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Corporate Governance Group Client Alert

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DELAWARE COURT OF CHANCERY DISMISSES DERIVATIVE ACTION BROUGHT AGAINST GOLDMAN SACHS DIRECTORS

Rejects claims relating to board's countenance of Goldman's "pay for performance" compensation philosophy and alleged failure to oversee "risky use of Goldman's assets"

Two of the "hot button" corporate governance issues arising from the 2008 financial crisis are the impact of executive compensation policies on corporate risk-taking and the role of the board of directors in overseeing business risk. Each of these issues was front and center in a recent stockholder derivative action brought against current and former directors of Goldman Sachs.

In *In Re The Goldman Sachs Group, Inc. Shareholder Litigation,*[1] the Delaware Court of Chancery granted the defendant directors' motion to dismiss, reaffirming that "[t]hrough the business judgment rule, Delaware law encourages corporate fiduciaries to attempt to increase stockholder wealth by engaging in those risks that, in their business judgment, are in the best interest of the corporation 'without the debilitating fear that they will be held personally liable if the company experiences losses.'" It is, of course, important to note that the Court did not rule that there are no circumstances under which directors could be found liable for the conduct complained of. Rather, in this ruling on defendants' motion to dismiss, the Court focused on plaintiffs' failure to satisfy the seemingly rigorous pleading standards in cases of this nature.

Background

Plaintiffs, purported Goldman stockholders, alleged that Goldman's board of directors breached its fiduciary duties by permitting a compensation structure based on a "'pay for performance' philosophy linking total compensation of its employees to the company's performance." Since at least 2006, the Goldman

[1] C.A. No. 5215-VCG (Del. Ch. Oct. 12, 2011).

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board had employed a Compensation Committee of independent directors to develop and implement this compensation policy. The Compensation Committee, in turn, consulted with senior management to establish a compensation ratio of expenses to projected net revenues based in part on a comparison of the ratios used by Goldman competitors. Plaintiffs charged that this approach "led management to pursue a highly risky business strategy that emphasized short term profits in order to increase their yearly bonuses" in a manner that "caused management's interests to diverge from those of the stockholders."

Plaintiffs also claimed that the directors "violated their fiduciary duties by failing to monitor adequately Goldman's operations and by 'allowing the Firm to manage and conduct the Firm's trading in a grossly unethical manner ....'" In this connection, plaintiffs claimed that management, in an effort to maximize revenue – and, consequently, their compensation – "achieved Goldman's growth 'through extreme leverage and significant uncontrolled exposure to risky loans and credit risks.'" Plaintiffs argued "this was a risky use of Goldman's assets, pointing out that Goldman's Value at Risk (VAR) increased between 2007 and 2009, and that in 2007 Goldman had a leverage ratio of 25 to 1, exceeding that of its peers." In plaintiffs' view, "this business strategy was not in the best interest of the stockholders, in part, because the stockholders did not benefit to the same degree that management did." Specifically, if an "investment went south, it was the stockholders' equity at risk, not that of the traders."

To bolster this allegation, plaintiffs also complained that Goldman managed risk "by hedging its positions – sometimes taking positions opposite to its clients." These hedging positions allegedly created conflicts of interest "to the detriment of the company's reputation." In this regard, plaintiffs cited the infamous "Abacus" transaction involving hedge fund manager John Paulson, a Goldman client who shorted a collateralized debt obligation while Goldman sold the long positions to some of its other clients, apparently without disclosing Paulson's position.

Because plaintiffs had failed to "make a demand upon the corporation's current board to pursue derivative claims owned by the corporation" before bringing the action themselves, defendants moved to dismiss on the ground that plaintiffs failed to allege "with particularity" facts demonstrating "that making demand would be futile." According to the Court, "demand is futile if a corporation's board is 'deemed incapable of making an impartial decision regarding the pursuit of the litigation.'" Plaintiffs countered that they were in fact excused from making a pre-suit demand under applicable Delaware legal standards. The Court, siding with the defendant directors, dismissed plaintiffs' claims "with prejudice" for failure to make a pre-suit demand on the board.

The Court's Analysis

The Court began by pointing out that "[t]he Delaware General Corporation Law … provides corporate directors and officers with broad discretion to act as they find appropriate in the conduct of corporate affairs." This "otherwise unconstrained realm of action" is subject to the "boundary" established by Delaware case law "requiring corporate officers and directors to act as faithful fiduciaries to the corporation and its stockholders." However, "[s]o long as such individuals act within the boundaries of their fiduciary duties, judges are ill-suited by training (and should be disinclined by temperament) to second-guess the business decisions of those chosen by stockholders" to "pursue corporate opportunities in any way that, in the exercise of their business judgment on behalf of the corporation, they see fit."

Against this backdrop, the Court turned to plaintiffs' specific claims and defendants' motion to dismiss. The Court bifurcated plaintiffs' assertions into those involving active decisions by the board, on the one hand, versus those involving board inaction, on the other, applying a different legal standard to each.

Board Approval of Compensation Structure – *Aronson*

For its analysis of the board's involvement in Goldman's compensation structure, the Court applied the two-pronged test developed in *Aronson v. Lewis*.[2] Under this test, "when a plaintiff challenges a conscious decision of the board, a plaintiff can show demand futility by alleging particularized facts that create a reasonable doubt that either (1) the directors are disinterested and independent or (2) 'the challenged transaction was otherwise the product of a valid exercise of business judgment.'" The former clause implicates the directors duty of loyalty; the latter, the duty of care.

The first prong requires plaintiffs to allege "particularized facts that create a reasonable doubt that 'a 'majority' of the directors could [have] impartially consider[ed] a demand' either because they were interested or lacked independence, as of the time that suit was filed." Generally, "[a] director's interest may be shown by demonstrating a potential personal benefit or detriment to the director as a result of the decision." To establish disqualifying interests on the part of the Goldman directors, plaintiffs cited a number of donations made by the private Goldman Sachs Foundation to various charities with which certain directors were associated, as well as certain business dealings between other directors (or associated organizations) and Goldman. The Court rejected the notion that these relationships caused a majority of the Goldman directors not to be independent, finding generally that plaintiffs failed "to provide any information on how the amounts given influenced [the directors'] decision-making process." Essentially, the "sparse and tenuous" nature of plaintiffs' allegations doomed their attempt to tarnish the independence of the board.

Under the second prong, because Goldman's certificate of incorporation includes "an 8 *Del. C.* § 102(b)(7) provision, providing that the directors are exculpated from liability except for claims based on 'bad faith' conduct," plaintiffs were required to "plead particularized facts that demonstrate that the directors acted with scienter; i.e., there was an 'intentional dereliction of duty' or 'a conscious disregard' for their responsibilities, amounting to bad faith." Citing the Delaware Supreme Court's 2006 *Disney* decision,[3] the Court explained that bad faith occurs "where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation … or … intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." The Court found plaintiffs' pleadings lacking in this regard, stating that simply because plaintiffs "may desire a different compensation scheme does not indicate that equitable relief is warranted." Rather, any change to Goldman's compensation scheme should "be accomplished through directorial elections, but not, absent a showing unmet here, through this Court."

Board Failure to Carry Out Oversight Duties – *Caremark and Rales*

Next, the Court turned to plaintiffs' allegation that the Goldman board "breached its duty to monitor the company as required under *Caremark,*"[4] utilizing for this purpose the test formulated in *Rales v. Blasband*.[5] Under *Rales*, "when a plaintiff complains of board *inaction*," it "must plead particularized

[2] 473 A.2d 805 (Del. 1984).

[3] *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006).

[4] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

[5] 634 A.2d 927 (Del. 1993).

facts that '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.'" The Court further explained that "'defendant directors who face a *substantial* likelihood of personal liability are deemed interested in the transaction and thus cannot make an impartial decision.'" However, for this purpose, "[t]he likelihood of directors' liability is significantly lessened where, as here, the corporate charter exculpates the directors from liability to the extent authorized by 8 *Del. C.* § 102(b)(7)." In such case, "plaintiffs must plead particularized facts showing bad faith in order to establish a substantial likelihood of personal directorial liability."

To face substantial likelihood of personal liability under *Caremark*, directors "must have '(a) … 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.'" Moreover, "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."

In this regard, plaintiffs alleged that the directors "failed to implement a monitoring and reporting system or consciously disregarded the information provided by that system" when they failed to prevent Goldman employees from engaging in "unethical trading practices in search of short term revenues … such as securitizing high risk mortgages, shorting the mortgage market, using naked credit default swaps, and 'magnifying risk' through the creation of synthetic CDOs." According to the Court, such allegedly "'unethical' conduct … is not the type of wrongdoing envisioned by *Caremark*." Rather, "[t]hese are actions that Goldman managers, presumably using their informed business judgment, [took] to hedge the Corporation's assets against risk or to earn a higher return. Legal, if risky, actions that are within management's discretion to pursue are not 'red flags' that would put a board on notice of unlawful conduct." While the "Abacus" transaction may have involved "disclosure problems" that resulted in a settlement involving the payment of fines to the SEC, that single case "without more is insufficient to provide a reasonable inference of bad faith on the part of the Director Defendants."

Plaintiffs also complained that the Goldman board breached its *Caremark* oversight duties by failing to monitor "business risk." In response, the Court noted that while "this Court has not definitively stated whether a board's *Caremark* duties include a duty to monitor business risk," the Court in *Citigroup*[6] did suggest that "it may be possible for a plaintiff to meet the burden under some set of facts." However, as in *Citigroup*, the Court declined to tackle this issue due to the inadequacies in plaintiffs' pleadings.

Nevertheless, the Court went on to perhaps provide some insight into how it may have ruled on this issue had the pleadings so required, observing that directors' "duty to monitor fraud and illegal activity" is "fundamentally different" from "imposing *Caremark*-type duties on directors to monitor business risk …." According to the Court, "[t]he manner in which a company 'evaluate[s] the trade-off between risk and return' is '[t]he essence of … business judgment.'" Further, even "[i]f an actionable duty to monitor business risk exists, it cannot encompass any substantive evaluation by a court of a board's

[6] *In re Citigroup Inc. S'holder Litig*., 964 A.2d 106 (Del. Ch. 2009). For a discussion of the *Citigroup* decision, please *see* our Client Alert entitled "*In Dismissing Derivative Claims Against Citigroup's Directors, Delaware Court of Chancery Discusses Board's Duty to Monitor and Manage Risk*" (dated March 17, 2009).

determination of the appropriate amount of risk. Such decisions plainly involve business judgment." Recognizing that the Goldman directors "kept themselves reasonably informed and fulfilled their duty of oversight in good faith," the Court emphasized that "[g]ood faith, not a good result, is what is required of the board."

Conclusion

The Court's analysis of the claims brought against the Goldman Sachs board contains no real surprises. Rather, it reinforces previous rulings of Delaware courts and highlights the Courts' continued unwillingness to infringe on the decision-making process that takes place in the corporate boardroom. By imposing a seemingly heavy burden on plaintiffs to plead with particularity sufficient facts to demonstrate the required lack of independence or bad faith on the part of directors – and thereby establish demand futility and survive a motion to dismiss – the Court has made it clear that it will not lightly question board decisions, even those that do not work out as well as planned or hoped for.

Further, the Court's comments regarding a board's responsibilities with regard to oversight of business risk provide an interesting insight into the application of *Caremark* duties in this highly-scrutinized area. The *Goldman Sachs* decision would appear to signal a reluctance on the part of the Court of Chancery to support a plaintiff's attempt to skirt the board-friendly business judgment rule by seeking to extend *Caremark* duties to encompass a duty to oversee business risk.

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