Westlaw Journal
CORPORATE OFFICERS & DIRECTORS LIABILITY
Litigation News and Analysis • Legislation • Regulation • Expert Commentary
VOLUME 27, ISSUE 9 / OCTOBER 24, 2011

Expert Analysis

Goldman Directors Win Dismissal Of Challenge to Management Compensation Structure

By Gardner Davis, Esq., and Danielle Whitley, Esq.
Foley & Lardner

In a much anticipated decision, *In re Goldman Sachs Group Inc. Shareholder Litigation*, 2011 WL 4826104 (Del. Ch. Oct. 12, 2011), the Delaware Chancery Court dismissed a shareholder derivative suit claiming the Goldman Sachs directors breached their fiduciary duty by adopting a flawed compensation policy that created a divergence of interest between Goldman's management and its stockholders.

The plaintiffs alleged that Goldman historically set compensation for the firm's management as a percentage of net revenue. Under this compensation structure, Goldman executives allegedly were motivated to grow net revenue at any costs and without regard to risks. The compensation structure allegedly caused Goldman employees to attempt to maximize short-term profits by engaging in highly risky trading practices and by over-leveraging Goldman's assets in a "heads — management wins, tails — shareholders lose" type arrangement.

CAREMARK INTERPRETED

In his first major opinion on corporate law matters, Vice Chancellor Sam Glasscock provides a thoughtful, well-crafted analysis of the pleading requirements necessary to overcome the pre-suit demand on the board under Chancery Court Rule 23.1, the interplay between corporate charitable giving and director independence, the legal elements of a corporate "waste" claim, and whether the *Caremark*[1] duty to monitor includes risk-management programs.

However, setting aside Vice Chancellor Glasscock's scholarly analysis, at a fundamental level, the premise of the plaintiffs' case is contrary to fundamental corporate law. Corporate directors should be protected from suit for fundamental business judgment decisions — in this case, how the board designed and implemented the management compensation system. There is no suggestion the Goldman directors had a

meaningful conflict of interest. The stockholders previously adopted a charter provision under 8 Del.C. § 102(b)(7) that exculpates the Goldman directors from liability except for claims based on "bad faith." *Goldman Sachs* begs the question of why baseless cases like this are filed, why Vice Chancellor Glasscock dignified the spurious lawsuit with such a well-written, scholarly decision, and why the Chancery Court doesn't act to deter these type lawsuits in the future.

DOUBLE STANDARD?

This case also includes a degree of irony insofar as the co-lead plaintiff is the Southeastern Pennsylvania Transportation Authority, which operates trains and buses in the Philadelphia area.

Interestingly, this is not SEPTA's first foray into corporate governance litigation. SEPTA also filed lawsuits claiming eBay's $2.4 billion offer for GSI Commerce was inadequate and seeking to block the $1.9 billion takeover of SRA International. One must ask whether the SEPTA board of directors would be willing to submit to the same standards of performance, conflict of interest and personal liability they seek to impose on the Goldman directors.

Although many people may dislike Goldman Sachs as a symbol of the American financial services industry, given the firm's track record, most would agree that the Goldman directors probably could do a better job than the SEPTA directors running any enterprise. One might suggest that the SEPTA board focus on running the trains and buses rather than filing frivolous suits against other boards of directors.

Facts pleaded in support of these allegations, if true, supported only the conclusion the directors made poor business decisions, which would be protected by the business judgment rule.

THE FACTS

The basic facts of the *Goldman* case are not in dispute. According to the complaint, Goldman engaged in three principal business activities: investment banking, asset management, and proprietary trading and principal investments. The majority of Goldman's revenue comes from the proprietary trading segment, where the firm trades for its own benefit with its own money.

Since its initial public offering in 1999, Goldman's common shareholder equity has grown from $10 billion to $73 billion as of 2010. The percentage of the company's revenue generated by proprietary trading has grown from 43 percent of Goldman's revenue in 1999 to 76 percent of its revenue in 2007.

According to the complaint, as the revenue generated by the trading segment grew, so did the trading department's stature within Goldman. The plaintiffs alleged that "the compensation for these traders was not based on performance and was unjustifiable because Goldman was doing 'nothing more than compensating employees for results produced by the vast amount of shareholder equity that Goldman had available to be deployed.'"[2] To put Goldman's 730 percent increase in shareholder equity in historical perspective, the Dow Jones Industrial Average increased about 30 percent during the same period.

"Goldman employed a 'pay for performance' philosophy, linking the total compensation of its employees to the company's performance."[3] Although total compensation paid by Goldman to all employees, including senior executives, varied significantly each year, total compensation as a percentage of net revenue remained relatively constant. The company's total net revenue was $46 billion in 2007, $22 billion in 2008 and $45 billion in 2009. During this period, Goldman paid its employees total

compensation of 44 percent of gross revenue ($20 billion) in 2007, 48 percent of gross revenue ($10.9 billion) in 2008 and 36 percent of gross revenue ($16 billion) in 2009. The total compensation initially approved in 2007 by Goldman's compensation committee was $16.7 billion, or 47 percent of total revenue, but this amount was reduced after public criticism.

The plaintiffs argued that because management was awarded a relatively constant percentage of total revenue, management could maximize their compensation by increasing Goldman's total net revenue and total shareholder equity. The plaintiffs contended the compensation structure led management to pursue a high-risk business strategy and to emphasize short-term profits in order to increase their yearly bonuses.

EXTREME LEVERAGE

The plaintiffs further alleged that Goldman's growth resulted from "extreme leverage and significant uncontrolled exposure to risky loans and credit risks."[4] They argued that although the trading and principal investment segment was the largest contributor to Goldman's revenue, it also required the largest commitment of the firm's capital and the greatest risk.

At the end of the day, this case against the Goldman directors was baseless and never should have been filed.

The plaintiffs further contended that in 2008 the trading segment produced $9 billion in net revenue, but as a result of discretionary bonuses paid to employees, lost more than $2.7 billion.

This contributed to Goldman's 2008 net income falling by $9 billion. The plaintiffs also contended that but for the cash infusion of Warren Buffett, federal government intervention and Goldman's conversion into a bank holding firm, the company would have gone into bankruptcy.

During this time, Goldman's audit committee was charged with overseeing risk and the company's guidelines, policies and processes for managing such risks. In December 2006 the CFO, in a meeting with Goldman's mortgage traders and risk managers, concluded that the firm was overexposed to the subprime mortgage market and decided to reduce its overall risk exposure. In 2007 as the housing market began to decline, a committee of senior executives, including the CFO and CEO, took an active role in monitoring and overseeing the mortgage unit. The committee eventually took the position that would allow Goldman to profit if housing prices declined. When the subprime mortgage markets collapsed, not only were Goldman's long positions hedged, the company actually profited more from its short positions than it lost from its long positions. The plaintiffs alleged that Goldman's profits resulted from positions that conflicted with its clients' interests, to the detriment of the company's reputation.

GROSSLY UNETHICAL

The plaintiffs alleged that the Goldman directors breached their fiduciary duties by:

- "Failing to properly analyze and rationally set compensation levels for Goldman employees.
- "Committing waste by 'approving a compensation ratio to Goldman employees in an amount so disproportionately large to the contribution of management, as opposed to capital, as to be unconscionable.'" [5]

- Violating their fiduciary duties by failing to adequately monitor operations and by allowing the firm "to manage and conduct the firm's trading in a grossly unethical manner."[6]

Rule 23.1 requires that "a plaintiff shareholder ... make a demand upon the corporation's current board to pursue derivative claims owned by the corporation before a shareholder is permitted to pursue legal action on the corporation's behalf."[7] Demand is required because "[t]he decision of whether to initiate or pursue a lawsuit on behalf of the corporation is generally within the power and responsibility of the board of directors."[8]

If, as in the *Goldman Sachs* case, the plaintiff does not first demand that the directors pursue the alleged cause of action, the plaintiff "must establish that demand is excused by satisfying 'stringent pleading requirements of factual particularity' by 'setting forth particularized factual statements that are essential to the claim' in order to demonstrate that making demand would be futile."[9] "Pre-suit demand is futile if a corporation's board is 'deemed incapable of making an impartial decision regarding the pursuit of the litigation.'"[10]

Although lawyers and judges may find these cases intellectually interesting and profitable, they collectively represent a significant, unproductive burden on the American economy.

BUSINESS JUDGMENT EXERCISE

The plaintiffs argued in this case that demand was futile because Goldman's board is interested and lacks independence because of financial ties between the director defendants and the company. They further argued there is a reasonable doubt as to whether the board's compensation structure was the product of a valid exercise of business judgment. Finally, the plaintiffs contended there was a substantial likelihood that the Goldman directors would face personal liability for dereliction of their duty to oversee Goldman's operations.

Under the two-pronged *Aronson*[11] 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 the directors are disinterested and independent, or 'the challenged transaction was otherwise the product of a valid exercise of business judgment.'"[12]

In this case, the thrust of the plaintiffs' argument is that the defendant directors lacked independence or were interested as a result of contributions made by the Goldman Sachs Foundation to various charitable organizations with which the individual directors were affiliated. Applying the *Hallmark*[13] and *J.P. Morgan*[14] standards, the court held that even though a defendant director was a member of a charitable board, and her general responsibilities included raising funds for the charity, where the director did not receive a salary for her work and did not actively solicit donations from the defendant corporation, the plaintiff failed to sufficiently show that the director was incapable of exercising independent business judgment.

The court also looked at other factors, including the percentage of overall contribution to the charity represented by the corporation's donation. In this case, Vice Chancellor Glasscock found that the plaintiffs' bare allegation that the corporation gave a donation to a charity at which the defendant director served as trustee, without more, did not demonstrate a lack of director independence.

Having determined that the plaintiffs had not pleaded particularized factual allegations that called into doubt the defendant directors' independence, the court applied the second-prong of *Aronson* to determine whether the plaintiffs had pleaded partic-

ularized facts that raised a reasonable doubt that Goldman's compensation scheme was otherwise the product of valid exercise of business judgment. [15]

A CORE BOARD FUNCTION

Goldman's charter contained an 8 Del.C. § 102(b)(7) provision providing that directors are exculpated from liability except for claims based on bad faith. Under *Stone v. Ritter*,[16] a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of a fiduciary duty of care (*i.e.*, gross negligence).

Vice Chancellor Glasscock noted that "the decision as to how much compensation is appropriate to retain and incentivize employees, both individually and in the aggregate, is a core function of the board of directors exercising its business judgment."[17] The vice chancellor found that the plaintiffs primarily alleged that the Goldman compensation scheme did not perfectly align the employees' interests with the shareholders' interests. "The plaintiffs' focus on percentages ignores the reality that over the past 10 years, in absolute terms, Goldman's net revenues and dividends have increased."[18] He found that the plaintiffs' desire for a different compensation scheme should be pursued by the election of directors rather than a lawsuit.

The plaintiffs argued that there was an intentional dereliction of duty or a conscious disregard by the defendant directors in setting compensation levels. However, they failed to plead with particularity that any of the defendant directors had the *scienter* necessary to give rise to a violation of the duty of loyalty. At most, the plaintiffs' allegations suggest that there were other metrics not considered by the board that may have produced a better compensation policy. However, the business judgment rule only requires the board to reasonably inform itself; it does not require perfection or consideration of every conceivable alternative.

WHAT IS WASTE?

The plaintiffs also argued that Goldman's compensation levels were unconscionable and constituted corporate waste. In order to establish that demand would be futile in the corporate-waste context, the "plaintiffs must plead particularized allegations that overcome the general presumption of good faith by showing the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests."[19]

"Waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade."[20]

Accordingly, if "there is any *substantial* consideration received by the corporation, and if there is a *good-faith* judgment that in the circumstances the transaction is worthwhile, there should be no finding of waste."[21]

Vice Chancellor Glasscock found that the plaintiffs failed to allege particularized facts that demonstrated that the work done by Goldman's 31,000 employees was of such limited value to the corporation that "no reasonable person in the directors' position would have approved their level of compensation."[22]

The plaintiffs also asserted a *Caremark* breach-of-duty-to-monitor claim against the directors for failure to monitor business risk.[23] Under the *Rales* standard outlined in *Rales v. Blasband*, 634 A.2d 927 (Del. 1993), in order to properly plead demand futility

in the failure-to-act context, a plaintiff must allege particularized facts that create a reasonable doubt that "the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[24] Because Goldman's charter contained a director-exculpation provision under 8 Del.C. § 102(b)(7), plaintiffs must plead particularized facts showing bad faith in order to establish the substantial likelihood of personal director liability. The court found that the conduct at issue was a legal business decision (not the illegal activity usually found in the *Caremark* claim context), although characterized as "unethical" behavior. To act in bad faith, there must be *scienter* on the part of the defendant directors.[25]

Vice Chancellor Glasscock noted that the Chancery Court had not definitely stated whether a board's *Caremark* duties include a duty to monitor business risk.[26] He also noted that although the plaintiffs molded their claim within the language of *Caremark*, the essence of their complaint was that the defendant directors should be personally liable for making business decisions that, in hindsight, turned out poorly for the company. "If an actionable duty to monitor business risk exists, it cannot encompass any substantive evaluation by a court of a board's determination of the appropriate amount of risk. Such decisions plainly involve business judgment."[27] The court found that the audit committee and the directors took an active role in overseeing risk, and therefore exercised their business judgment in choosing and implementing a risk-management system they presumably believed would keep them reasonably informed. Vice Chancellor Glasscock noted that "good faith, not a good result, is what is required of the board."[28]

Therefore, the court dismissed the plaintiffs' claims that the Goldman directors violated their fiduciary duties in setting compensation levels and failing to oversee the risk created thereby. Vice Chancellor Glasscock said the facts pleaded in support of these allegations, if true, supported only the conclusion the directors made poor business decisions, which would be protected by the business judgment rule.

CONCLUSION

At the end of the day, this case against the Goldman directors was baseless and never should have been filed. The board and senior executives did a better job navigating the housing market collapse and severe recession of 2007-2008 than many other financial institutions, such as Bear Stearns, Merrill Lynch, Lehman, AIG and Bank of America.

Lawsuits attacking directors for alleged mistakes in business judgment, particularly where the defendants enjoy the protection of Section 102(b)(7) charter provisions and no material conflict of interest is alleged, need to be reined in. Although lawyers and judges may find these cases intellectually interesting and profitable, they collectively represent a significant, unproductive burden on the American economy. The board of directors of SEPTA, which served as co-lead plaintiff in *Goldman*, should ask themselves whether they are really acting reasonably, in good faith and in the best interest of their institution by sponsoring spurious litigation.

NOTES

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

2 *Goldman Sachs*, 2011 WL 4826104 at *3.

3 *Id.*

4 *Id.* at 4.

[5] *Id*. at 5.

[6] *Id*.

[7] *Id*. at 6 (quoting *In re JPMorgan Chase & Co. S'holder Litig*., 906 A.2d 808, 820 (Del. Ch. 2005).

[8] *Id.* (quoting *In re Citigroup Inc. S'holder Derivative Litig*., 964 A.2d 106, 120 (Del. Ch. 2009).

[9] *Id.* (quoting *Citigroup*, 964 A.2d at 120-121).

[10] *Id.* (citing *Beam v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004).

[11] *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984).

[12] *Goldman* at 6 (quoting *Aronson*, 473 A.2d at 814).

[13] *S. Muoio & Co. v. Hallmark Entm't Inv. Co.*, 2011 WL 863007 (Del. Ch. Mar. 9, 2011).

[14] *In re JPMorgan Chase & Co. S'holder Litig*., 906 A.2d 808, 814-15 (Del. Ch. 2005).

[15] *Goldman* at 6 (quoting *JPMorgan*, 906 A.2d at 824).

[16] *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2009).

[17] *Goldman* at 13 (quoting J.*P. Morgan*, 906 A.2d at 824).

[18] *Id.* at 14.

[19] *Id*. at *16 (quoting *Citigroup*, 964 A.2d at 136).

[20] *Id.* at 16 (quoting *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997)).

[21] *Id.*

[22] *Id.* at 17 (citing *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000)).

[23] *Caremark* 698 A.2d 959.

[24] *Goldman* at 18 (citing *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).

[25] *Id.* at 20. *See, generally In re Massey Energy*, 2011 WL 2176479 at *16 (Del. Ch. 2011)

[26] *See Citigroup*, 964 A.2d at 131.

[27] *Goldman* at 22.

[28] *Id*. at *23.

Gardner Davis (left) is a partner, and **Danielle Whitley** (right) is senior counsel in the transactional and securities practice of **Foley & Lardner** in Jacksonville, Fla. They can be reached at gdavis@foley.com and dwhitley@foley.com, respectively.