

IN THE SUPREME COURT OF THE STATE OF DELAWARE

-----  
NO. 3892-CS  
-----

CLARE C. MARSHALL,	)	
	)	
Appellant,	)	On appeal from the
	)	Court of Chancery of
v.	)	the State of Delaware
	)	
CHARLES H. SALIGMAN, PATRICK C. RICHMOND,	)	
YVONNE M. CRAIG, MARTIN OP. ROTHSCHILD,	)	
ELAINE A. LASATER, WILLIAM M. LEWIS,	)	
GILBERT W. COULSON, RACHEL N. LIEBERMAN,	)	
TIMOTHY M. STOCKDALE AND CARLOS B. HUELVA	)	
	)	
Appellees,	)	
	)	
- and -	)	
	)	
SECURANCE INCORPORATED,	)	
	)	
Nominal Appellee.	)	

-----  
BRIEF FOR APPELLEES  
-----

Team U  
Counsel for Appellees  
Charles H. Saligman, et. al.

Dated: February 15, 2009

TABLE OF CONTENTS

TABLE OF CITATIONS .....iii

NATURE OF PROCEEDINGS .....1

SUMMARY OF THE ARGUMENT .....1

STATEMENT OF FACTS .....3

QUESTIONS PRESENTED .....5

ARUGMENT .....6

I. THIS COURT SHOULD AFFIRM THE CHANCERY COURT’S DISMISSAL OF MARSHALL’S COMPLAINT AGAINST THE DIRECTORS AND OFFICERS OF SECURANCE FOR FAILURE TO MAKE A DEMAND UNDER CHANCERY RULE 23.1 BECAUSE THE PLAINTIFF FAILED TO PLEAD DEMAND FUTILITY WITH SUFFICIENT PARTICULARITY.....7

II. MARSHALL FAILED TO PROPERLY STATE A CLAIM UNDER COURT OF CHANCERY RULE 12(b)(6) FOR BREACH OF FIDUCIARY DUTY BECAUSE HER COMPLAINT IS DEVOID OF SPECIFIC FACTS WHICH WOULD CREATE A PLAUSIBLE INFERENCE THAT THE OFFICERS ACTED IN BAD FAITH WHEN MONITORING SECURANCE.....15

a. Securance Officers should be afforded the same protection as Securance Directors in Marshall’s oversight liability claim because such extension supports efficient corporate operation.....15

b. This Court should affirm the dismissal of Marshall’s complaint under Court of Chancery Rule 12(b)(6) for failure to allege non-conclusory facts supporting a plausible inference that the Securance Officers breached their duty of oversight.....20

CONCLUSION .....25

**TABLE OF CITATIONS**

**UNITED STATES SUPREME COURT CASES**

Bell Atlantic Corp. v. Twombly, 127 S.Ct. 1955 (2007).....21

**UNITED STATES COURT OF APPEALS CASES**

Int'l Ins. Co. v. Johns, 874 F.2d 1447 (11th Cir. 1989).....13,23

**DELAWARE SUPREME COURT CASES**

Brehm v. Eisner, 746 A.2d 244 (Del. 1998).....1, 10

Gantler v. Stephens, 2009 WL 188828 (Del. Jan. 27, 2009).....1,18,22

Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963).....9,19

Grobow v. Perot, 539 A.2d 180 (Del. 1988).....1,21

Kaplan v. Peat, 540 A.2d 726 (Del. 1988).....2,8

Rales v. Blasband, 634 A.2d 927 (Del. 1993).....2,8,14,15

Stone v. Ritter, 911 A.2d 362 (Del. 2006).....9,16,21

Walt Disney Co. v. Eisner, 906 A.2d 27 (Del. 2006).....9,11

**DELAWARE COURT OF CHANCERY CASES**

Conrad v. Blank, 940 A.2d 28 (Del. Ch. 2007).....8,10,11

Desimone v. Barrows, 924 A.2d 908 (Del. Ch. 2007).....20,21,22

Forsythe v. ESC Fund Mgmt. Co., Inc., 2007 WL 2982247 (Del. Ch. Oct. 9, 2007).....9

Guttman v. Huang, 823 A.2d 492 (Del. Ch. 2003).....8,9,11

In re Caremark Int'l Inc., 698 A.2d 959 (Del. Ch. 1996).....9,11,12,15

In re Citigroup Inc., 2003 WL 21384599 (Del. Ch. June 5, 2003).....10,21

In re InfoUSA, Inc., 953 A.2d 963 (Del. Ch. 2007).....8

Lewis v. Aronson, 466 A.2d 375 (Del. Ch. 1983), rev'd on other grounds, 473 A.2d 805 (Del. 1984), overruled by Brehm v. Eisner, 746 A.2d 244 (Del. 1998).....16

Postorivo v. AG Paintball Holdings, Inc., 2008 WL 553205 (Del. Ch. Feb. 29, 2008).....2,10

<u>Rattner v. Bidzos</u> , 2003 WL 22284323 (Del. Ch. Sept. 30, 2003).....	8
<u>Solomon v. Pathe Commc'n Corp.</u> , 1995 WL 250374 (Del. Ch. Apr. 21, 1995).....	20,21,22

**STATUTES**

Del. Code. Ann. tit. 8, § 141(a) (2007).....	7
CIS Index 144-49 2002, Legislative Histories, PL 107-204.....	19
Sarbanes-Oxley Act, PL 107-204, 116 Stat 745 (2002) (codified in scattered sections of 15 U.S.C. § 7262, 18 U.S.C. § 1350).....	19,20

**RULES**

Del. Ch. Ct. R. 8(a) (2007).....	10
Del. Ch. Ct. R. 12(b) (6) (2007).....	1,20,21,25
Del. Ch. Ct. R. 23.1 (2007).....	1,7,10,21

**SECONDARY SOURCES**

Gregory Scott Crespi, <u>Should the Business Judgment Rule Apply to Corporate Officers, and Does it Matter?</u> , 31 Okla. City U. L. Rev. 237 (2006). .....	19
Lawrence A. Hamermesh & A. Gilchrist Sparks III, <u>Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson</u> , 60 Bus. Law. 865 (2005).....	16,17,18,19
Lawrence A. Hamermesh, <u>The Policy Foundations of Delaware Corporate Law</u> , 106 Colum. L. Rev. 1749 (2006).....	20

### **NATURE OF PROCEEDINGS**

Marshall filed a shareholder derivative action in the Delaware Court of Chancery against the Directors and three Officers of Securance, alleging breach of their fiduciary duties. Op. at 2. Marshall failed to make a pre-suit demand on Securance's Board as required by Chancery Rule 23.1. Op. at 21. Consequently, the court dismissed Marshall's complaint on January 6, 2009 for failure to adequately allege demand futility. Op. at 26. Additionally, Chancellor Siegel ruled the complaint failed to state a claim against the Officers pursuant to Chancery Rule 12(b)(6). Op. at 29. Marshall subsequently filed notice of appeal, to which Appellees reply in opposition. Op. at 1

### **SUMMARY OF THE ARGUMENT**

I. Marshall's complaint fails to allege demand futility because it lacks particularized facts indicating that the Board was liable for failing to monitor Securance's existing compliance systems. In support of her claim, Marshall alleges the Director's failed to examine profit increase with a critical eye and ignored red flags. However, a corporation's increase in profits can be attributed to a number of legitimate causes, and does not necessarily indicate fraud. Further, by implementing an Incentive Compensation Plan, the Board did not create a motivation for fraudulent activity. Such plans are commonly used in corporate America to encourage production, and to impute misconduct from the plan's existence destroys a capitalist tradition.

Furthermore, consent decrees which are distinct in subject, do not admit culpability, and are entered into as a result of sound business judgment cannot serve as a warning that fraudulent activity of a different kind will occur. Finally, Marshall's complaint is devoid of allegations that a majority of the Board would be unable to impartially make a judgment on the demand for action against the Officers.

II. The protection afforded to Securance Directors in oversight liability claims should be extended to the Securance Officers. Because other mechanisms are in place to hold corporate officers accountable to the stockholders and corporation, the extension of this protection is warranted to prevent harmful inefficiency in all Delaware corporations. Under this protection, officers should only be liable in an oversight liability claim if the claimant can prove the officers acted in bad faith. Here, Marshall failed to support her allegations of Officer wrongdoing by not alleging specific facts to support a plausible inference linking the Officers' alleged bad faith behavior to the Senior Managers' fraudulent activity. Marshall merely concluded the presence of an incentive compensation plan, together with the unrelated consent decrees and an increase in profits, gave notice to the Officers of problems with Securance's compliance system. Therefore, Appellants claim must be dismissed under Court of Chancery Rule 12(b)(6).

### **STATEMENT OF FACTS**

For seven years, the Delaware corporation Securance has existed as a for-profit managed health care company that is publically traded on the New York Stock Exchange. Op. at 3. Securance works with federal and state governments to efficiently provide health coverage to Medicaid patients. Op. at 4. Specifically, Securance serves as the government's "liason" by contracting with doctors to provide hospital, medical, and prescription drug benefits to indigent and disabled persons. Op. at 5. As a capitated Medicaid HMO, Securance receives a premium from the state and federal governments for each Medicaid recipient enrolled in its plan. Op. at 5. In turn, Securance makes the necessary payments to health care providers and reports to each state the "medical loss ratio" (amount of money spent on direct medical care). Op. at 5.

The HMO industry is pervasively regulated. By law, Securance is required to spend 80% of its premiums on direct medical services for patients or refund the revenue to the states. Op. at 5-6. Securance must manage its medical loss ratio efficiently to survive within a restricted 20% profit margin. Op. at 6. To encourage such efficiency, the Directors adopted an Incentive Compensation Plan that provided a bonus to senior executives based on the success of their respective business segments. Op. at 13.

While Securance was accused of offering improper financial incentives to doctors in 2004, Securance was never found guilty of such activity and entered into consent decrees as a practical business alternative to the costs of enduring litigation. Op. at 13. The consent decrees did not suggest that Securance's compliance systems

were inadequate. Op. at 14. However, Securance admits that from 2005 to 2007, three of its former Senior Managers [Managers] operated their own fraudulent scheme designed to artificially boost company profits. Op. at 6. By overstating the company's medical loss ratio to its "gold band" states: Ohio, Pennsylvania, New York, and New Jersey; the Managers avoided any refund obligations to the states and siphoned off the "profit" to Total Reinsurance, a wholly-owned subsidiary of Securance. Op. at 6-7. Due to the financial misstatements, Securance stock appreciated to \$110 per share in 2007 and attracted the attention of market analysts. Op. at 8. Eventually the Managers' scheme was uncovered, and they pled guilty to conspiracy to commit Medicaid fraud. Op. at 7-8. In their plea negotiations, the Managers alleged that they acted with the support of the company's "senior officers" but did not identify them by name or position. Op. at 10.

On June 3, 2008, Securance pled guilty to one count of mail fraud and arranged to pay \$400 million in penalties and \$120 million in refunds to the defrauded states. Op. at 11. To set the record straight, the Board of Directors [Directors] also decided to restate the company's earnings for the past 3 years, resulting in a \$3 billion market capitalization loss. Op. at 11. Further, Securance agreed to transfer control of compliance matters from the audit committee to a new committee established solely for that purpose. Op. at 11.

**QUESTIONS PRESENTED**

- I. Under Delaware Chancery Rule 23.1, was Marshall's complaint properly dismissed for failure to allege demand futility when the complaint lacked particularized factual allegations that Securance Directors could not exercise disinterested and independent business judgment when considering a pre-suit demand?
- II. Under Delaware Chancery Rule 12(b)(6), was Marshall's complaint properly dismissed for failure to state a claim against Securance Officers when the complaint lacked factual allegations supporting a plausible inference that the Officers breached their duties to oversee the operations of the company in good faith?

## ARGUMENT

Marshall's complaint failed to state particularized facts supporting her allegation that a demand to the Directors of Securance would be futile, and even if Marshall properly pled demand futility, she failed to state a claim against the Officers for failure to oversee the operations of Securance.

When presented with a motion to dismiss under either Chancery Rule 23.1 or Rule 12(b)(6), the court will only accept as true those well-pleaded factual allegations and all reasonable inferences which can be drawn from them. Grobow v. Perot, 539 A.2d 180, 187 n.6 (Del. 1988); Del. Ch. Ct. R. 23.1 (2007); Del.Ch. Ct. R. 12(b)(6) (2007). The Court will not assume the truth of any "conclusory allegations of fact or law not supported by allegations of specific fact." Id. This Court exercises de novo review upon the Court of Chancery's ruling on both motions. Brehm v. Eisner, 746 A.2d 244, 253 (Del. 1998); Gantler v. Stephens, 2009 WL 188828 at \*4 (Del. Jan. 27, 2009).

The appropriate remedy in this case would be to affirm the Court of Chancery's dismissal of Marshall's complaint for failure to allege demand futility and affirm its finding that Marshall failed to state a claim against the Officers. Mindful that the first issue is determinative, it will first be shown that Marshall's complaint is devoid of particularized facts that would indicate the Directors could not have independently and disinterestedly considered a demand. Second, the facts will show that even if Marshall sufficiently alleged demand futility, she failed to state a claim under Chancery Rule 12(b)(6) against the Officers for a conscious failure to monitor Securance's operations.

**I. THIS COURT SHOULD AFFIRM THE CHANCERY COURT'S DISMISSAL OF MARSHALL'S COMPLAINT AGAINST THE DIRECTORS AND OFFICERS OF SECURANCE FOR FAILURE TO MAKE A DEMAND UNDER CHANCERY RULE 23.1 BECAUSE THE PLAINTIFF FAILED TO PLEAD DEMAND FUTILITY WITH SUFFICIENT PARTICULARITY.**

For a demand to be excused, the plaintiff's complaint must contain particularized factual allegations sufficient to create reasonable doubt that, at the time the complaint was filed, the directors could have properly exercised their independent and disinterested judgment when evaluating the plaintiff's demand. Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993).

A demand on a corporation's board of directors to act in response to a shareholder's grievance is required prior to the filing of a derivative complaint. Postorivo v. AG Paintball Holdings, Inc., 2008 WL 553205 (Del. Ch. Feb. 29, 2008). While the directors are charged with managerial responsibility, they owe fiduciary responsibilities to the shareholder owners. Kaplan v. Peat, 540 A.2d 726, 729 (Del. 1988) (citing 8 Del C. § 141(a)(2007)). Should the directors breach their duties of care or loyalty, a shareholder maintains a right of action in the form of a derivative suit. Id. at 730. However, under Delaware Chancery Rule 23.1, a shareholder's cause of action does not accrue until she has made a demand on the directors of the corporation, and they have declined to take action in bad faith. Id.; Del. Ch. Ct. R. 23.1 (2007). Absent doubt of good faith, courts are hesitant to question the prerogatives of the board. Postorivo, 2008 WL 553205, at \*5. Consequently, the demand requirement serves as a threshold to ensure that plaintiffs exhaust intra-corporate remedies before prematurely resulting to strike suits. Id. at \*4.

Only if a plaintiff can create reasonable doubt that, at the time the complaint was filed, a majority of the directors could have exercised their independent and disinterested business judgment in responding to a demand, will the demand be excused. Rales, 634 A.2d at 934; Conrad v. Blank, 940 A.2d 28 (Del. Ch. 2007). A director acts independently when her decision regarding a plaintiff's demand is based on the best interests of the corporation and not on external influences. Rales, 634 A.2d at 936. When a director receives a benefit upon which she is so dependent that threatened loss would influence her decision, she is considered "beholden" to the individual imparting the benefit, and her impartiality is impaired. In re InfoUSA, Inc., 953 A.2d 963, 985 (Del. Ch. 2007).

A director will be considered interested for the purposes of demand futility when the decision of whether to act on a shareholder's demand will have a "detrimental impact on [the] director, but not on the corporation or shareholders." Rales, 634 A.2d at 936. For example, when the plaintiff's well-pleaded complaint raises suspicion that the director may be held liable as a result of the derivative claim, the director is interested in the outcome of the demand, and is no longer impartial. Conrad, 940 A.2d at 37. However, to have their impartiality compromised in such circumstances, directors must face a substantial likelihood of liability by committing a non-exculpated breach of fiduciary duty. Guttman v. Huang, 823 A.2d 492, 503 (Del. Ch. 2003); Rattner v. Bidzos, 2003 WL 22284323 at \*9 (Del. Ch. Sept. 30, 2003).

Directors face a substantial likelihood of liability when a plaintiff claims a breach of their duty of loyalty in the execution of their managerial responsibilities. Kaplan, 540 A.2d at 729.

Intertwined within the duty of loyalty is the duty to act in good faith. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). The three possible ways a director could fail to act in good faith are: 1) intentionally acting with a purpose other than advancing the best interests of the corporation, 2) violating the law, or 3) intentionally failing to act in the face of a known duty to act. Walt Disney Co. v. Eisner, 906 A.2d 27, 69 (Del. 2006).

Specifically, directors have a known duty to implement an adequate compliance system which they believe will notify officers and the directors if the corporation violates the law. In re Caremark Int'l Inc., 698 A.2d 959, 969 (Del. Ch. 1996). However, directors cannot be charged with wrongdoing for simply relying on the integrity and honesty of their employees. Id. Generally, they need not engage in "a corporate system of espionage to ferret out a wrongdoing." Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).

In fact, in Guttman this Court held that only a "sustained or systematic" failure of the board to oversee will establish the lack of good faith, and thus breach of the duty of loyalty, that is a pre-condition to liability. 823 A.2d at 506. A systematic oversight failure occurs when the directors have consciously failed to monitor existing compliance systems. Stone, 911 A.2d at 370. In such cases, directors can only face potential liability for breach of their oversight duties if they ignore red flags which actually alert them to potential wrongdoing. Forsythe v. ESC Fund Mgmt. Co., Inc., 2007 WL 2982247 (Del. Ch. Oct. 9, 2007).

However, ignorance of "red flags" can only indicate a conscious failure to monitor compliance systems when they are "waived in [the

directors' ] faces," and bring to the directors' attention the specific wrongful conduct or the existence of a weakness in the corporation's compliance system. In re Citigroup Inc., 2003 WL 21384599, at \*2 (Del. Ch. June 5, 2003). For example, emails and memos distributed to a corporation's subsidiary were unlikely to come to the attention of the board of directors of the parent company and therefore did not constitute red flags. Id. In contrast, an audit committee report provided to the directors constituted a red flag because it gave actual notice to the directors that stock options had been mispriced in previous years. Conrad, 940 A.2d at 34.

Finally, when asserting demand futility, a shareholder must plead with factual particularity specific instances supporting her theory, and may not rest on conclusory statements. Brehm v. Eisner, 746 A.2d 244, 254 (Del. 1998). To avoid creating a "blunderbuss of conclusory language," detail is a necessary pre-requisite to particularity. Id. at 267. Therefore, to satisfy the stringent pleading requirements of Chancery Rule 23.1, the shareholder's complaint must include particularized facts which are essential to every alleged action or failure to act by every challenged director. Brehm, 746 A.2d at 254; Del. Ch. R. 23.1. Merely pleading the notice standard of Chancery Rule 8(a) is insufficient when the courts require a fact-by-fact, director-by-director analysis. Postorivo, 2008 WL 553205, at \*6; Del. Ch. R. 8(a) (2007).

For example, in a derivative suit claiming liability based on a director's failure to oversee accounting practices, the court found the shareholder's claim of demand futility inadequate because it merely stated that the directors participated in "back in" investing.

Guttman, 823 A.2d at 494, 507. Rather, the complaint should have presented facts such as (1) the company lacked an audit committee; (2) the company's audit committee met only sporadically; (3) the audit committee devoted an insufficient amount of time to its work or (4) the audit committee had clear notice of serious accounting irregularities. Id. at 507. Conversely, a plaintiff provided the court with "thorough and convincing pleadings" when he identified specific instances of misconduct and included statistical analyses to support inferences of wrongdoing by the directors. Conrad, 940 A.2d at 39.

Here, the allegations in Marshall's complaint failed to create a reasonable doubt that the Directors could consider her demand for action against the Directors and Officers of Securance with disinterest and independence. Marshall misstates the test for oversight liability by claiming that recklessness, or gross negligence, would impute liability for a breach of the oversight duties on a board of directors. Compl. at 22-23. Specifically, Marshall claims that the Directors failed to act in good faith when fulfilling their oversight responsibilities because they were "consciously aware or recklessly disregarded" the fraudulent practices of the Medicare reporting systems in the "gold band" states. Compl. at 22. However, recklessness, or gross negligence, cannot be a basis for a breach of the duty of good faith. Caremark, 698 A.2d at 960-970; Walt Disney, 906 A.2d at 62. Therefore, Marshall must prove demand futility based on her claim that the Directors faced a substantial likelihood of liability by "consciously" disregarding their oversight responsibilities. Further, because Marshall admits a compliance system existed, she must allege particularized facts supporting an inference

that the Directors consciously failed to monitor the existing system to succeed on her claim. Compl. at 16, 20.

However, Marshall's complaint lacked any concrete fact supporting an inference that the Directors consciously did not fulfill their oversight responsibility to ensure compliance with state Medicaid regulations. Although Marshall claims the Directors failed to use a "critical eye" in evaluating the increase in company profits, these allegations do not establish the requisite consciousness for director liability. The derivative complaint alleges the Directors were aware of the extensive regulations in the Medicaid industry and that Securance operated under a thin profit margin. Compl. at 9. Indeed, she asserts that historically Securance was statutorily required to refund between 4% and 6% of premium revenue to the "gold band" states resulting in a net income of approximately \$49 million in 2004. Compl. at 13. However, once the Managers commenced their fraudulent activity, no premium revenue was refunded to the "gold band" states, and the net income of the company nearly doubled in 2005. Compl. at 13. Securance's net income continued to increase throughout the two years in which the Managers engaged in the fraudulent activity. Compl. at 13. Marshall continues that such an increase "exceed[ed] analyst expectations" and was considered "the best in the Medicaid space." Compl. at 13.

These factual assertions do not indicate that the directors consciously knew of the illicit activity, nor that there was a weakness in Securance's compliance systems. In light of this Court's holding in Caremark, a dramatic increase in profit alone cannot constitute "grounds to suspect deception" because there are a variety

of legitimate reasons for an increase in profit. 698 A.2d at 969. Corporate profits could increase because of worker dedication or the implementation of more efficient business procedures at the managerial level. Therefore, Securance's Directors were entitled to believe that the increase in profits was the result of the hard work of the company's employees and not due to illegal and fraudulent activity.

Moreover, the implementation of the Incentive Compensation Plan for senior executives does not, standing alone, create a red flag which would be sufficient to impute bad faith onto the Directors in exercising their oversight responsibilities. The incentive plan was applicable to corporate executives including Director-Officers Saligman, Richmond, and Craig and Officers Lieberman, Stockdale, and Huelva. Compl. at 19. The plan gave a bonus to the individual executives based on the operating profit yielded by each of their respective business segments. Compl. at 19. According to Marshall, the incentive plan created a motivation for the corporate executives to increase profit margins at all costs, thereby exacerbating any temptation to engage in fraudulent activity. Compl. at 19.

However, similar incentive plans are commonly used to improve a corporation's future performance, and do not per se serve as motivation to commit fraudulent activity. See Int'l Ins. Co. v. Johns, 874 F.2d 1447, 1464 (11th Cir. 1989). It cannot be reasonably inferred that the Directors had notice of probable wrongdoing by their Managers merely from the implementation of a bonus system. In her complaint, Marshall faults the Directors for not anticipating criminal activity by merely alleging the existence of a compensation plan. Compl. At 18-19. Because the complaint was devoid of particularized facts

indicating how the compensation plan incited wrongful conduct, Marshall has wholly failed to plead the plan was a red flag warning the Directors of the need to oversee compliance with state laws.

Further, Marshall does not establish bad faith by suggesting the 2004 consent decrees were red flags which the Directors consciously ignored. Marshall contends Securance has a "history" of fraudulent and unethical activities that should have put the company on notice that its' compliance systems were insufficient and needed better observation or structuring. Compl. at 20. However, entry of the 2004 consent decrees could not provide notice to the Directors of the fraudulent reporting of medical loss ratios. The 2004 consent decrees arose as a result of alleged unethical financial incentives to doctors. Compl. at 19. These allegations did not involve the same reporting practice or the same departments as the current fraudulent activity. Compl. at 10-11, 19. In addition, in each consent decree, there was a stipulation that the decree was entered "without adjudication, or admission of any fact or law." Compl. at 20. Therefore, the Directors are justified in believing that no wrongful activity occurred and that the decrees were entered into as a matter of business judgment.

Finally, Marshall has utterly failed to allege that the Directors would be unable to exercise an independent and disinterested judgment in evaluating her demand for action against the Officers. As discussed above, to establish demand futility a plaintiff must allege particularized facts which would suggest the directors faced a substantial likelihood of liability, or indicate that the directors were "beholden" to the alleged wrongdoers. Rales, 634 A.2d at 934-36.

Even if some of the directors are biased, the demand is necessary if a majority remains disinterested and independent. Id. at 930.

Here, only three of the seven members of the Board also served as officers. Compl. at 3-4. Thus, even if Marshall could establish a legitimate claim against the Officer-Directors, Securance's Directors would maintain their ability to review her demand with impartiality. Further, the complaint lacks any particular facts which would indicate that the majority of Directors were "beholden" to the Officers. Marshall has not alleged that the Directors received benefits from the Officers, or that any familial or employment connection existed between them which could possibly influence their decision. Compl. at 1-28. Therefore, a pre-suit demand was required with respect to Marshall's claims against the Officers.

Filled with vague and conclusory statements, Marshall's complaint lacks the facts necessary to warrant demand excusal.

**II. MARSHALL FAILED TO PROPERLY STATE A CLAIM UNDER COURT OF CHANCERY RULE 12(b)(6) FOR BREACH OF FIDUCIARY DUTY BECAUSE HER COMPLAINT IS DEVOID OF SPECIFIC FACTS WHICH WOULD CREATE A PLAUSIBLE INFERENCE THAT THE OFFICERS ACTED IN BAD FAITH WHEN MONITORING SECURANCE.**

**a. Securance Officers should be afforded the same protection as Securance Directors in Marshall's oversight liability claim because such extension supports efficient corporate operation.**

The Securance Officers should not be held liable for breach of their oversight duties unless they acted in bad faith. Delaware courts have strongly suggested that both corporate directors and officers are afforded the same protection from oversight liability, but have yet to expressly apply this standard to officers. In re Caremark Int'l Inc., 698 A.2d 959, 969 (Del. Ch. 1996); Op. at 26-27. However, a director

is liable for breach of oversight duties if she acted in bad faith by intentionally failing to monitor the company's operations. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). In support of extending this standard to officers, an analogy can be drawn to the business judgment rule which creates a demanding standard of liability to protect both directors and officers from having their decisions evaluated under a negligence standard. Lewis v. Aronson, 466 A.2d 375, 384 (Del. Ch. 1983), rev'd on other grounds, 473 A.2d. 805 (Del. 1984), overruled by Brehm v. Eisner, 746 A.2d 244 (Del. 1998).

First, corporate officers must be afforded a heightened degree of oversight liability protection to efficiently serve in such capacities. Cf. Lawrence A. Hamermesh & A. Gilchrist Sparks III, Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson, 60 Bus. Law. 865, 870 (2005) (explaining the principal justification for the business judgment rule is to encourage officers to serve and take risks). Were a negligence standard imposed, the high compensation available to corporate officers would not be sufficient to attract and sustain highly qualified individuals because the compensation would be offset by the potential for personal liability. Cf. id. at 871. Further, even if corporate officers serve, the high risk of personal liability will cause them to be inefficient by imposing extraneous monitoring procedures. Cf. id. at 873 (explaining how denying the business judgment rule protection to officers would render them "unduly cautious"). Such inefficient conduct would be detrimental to the financial interests of the stockholders. Cf. id. at 873 (justifying the extension of the business judgment rule to officers as beneficial to stockholders).

Here, the Securance Officers face considerable personal liability which overshadows their compensation. Compl. at 27. Even though in 2008 Officer Lieberman earned \$2.8 million, Officer Stockdale earned \$2.6 million, and Officer Huelva earned \$2.5 million, these salaries pale in comparison to the \$520 million lawsuit they are facing. Compl. at 4-5. Moreover, were the Officers held to a negligence standard in oversight liability claims, they would spend corporate capital on monitoring procedures that would be unnecessary in light of the pre-existing compliance committee. Compl. at 20. Further, Securance is a sizeable corporation that works with the Federal Medicaid and Medicare programs, contracting with individual healthcare providers in eighteen states. Compl. at 6-7. As such, Securance relies on delegation to operate efficiently. If this Court allows a negligence standard for this oversight claim against the Officers, it would send a frightening message to all officers, likely causing “unduly cautious” behavior to permeate Delaware corporations.

Second, officers should be afforded greater oversight liability protection to limit judicial intrusion into corporate affairs. Cf. Hamermesh, A Reply, at 873 (stating this rationale supports extension of the business judgment rule to officers). Primarily, the complex nature of corporations serves as an obstacle that hinders a fair determination of oversight liability. Cf. id. at 873 (noting the court recognizes “their limited ability to evaluate and attach liability to complex business judgments” Id.). Because director and officer roles often overlap, courts and certainly juries would be burdened to untangle the web of responsibilities so as to accurately assign liability. Cf. id. at 874. Additionally, in such high stakes cases,

the risk of “hindsight bias” proves a strong incentive for deferring to intra-corporate mechanisms. Cf. id. Therefore, imposing liability for negligence on officers involving oversight claims would unduly force the court to intrude into corporate affairs as well as tax judicial economy. Cf. id.

In this case, Marshall names seven Directors, three Officer-Directors, and three Officers as defendants. Compl. at 3-5. The descriptions of their monitoring roles overlap in the complaint. Compl. at 3-5. Moreover, the Directors utilize the Officers in the performance of their responsibilities. Compl. at 4. It would be difficult for the Court to attach liability to the appropriate party because the complaint is silent as for which duties the Officers are ultimately responsible. Compl. at 3-5. With over \$520 million at stake, applying multiple standards of liability based on an ambiguous assignment of duties would not provide a fair adjudication based on the merits of the case. Compl. at 27.

Third, officers must be afforded the same protection from oversight liability as directors to preserve board governance. Since the Securance Directors and Officers share fiduciary duties, it is only logical that they be treated in a uniform manner when they allegedly breach such duties. Gantler v. Stephens, 2009 WL 188828, at \*9 (Jan. 27, 2009); Cf. Hamermesh, A Reply, at 874 (noting that directors and officers owe the same fiduciary duties to the corporation, and holding them to different standards of liability would disrupt the integral dynamic between directors and officers). Directors must be able to delegate monitoring responsibilities to officers because officers serve as the arm of the Board and are better

equipped to monitor the corporation. See Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 128 (Del. Ch. 1963) (noting “by reason of the extent and complexity of the company’s operations, it is not practicable for the Board to consider in detail specific problems of the various divisions” Id.). If officers were subjected to a negligence standard, they would be reluctant to carry out the board’s directives for fear of facing personal liability. Cf. Hamermesh, A Reply, at 872. Without a command-style management structure, directors and shareholders would see a top-heavy corporation fall.

Here, for Securance to operate efficiently, the Directors must entrust oversight responsibilities to Officers Lieberman, Stockdale, and Huelva. Without equal protection in oversight claims, the fear of personal liability would stop the flow of responsibilities from Director to Officer and bring Securance to a grinding halt.

Lastly, Courts need not resort to imposing a negligence standard because there are better mechanisms in place to hold officers accountable for their actions. First, there is a highly competitive market for responsible corporate officers. Gregory Scott Crespi, Should the Business Judgment Rule Apply to Corporate Officers, and Does it Matter?, 31 Okla. City U. L. Rev. 237, 242 (2006). In a “post-Enron” corporate environment, failure to satisfy fiduciary duties will severely impair employment opportunities for the officers. Id. (noting “the market probably has a more significant influence on officer conduct than would the increased fear of liability for negligent duty of care violations” Id.). Second, in 2002, Congress responded to the corruption of corporate officers by creating The Sarbanes-Oxley Act [the Act]. CIS Index 144-49 2002, Legislative Histories, PL 107-204.

The Act holds officers accountable for their actions by refurbishing the independence of the board and encouraging stronger regulation of corporate officers. Sarbanes-Oxley Act, PL 107-204, 116 Stat 745 (2002) (codified in scattered sections of 15 U.S.C. § 7262, 18 U.S.C. § 1350). Third, Delaware has historically allowed directors to internally manage the corporation and has benefitted from substantial corporate law stability. Lawrence A. Hamermesh, The Policy Foundations of Delaware Corporate Law, 106 Colum. L. Rev. 1749, 1772 (2006). Changing such practice will tarnish Delaware's reputation as the established capital for American corporations.

In light of these policy rationales, officers should be afforded the same protection as directors and should not be subjected to a negligence standard in oversight liability claims. Consequently, Marshall must plead that Securance Officers failed to monitor the corporation in bad faith.

**b. This Court should affirm the dismissal of Marshall's complaint under Court of Chancery Rule 12(b)(6) for failure to allege non-conclusory facts supporting a plausible inference that the Securance Officers breached their duty of oversight.**

Marshall's complaint fails to allege non-conclusory facts to support a plausible inference that the Officers breached their fiduciary duty of loyalty. In Delaware, to survive a Rule 12(b)(6) motion, the complainant must avoid reliance on non-conclusory statements, and instead include specific facts creating a claim that is not just conceivable but actually plausible. Del. Ch. Rule 12(b)(6) (2007); Desimone v. Barrows, 924 A.2d 908, 928 (Del. Ch. 2007). Courts should apply this pleading test with "special care" in derivative suits. Solomon v. Pathe Commc'n Corp., 1995 WL 250374 at \*4 (Del. Ch.

Apr. 21, 1995). Such treatment is required because, "the realities of . . . complex litigation make proceeding past the pleading stage . . . exceedingly expensive." Desimone, 924 A.2d at 928. A complaint that survives a motion to dismiss motivates a defendant to prematurely settle such claims, creating the threat of strike suits. Bell Atlantic Corp. v. Twombly, 127 S.Ct. 1955, 1967 (2007); Solomon, 1995 WL 250374 at \*4. As a result, while a complainant need not satisfy the particularity required under Chancery Rule 23.1 for demand futility, the complainant must provide more than conclusions or inferences unsupported by specific facts. Grobow v. Perot, 539 A.2d 180, 187 n.6 (Del. 1988); Del. Ch. R. 23.1

To satisfy the heightened pleading standard in a derivative suit for breach of fiduciary duty, the complainant must plead specific facts which support a plausible inference that the corporate officer acted in bad faith by consciously failing to monitor the company. See Stone, 911 A.2d at 370. A complainant can impute consciousness onto officers by alleging that they ignored red flags warning them of the employee wrongdoing at issue. In re Citigroup Inc., 2003 WL 21384599, at \*2 (Del. Ch. June 5, 2003). Furthermore, should this Court allow a complainant to establish an oversight liability claim against officers based on a reckless failure to monitor, the complainant must still plead specific facts to support how the officers acted recklessly. Desimone, 924 A.2d at 928. Without such factual specificity, a derivative complaint cannot survive a defendant's Rule 12(b)(6) motion to dismiss. Id.

The factual specificity required for a plausible claim will be satisfied by describing how the officer's actions are linked to a

corporate harm and resulted in a breach of fiduciary duty. See Solomon, 1995 WL 250375, at \*4. For example, when presented with a complaint which described explicitly how an officer's failure to exercise diligence, as ordered by the board, caused a crucial merger offer to be withdrawn, the court held, "the pled facts provide a sufficient basis to conclude . . . [the officer] acted disloyally." Gantler, 2009 WL 188828, at \*8-9. Conversely, in Desimone, the court rejected the plaintiff's attempt to prove manipulation by relying on the coincidental timing of the Director Grants which provided a strategic financial advantage. 924 A.2d at 948. The court required specific instances of fraudulent activity to sustain the plaintiff's claim. Id.

Here, Marshall did not plead specific facts which would support a plausible claim that the Officers consciously failed to monitor the compliance systems of Securance, and therefore acted in bad faith. Indeed, Marshall did not even plead specific facts which could support a plausible inference that the Officers were reckless in monitoring Securance.

First, Marshall's allegations that the Officers failed to act with a "critical eye" in evaluating the increase in company profits are not sufficient to impute them with consciousness of the employee wrongdoing at issue. Marshall alleges that the Officers were aware that Securance operated under a thin profit margin resulting from the extensive regulations in the Medicaid industry. Compl. at 9. Further, Marshall alleges that Securance historically refunded between 4% and 6% of premium revenue to the "gold band" states, yet beginning in 2005 no premium revenue was refunded. Compl. at 11. Standing alone, these

allegations fail to support a plausible inference that the Officers consciously failed to monitor Securance because there are a variety of legitimate explanations for an increase in profits. Compl. at 9. Therefore, the Officers were entitled to believe that the increase was the result of other cost-saving mechanisms. Moreover, Marshall's allegations do not even satisfy the requirements for recklessness because they only state conclusions of suspicious activity but are devoid of supporting facts.

Second, Marshall fails to establish that the Incentive Compensation Plan served as a "red flag" to put the Officers on notice of fraudulent behavior. Compl. at 26. While the plan was applicable to all Officers of Securance including the named Officer-Defendants, such plans are common among corporations as a means to encourage efficient management. Compl. at 18-19; Int'l Ins. Co. v. Johns, 874 F.2d 1447, 1463 (11th Cir. 1989). Therefore, the utilization of such a common strategy cannot indicate that the Officers acted recklessly by ignoring a substantial risk of fraudulent activity nor support a plausible inference of bad faith.

Third, Marshall does not establish bad faith by suggesting the 2004 consent decrees were "red flags" which the Officers consciously ignored. Compl. at 26. Marshall states that Securance has a history of fraudulent behavior that should have put the company on notice that their compliance systems were insufficient. Compl. at 20. However, the 2004 allegations were never adjudicated and Securance never admitted to any wrongdoing. Compl. at 19. The entry of the consent decrees was likely the result of sound business judgment because Securance settled for \$200,000 instead of incurring far more in litigation expenses.

Compl. at 20. Further, the conduct giving rise to the consent decrees is distinct from the conduct leading to the instant action. Compl. at 19-20. The 2004 consent decrees addressed questionable incentives given to physicians treating Medicaid recipients. Compl. at 19. In contrast, the Managers were charged with false financial reporting. Compl. at 10- 12. Thus, the existence of the 2004 consent decrees does not support a plausible inference that the Officers were subjectively aware of the Managers' illegal activity. Indeed, the possible unethical conduct in 2004 is so far removed from current alleged conduct that it could not even foreshadow a substantial risk of fraudulent financial reporting to constitute reckless behavior.

Lastly, Marshall did not support her allegation that the Officers consciously failed to oversee the Managers by alluding to the statements contained in the plea agreements in conjunction with the Officers' responsibilities. The plea agreements simply state that the Managers worked with "the express or implied support of the company's senior officers," but do not identify anyone specifically. Compl. at 15. Moreover, simply because Officer Lieberman and Officer Huelva supervised the Managers' departments and Officer Stockdale "worked closely" with the Managers to prepare the company's Medicaid reports, this does not, without more, suggest they endorsed the Managers' illegal conduct. Compl. at 15-16. Consequently, bad faith cannot be attached to the Officers by such vague assertions. In the same manner, Marshall's contentions are insufficient to assert a viable claim of recklessness. Although illegal activity occurred, Marshall's claim cannot rest on the Officers' proximity to the conduct without

identifying specific ways in which they consciously disregarded a substantial risk of fraudulent behavior.

With the protection of oversight liability extending to Officers, Marshall was required to plead the Officers failed to monitor the operations of Securance in bad faith. However, Marshall made generalized charges of wrongdoing, unaccompanied by facts supporting a plausible inference that the Officers' behavior constituted bad faith or even recklessness. Because her complaint fell short of the pleading burden, Marshall's claim against the Officers must be dismissed under Chancery Rule 12(b) (6).

**CONCLUSION**

For the foregoing reasons, the Appellees respectfully request that this Court affirm the dismissal of Marshalls's complaint on the ground that she failed to allege demand futility pursuant to Chancery Rule 23.1. Appellees also request this Court affirm the dismissal of Marshall's complaint on the ground that she failed to state a claim against the Officers pursuant to Chancery Rule 12(b) (6).

Respectfully Submitted,

Team U