

THE SUPREME COURT OF THE STATE OF DELAWARE

CLARE C. MARSHALL,)
)
 Plaintiff Below-)
 Appellant,)
) Civil Action
 v.) No. 3892-CS
)
)
 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.)

Appellee's Answering Brief
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 M. Huelva and
Securance Incorporated.

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NATURE OF PROCEEDINGS

Securance Incorporated ("Securance") is a Delaware corporation headquartered in Frederick, Maryland. Clare C. Marshall ("Marshall") is a shareholder of Securance and she seeks to bring this derivative action on behalf of Securance against the Company's seven-member board of directors as well as against several of the Company's senior officers. Marshall filed a Complaint July 3, 2008. In that Complaint she alleged in Count I that the directors had breached a fiduciary duty of loyalty and in Count II that the officers had breached a duty of loyalty.

Securance made a motion to dismiss the derivative complaint November 5, 2008 pursuant to Court of Chancery Rules 12(b)(6) and 23.1 for failure to state a claim and failure to adequately plead that pre-suit demand is excused in this case. The motion to dismiss was granted by the lower court on January 6, 2009. The court concluded that demand was not excused because neither the directors nor the officers had breached their duty of loyalty to the company.

On January 16, 2009, the Supreme Court of the State of Delaware issued a Notice of Appeal. The Court ordered that for the purposes of this proceeding, Marshall be designated as Appellant, and Securance be designated as the Appellee. Appellant and Appellee were ordered to serve and file their briefs on or before February 17, 2009.

QUESTIONS PRESENTED

1. Should this court dismiss the Derivative Suit under the standards of Court of Chancery Rules 23.1 and 12(b)(6) because pre-suit demand was not futile, the directors did not breach their duty of loyalty?
2. Should this court allow a derivative suit against the Securance Directors for breaching their fiduciary duty of loyalty to the company?
3. Additionally, should this court allow a derivative suit against several of the officers of Securance for breaching their fiduciary duty of loyalty to the company?

SUMMARY OF ARGUMENT

- I. This Court should affirm the Court of Chancery's decision to dismiss the Appellant's derivative claim because the Appellant failed to make demand on Securance's board of directors to bring a suit against the directors and officers of Securance. Making a demand to bring suit on the directors was not excused because the directors and director officers were not substantially likely to be found liable for breach of their duty of oversight.
- II. The director officers did not breach their duty to oversee Securance employees. Demand was not excused because the "red flags" that Appellant alleges should have alerted Appellees were not of the same kind or character of the fraud that the senior managers undertook.

STATEMENT OF FACTS

Securance is a for-profit managed care services company serving Medicaid and Medicare patients in various state markets. (Memorandum Opinion, January 6, 2009 ("Op.") at 3). As a result of a conspiracy among three senior managers of the Company (none of whom is a defendant in this case) to defraud Medicaid agencies in four states, Securance has suffered \$400 million in fines and \$120 million in refunds of premiums overcharged by Securance to these four states. (Op. at 1). Securance has also been disqualified for three years from doing business in these four states, which collectively have accounted for approximately 40% of the Company's business. *Id.* The market price of Securance's common stock collapsed from a high of \$110 to \$37 per share. *Id.*

In 2003, the compensation committee recommended a Senior Officer Performance Compensation Plan (the "Incentive Compensation Plan"), applicable to senior corporate executives including Director Appellees Saligman, Richmond and Craig as well as the Officer Defendants and the Board approved it. (Op. at 12). The Incentive Compensation Plan provided for bonus compensation based on the operating profit yielded by each of Securance's business segments. (Op. at 13).

In 2004, state officials in Connecticut and Virginia suspected that Securance was systematically denying certain medical services to the Company's indigent and disabled members to boost profits. (Op. at 13). Officials alleged that Securance had offered improper financial incentives and bonuses for doctors to deny needed diagnostic and specialist services to members to make a larger profit. *Id.*

Securance entered into court approved consent decrees with each state promising to not offer financial incentives to doctors who limit the Company's medical loss ratios. Securance did not admit any wrongdoing at that time. *Id.*

The allegations of wrongdoing in this case are focused exclusively on the Medicaid aspect of Securance's business. The Medicaid program provides medical care to indigent and disabled persons. (Op. at 4). Under its contracts Securance is required to report to each state the amount of money it spends on direct medical care through a metric known as the "medical loss ratio." (Op. at 5). The Company's "medical loss ratio" reflects the percentage of premiums Securance actually spends on medical services for covered Medicaid patients (excluding Securance's administrative costs and profit). *Id.* Securance is required either to (a) spend 80% of the premiums it receives from each state on direct medical services for Medicaid patients in its managed care plans or (b) refund premium revenue to each state for any shortfall below that 80% benchmark. (Op. at 5-6). The ability of Securance or any other HMO in this industry to operate profitably is dependent on a company's ability to operate efficiently to maximize the company's percentage of profit within the legally limited 20% band of premium revenue. (Op. at 5).

In early 2005, three former senior managers of Securance - Gregory J. Devlin, Finance Manager; Susan E. Larner, Vice President-Operations; and Robert S. Hooper, Vice President-Accounting (collectively, the "Senior Managers") - developed a plan to increase Company profits illegally by falsifying medical expense reports to

certain state regulators. *Id.* These Senior Managers, with shared responsibility for reporting data on the Company's medical loss ratios to state regulators, conspired to boost profits artificially by deliberately overstating medical loss ratios to state regulators in Ohio, Pennsylvania, New York and New Jersey which have accounted for approximately 40% of the Company's annual premium revenue. *Id.* Securance improperly retained, and publicly reported as part of the Company's net income for these years, approximately \$120 million in Medicaid premiums that should have been refunded to these four states. (Op. at 7). These unspent Medicaid premiums were transferred to the Company's wholly-owned Cayman Islands subsidiary, Total Reinsurance ("Total Re"), ostensibly to purchase reinsurance, to artificially inflate Securance's publicly reported net income for 2005, 2006 and 2007 by including Total Re's profits into Securance's consolidated financial statements. (Op. at 7). Devlin, Larner and Hooper all eventually pled guilty to conspiracy to falsify that data during the years 2005, 2006 and 2007, voluntarily resigned their positions with the Company, and are all now serving two-year prison sentences. (Op. at 8). In their plea agreements each of the Senior Managers stated that they acted with the express or implied support of the Company's seniors officers, although none of the plea agreements identify these "senior officers" by name or position. (Op. at 10).

The derivative complaint in this case does not allege that these Senior Managers reported to or otherwise had interaction with any members of the Board, including the three members of the Board comprising Securance's most senior officers (*i.e.*, Saligman, Richmond

and Craig). *Id.* Nor does the complaint allege direct participation in the fraud by any of the Officer Defendants. *Id.* Plaintiff alleges only that Officer Defendant supervised the departments in which Devlin, Larner, and Hooper worked. *Id.* The earnings misstatements were uncovered when analysts began to notice disparities in the percentage of premiums the Company spent on medical care as reported in its state regulatory filings versus its SEC filings. (Op. at 9). In March 2008, the Medicaid Fraud Control Units for Ohio, Pennsylvania, New York and New Jersey commenced a joint investigation of Securance. (Op. at 9-10). After the government searched the Company's headquarters, the Securance Board convened a special meeting at which the Board authorized and directed the Board's audit committee to retain independent outside counsel and to work with counsel to investigate and negotiate a possible settlement of all claims, civil and criminal, arising out of the reporting of medical loss ratios and refund-of-premiums issues. (Op. at 11).

As part of its settlement with the states, Securance agreed to establish a new and separate compliance committee of the Board that is expected to be more engaged and proactive going forward. *Id.* Prior to this settlement, compliance matters were handled by the Board's audit committee. *Id.*

ARGUMENT

I. THE COURT OF CHANCERY PROPERLY DISMISSED THE DERIVATIVE ACTION AS A RESULT OF A FAILURE TO MAKE DEMAND

a. Standard of Review

This Court's decision as to whether demand is required depends on the Court's interpretation of Court of Chancery Rule 23.1.

Allegations of demand futility under Rule 23.1 "must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed solely by Chancery Rule 8(a)." *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000). This Court reviews *de novo* a Court of Chancery's decision to dismiss a derivative suit under Rule 23.1. *Beam ex rel. Martha Stewart Living Omnimedia Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004).

b. Merits

The right of a stockholder to prosecute a derivative suit is limited to situations where either the stockholder has demanded the directors pursue a corporate claim and the directors have wrongfully refused to do so, or where demand is excused because the directors are incapable of making an impartial decision regarding whether to institute the litigation. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 367 (Del. 2006). Because demand was not made, the derivative claim may only continue if it can be proven that demand should be excused.

Charles H. Saligman, Patrick C. Richmond, Yvonne M. Craig, Martin R. Rothschild, Elaine A. Lasater, William M. Lewis and Gilbert W. Coulson ("Director Appellees") did not make a business decision in

this case. The Appellant claims that the Director Appellees breached their fiduciary duty of loyalty at the Board level by failing to act in good faith to fulfill their oversight responsibilities. (Op. at 14). This type of alleged failure to act is not seen as a business decision. See *Graham v. Allis-Chalmers Mfg. Co.*, 188 A. 2d 125, 130 (Del. 1963); *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959,967 (Del.Ch. 1996)(holding a failure to act or a failure to know that wrongdoing is occurring to not be a business decision). Where a business decision is absent, a court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to demand. *Rales v. Blansband*, 634 A.2d 927 (Del. 1993).

In *Stone* the court dealt with a situation similar to this case. *Stone*, 911 A.2d at 367. The plaintiffs in *Stone* attempted to satisfy the *Rales* test by asserting that the Director Appellees faced a substantial likelihood of liability that made them personally interested to the point where demand was excused. *Id.* In *Rales*, the Court determined the directors' likelihood of liability should be evaluated in terms of their usage of good faith when overseeing ordinary operations. *Id.* at 368. The Appellants attempt to make a similar allegation, and thus the conduct of the directors should be evaluated with a good faith standard. A failure to act in good faith can result in liability because the requirement to act in good faith is a subsidiary element of the fundamental duty of loyalty. *Id.* at

370.

- i. *The Director Appellees did not breach their duty of loyalty by a conscious failure to monitor and thus the Court of Chancery properly ruled demand to be required*

The Appellants charge the Director Appellees with breach of their duty of care and loyalty to the Company and its stockholders, including the obligation to remain proactively engaged in the Company's affairs and to act in good faith to oversee operations of the Company. (Complaint ¶48). The complaint thus does not charge either that the directors were involved in self-dealing or the more difficult loyalty-type problems arising from cases of suspect director motivation. This theory of charging directors with responsibility for corporate losses where there is no conflict of interest or where facts do not exist to suggest suspect motivation is possibly the most difficult theory in corporation law upon which plaintiff might hope to win a judgment. *Caremark*, 698 A.2d at 967

The Appellants allege that the Director Appellees breached their duty of loyalty by failing to: supervise the Senior Managers, act with a "critical eye" in assessing the company's rapidly improving earnings, and recognize "red flags" associated with the profits-based Incentive Compensation Plan. (Op. at 14). These failures in oversight are not the type that rise to the level of a breach of the duty of loyalty. The *Stone* Court held that:

Caremark articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, *consciously failed* to monitor its operations thus disabling themselves from being informed of risks or problems requiring their attention.

Stone, 911 A.2d at 370 (emphasis added). Appellant's complaint in this case admits to the existence of a regulatory compliance program at Securance as early as 2004 (well before the fraud committed by the Senior Managers on which Appellant's oversight claims are based.) (Op. at 20). Consequently, the lower court rightly ruled that part (a) of the *Stone*'s two-pronged formulation to be inapplicable. *Id.* Therefore, the allegations will be examined exclusively under *Stone*'s "conscious fail[ure] to monitor" formulation.

The Appellants contend that the Director Appellees breached their duty of loyalty in several ways. They first allege that the Director Appellees did not fulfill their oversight responsibilities by disregarding that the Company's Medicaid reports in 2005, 2006 and 2007 were overstated as well as disregarding that Securance had evaded its obligation to make refunds of premiums. (Complaint ¶49). The Director Appellees had no reason to scrutinize the Medicaid reports as nothing had occurred that would cause them to believe the reports were not in order. Absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf. *Caremark*, 698 A.2d at 969.

The Company's Medicaid reports do not seem to be the type of matter that would be brought to board members' attention. The board is only required to authorize the most significant corporate acts or transactions such as mergers and changes in capital structure. *Caremark*, 698 A.2d at 968. The Medicaid reports are a daily part of Securance's business. This is not the type of significant corporate

act described in *Caremark*. Many of the Director Appellees likely did not see these reports on a regular basis and would not have noticed a problem had they been presented with the forms from the fraudulent years. As described above, there had been a regulatory compliance system in place since 2004, which the Director Appellees would have relied upon when viewing these reports. Thus the alleged failure to scrutinize the Medicaid reports does not satisfy the *Stone* test because the Director Appellees had no reason to believe there was a problem.

The Appellants further allege that the Director Appellees failed to act with a "critical eye" in examining the improvement in earnings performance and soaring stock prices. (Complaint ¶51). The Director Appellees did not consciously fail to monitor the activities of its subordinates as required by *Stone*. Although earnings rose dramatically, the complaint contains no allegations that such dramatic improvements were not explained to the board by facially valid business principals. In this instance as with the alleged failure to monitor the Medicaid reports, there was no reason for the Director Appellees to be suspicious and thus they could not be expected to act. *See Graham*, 188 A.2d at 130. (holding that the directors must be on notice of wrongdoing to be held accountable).

The Appellants further allege certain "red flags" that should have caused suspicion and thus action on the part of the Director Appellees. The *Stone* Court believed that without "red flags," directors' actions should not be second-guessed in light of an adverse outcome. *Stone*, 911 A.2d at 373. However, the court does not go on

to define what would rise to the level of a "red flag." In *Caremark*, the Court of Chancery recognized that: "[g]enerally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation...only a sustained or systematic failure of the board to exercise oversight- such as an utter failure to attempt to assure a reasonable information and reporting system exists-will establish the lack of good faith that is a necessary condition to liability." *Caremark*, 698 A.2d at 959. This type of sustained and systematic failure seems to be the type of "red flag" described by *Stone* because both are attempting to evaluate good faith. Therefore, only sustained or systematic failure should be used to define a "red flag."

One situation the Appellant attempts to label a "red flag" is the 2004 consent decrees. However, these consent decrees do not seem to rise to the level of "red flags," as noted in the lower court. (Op. at 25). As noted in the Court of Chancery, both 2004 consent decrees disavowed any admission of wrongdoing, and the fines of \$200,000 when compared to \$49 million in revenue hardly seems immaterial. (Op. at 25). A comparatively small fine that did not seem material to the Court of Chancery does not seem like the kind of sustained or systematic failure as described in *Caremark*.

The Appellants further allege that the "Incentive Compensation Plan" was a "red flag." (Complaint ¶38). The Appellants believe that by simply using an incentive based compensation program, a "red flag" was created. There is nothing inherently wrong with an incentive based compensation program. They can create positive growth and

competition as long as results are achieved ethically. Nothing in the Complaint alleges that there was any reason for the Director Appellees to presume the program was creating a problem. (Complaint ¶138). Without more information, simply placing the "Incentive Compensation Plan" in motion does not seem to be a "red flag" foretelling likely fraud as noted by the Court of Chancery. (Op. at 24).

While the Appellant presents the great harm that has been caused to Securance, there does not seem to be proof that a factual link exists between that harm and the Board's purported conscious failure to exercise adequate oversight. See *Caremark*, 698 A.2d at 967 (stating that a finding by a judge or jury that conduct was substantively wrong does not provide a grounds for director liability as long as the court determines that the process employed was either rational or employed in good faith.) While the harm is great, the factual allegations of oversight do not seem to rise to the level of a conscious oversight as described in *Caremark*. "With the benefit of hindsight, the Appellants' complaint seeks to equate a bad outcome with bad faith." *Stone*, 911 A.2d at 373. It has been shown that the "red flags" described by the Appellants are not the type of failures which establish a lack of good faith. The extent of the damage caused should not change the level of liability.

The fact that the Director Appellees did not realize what the Senior managers was doing does not rise to the level of a conscious failure to monitor. There was nothing to bring the illegal activity to their attention, and they should not be charged with being unable to uncover a clever and underhanded plot. Absent grounds to suspect

deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf. *Caremark*, 698 A.2d at 969.

For all the foregoing reasons, this court should find that the Appellants have failed to allege specific facts with particularity that the Director Appellees have breached their fiduciary duty of loyalty. Consequently, the derivative complaint must be dismissed under Court of Chancery Rule 23.1 for failure to adequately allege demand futility.

ii. The fact that three Directors functioned as officers does not destroy demand, even if they are found to be incapable of evaluating demand.

Charles H. Saligman is also Chairman and Chief Executive Officer of Securance; Patrick C. Richmond is also Chief Financial Officer of Securance; and Yvonne M. Craig is also Executive Vice President of Securance. (Complaint ¶5). These three men will hereinafter be referred to as "Director Officers." Whether these Director Officers failed to act in an appropriate manner when acting in their roles as Officers will be discussed in section II.

Should it be found that the Director Officers were incapable of properly evaluating a derivative suit, demand will not be futile. In order for demand to be futile where certain directors can be shown to not be independent, the interested directors must have at least 50 percent of the votes on the board of directors. *Stewart*, 845 A.2d at 1046. (holding that three of the six members of the board must be

shown as incapable of an independent decision for demand to be futile). Only three of the seven directors are Director Officers. Even if all three of the Director Officers are shown to be incapable of an independent decision, the four other Director Appellees would still hold a majority. Thus the fact that three of the seven Directors were also Officers is immaterial.

II. The COURT OF CHANCERY'S DECISION TO DISMISS THE SUIT SHOULD BE UPHeld BECAUSE DEMAND WAS NOT FUTILE AND NO PARTICULAR FACTS INDICATING DEMAND FUTILITY WERE PLED.

a. Standard of Review

Whether demand is required depends on this Court's interpretation of Court of Chancery Rule 23.1. Generally allegations of demand futility under Rule 23.1 "must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed solely by Chancery Rule 8(a)." *Brehm v. Eisner*, 746 A.2d at 254. This Court reviews a Court of Chancery's decision on a *de novo* basis in considering whether to dismiss a derivative suit under Rule 23.1. *Stewart*, 845 A.2d at 1048.

b. Merits

i. Demand is Required

The derivative complaint in this case does not allege that criminally responsible Senior Managers structurally reported to or had interaction with any Appellee members of the Board, including the three members of the Board comprising Securance's most senior officers (*i.e.*, Saligman, Richmond and Craig). Nor does the complaint allege direct participation in the fraud by any of the Officer Appellees.

Appellant alleges only that the Officer Appellee's supervised the departments in which Devlin, Larner, and Hooper worked.

A stockholder has no right to file suit on the corporation's behalf unless she has demanded that the corporation bring the suit and the demand has been answered by a refusal. *Ainscow v. Sanitary Co. of America*, Del. Ch., 21 Del. Ch. 35, 180 A. 614, 615 (1935); Chancery Rule 23.1. When plaintiffs do not make a demand on the corporate board, the complaint must plead specific facts establishing that demand is excused. *Desimone v. Barrows*, 924 A.2d 908, 927-928 (Del. Ch. 2007), citing *Gutterman v. Huang*, 823 A.2d 492, 499 (Del. Ch. 2003).

ii. Demand futility due to liability must be alleged with Particularity

The *Rales* test requires courts to analyze whether a complaint pleads particularized facts demonstrating that the conduct makes the directors interested, or at least half of the directors, face a sufficiently substantial threat of personal liability as to the conduct alleged in the complaint to compromise their ability to act impartially on a demand. *Gutterman*, 823 A.2d at 501-503 citing *Rales*, 634 A.2d at 927. Mere notice pleading is insufficient to meet the plaintiff's burden to show demand excusal in a derivative case. *Id.*

In *Baxter International, Inc.*, 654 A.2d 1268 (Del. Ch. 1995), a derivative claim was dismissed for failure to plead with particularity the reasons for not demanding action by the directors concerning a failure of oversight, as required by Rule 23.1. *Baxter*, was a major seller of medical supplies who provided products at preferred prices

to the Veterans Administration ("VA"). *Id.* Baxter employees began to systematically overcharge the VA. *Id.* Ultimately, the VA suspended Baxter from receiving any new government contracts and debarred the two defendants who were officers as well as directors from competing for or being awarded government contracts. *Id.* The complaint in *Baxter* was found to be conclusory because it did not include specific facts about the alleged scheme suggesting that the directors must have known of it. *Id.* The court held that it could not conclude from the face of the complaint that it was a rare case where the circumstances were so egregious that there was a substantial likelihood of liability. *Id. citing Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1985). Here there were no indications of the massive fraud that senior managers were conducting. The 2004 consent judgment concerning an alleged plan to pay doctors to not have members given the specialized treatments is very different than a plan to misreport the actual amount spent on providing medical services.

The court in *Bridgeport Holdings, Inc.*), 388 B.R. 548, 575-576 (Bankr. D. Del. 2008), found the complaint in *In re Enivid*, 345 B.R. 426, 440 (Bankr. D. Mass. 2006), actually did allege the conduct of the officers with particular detail, including: numerous exchanges of e-mails and memoranda between the officers and memoranda from the officers to the board of directors, and numerous oral communications among the officers and the directors. *Id.* at 440-41. The *Enivid* complaint and opinion alleged actions and inactions to show that each defendant officer failed to satisfy the duty of care, through concealment of material facts from the board of directors and other

intentional disregard of his responsibilities. *Id.* at 451-52.

Appellants have failed to allege specific precautionary measures that each specific Appellee should have taken, including how their job responsibilities entailed verifying the amount spent on medical services as opposed to what was reported.

A conclusory allegation at the end of a general description of transactions alleging that Defendants were aware of or consciously ignored their duties is not sufficient to support a separate *Caremark* claim or demonstrate conscious disregard of the directors' duties. *Canadian Commer. Workers Indus. Pension Plan v. Alden*, 2006 Del. Ch. LEXIS 42 (Del. Ch.). Thus, Appellant's explanation of the scheme of fraud that the Senior Managers constructed, and alleging generally that Appellees should have known of it, does not provide specific duties or actions that the Appellees failed to fulfill.

In *Boeing Co. v. Shrontz*, 1992 Del. Ch. LEXIS 84 (Del. Ch. 1992), Boeing had been the subject of millions of dollars in fines and governmental investigations. Despite the obvious trend of misconduct, the plaintiffs were required to file an amended complaint addressing how demand was wrongfully refused. *Id.* However, the "red flags" indicating misconduct were enough for the court to deny a motion to dismiss the complaint, because the derivative plaintiffs had alleged instances of wrongful conduct resulting in sanctions against Boeing of which they contended the board members had knowledge. *Id.* Conversely, in this case there is not such a trend of systematic misconduct of which Appellee officers and directors should have been aware. Appellant has not shown that specific misconduct was brought

to the attention of any Appellees and that the Appellees failed to react.

iii. *A majority of the members of the board are named as defendants.*

Aronson explicitly held that the mere fact that a majority of the directors were named in the complaint did not constitute an interest on the part of the defendant directors sufficient to excuse demand being made. *Aronson*, 473 A.2d at 815. The mere threat of personal liability, standing alone, is insufficient to challenge either the independence or disinterestedness of director. *Id.*; *See Seminaris v. Landa*, 662 A.2d 1350 (Del. Ch. 1995). Further, a board will not be deemed interested for purposes of *Aronson* where the potential for directors' personal liability is a mere threat, but only if personal liability amounts to a substantial likelihood. *Rales*, 634 A.2d at 936.

In *Rattner v. Bidzos*, 2003 Del. Ch. LEXIS 103 (Del. Ch. 2003), *Rattner* claimed that demand was excused with respect to the Accounting Oversight Claims because all of the members of the Board were potentially liable for failure to exercise proper supervision over VeriSign's financial recording and reporting systems. In *Rattner* the court felt the Complaint's allegations lacked relevant and particularized facts regarding the Company's internal financial controls, notably the actions and practices of the defendant's audit committee. *Rattner*, 2003 Del. Ch. LEXIS 103 at 50 (2003). Relevant facts generally include "whether the company had an audit committee during that period, how often and how long it met, who advised the committee, and whether the committee discussed and approved any of the

allegedly improper accounting practices." *Gutterman*, 823 A.2d at 498. The complaint in *Rattner* was found to be lacking any facts regarding the Board's involvement in the preparation of the financial statements and the release of financial information to the market and thus the allegations of lack of oversight were not pled with particularity. *Rattner*, 2003 Del. Ch. LEXIS 103 at 50 (2003). Similarly, the Appellant's complaint fails to set out how often the preexisting audit committee met, or disclose inadequate audit procedures. Appellants failed to set out any specific facts regarding the Officer Appellee's involvement in the certification of financial statements and the release of information. Generally a Chief Financial Officer like Defendant Richmond would have to sign off on financial statements, but Appellant must plead this information as a fact if she intends to rely on it to prove her case.

iv. The Officers were not so substantially liable for breach of the duty to oversee that their discretion was tainted

Delaware law does impose a fiduciary duty requiring oversight on officers. *In re World Health Alternatives, Inc.*, 385 B.R. 576, 592-593 (Bankr. D. Del. 2008). In *Graham*, the court felt that "[A]bsent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealing on the company's behalf." 188 A.2d at 130-31. Although often officers are required to sign off on financial statements and possibly even account statements, Delaware law sets out that without any reason to suspect deception, officers can assume that employees are conducting company

business with integrity. *Id.* The alleged misconduct that occurred in 2004 was of such a different character that there was no reason for directors or officers to question the honesty or integrity of the senior managers that perpetrated the fraud most recently.

Appellant alleges that Appellee officers breached their duty of loyalty by failing to exercise the requisite degree of oversight over company affairs. Referred to as a Caremark claim, this cause of action permits directors and officers to be held liable for their inaction or ignorance of liability-creating activities within the corporation. *See Caremark*, 698 A.2d 959. *Caremark* duties are breached when fiduciaries either fail to implement any reporting or information system or controls or, having implemented such controls, consciously fail to oversee their operation, thus disabling themselves from being informed of risks or problems requiring their attention. *Stone*, 911 A.2d at 370. Courts look to see if there were "red flags" that should have put defendants on notice of the offensive conduct or weakness of the corporation's internal controls. *Id.* "[I]mposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations." *Id.* Here there is no indication that Officer Appellees actually knew the audit committee was not informing them of necessary information. If Appellee Officers were not fulfilling their oversight duties, they did not know information was not being reported to them.

In re Brocade Communs. Sys. Derivative Litig., 2009 U.S. Dist. LEXIS 295, 57-59 (N.D. Cal. Jan. 6, 2009), the Compensation Committee

exercised little to no supervision over what they were doing, and the Committee's members themselves signed backdated grant documentation. At one point, the Committee asked for a certificate evidencing the stock option grants, but the committee did not comply and the Board took no further action. Plaintiff adequately pled that Defendants consciously failed to monitor the reporting systems. *Id.* Here Appellants did not allege any instance where it was brought to the attention of the Appellee Officers that the audit committee was not properly checking the financial statements or account information sent to clients or failing to send them information.

v. Alleged "Red Flags"

In 2004, Securance encountered some regulatory issues with state officials in Connecticut and Virginia who alleged that Securance was systematically denying some medical services to the Company's indigent and disabled members to boost profits. (Op. at 12). Securance entered into court approved consent decrees denying any wrongdoing and paying \$200,000 in fines. Appellants argue the events of 2004 should have been a "red flag" to the Appellee officers and directors that a new compliance regime was needed (Op. at 13, 25). Claimed "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." *See In re Citigroup Inc. S'holders Litig.*, 2003 Del. Ch. LEXIS 61, at 2 (Del. Ch. June 5, 2003). The 2004 charges do not amount to "red flags" because they disavowed any admission of wrongdoing and the combined fines of \$200,000.00 were very insignificant in relation to the Company's profit of \$49 million that year. They were of such a

different kind and character of misconduct that the Appellees and audit committee would not have had an obvious break down in information reporting or auditing waived in their faces. The fact that the consent decrees at issue in this case, resolving the overcharging claims, established a new compliance committee that is more actively involved cannot be used to show that the Appellees were consciously choosing to disregard their duties.

vi. Compensation Plan

On its face a compensation plan is not inherently problematic. Depending on how aggressive it was and how much compensation was involved could help explain the program, but it is impossible to know without more information. The Appellant failed to state a claim that the Compensation Plan encouraged misconduct and resulted in a failure oversight by the Appellees because Appellant failed to state facts about how the compensation plan was set up, or that Appellees should have known that it encouraged malfeasance by encouraging profits higher more than any other similarly situated company.

The value of assets bought and sold in the marketplace, including the personal services of executives and directors, is a matter best determined by the good faith judgments of disinterested and independent directors, men and women with business acumen appointed by shareholders precisely for their skill at making such evaluations. *In re infoUSA, Inc. S'holders Litig.*, 953 A.2d 963, 984 (Del. Ch. 2007). The Court of Chancery does not safeguard shareholders by substituting the opinion of a judge for that of a business person merely because a plaintiff shows up at the courthouse asking for relief. *Id.* Rather,

a judge does his duty by ensuring that business decisions, whatever their merit, were undertaken by a director without consideration of his self-interest or for the sake of some third-party. *Id.* There is simply not enough information to find that any Appellee was interested in the increase in pay. The compensation plan was suggested by the compensation committee, not by any one specific interested director or officer.

III. CONCLUSION

For the foregoing reasons, the Appellees respectfully request that this court affirm the dismissal of Appellant's derivative suit for failure to make a demand of the board of directors.

Dated: February 16, 2009