

IN THE  
SUPREME COURT OF THE STATE OF DELAWARE

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No. 27, 2009

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CLARE C. MARSHALL,	)	
	)	
Plaintiff Below-Appellant,	)	Court Below:
	)	Court of Chancery
v.	)	of the State of Delaware
	)	Civil Action 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.	)	
LIBERMAN, TIMOTHY M. STOCKDALE,	)	
AND CARLOS B. HUELVA,	)	
	)	
Defendant Below-Appellee,	)	
	)	
and	)	
	)	
SECURANCE INCORPORATED,	)	
	)	
Nominal Defendant Below-	)	
Appellee.	)	

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Brief for Appellees

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Team W  
Counsel for  
Defendant Below-Appellees  
Securance, Inc.

Dated: February 16, 2009

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### NATURE OF PROCEEDINGS

On July 3, 2008 Plaintiff Below-Appellant and Shareholder Clare C. Marshall ("Shareholder") filed a Derivative Complaint against the Board of Directors and three officers of Securance, Inc. in Civil Action No. 3892-CS.<sup>1</sup> (Op., 2; Complaint, 28). On January 6, 2009 Chancellor Siegel of the Delaware Court of Chancery issued a Memorandum Opinion and Order<sup>2</sup> properly dismissing Shareholder's Complaint under Court of Chancery Rules 23.1 and 12(b)(6). (Op., 28-29). On January 16, 2009 the Shareholder filed a Notice of Appeal<sup>3</sup> against all Defendants Below-Appellees. (Notice, 1-3).

### SUMMARY OF THE ARGUMENT

1. The Court of Chancery correctly dismissed the Complaint under Rules 23.1 and 12(b)(6). Applying *Rales v. Blasband*, the court correctly found the factual allegations of the Complaint were conclusory and insufficiently particularized to create a reasonable doubt that a majority of the Board of Directors were disinterested and independent when four of the Directors were not Securance employees, officers, or dominated by the same. Moreover, based on the Complaint, the Directors fulfilled their *Caremark* duties in good faith to monitor when: (1) the audit committee complied with NYSE and SEC regulations to monitor, (2) the Directors adopted the Compensation Plan upon the compensation committee's recommendation under 8 *Del. C.* § 141(e), and

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<sup>1</sup> Plaintiff below-appellant's Derivative Complaint dated July 3, 2008 (hereinafter "Complaint").

<sup>2</sup> Chancellor Siegel's Memorandum Opinion and Order dated January 6, 2009 dismissing Plaintiff's complaint under Court of Chancery Rules 23.1 and 12(b)(6) (hereinafter "Op.").

<sup>3</sup> Plaintiff below-appellant's Notice of Appeal dated January 16, 2009 (hereinafter "Notice").

(3) the context and frequency of the unrelated 2004 issue occurred once in isolation with only a small fine and no allegation or admission of wrong-doing to put the Directors on notice.

2. This Court should affirm the Court of Chancery's dismissal of the Shareholder's complaint against the Officers because the Shareholder did not meet the pleading requirements established in Court of Chancery's Rules 23.1 and 12(b)(6). Because the Shareholder failed to meet the Ch. Ct. R. 23.1 pleading burden, Delaware case precedent dictates that this Court should grant deference to the Securance Directors to exercise their business judgment to determine whether litigation against the Officers is proper. Case law and commentary by corporate law scholars also strongly supports the Court of Chancery's assumption that the business judgment rule applies to officers in the same manner that the rule applies to directors. Since that assumption was correct, the Court of Chancery rightly theorized that the *Stone* test for oversight liability should also apply to the Officers. Thus, as the Shareholder failed to state a claim against the Officers for conscious failure to monitor, this Court should affirm the dismissal pursuant to Ch. Ct. R. 12(b)(6).

#### **STATEMENT OF FACTS**

Nominal Defendant and Appellee Securance, Inc. ("Securance") is a Delaware corporation headquartered in Frederick, Maryland. (Op., 3). Securance has been publicly traded on the New York Stock Exchange since 2002, with 42 million shares of outstanding common stock. (Op., 3). Securance's Board of Directors and Appellees include three officers and four independent directors (collectively, the

"Directors"). (Op., 3). There are three, non-director, officer Appellees (collectively, the "Officers"). (Op., 3).

Securance provides healthcare services to Medicaid and Medicare recipients by contracting with state and federal governments. (Op., 3-5). In 2003, shortly after Securance's 2002 IPO at \$42/share, the Directors acted on the recommendation of the compensation committee to approve a Senior Officer Performance Compensation Plan (the "Compensation Plan"). (Op., 12). From January 2002 through December 2007, the Board's audit committee handled oversight compliance matters. (Op., 14). In 2004, Securance reported \$1.4 billion in revenue and \$49 million of net income. (Op., 6).

Credit Suisse's May 2006 report described Securance's first quarter 2006 results as "best in the Medicaid space." (Op., 9). In August 2007, CIBC World Markets reported that "Securance's second quarter [2007] earnings handily beat expectations and should dispel any investor concern surrounding Securance." (Op., 9). However, Goldman Sachs' February 4, 2008 report suggested Securance was shifting profits to its subsidiary Total Reinsurance. (Op., 9).

On March 12, 2008, federal agencies searched Securance's headquarters and seized numerous boxes of documents. (Op., 10). Three days later on March 15, 2008, the Directors held a special meeting to authorize the audit committee to retain and work with independent counsel to "investigate and negotiate a possible settlement of all claims" that may arise. (Op., 10-11). The next day on March 16, 2008, three senior managers pled guilty to one count of conspiracy to commit Medicaid fraud. (Op., 10). On June 3, 2008 Securance pled guilty "to

one count of mail fraud . . . and stipulated to \$400 million in criminal penalties" (Op., 11). Under the plea agreement, Securance agreed to: (1) restitution to and (2) disqualification from doing business in Ohio, Pennsylvania, New York and Jersey until June 2011. (Op., 11). Securance also agreed to add "a new and separate compliance committee of the Board" to accompany the pre-existing audit committee. (Op., 11). "None of the other 14 states with whom Securance does business has threatened to disqualify [Securance] within their jurisdictions." (Op., 17).

In early 2004, Securance disputed allegations unrelated to the 2008 events. (Op., 13). In July 2004, Securance entered into consent decrees with Connecticut and Virginia to not offer financial incentives to doctors and pay a nominal fine of \$100,000 to each state. (Op., 13). The consent decrees did not involve any allegations of criminal activity or any wrongdoing. (Op., 13; Complaint, 20).

#### **QUESTIONS PRESENTED**

- I. Should this Court affirm the Chancery Court's order dismissing the Shareholder's Complaint under Chancery Court Rules 23.1 and 12(b)(6) when (1) the Chancery Court found the factual allegations of the Complaint were conclusory and insufficiently particularized to excuse pre-suit demand, (2) the audit committee monitored compliance matters, (3) the Directors approved the compensation plan upon the compensation committee's recommendation, and (4) the unrelated 2004 issue was not a red flag?
- II. Should this Court affirm the Delaware Chancery Court's order dismissing the Shareholder's Complaint against the Securance Officers pursuant to Court of Chancery Rules 23.1 and 12(b)(6), when (1) the Chancery Court determined that the independent and disinterested Securance Board is charged with the power to determine whether to cause the corporation to bring an action against the non-director Officers and (2) the Shareholder's Complaint fails to state a claim for fiduciary oversight liability against the Officers?

## ARGUMENT

I. PURSUANT TO RULE 23.1, THE CHANCERY COURT CORRECTLY FOUND THAT THE SHAREHOLDER'S FACTUAL ALLEGATIONS WERE CONCLUSORY AND INSUFFICIENTLY PARTICULARIZED TO EXCUSE PRE-SUIT DEMAND. MOREOVER, BASED ON THE FACTUAL ALLEGATIONS OF THE COMPLAINT, THE DIRECTORS FULFILLED THEIR FIDUCIARY DUTY OF LOYALTY TO MONITOR IN GOOD FAITH WHEN (1) THE BOARD'S AUDIT COMMITTEE MONITORED COMPLIANCE MATTERS, (2) THE BOARD APPROVED THE COMPENSATION PLAN UPON THE COMPENSATION COMMITTEE'S RECOMMENDATION, AND (3) THE UNRELATED 2004 ISSUE WAS NOT A RED FLAG.

### A. Scope of Review

The Supreme Court of Delaware's review of Court of Chancery decisions applying both Rule 23.1 and Rule 12(b)(6) is de novo and plenary. *Brehm v. Eisner*, 746 A.2d 244, 253-254 (Del. 2000). On a motion to dismiss under Chancery Court Rules 23.1 or 12(b)(6), the court shall consider well-pled allegations in the complaint as true and make reasonable inferences in favor of the nonmoving party. *Beam ex rel. Martha Stewart Living Omnimedia Inc. v. Stewart*, 833 A.2d 961, 970 (Del. Ch. 2003). The complaint shall be dismissed when no state of facts consistent with the factual allegations would entitle the nonmoving party to relief. *Lewis v. Vogelstein*, 699 A.2d 327, 338 (Del. Ch. 1997).

### B. Merits of the Argument

1. *The Shareholder's factual allegations are not sufficiently particularized to create a reasonable doubt that, when the complaint was filed, the Directors could have properly exercised their independent and disinterested business judgment in responding to a pre-suit demand because (1) the Shareholder made conclusory allegations of fraud without support from any evidence and (2) a majority of the board is disinterested and independent.*

Under Ch. Ct. R. 23.1(a), a derivative complaint shall, *inter alia*, "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the

directors or comparable authority . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Demand futility is not for the Shareholder to decide nor is the Shareholder's failure to make a demand upon the Directors automatically excused by conclusory allegations stated in the complaint. *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993). Rather, to determine if demand is excused the court applies the substantive law of the state of incorporation. *Kamen v. Kemper Fin. Serv., Inc.*, 500 U.S. 90 (1991). In Delaware, the courts have the discretionary right to excuse pre-suit demand. *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984). The court may excuse pre-suit demand only when the complaint alleges particularized facts creating a reasonable doubt that "(1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Id.* Although conjunctively phrased, "either showing" is sufficient to establish demand futility. *Levine v. Smith*, 591 A.2d 194, 205 (Del. 1991).<sup>4</sup> When directors are deprived from making a decision, the *Rales* test applies in lieu of the *Aronson* test. *Rales*, 634 A.2d at 934.

In *Rales*, plaintiff brought "a first cousin to a double derivative suit" against two of the eight directors and the corporation after a merger alleging a breach of the duty of loyalty. 634 A.2d at 930. The two director defendants were also the chairmen of the board and of the executive committee (the "Rales Brothers"). *Id.*

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<sup>4</sup> See also STEPHEN M. BAINBRIDGE, CORPORATE LAW 206 (2d ed. 2009) (plaintiff need not create a reasonable doubt as to both prongs).

at 930. This Court excused pre-suit demand "because the amended complaint allege[d] particularized facts creating a reasonable doubt that a *majority* of the Board would be disinterested or independent in making a decision on a demand." *Id.* at 930 (emphasis added). Three of the eight directors were "financial[ly] interested" in the outcome because they were board members of both merging companies. *Id.* at 936. One other director was not independent because he was president and CEO while the Rales Brothers were board chairman and executive committee chairman. *Id.* at 937. Yet another director, Ehrlich, was not independent because the Rales Brothers were directors of Ehrlich's company at which Ehrlich was president and his two brothers were vice presidents. *Id.* This Court reasoned that because the complaint did not challenge a board decision, since the board did not make a decision, neither the business judgment rule nor the *Aronson* test applied. *Id.* at 930-933. Thus, when *Aronson* is inapplicable the court must determine whether "the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint was filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." *Id.* at 934.

In *Wood v. Baum*, this Court affirmed the Chancery Court's dismissal of a derivative complaint when plaintiff failed to plead with particularity that directors "acted with scienter." 953 A.2d 136, 141 (2008). To create reasonable doubt, a plaintiff must plead particularized facts demonstrating the directors "acted with scienter, *i.e.*, that they had 'actual or constructive knowledge' that their

conduct was legally improper." *Id.* at 141. This Court found the complaint did not plead specific facts to support a fraud claim when the complaint merely alleged "affirmative misrepresentation" and that the directors "actively condoned and facilitated a campaign of deceit" reasoning that transaction approval is insufficient particularity because "board approval of a transaction, even one that later proves to be improper, without more, is an insufficient basis to infer culpable knowledge or bad faith on the part of individual directors." *Id.* at 141-42. This Court also suggested the complaint may have included particularized facts if the plaintiff had made a book and records request prior to filing the complaint. *Id.* at 143-44.

Applying the *Rales* test here, the Chancery Court correctly concluded that the Shareholder did "not allege[] particularized facts - as opposed to merely conclusory allegations - to show that the [Directors] face a substantial likelihood of liability." (Op., 2). The Directors do not face a substantial likelihood of liability under the *Rales* test because the majority is both disinterested and independent. In *Rales*, a majority of the board was either interested and/or dependent because of a director's concurrent position as CEO or the *Rales* Brothers' influence on a director's family members' jobs. *Rales*, 634 A.2d at 937. But here, unlike *Rales*, while three Directors are also senior officers perhaps interested in their corporate income, four of the seven Directors were not officers and not dependent on the corporation for a salary. Since four Directors, who comprise a majority of the board, are independent and disinterested the Shareholder must make a pre-suit demand to provide the Directors with

the opportunity to exercise their business judgment in the best interests of the corporation. However, the Shareholder "made no demand upon the [Directors]." (Complaint, 21). So, the Directors were stripped of their legal authority to exercise their business judgment.

Here the Shareholder blindly asserts that "any such demand would be a futile act." (Complaint, 21). However, had the Shareholder made a pre-suit demand, the Directors would have exercised their best business judgment under *Aronson* to make an informed decision "in good faith, and in the honest belief that the [decision made] was in the best interests of the company." *Aronson*, 473 A.2d at 812. The Directors would have decided with only the "best interests of the company" in mind because their decision would have been protected by the presumption of the business judgment rule. *Id.* The business judgment rule enables a board of directors to govern and take chances in the corporation's best interests.<sup>5</sup> Moreover, any effective rebuttal of that presumption would not lead to the Directors' substantial likelihood of personal liability due to Securance's exculpation clause within the articles of incorporation. "Securance's certificate of incorporation contains an expansive exculpatory provision pursuant to § 102(b)(7) of [the] Delaware General Corporation Law ("DGCL")." (Op., 20 n.18). A § 102(b)(7) clause encourages directors in good faith to "undertake risky, but potentially value-maximizing, business strategies." *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 752 (Del. Ch. 2005) quoting *Prod. Res. Group, L.L.C. v. NCT Group*,

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<sup>5</sup> See Bainbridge, *supra* note 4, at 105 (the business judgment rule encourages directors to take risks without the scrutiny of hindsight).

*Inc.*, 863 A.2d 772, 777 (Del. Ch. 2004). Rather than the Directors using their business judgment to decide whether save the time and expense of this suit, the Shareholder sued and failed to use the "tools at hand" to carry the pleading burden. *Brehm*, 746 A.2d at 266.

"If the facts to support reasonable doubt could have been ascertained through more careful pre-litigation investigation, the failure to discover and plead those facts still results in a waste of resources of the litigants and the Court and, in addition, ties the hands of [the] Court to protect the interest of the shareholders . . . and further erodes public confidence in the legal protections afforded to investors." *Beam*, 833 A.2d at 982 (dismissing derivative complaint for failure to allege facts sufficient to excuse pre-suit demand when a book and records inspection may have helped).

Like *Wood*, the Shareholder here did not seek a book and records inspection under 8 *Del. C.* § 220(b) from which further facts may have been gathered. Here, the Shareholder had access to "an entire moving truck" of "disks and numerous boxes of documents," (*Op.*, 10) which is more information than the plaintiff in *Wood* possessed. But, the Shareholder did not use the information to help carry the pleading burden. Instead, the Shareholder merely alleged that the "items and documents establish that the fraud . . . could not have been the work of low-level employees." (*Complaint*, 15).<sup>6</sup> Here, when the Shareholder failed to use the "tools at hand," judicial efficiency suffered.

Under Ch. Ct. R. 23.1(a), since the Shareholder failed to make a pre-suit demand and similarly failed to allege with particularity the specific reasons for that failure, the Court of Chancery correctly dismissed the Complaint.

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<sup>6</sup> See e.g., *Seminaris v. Landa*, 662 A.2d 1350, 1355 (Del. Ch. 1995) (Applying *Rales*, the complaint was dismissed when the shareholder merely alleged the directors "looked the other way.").

2. *Based on the factual allegations of the Complaint, the Directors fulfilled their duty of loyalty to monitor in good faith on behalf of the shareholders when the board's audit committee monitored compliance matters, the board approved the compensation plan upon the recommendation of the compensation committee, and the unrelated 2004 issue was not a red flag.*

The Directors' fiduciary duties require them to monitor and oversee the corporation in good faith.<sup>7</sup> "[O]nly 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." *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996). "[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 dealings on the company's behalf." *Id.* at 969, interpreting *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) (emphasis added).

"*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 or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2008).

"[L]iability requires that the directors knew they were not discharging their fiduciary obligations." *Id.*

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<sup>7</sup> See Bainbridge, *supra* note 4, at 163 ("Directors are not expected to know, in minute detail, everything that happens on a day-to-day basis. Instead, a director is expected to have a rudimentary understanding of the firm's business and how it works . . . . engage in a general monitoring of corporate affairs.").

In *Caremark*, while approving settlement of a derivative suit, the court addressed whether the board of directors effectively monitored the corporate operations. 698 A.2d 959 (Del. Ch. 1996). The board issued and regularly updated guidelines forbidding illegal payments for services, defining appropriate contractual relationships with doctors, and prescribing a training program for employees to ensure compliance. *Id.* at 962. Outside auditors reported that the company had no "material weaknesses" and the audit committee reviewed the company's compliance policies. *Id.* at 963. The court reasoned that the board fulfilled its duty to oversee by "attempt[ing] in good faith to assure . . . a corporate information and reporting system." *Id.* at 970. 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 to liability." *Id.* at 971. Chancellor Allen emphasized that established reporting systems are necessary for directors to be informed about "material acts, events or conditions within the corporation, including compliance with applicable statutes and regulations." *Id.* at 969.

In *Stone*, the court affirmed dismissal of a derivative action against 15 present and former directors alleging failure to oversee, "a classic *Caremark* claim," when AmSouth Bank shareholders failed to satisfy pre-suit demand. 911 A.2d 362, 364 (Del. 2006). In 2004, AmSouth bank paid \$50 million in fines and penalties when bank employees failed to file suspicious activity reports arising from two bank account holders' Ponzi scheme, but the directors incurred no fines, penalties or regulatory action. *Id.* at 365. Of the eight

current directors, one director was an officer and seven were outside directors. *Id.* at 367 n.12. The court held that *Caremark* "articulates the necessary conditions predicate for director oversight liability," as outlined above, reasoning that "[s]uch a test of liability . . . is probably beneficial to corporate shareholders . . . since it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors." *Id.* at 372. The court found that AmSouth had a reasonable system for reporting suspicions including a compliance officer and department, annual employee training on how to report suspicions, and an audit committee. *Stone*, 911 A.2d at 371. The court reasoned, in part, on an outside auditor's results that found the board "received and approved relevant policies and procedures, delegated to certain employees and departments the responsibility for . . . monitoring compliance, and exercised oversight by relying on periodic reports from them." *Id.* at 373. Drawing from *Caremark*, the *Stone* court further held that only a "failure to act in the face of known duty to act" is a breach of the duty of loyalty. *Id.* at 371 (emphasis added). "In the absence of red flags, good faith in the context of oversight must not be measured by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome." *Id.* at 373.<sup>8</sup>

Here, the Directors fulfilled their duty of loyalty in overseeing the corporation by (1) utilizing the controls of the audit committee

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<sup>8</sup> See also Hillary A. Sale, *Good Faith's Procedure and Substance: In re Caremark Int'l Inc., Derivative Litig.*, in *THE ICONIC CASES IN CORPORATE LAW* 278-296, 285 (Jonathan R. Macey ed., 2008) ("[N]o system, regardless of its design, can prevent all bad acts or ensure that those acts will be caught.").

in compliance with Listing Standards and SEC Rule 10A-3; (2) relying in good faith under 8 Del. C. § 141(e) on the compensation committee's recommendation to adopt the Compensation Plan; and (3) because the unrelated 2004 issue was not a red flag sufficient to put the Directors on notice.

- a. The Directors fulfilled their duty of loyalty in good faith by utilizing the audit committee to monitor in compliance with NYSE Listing standards and the Sarbanes-Oxley Act of 2002.

Since Securance is publicly traded on the NYSE and Securance's audit committee monitored compliance matters, it can be inferred that Securance complied with NYSE and SEC regulations. Under the NYSE, Inc. Listed Company Manual § 303A.06 (2004), a listed company must have an audit committee that satisfies SEC Rule 10A-3. All audit committee members must be independent. *Id.* at § 303A.07(b). An independent member or director is one who has "no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)." *Id.* at § 303A.02(a). The duties of the audit committee include, *inter alia*, "assist[ing] board oversight of (1) the integrity of the company's financial statements, (2) the company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the company's internal audit function and independent auditors." *Id.* at § 303A.07(c). Rule 10A-3(b)(3)(ii) of the Exchange Act requires that "[e]ach audit committee must establish procedures for . . . [t]he confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters."

SEC Listing Standards Relating to Audit Committees, 17 C.F.R. § 240.10A-3(b)(3)(ii) (2008).

From January 2002 through December 2007, "oversight for compliance matters was handled . . . through the Board's audit committee." (Op., 14). Since no federal agency alleged, and the Shareholder failed to plead otherwise, it then can be inferred that the audit committee properly monitored and established a reporting mechanism under the NYSE Listed Co. Manual and SEC Rules. As in *Stone*, where AmSouth had a reasonable system for reporting suspicions, here the Shareholder has not pled facts sufficient to allege that Securance's audit committee and related reporting mechanisms in compliance with the NYSE Listed Co. Manual and SEC Rules were not established and maintained in good faith by the Directors in their good faith fulfillment of their duty of loyalty.

- b. The Directors fulfilled their duty of loyalty by relying in good faith under 8 Del. C. § 141(e) on the compensation committee's recommendation in adopting the Compensation Plan.

Under 8 Del. C. § 141(e), the Directors shall "be fully protected in relying in good faith upon . . . such information, opinions, reports or statements presented to the corporation by any of the corporation's . . . officers or employees, or committees of the board of directors." Listed companies "must have a compensation committee composed entirely of independent directors." NYSE, Inc. Listed Company Manual § 303A.05(a) (2004). One of the many duties of the compensation committee is to "make recommendations to the board with respect to . . . incentive-compensation plans." *Id.* at § 303A.05(b). In compliance with regulatory standards, the Directors, "acting on the

recommendation of its compensation committee, approved" the Compensation Plan. (Op., 12). Having made a decision to approve the compensation plan, the business judgment rule applies. The Shareholder has made little effort to rebut the presumption, but instead merely alleged that enactment of the Compensation Plan made the Directors "aware [of] a system . . . to inflate the [profit] results." (Complaint, 13). Here, because the Directors relied in good faith by acting upon the recommendation of the compensation committee under 8 Del. C. §141(e) the Directors fulfilled their duty of loyalty.

c. The unrelated 2004 issue was not a red flag sufficient in context to put the Directors on notice.

Red flags are "obvious danger signs of employee wrongdoing." *Graham*, 188 A.2d at 130.<sup>9</sup> "To determine whether a red flag is present, the court asks whether the fiduciaries either actually knew or should have known about the alleged problem."<sup>10</sup> Context<sup>11</sup> and frequency<sup>12</sup> are also factors when determining whether something is a red flag.<sup>13</sup> However, red flags "are only useful when they are either waved in

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<sup>9</sup> See also H. Lowell Brown, *The Corporate Director's Compliance Oversight Responsibility in the Post Caremark Era*, 26 Del. J. Corp. L. 1, 15 (2001) (discussing directors duty of care where red flags are "specific indicia suggesting misconduct").

<sup>10</sup> Sale, *supra* note 7, at 292.

<sup>11</sup> *McCall v. Scott*, 239 F.3d 808, 822 (6th Cir. 2001) (event was a red flag only because it occurred in the context of ongoing litigation).

<sup>12</sup> E.g. *In re Abbott Laboratories Derivative S'holders Litig.*, 325 F.3d 795, 803 (7th Cir. 2003) (finding a pattern of regulatory noncompliance marked by several newspaper articles questioning corporate practices, an ongoing governmental investigation, and an outside auditor's report were sufficient red flags).

<sup>13</sup> See *Boeing By Levit v. Shrontz*, 1992 WL 81228, at \*1 (Del. Ch.) (where indicia were red flags because of the large fines and duration including 15 years of allegations, over \$50 million in fines, restitution and settlements; and allegations of an intentional low contract bid resulting in \$385 million loss to the corporation).

one's face or displayed so that they are visible to the careful observer." *In re Citigroup Inc. S'holders Litigation*, 2003 WL 21384599, at \*2 (Del. Ch.).

The 2004 issue was not a red flag because there were no other contextual inconsistencies, such as ongoing litigation, as in *McCall*. Moreover, the 2004 issue was not a red flag because the consent decrees were without "adjudication or admission of any issue of fact or law," and the "nominal fine" of \$200,000 to two states other than the states at issue here. (Op., 13). This is unlike *Boeing* where the fines were large much larger in comparison to annual revenue accompanied by a long duration of red flags.

Unlike *Abbott Labs* where the governmental investigation sparked no reaction from the board, here the Directors convened a special meeting to authorize an independent investigation only three days after the federal search of Securance's headquarters. So, the Directors acted in the face of a known duty to act thus fulfilling their good faith duty of loyalty.

Thus, the Directors fulfilled their duty of loyalty to monitor in good faith on behalf of the shareholders when the board's audit committee monitored compliance matters, the board approved the compensation plan upon the recommendation of the compensation committee, and the unrelated 2004 issue were not red flags.

II. THIS COURT SHOULD AFFIRM THE DELAWARE CHANCERY'S COURTS MOTION TO DISMISS THE SECURANCE SHAREHOLDER'S COMPLAINT AGAINST THE OFFICERS PURSUANT TO COURT OF CHANCERY RULES 23.1 AND 12(B)(6), BECAUSE (1) THE CHANCERY COURT CORRECTLY DETERMINED THAT THE INDEPENDENT AND DISINTERESTED SECURANCE BOARD IS CHARGED WITH THE POWER TO DECIDE WHETHER TO CAUSE SECURANCE TO BRING AN ACTION AGAINST THE OFFICERS, AND (2) THE SHAREHOLDERS' COMPLAINT FAILS TO STATE OF CLAIM FOR FIDUCIARY OVERSIGHT LIABILITY AGAINST THE OFFICERS.

A. Scope of Review

This Court's review of the Court of Chancery's motion to dismiss pursuant to Court of Chancery Rule 23.1 and 12(b)(6) is identical to that stated, *supra*, in Section I(A).

B. Merits of the Argument

1. *This Court should affirm the Chancery's Court's motion to dismiss the complaint against the Officers because the Shareholder failed to satisfy the demand-futility pleading standards of Ch. Ct. R 23.1, and thus the Securance Board shall exercise its own business judgment to determine if Securance should bring a legal action against the Officers.*

The Court of Chancery correctly dismissed the Shareholder's oversight claims against the non-director Officers pursuant to Ch. Ct. R. 23.1, since the Shareholder failed to plead specific facts indicating that the Directors are incapable of acting independently or disinterestedly on a demand to bring an oversight claim either against the Board itself or the Officers. (Op., 26). Delaware entrusts the management of the business and corporate affairs to its directors. 8 Del. C. §141(a). Absent a showing that demand is futile, there are very rare situations mandating that a court to take a direct and active role in overseeing the decisions and actions of corporate directors. *Paramount Communications v. QVC Network*, 637 A.2d 34, 41 (Del. 1994). Delaware courts, moreover, have granted greatest deference to the managerial decisions of the board of directors. See

Stephen M. Bainbridge, Star Lopez, and Benjamin Oklan, *The Covergence of Good Faith and Oversight*, 55 UCLA L. Rev. 559, 571 (2008) (When there is no evidence of self-dealing by the directors, "Delaware courts historically were willing to acknowledge their limitations vis-a-vis boards of directors, and to defer to the latter as the appropriate final decision maker.").

As shown, *supra* in Section I(B)(1), the Shareholder failed to plead facts rebutting the presumption that the Directors are disinterested, independent and not tainted by self-dealing. Moreover, as discussed *supra* in Section I(B)(1), the Shareholder has failed to plead demand futility. Pursuant to the notion firmly established in Delaware courts, and specifically indicated in *Paramount Communications*, this Court will not interfere with the Board's decision-making unless demand is futile, as this Court grants greatest deference to directors to determine if litigation against officers is proper. The Directors should thus be allowed to exercise their business judgment in determining whether the Officers breached their duty of oversight. Accordingly, since the Securance Board of Directors are responsible for managing the Officers, the Directors, not the judiciary, shall determine whether reasonable doubt exists that the Officers breached any fiduciary duties.

2. *This Court should affirm the motion to dismiss the complaint against the Officers because the Stone pleading standard should apply to claims of oversight liability against the Officers, and the Shareholder failed to meet this stringent pleading standard.*

a. The Chancery Court correctly determined that the business judgment rule should apply with equal force to protect the decisions made by non-director corporate officers.

The business judgment rule creates a presumption that in making business decisions, the board acted with due care and in good faith that the business action taken was in the best interest of the corporation. *Aronson*, 473 A.2d at 812. When shareholders allege a breach of the duty of care against the directors, the shareholders must plead with particularity that the directors were grossly negligent in their decision process. *Brehm*, 746 A.2d at 264.

While there is not complete accord regarding the business judgment rule's application to corporate officers<sup>14</sup>, in an article that supports applying this rule to corporate officers, Professor Lawrence Hamermesh and A. Gilchrist Sparks III note that there is a substantial legal justification for the notion that this rule should protect officers' business decisions. Lawrence A. Hamermesh & Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865 (2005). [hereinafter "Hamermesh, *Corporate Officers*"]. As these scholars indicate, both The American Law Institute and the American Bar Association have affirmed that the business judgment rule should apply to officers' decisions.<sup>15</sup>

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<sup>14</sup> See generally, Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 435, 440 (2005), in which Professor Johnson argues that the business judgment rule "should not be extended to corporate officers in the same broad manner in which it is applied to directors."

<sup>15</sup> The American Law Institute affirmed that "sound public policy points in the direction of holding officers to the same duty of care and business judgment standards as directors, as does the little case authority that exists on the applicability of the business judgment standard to officers, and the views of most commentators on this position." 1 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994) §4.01 cmt. a. (quoted in Hamermesh, *Corporate Officers* at 868). Likewise, the American Bar Association Committee on Corporate Laws expounds that "the business

While the issue of whether officers should receive the same protections as directors in their role as fiduciaries is a matter of first impression in this Court, it is a notion that is also strongly supported in Delaware case law<sup>16</sup> and in previous references by this Court. In *Cede & Co. v. Technicolor*, for instance, this Court noted that the business judgment rule "attaches to protect corporate officers and directors and the decisions they make." 634 A.2d 345, 361 (Del. 1993). Likewise, in *Stanziale v. Nachtomi*, the Bankruptcy Court for the District of Delaware granted a motion to dismiss a suit brought by a trustee against directors and officers of a debtor corporation that specialized in aircraft operations. 330 B.R. 56, 65 (D. Del. 2004); *aff'd* 416 F.3d 229, 234 (3d Cir. 2005). Among the claims that the court dismissed was the trustee's allegation that the officers breached their fiduciary duties by failing to maintain the proper oversight and control of ticket processing and operation. *Id.* at 65. The court held the business judgment rule's protections applied to corporate officers noting that "a corporate officer or director is not legally responsible . . . for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith." *Id.* at 61 (quoting *Gagliardi v. TriFoods Int'l, Inc.*,

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judgment rule will normally apply to decisions within an officer's discretionary authority." ABA Comm. on Corporate Laws, *Changes in the Model Business Corporation Act Pertaining to the Standards of Conduct for Officers: Inspection Rights and Notices—Final Adoption*, 54 Bus. Law 1229, 1231 (1999) (quoted in Hamermesh, *Corporate Officers* at 868).

<sup>16</sup> Professor Hamermesh and Mr. Sparks note that at the time of their writing *no court* had opined that the business judgment rule does not apply to officers, while multiple opinions in Delaware and outside that state have held that it does. Hamermesh, *Corporate Officers* at 869.

683 A.2d 1049, 1051 (Del. Ch. 1996)). Moreover, the court held, an officer is not personally liable to the corporation for losses that are the result of an officer's good faith decision making. *Id.* at 63.

Here, Chancellor Siegel correctly acknowledged that scholars have not adopted a unified position regarding whether the business judgment rule should protect corporate officers' business decisions. However, as the foregoing shows, the Chancellor's assumptions that "the business judgment rule applies with equal force to protect decisions of non-director corporate officers" (Op., 27) and that "non-director officers deserve the same degree of protection in exercising their managerial oversight responsibilities" as directors (Op., 28) has strong precedent in Delaware case law and scholarly legal commentary.

- b. Since the business judgment rule can apply to officers, the Chancery Court correctly assumed that the Stone test for oversight liability also should apply to the Officers.

The rationale supporting application of the business judgment rule to officers was recently applied to allegations of the failure to oversee. In *Miller v. McDonald, et al.*, for instance, the Bankruptcy Court in the District of Delaware opined that the fiduciary duties of officers and directors are identical. 385 B.R. 576, 592 (2008). As such, both are subject to similar protections as well as similar liability for breach of the duty of care and loyalty. *Id.* (quoting *Stanziale*, 416 F.3d at 234, "With respect to the obligation of officers to their own corporation and its stockholders, there is nothing in any Delaware case which suggest that the fiduciary duty owed is different in the slightest from that owed by directors.").

In *Miller*, the court denied an officer's motion to dismiss, pursuant to Fed. R. Civ. P. 12(b)(6), in a suit brought by a trustee against officers and directors when the corporation filed for Chapter 11 bankruptcy. Among the allegations pled in the complaint were that the defendant officers and directors breached their duty of care when they failed to implement an adequate monitoring system or failed to use a monitoring system to safeguard against corporate wrongdoing. *Miller*, 385 B.R. at 584-589. The court opined that the *Caremark* decision in itself, while addressing directors' oversight liability, suggests that the same test would apply to officers. *Miller*, 385 B.R. at 592. The court relied on *Caremark* to support the proposition that "absent grounds of 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." *Id.* at 592, quoting *Caremark* 698 A.2d at 969 (emphasis in the original). Moreover, the Court noted that "the fiduciary duties of officers have been assumed to be identical to those of directors." *Id.* at 592, quoting *In re the Walt Disney Co. Derivative Litig.*, 2004 WL 2050138, at \*3 (Del. Ch.). Since officers and directors have similarly situated fiduciary duties, Delaware law does impose a duty to oversee upon officers, subject to the *Caremark* standards. (*Miller*, 385 B.R. at 591).

In 2008, the Del. Ch. Ct. likewise imposed the same fiduciary duties on officers as directors. *Midland Grange No. 27 Patrons of Husbandry v. Walls*, 2008 WL 616239, at \*7 (Del. Ch.). In *Midland Grange*, shareholders alleged that corporate officers breached their

duty of care in connection with a sale of corporate property and breached their duty of loyalty because the officers purportedly acted in bad faith by ignoring corporate voting by-laws. *Id.* at 6. The court indicated that an officer's fiduciary duties to the corporation are the same as those of a director. *Id.* at 7. The court held since the officers apprised themselves of all material facts and made an informed decision regarding a secret ballot voting system, they acted in good faith and thus fulfilled their duty of loyalty. *Id.* at 11.

Here, the Shareholder has failed to plead with particularity the failure to monitor claim against the Officers. *Miller* presumably denied the defendant officer's motion to dismiss because it found that the trustee met the *Caremark* pleading standards at the time that the complaint was filed. However, unlike in *Miller* where the shareholder's plead particularized facts surviving the Rule 12(b)(6) motion, here the derivative suit against the Securance Officers was rightly dismissed. As both *Miller* and *Midland Grange* indicate, corporate officers have the same fiduciary duty of loyalty as corporate directors. Because officers are accountable for identical fiduciary duties, they should consequently be offered the same legal protections that directors have against derivative suits. Thus, to survive a motion to dismiss in a claim again the Securance Officers, the Shareholder must meet the requirements enunciated in *Caremark* and affirmed in *Stone*.

Here, the Complaint does not meet the *Caremark* and *Stone* tests and cannot survive the motion to dismiss since the complaint is void of particularized facts that sufficiently indicate that the Securance Officers were aware of criminal conduct afoot. Moreover, the

Shareholder fails *Stone's* second prong since the complaint lacked specific facts to indicate the Officers did not act in good faith to prevent a known violation or to remedy a known harm.

- c. This Court should affirm the motion to dismiss pursuant to Rule 12(b)(6) because the Chancery Court properly determined that the Shareholder failed to state a claim against the Officers for conscious failure to monitor Securance's operations.

As indicated *supra* in Section I(B)(2), *Stone* adopted the *Caremark* test for determining whether a director fails to monitor. *Stone*, 911 A.2d at 370. In a derivative action when shareholders allege bad faith, they must plead with particularity the specific conduct that allegedly amounted to gross negligence. *Id.* If shareholders are unable to meet this test, the complaint must be dismissed. *Beam*, 833 A.2d at 976. As argued *supra* in Section II(B)(1), the pleading standards for directors' liability should be applied to derivative suits claiming officers' failure to monitor. The Shareholder has failed to satisfy this pleading requirement in the complaint against the Officers.

The Shareholder alleged the same conclusory charges against both the Securance Directors and the Officers. Thus, the Shareholder failed to satisfy the pleading burden against the Officers for the same reasons the Shareholder failed to meet the pleading standard against the Directors. Therefore, this Court should affirm the Court of Chancery's motion to dismiss for failure to state a claim.

#### CONCLUSION

For the foregoing reasons, this Court should affirm the Court of Chancery's proper dismissal of the Complaint against Securance, the Directors and the non-director Officers.