Defendants for breach of their duty of loyalty for failure to carry out their oversight responsibilities in good faith requires facts showing a conscious failure to monitor or oversee the existing compliance system.**

The Officer Defendants' performance of their duty to oversee Securance's operations, as delegated by the Board, warrants the same judicial deference that Director Defendants receive. Recently, this Court affirmed that "the fiduciary duties of officers are the same as those of directors." *Gantler v. Stephens*, No. 132, 2008, 2009 WL 188828, at \*9 (Del. Jan. 27, 2009). Without specifically announcing that the same standards of liability apply to officers as to director defendants, this Court used the same standard to find an officer liable for a self-interested breach of duty of loyalty. *Id.* at \*10.

In *Gantler*, this Court considered the liability of a non-director officer for failing, along with a director, to provide due diligence materials requested by a potential purchaser of his employer during a

formal bid consideration period. *Id.* This Court held that it was reasonable to infer that a non-director officer breached his duty of loyalty when he “aided and abetted [the] separate loyalty breach” of a director defendant. *Id.* By leaping past the duty of care directly to duty of loyalty concerns, the *Gantler* court indicated that liability for the officer defendant could not be sustained absent such a finding, since like the director defendants, an officer’s decisions would otherwise be protected by the business judgment rule. See *id.*; *Cede & Co. v. Technicolor*, 634 A.2d 345, 361 (Del. 1993) (noting that “the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess th[o]se business judgments”). Significantly, *Gantler* does not mention an ordinary care or negligence standard of liability for officers. *Gantler*, 2009 WL 188828, at \*10. *Contra* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 Bus. Law. 439, 466-69 (2005) (arguing that the proper officer liability standard is ordinary care or negligence).

The basic reasoning underlying the good faith standard for director oversight liability applied by both *Caremark* and *Stone II* applies with equal force to officers. The *Caremark* standard is founded on the fundamental principle of Delaware law that judicial review of business decisions must focus on the good faith basis of the decision-making process, rather than questioning the decision’s soundness. *Caremark*, 698 A.2d at 967-68. The *Caremark* court extended this reasoning to its standard for oversight liability by focusing on the good faith establishment and monitoring of “an adequate corporate

information and reporting system" based on several policy reasons. *Id.* at 970. First, negligence and ordinary care standards are fundamentally inapplicable to business decisions because of the importance of risk-taking and individual judgment in corporate decision-making. *Id.* at 968, n. 16. Second, a standard requiring knowledge of "detailed information about all aspects of the operation" would "simpl[y] be inconsistent with the scale and scope of efficient organization size in this technological age." *Id.* at 971. Finally, a "demanding test of liability" is critical to making "service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of a duty.*" *Id.*

These reasons for applying the good faith standard to directors, specifically to avoid inhibiting risk-taking and individual judgment, judicial enforcement of inefficient oversight mechanisms, and deterring service by qualified candidates, pertain equally to officers when they are subject to the same fiduciary duties as directors. Likewise, the oversight liability standard adopted in *Stone II*, which extends from the duality of good faith and the duty of loyalty, must apply equally to corporate officers. Therefore, the same good faith standard stated in *Caremark* and *Stone II* for director oversight claims is the proper liability standard for the Officer Defendants, not the negligence standard proposed by the Plaintiff below. *Marshall*, No. 3892-CS at 27. The Plaintiff's Complaint concedes this by alleging the Officer Defendants breached their "duty of loyalty" for failure "to act in good faith in exercise of their managerial oversight responsibilities." (Compl. ¶ 56.)

2. **The Plaintiff's Complaint lacks specific factual allegations sufficient to state a claim against the Officer Defendants for conscious failure to monitor or oversee Securance's compliance system, when the Complaint alleges only the existence of reporting relationships with the Senior Managers who committed the fraud, unsupported assertions from the plea agreements, and conclusory claims about Securance's corporate culture.**

On a motion to dismiss under Rule 12(b)(6), the court looks solely at the allegations in the complaint. *In re Tri-Star Pictures, Inc., Litig.*, 634 A.2d 319, 326 (Del. 1993). The court must accept all well-pleaded facts and reasonable inferences based on those facts as true. *Id.* However, conclusory statements not supported by specific well-pleaded factual allegations are not accepted as true. *Id.* at 326. Although this represents a "lessened standard" when compared to Rule 23.1, *Grobow v. Perot*, 539 A.2d 180, 187-88 (Del. 1988), the Plaintiff's Complaint fails to state any set of specific factual allegations sufficient to support the claim against the Officer Defendants.

Applying *Stone II's* standard under Rule 12(b)(6), the Plaintiff's Complaint lacks the specific, well-pleaded factual allegations, even accepting all reasonable inferences, necessary to show a conscious failure by the Officer Defendants to monitor Securance's existing compliance system. *Stone II*, 911 A.2d at 370. First, the Complaint states conclusory allegations regarding the extent of the fraud including assertions that Securance had a "profit-by-any-means-necessary" culture "condoned" by the Officer Defendants and that the inventory of items seized when government officials searched Securance "establishes that the fraud . . . permeated the company's operations." (Compl. ¶¶ 17, 29.) The sole fact attempting to support these

conclusory allegations is that the "the items seized from Securance filled an entire moving truck." (Compl. ¶ 28.) Next, the Complaint alleges liability because the Senior Managers' plea agreements stated that they "acted with the express or implied support of the Company's Senior Officers," yet they fail to identify any specific officers despite ample reasons to do so. (Compl. ¶ 31.) Absent specific facts, the Senior Managers' claim is nothing more than another unsupported, conclusory allegation which must be disregarded by the court.

Finally, the only specific fact relating to the Officer Defendants, e.g. the reporting relationships of the Senior Managers responsible for the fraud with the Officer Defendants (Compl. ¶¶ 19, 31), does not support a reasonable inference that the Officer Defendants consciously disregarded fraudulent activities. Under the good faith standard of the duty of oversight, there is no presumption that officers must be aware of all details of the operations of the business segments they supervise. *Stone II*, 911 A.2d at 368 (quoting *Caremark*, 698 A.2d at 971). Thus, the mere allegation of a reporting relationship between an employee who commits fraud and a director or officer does not satisfy the standard for liability.

Additionally, the purported "red flags" noted in the Plaintiff's Complaint do not support a reasonable inference that the Officer Defendants knowingly ignored a duty to address deficiencies in Securance's compliance system. See *Desimone*, 924 A.2d at 940 (citing *Stone II*, 911 A.2d at 373). First, the existence of a profit-based incentive plan in the Officers' own compensation package (Compl. ¶ 38) does not support a reasonable inference that they knowingly failed to

take steps to avert illegal behavior by their subordinates. The Plaintiff's Complaint provides no specific facts showing how the incentive plan encouraged the Senior Managers to commit the fraud that would put the Officer Defendants on notice of potential illegality.

Second, the 2004 consent decrees lack the "critical connection" between the previously alleged violations and the present fraud necessary to constitute a "red flag." See *ITT*, 588 F. Supp. 2d at 512-13. The additional allegation that Officer Defendants were "supinely content with the status quo" (Compl. at ¶44) is merely a conclusory statement unsupported by specific facts. Furthermore, the conflicting facts stated in the Complaint that Securance promised "*among other things*" to halt certain incentives to doctors (Compl. ¶ 40) undermines the inference that the Officer Defendants knowingly disregarded their duty and instead shows that Securance actually responded by modifying its business practices to avoid future harm.

In sum, taking all the Complaint's specific factual allegations and reasonable inferences as true, the Plaintiff fails to state a claim that the Officer Defendants consciously failed to monitor and oversee Securance's compliance system to breach their duty of loyalty.

#### **CONCLUSION**

For the foregoing reasons, the Appellees respectfully request that this Court affirm the Court of Chancery's decision to dismiss the Appellant's claims pursuant to Court of Chancery Rules 23.1 and 12(b)(6).

Respectfully submitted by,           T            
Attorneys for **APPELLEES**

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