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IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE THE GOLDMAN SACHS GROUP, INC. SHAREHOLDER LITIGATION	C.A. No. 5215-CC

DEFENDANTS' BRIEF IN SUPPORT OF THEIR MOTION TO DISMISS THE SECOND AMENDED COMPLAINT

OF COUNSEL:

Gandolfo V. DiBlasi
Richard H. Klapper
Theodore Edelman
David M.J. Rein
SULLIVAN & CROMWELL LLP
125 Broad Street
New York, New York 10004-2498
(212) 558-4000

Gregory V. Varallo (#2242)
Rudolf Koch (#4947)
RICHARDS, LAYTON & FINGER, P.A.
One Rodney Square
920 N. King Street
Wilmington, Delaware 19801-3319
(302) 651-7700

Attorneys for Nominal Defendant The Goldman Sachs Group, Inc. and Defendants Lloyd C. Blankfein, Gary D. Cohn, John H. Bryan, Claes Dahlbäck, Stephen Friedman, William W. George, Rajat K. Gupta, James A. Johnson, Lois D. Juliber, Lakshmi N. Mittal, James J. Schiro, Ruth J. Simmons, David A. Viniar, and J. Michael Evans.

February 4, 2011

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Page(s)

CASES

RLF1 3786299v. 1
RLF1 3798339v. 1

Nominal defendant, The Goldman Sachs Group, Inc. ("Goldman Sachs"), and individual defendants Lloyd C. Blankfein, Gary D. Cohn, John H. Bryan, Claes Dahlbäck, Stephen Friedman, William W. George, Rajat K. Gupta, James A. Johnson, Lois D. Juliber, Lakshmi N. Mittal, James J. Schiro, Ruth J. Simmons, David A. Viniar, and J. Michael Evans (collectively, "defendants") submit this brief in support of their motion to dismiss plaintiffs' second amended complaint ("Am. Compl." or "Complaint") pursuant to Delaware Chancery Court Rules 12(b)(6) and 23.1 and the Court's Order rendered during the January 19, 2011 telephonic conference with the parties.

PRELIMINARY STATEMENT

Plaintiffs initially brought this consolidated putative shareholder derivative action[1] in an effort to capitalize on ongoing public attention to corporate compensation and, in particular, Goldman Sachs' anticipated announcement of its 2009 compensation levels. Plaintiffs' original complaint challenged Goldman Sachs' 2009 employee compensation as "excessive" based on a prediction that Goldman Sachs would pay compensation for the year 2009 amounting to "approximately 50%" of its net revenues. That prediction turned out to be wrong when Goldman Sachs announced on January 21, 2010 that its compensation expense for the year 2009 was 35.8% of its net revenues.

Unlike in several substantively similar derivative actions filed in the New York State courts, where the plaintiffs resolved that their claims were no longer tenable, plaintiffs here opted to proceed despite the announced 2009 compensation levels, and defendants moved to dismiss the original consolidated complaint on March 9, 2010. Plaintiffs took no action towards arranging a schedule for briefing that motion. But when an entirely separate matter occurred—

[1] On January 19, 2010, plaintiffs filed two actions, which were consolidated by Order of this Court entered March 10, 2010.

the April 16, 2010 enforcement action by the Securities and Exchange Commission ("SEC") charging a Goldman Sachs affiliate ("GS & Co.") with securities law violations in connection with a synthetic collateralized debt obligation ("CDO") offering—plaintiffs again sought to capitalize by amending their complaint to expand their derivative claims. Specifically, citing the SEC complaint as well as pronouncements by certain members of a Senate subcommittee, plaintiffs added allegations that Goldman Sachs' directors allowed the firm to operate in a risky and "unethical" manner in its mortgage business, supposedly exposing the firm to reputational harm and civil liability, thereby assertedly breaching their duties of oversight. (Am. Compl. ¶¶ 75, 83.) Significantly, the SEC action did not allege that Goldman Sachs operates its business as "a 'moral bankruptcy,' fraught with conflicts of interest and the systemic breaking of ethical lines," as plaintiffs seek to assert here. (*Id.* ¶ 4.) Rather, the SEC's complaint alleged that GS & Co. and one of its employees violated federal securities laws by failing to disclose the role of one hedge fund (Paulson & Co. ("Paulson")) in the selection of the portfolio for one CDO offering. GS & Co. settled the SEC Action on July 14, 2010 without admitting or denying any of the substantive allegations in the complaint. (*Id.* ¶¶ 73, 74.)

After receiving defendants' opening brief in support of their motion to dismiss, plaintiffs sought to amend their complaint for a second time, explaining that "the necessity for altering the pleading became apparent" from reviewing the brief. (Reply ¶ 33.) Plaintiffs' amendments, however, cured neither the Complaint's failure to plead with the requisite particularity why plaintiffs are excused from making a pre-suit demand on the Goldman Sachs Board, or its failure to state a claim.

The Complaint erroneously seeks to excuse the threshold demand requirement because the directors supposedly are conflicted by a disqualifying interest arising out of their affiliations with charitable institutions that have received donations from the Goldman Sachs Foundation (the "Foundation") or as a result of other business relationships they allegedly have with Goldman Sachs. Those allegations—which plaintiffs made no attempt to buttress in their recent amendments—are legally deficient. Indeed, the federal appeals court and two district courts in the Second Circuit each recently applied the long line of Delaware precedents in holding that almost identical allegations of directors' charitable and business affiliations did not raise doubt as to the directors' independence so as to excuse demand on the same Goldman Sachs Board.[2]

The Complaint does not excuse plaintiffs' lack of demand by alleging that the director defendants face a "substantial likelihood of liability" for decisions at the core of the business judgment rule, particularly given the firm's charter provision immunizing the directors from personal liability under 8 Del. C. § 102(b)(7) for actions taken in good faith. Specifically, plaintiffs' compensation claims assert nothing more than a difference of opinion with Goldman Sachs' directors as to the proper levels at which to compensate and incentivize Goldman Sachs' thousands of employees who have made the firm consistently profitable—a matter quintessentially within the board's business judgment. And their failure-of-oversight claims are deficient because the Complaint does not allege that the Board failed to ensure the existence at Goldman Sachs of a functioning corporate information and reporting system, let alone specify any way in which such a system would have prevented the single alleged disclosure violation that was at issue in the SEC action. This is hardly the kind of "systematic" failure that evidences

[2] *See Louisiana Mun. Police Employees Ret. Sys.* v. *Blankfein*, No. 08 Civ. 7605 (LBS), 2009 WL 1422868, at *5-8 (S.D.N.Y. May 19, 2009), *recons. denied*, 2009 WL 2191243 (S.D.N.Y. July 20, 2009) (hereinafter, "*LMPERS*"); *Bader* v. *Blankfein*, No. 07 Civ. 1130 (SLT) (JMA), 2008 WL 5274442, at *8-9 (E.D.N.Y. Dec. 19, 2008), *aff'd*, 356 F. App'x 471 (2d Cir. 2009), *cert. denied*, 130 S. Ct. 3287 (2010); *Bader* v. *The Goldman Sachs Group, Inc.*, No. 08 Civ. 255 (SLT), 2010 WL 3938410, at *6-7 (E.D.N.Y. Sept. 30, 2010), *appeal docketed*, No. 10-4364 (2d Cir. Oct. 26, 2010).

a conscious, bad-faith decision on the part of directors to harm their company or the type of wholesale abdication of oversight that *Caremark* requires. In addition, plaintiffs' attempts to predicate their claims on the questions of whether Goldman Sachs should have conducted its CDO trading activities without "a relentless focus on profit" (Am. Compl. ¶ 77) are not true *Caremark* claims and, indeed, raise no cognizable legal causes of action. At most, these claims challenge, with the benefit of hindsight, defendants' risk management decisions in the midst of a global economic crisis; but such determinations are firmly committed to the defendants' "business judgment."

Nor do plaintiffs' most recent amendments salvage their claims by endeavoring to recharacterize Goldman Sachs' compensation determinations as creating a "conflict" between Goldman Sachs personnel and shareholders. Indeed, those allegations implicitly concede that affording "management" a share of the firm's profits *aligned* its interests in successfully managing the company with that of Goldman Sachs' shareholders—which most investors would applaud. Moreover, plaintiffs' amendments, which suggest that Goldman Sachs managers and directors *consciously* pursued business strategies in order to maximize the company's profit, merely reinforce plaintiffs' continuing failure to plead a failure of oversight or "knowing[] abdicat[ion]" (Am. Compl. ¶ 3) of supervisory responsibility that is essential for the claims asserted here. In short, plaintiffs ask this Court to second-guess the directors' business judgment as to business selection and risk management. These claims fail to excuse demand, *see infra* at 18-42; and, for similar reasons, fail to state a claim on the merits, *see infra* at 42-46.

For these reasons, this Court should dismiss plaintiffs' Complaint with prejudice.

BACKGROUND

A. The Parties.

1. Goldman Sachs' Trading Business and Its Strong Performance.

Nominal Defendant Goldman Sachs is a Delaware corporation headquartered in New York that has more than 30,000 employees worldwide.[3] (Am. Compl. ¶ 14; Declaration of Rudolf Koch ("Koch Decl.") Ex. A, at 14.) Goldman Sachs' activities during the relevant timeframe were divided into three segments: (i) Investment Banking; (ii) Trading and Principal Investments; and (iii) Asset Management and Securities Services. (Am. Compl. ¶ 37.)

The Trading and Principal Investments. The Trading and Principal Investments segment was further divided into Fixed Income, Currency and Commodities Division ("FICC") and Equities, and Principal Investments. Through FICC, Goldman Sachs "makes markets in and trades interest rate and credit products, mortgage-related securities and other asset backed instruments, currencies and commodities." (Am. Compl. ¶ 42.) In this division, Goldman Sachs also "structures and enters into a wide variety of derivative transactions and engages in proprietary trading and investing." (*Id*.)

One of the many products and services offered by the Trading and Principal Investments business was synthetic CDOs.[4] A synthetic CDO "is a security that rather than

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[3] For purposes of this motion only, the Court and parties must "accept all well-pled allegations of fact as true and draw all reasonable inferences in [plaintiffs'] favor." *Desimone* v. *Barrows*, 924 A.2d 908, 928 (Del. Ch. 2007). In addition, the Court may consider documents that are "integral to or are incorporated by reference into the complaint," as well as facts subject to judicial notice. *In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 727 (Del. Ch. 1999); *see also In re Gen. Motors (Hughes) S'holders Litig.*, 897 A.2d 162, 170 (Del. 2006). Of course, "a complaint must plead enough facts to plausibly suggest that the plaintiff will ultimately be entitled to the relief she seeks" and if the "complaint fails to do that and instead asserts mere conclusions, a Rule 12(b)(6) motion to dismiss must be granted." *Desimone* v. *Barrows*, 924 A.2d 908, 929 (Del. Ch. 2007).

[4] A CDO is a debt security issued by a special-purpose vehicle that, in turn, holds a portfolio of underlying interest-bearing securities, such as residential mortgage-backed securities ("RMBS"). An RMBS is an interest-bearing security collateralized by a pool of residential

containing actual financial assets, contains derivatives, or contracts referencing the performance of other financial assets." (Am. Compl. ¶ 55.) According to the Complaint, a synthetic CDO functioned as follows:

> In the case of many of the deals created by Goldman [Sachs], the financial assets were mortgages. Bonds backed by the mortgages were bundled together in a process which enabled mortgage lenders to make even more loans, called credit default swaps. The synthetic CDOs consisted of these credit default swaps, which operated like insurance policies written on these mortgage bonds. If the bonds performed well, those who bought the credit default swaps would make a steady stream of small payments—much like insurance premiums—to investors who bought the synthetic CDO notes. If the bonds performed poorly, those who bought the credit default swaps would receive potentially large payouts. (Am. Compl. ¶ 55.)

"[B]y its very design," a synthetic CDO "has long and short parties." (Am. Compl. ¶ 56.) In other words, "[o]ne party takes the short position betting on the fact that the underlying mortgages will fail"; the other party "takes the long position betting on the fact that the underlying mortgages will do well." (*Id.*)

Goldman Sachs' Performance in 2007, 2008 and 2009. According to the Complaint, since 1999, Goldman Sachs' officers "have been able to exceed the returns obtained by average hedge funds," principally by "leveraging the firm's assets to speculative levels." (Am. Compl. ¶ 7.) "Such speculative leveraging was responsible for the demise of several investment banks, including Lehman Brothers and Bear Stearns." (*Id.* ¶ 8.)

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mortgages. A credit default swap ("CDS") is a derivative instrument pursuant to which, in return for the payment of periodic fees, a counterparty agrees to reimburse the purchaser of the instrument in the event that the underlying debt securities are subject to certain credit events, such as default. In a synthetic CDO transaction, a special-purpose vehicle sells credit protection by means of CDS or otherwise on a portfolio of "reference" securities, which may be RMBS, (and is, thus, necessarily "long" those securities) and issues debt securities against the payment stream it receives from the counterparties to which it sold protection (which necessarily are "short" the reference securities). (*Cf.* Am. Compl. ¶¶ 55-56.)

Unlike those other public companies, Goldman Sachs recorded a profit even in 2008, when the economy imploded, and the company achieved its most and second-most profitable years in 2007 and 2009, respectively. (Koch Decl. Ex. A, at 76-77; *see also* Am. Compl. ¶ 123.) Indeed, the Complaint openly pleads that Goldman Sachs' "massive shareholder equity, supplemented by the government's TARP capital infusion and the FDIC loan guarantees, put it in a position to generate substantial net revenues in 2009." (Am. Compl. ¶ 97.)

2. The Individual Defendants.

The individual defendants are comprised of Goldman Sachs' Chief Executive Officer and Co-Chief Operating Officer, who are also members of the company's Board of Directors (Am. Compl. ¶¶ 15-16); ten outside directors who are not employees of Goldman Sachs, including all ten members of the Board's Compensation Committee and all nine members of the Board's Audit Committee for the year 2009 (*id.* ¶¶ 17-26, 32-33); and two additional senior officers of the company who are not Board members (*id.* ¶¶ 27-28).

The outside director defendants at the time this action was filed were comprised of current or former leaders of some of the world's largest corporations and other highly sophisticated business executives and academic leaders, many of whom have extensive experience serving on the boards of directors of other public companies:

- ***Bryan***. Defendant John H. Bryan served as Chief Executive Officer of the Sara Lee Corporation for 25 years between 1975 and 2000, and as Chairman of its Board of Directors for 25 years between 1976 and 2001. In addition to his directorship at Goldman Sachs, he also serves on the Board of General Motors. (Koch Decl. Ex. B, at 9.)[5]

- ***Dahlbäck***. Defendant Claes Dahlbäck served as President and CEO of Investor AB, a Swedish investment company, for 21 years between 1978 and 1999, as its Vice Chairman

[5] The Court may take judicial notice of these facts, which are disclosed in the 2009 proxy statement that Goldman Sachs filed with the SEC. *See In re Tyson Foods, Inc. Consol. S'holder Litig.*, Civ. A. No. 1106-CC, 2007 WL 2351071, at *2 (Del. Ch. Aug. 15, 2007).

from 1999 until 2002, and as nonexecutive Chairman from 2002 until 2005. Since 2005, he has served as Senior Advisor to Investor AB. (*Id.*)

- ***Friedman***. Defendant Stephen Friedman has served as Chairman of Stone Point Capital, a private equity firm, since 2006. He served as Chairman of the Federal Reserve Bank of New York from January 2008 until May 2009, and further served as Director of the National Economic Council and Assistant to the President for Economic Policy from December 2002 until December 2004. Mr. Friedman held various positions at Goldman Sachs between 1966 and 1994, retiring in 1994 as Chairman of Goldman Sachs' Management Committee. (*Id.* at 10.)

- ***George***. Defendant William W. George is a Professor at Harvard Business School. He served as CEO of Medtronic, Inc. for ten years between 1991 and 2001, and as Chairman of its Board for six years between 1996 and 2002. He joined Medtronic as its President and Chief Operating Officer in 1989. (*Id.*)

- ***Gupta***. Defendant Rajat K. Gupta served as Worldwide Managing Director of McKinsey & Co. from 1994 until 2003, and now is Senior Partner Emeritus of McKinsey. In addition to his directorship at Goldman Sachs, Mr. Gupta also serves on the Boards of AMR Corp., Genpact LTD, Harman International, and Procter & Gamble. (*Id.*) Mr. Gupta ceased serving as a Goldman Sachs director in May 2010.

- ***Johnson***. Defendant James A. Johnson has served as Vice Chairman of Perseus, L.L.C., a merchant banking and private equity firm, since 2001. He served as Chairman and CEO of Fannie Mae from 1991 through 1998. In addition to his directorship at Goldman Sachs, Mr. Johnson also serves on the Boards of Target Corporation and Forestar Real Estate Group, Inc. (*Id.*)

- ***Juliber***. Defendant Lois D. Juliber served as a Vice Chairman of Colgate-Palmolive Company from 2004 through 2005, and as its Chief Operating Officer from 2000 through 2004, as its Executive Vice President for North America and Europe from 1997 through 2000, and as President of Colgate North America from 1994 through 1997. In addition to her directorship at Goldman Sachs, Ms. Juliber also serves on the Boards of E.I. du Pont de Nemours & Co. and Kraft Foods, Inc. (*Id.* at 11.)

- ***Mittal***. Defendant Lakshmi N. Mittal has been Chairman and Chief Executive Officer of ArcelorMittal since 2008, before which he served as its President and CEO from 2006 to 2008, and as CEO of Mittal Steel Company N.V. beginning in 1976, when he founded the company. In addition to his directorship at Goldman Sachs, Mr. Mittal also serves on the Boards of European Aeronautic Defence and Space Company EADS N.V. and ICICI Bank Limited. (*Id.*)

- ***Schiro***. Defendant James J. Schiro has been Chief Executive Officer of Zurich Financial Services since May 2002. He previously served as Chief Executive Officer of PricewaterhouseCoopers LLP from 1998 to 2002 and as Chairman and CEO of its predecessor, Price Waterhouse, from 1995 to 1998. In addition to his directorship at

Goldman Sachs, Mr. Schiro also serves on the Boards of PepsiCo, Inc. and Royal Philips Electronics. (*Id*.)

- ***Simmons***. Defendant Ruth J. Simmons has served as President of Brown University since 2001, and previously served as President of Smith College from 1995 through 2001 and as Vice Provost of Princeton University from 1992 to 1995. Ms. Simmons also serves on the Board of Texas Instruments, Inc. (*Id*.) Ms. Simmons ceased serving as a Goldman Sachs director in May 2010.

3. Plaintiffs.

Plaintiffs Southeastern Pennsylvania Transportation Authority and International Brotherhood of Electrical Workers Local 98 Pension Fund claim to have been shareholders of Goldman Sachs "at all times material" to this action. (Am. Compl. ¶¶ 12-13.)

B. Procedural History of This and Related Actions.

1. The Prior New York State Court Actions Challenging Goldman Sachs' Employee Compensation.

Between December 2009 and January 2010, several shareholders filed actions in the Supreme Court of New York, purportedly on the company's behalf, alleging that Goldman Sachs' compensation for the year 2009 would be excessive. (*See* Koch Decl. Ex. C ¶¶ 1-4; *id.* Ex. D ¶¶ 1-4; *id.* Ex. E ¶¶ 1-20.)

Plaintiffs filed their actions here shortly thereafter, on January 19, 2010, against the same defendants named in the New York actions; and their actions were consolidated on March 10, 2010. Plaintiffs asserted virtually identical claims for waste and breach of the duty of loyalty premised on their prediction that defendants would approve, and that Goldman Sachs would pay, "almost 50% of net revenues" as compensation for 2009. (Compl. ¶ 4; *accord* Koch Decl. Ex. C ¶ 95; *id.* Ex. D ¶ 132; *id.* Ex. E ¶ 127.) Plaintiffs based their claims not on the expected compensation for any particular officer or employee, but rather on the overall level of compensation that they predicted Goldman Sachs would pay its thousands of employees for 2009. Plaintiffs also sought to excuse demand on virtually identical grounds as had the New

York plaintiffs, *i.e.*, that defendants had "participated in, approved, and/or permitted the wrongs alleged." (*Compare* Compl. ¶ 117 *with* Koch Decl. Ex. C ¶ 88; *id*. Ex. D ¶ 99.)

2. Goldman Sachs' January 21, 2010 Earnings Announcement.

On January 21, 2010, Goldman Sachs issued a press release—which it also included as an exhibit to a report on Form 8-K filed with the SEC—regarding its financial performance for the fourth quarter of 2009 and the full year. In that press release, Goldman Sachs culminated a lengthy annual compensation process, which largely predated this lawsuit, by announcing that its total compensation and benefits expense for 2009 was $16.19 billion and that its ratio of compensation and benefits to net revenues for the year 2009 was 35.8%—far less than the $22 billion and "approximately 50%" predictions on which plaintiffs in the New York cases and this action had relied as the fundamental predicate of their compensation-related claims. (Koch Decl. Ex. F, at Ex. 99.1, at 1, 5.)[6]

In light of this announcement, on April 8, 2010, the plaintiffs in the New York compensation actions—but not plaintiffs here—moved to dismiss voluntarily all three of their actions as "moot."[7] (Koch Decl. Ex. G, at 1.)

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[6] Because this press release was submitted to the SEC as an attachment to a Form 8-K that Goldman Sachs filed on the same day and that itself also contained the same disclosure about Goldman Sachs' ratio of compensation and benefits to net revenues (Koch Decl. Ex. F, at Ex. 99.1, at 5), the Court may take judicial notice of this disclosure without converting this motion to one for summary judgment. *See In re Gen. Motors (Hughes) S'holder Litig.*, 897 A.2d at 170 (court may properly take judicial notice of facts disclosed in company's SEC filings that are not subject to reasonable dispute without converting motion to one for summary judgment). Goldman Sachs also disclosed the same information in its subsequent report on Form 10-K filed with the SEC on February 26, 2010. (Koch Decl. Ex. A, at 57, 80.)

[7] The plaintiffs in the New York actions also purported to declare victory and have moved for an award of attorney's fees based on the argument that their lawsuits influenced Goldman Sachs' compensation levels. That motion, which defendants have opposed, has not yet been adjudicated.

3. The SEC Action, the Complaints Filed in Its Wake, and the SEC Settlement.

The SEC filed an action against GS & Co. (Goldman Sachs' principal U.S. broker-dealer subsidiary) and one of its employees on April 16, 2010. (Koch Decl. Ex. H.) The SEC's complaint alleged that—in a synthetic CDO transaction called ABACUS 2007-AC1—GS & Co. prepared marketing materials that allegedly failed to disclose Paulson's role in selecting the portfolio of CDOs referenced by, and Paulson's short position relating to, the CDO. (*See id.* ¶¶ 70, 74.) Specifically, the SEC contended that the marketing materials for that offering were misleading because they did not disclose "Paulson's adverse economic interests" in the transaction or Paulson's role in selecting the reference portfolio. (*Id.* ¶ 2; *see also id.* ¶¶ 3, 36, 70, 74 (same).) Similarly, the SEC complaint alleged that GS & Co. and one of its employees knowingly or recklessly misled ACA Management LLC ("ACA"), the portfolio selection agent for the transaction, into believing that Paulson had invested in the equity of the deal, and that ACA's and Paulson's economic interests were therefore aligned. (*Id.* ¶¶ 70, 74.)

On July 14, 2010, Goldman Sachs settled the SEC action "[w]ithout admitting or denying" the substantive allegations contained in the SEC's complaint. (Koch Decl. Ex. I ¶ 2(a).) In connection with that settlement, GS & Co. paid $550 million in disgorgement and fines, without any admission of wrongdoing (much less fraud) and made an acknowledgement only that it was a "mistake"—not an intentional violation of any statute or SEC rule—not to include in the marketing materials for the ABACUS 2007-AC1 transaction reference to Paulson's economic interest in, and role in selecting, the reference portfolio for that transaction.

(*Id.* ¶ 3; *see* Am. Compl. ¶¶ 73-74.) The SEC lawsuit triggered many others in the New York courts.[8]

C. The Substantive Allegations in the Complaint.

1. Claims Based on Excessive Compensation.

Although the plaintiffs in the New York compensation-based actions have voluntarily dismissed their claims, plaintiffs here continue to allege that Goldman Sachs has "overcompensated" its employees through a historical practice of paying "almost 50% of net revenues from 2007 through 2009" as compensation. (Am. Compl. ¶¶ 5, 85.) According to plaintiffs, Goldman Sachs' "substantial net revenues in 2009" were not the result of "the particular skill of its managers" (*id.* ¶¶ 102, 105), but rather of "[i]ts massive shareholder equity, supplemented by the government's TARP capital infusion and the FDIC loan guarantees" (*id.* ¶ 102). The Complaint does not attempt to explain why, if skill supposedly is irrelevant to Goldman Sachs' financial performance, other beneficiaries of even larger amounts of government support did not perform as well as Goldman Sachs. Additionally, at other points, the Complaint specifically acknowledges that Goldman Sachs' financial successes were "fuel[ed]" by the company's employees. (Am. Compl. ¶ 108.) Nonetheless—seeking to substitute their judgments on compensation for those of Goldman Sachs' managers—plaintiffs contend that, in light of the factors allegedly driving Goldman Sachs' performance, the level of risk that

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8 Shortly after the filing of the SEC's complaint, two shareholder plaintiffs filed derivative actions in the Supreme Court of New York, and another eight have been filed in the United States District Court for the Southern District of New York, principally on the theory that Goldman Sachs' directors and other individual defendants are liable for (1) falsely stating or causing the company to state that it did not bet against its clients' interests in connection with the ABACUS 2007-AC1 and other transactions, and (2) failing to disclose Goldman Sachs' receipt of a Wells Notice in advance of the SEC action. Two other shareholders have demanded that Goldman Sachs' board of directors institute suit based principally on the misconduct alleged in the SEC action. Additionally, a number of shareholders have filed securities class actions against Goldman Sachs and certain individual defendants, also in the federal district court in Manhattan, purportedly based on similar alleged disclosure violations.

Goldman Sachs allegedly assumed, and the level of compensation allegedly paid to others in comparable businesses, such as hedge fund managers or employees of other financial institutions, "the managers and officers of Goldman have not performed at a level even remotely sufficient to justify" Goldman Sachs' level of employee compensation. (*Id.* ¶¶ 120, 171.)

The Complaint targets Goldman Sachs' (supposed) "original allocation of 47% of net revenues and ultimate allocation and payment of 36% of net revenues" for compensation for 2009. (Am. Compl. ¶ 138.) The Complaint acknowledges that Goldman Sachs announced "that its top 30 executives would receive *no* cash bonuses for 2009 and would be awarded only stock that cannot be sold for five years." (*Id.* ¶ 108 (emphasis added).) The Complaint nonetheless claims that these changes "are only for 2009 and do not necessarily affect the more than 31,000 other Goldman [Sachs] employees, . . . which includes traders and other employees who are fueling most of this year's revenue and profit surge." (*Id.*) Besides generally crediting these thousands of employees with "fueling" the company's "surge" in revenues and profits, the Complaint alleges nothing about any individual employee's performance or compensation level, why any specific employee's compensation is excessive, or that Goldman Sachs has ever restated its past earnings in any respect, as have some of its competitors.

The Complaint takes a similar blunderbuss approach in its allegations regarding Goldman Sachs' September 2008 conversion to a bank holding company, alleging that the compensation decisions at issue here were somehow improper given that the conversion subjected Goldman Sachs to regulatory scrutiny by the Federal Reserve Bank of New York. (Am. Compl. ¶¶ 131-41.) Significantly, the Complaint nowhere alleges that the conversion decision, itself, was imprudent or improper. Instead, plaintiffs assert that, as a result of the increased regulatory obligations to which Goldman Sachs is subject following the conversion, and other developments following the onset of the financial crisis, defendants should have paid lower compensation in 2008 in order to ensure that "there was enough cash on hand to balance the Firm's risks." (Am. Compl. ¶¶ 137.) Even if such an overt challenge to matters at the core of the business judgment rule were permissible, the Complaint does not allege that the cash and assets available at Goldman Sachs at any time were insufficient to cover the company's risks and obligations, let alone specify, even in general terms, the amount by which compensation at Goldman Sachs should have been reduced for that purpose.

Based on these allegations, plaintiffs claim that defendants are liable for corporate waste because they "approv[ed] a compensation ratio to Goldman [Sachs] employees in an amount so disproportionately large . . . as to be unconscionable." (Am. Compl. ¶ 177.) In challenging the core business judgment of Goldman Sachs' Board, plaintiffs similarly claim that defendants breached their fiduciary duties by failing adequately to analyze the extent of the contribution by Goldman Sachs' management to the company's performance or to compare the compensation paid to Goldman Sachs' personnel with benchmarks that plaintiffs consider relevant, including compensation of hedge fund managers. (*Id.* ¶¶ 170-176.)

2. Claims Based on Goldman Sachs' CDO Business.

In their first set of amendments to the Complaint, plaintiffs alleged that the director defendants breached their fiduciary duties by "allowing the Firm to manage and conduct the Firm's trading segment in a[] grossly unethical manner," thereby subjecting Goldman Sachs "to potential civil liability and severe reputational harm, which will have a long-term impact on the Company." (Compl. ¶ 10; *accord id.* ¶¶ 1, 83, 150.) In their most recent amendments, plaintiffs have attempted to amplify this theme by postulating that the root cause of the alleged misconduct was that "management" supposedly had a "greater interest in the profits of the enterprise" than did Goldman Sachs' shareholders. (Am. Compl. ¶ 3.)

Plaintiffs allege that this "unethical" conduct took place "with respect to the housing and mortgage markets," in which Goldman Sachs allegedly failed to abide by the principle that "'[its] clients' interests always come first.'" (Am. Compl. ¶¶ 63, 64.) Plaintiffs acknowledge that Goldman Sachs achieved "very strong results" and "huge 'trading' profits" (*id.* ¶¶ 62, 82) by engaging in various protective activities, such as hedging transactions to reduce or offset the company's long exposure to CDOs. (*Id.* ¶¶ 62, 82.) They nonetheless claim that Goldman Sachs "crossed a clear line" by ending up with an "'overall net short'" position (*id.* ¶¶ 62, 63), because Goldman Sachs was "not only using its extensive analytical tools to direct its own Firm's and partners' capital investments, but was advising and urging its clients to put their money in investment vehicles that Goldman [Sachs'] analyses showed were likely to collapse." (*Id.* ¶ 63.) Relying extensively on statements by the Permanent Subcommittee on Investigations, the Complaint alleges that, even though the short strategy insulated the firm from the devastating losses that many other firms suffered and the counterparties were among the most sophisticated institutional investors in the world, Goldman Sachs suffered "reputational harm" by engaging in CDO transactions (such as those titled Hudson Mezzanine 2006-1, Anderson Mezzanine Funding 2007-1, and Timberwolf I) while taking positions that sought to "'profit[] from the decline of the mortgage market.'" (*Id.* ¶ 75.)

When it comes to identifying potential legal risk in connection with Goldman Sachs' CDO-related activities, plaintiffs rely on one transaction—the ABACUS 2007 AC-1 deal that is the subject of the SEC settlement. (Am. Compl. ¶ 73-74.) Plaintiffs seek to extrapolate from that one transaction allegations of a general failure of oversight resulting in a "systemic breaking of ethical lines." (*Id.* ¶ 4.) Plaintiffs assert that, in that transaction, Goldman Sachs "help[ed] one of its clients," Paulson, design a security allegedly "built out of a set of risky mortgage assets that [Paulson] helped select." (*Id.* ¶ 65.) Paulson then "placed a 'short' bet that the mortgages contained in the ABACUS CDO, ABACUS 2007-AC1, would fall in value," while Goldman Sachs "marketed long positions, *i.e.*, bets that the mortgage portfolio would increase in value, to other clients without disclosing Paulson's involvement in creating the portfolio and his bearish bet." (*Id.*) Plaintiffs do not appear to disagree that a synthetic CDO necessarily has a short side, as a result of which the "short bet" was obvious to any potential investor in the CDO. Nor does the Complaint dispute that the reference portfolio for the ABACUS 2007-AC1 CDO—however selected and regardless of who took the short side—was static and fully disclosed so that the sophisticated potential investors could make their own investment decisions whether they wished exposure to the portfolio based on their own analysis, economic assumptions, and desired exposure level.

Plaintiffs also acknowledge that Goldman Sachs acted as intermediary in the ABACUS deal (that is, matching long positions with short positions), for which it received fees of $15 million and, in fact, lost $90 million on long positions that Goldman Sachs allegedly was unable to resell. (Am. Compl. ¶ 69.) Goldman Sachs' role as a market-maker in the transaction was thus fully consistent with the marketing materials for the transaction, which the Complaint incorporates by reference. (*See id.* ¶ 72 (referring to the "creating and marketing [of] the ABACUS 2007-AC1 financial instruments").) Specifically, Goldman Sachs fully disclosed that, in its roles as initial purchaser and protection buyer (in which it acquired long and short positions that it then planned to resell to investors), it "may enter into credit derivative or other derivative transactions with other parties pursuant to which it sells or buys credit protection." (Koch Decl. Ex. J, at 33.) Goldman Sachs also expressly disclosed and confirmed that:

- Goldman Sachs was *not* "acting as a fiduciary or financial or investment adviser for the purchaser";

- The purchaser was "not relying (for purposes of making any investment decision or otherwise) upon any advice, counsel or representation" of Goldman Sachs or other enumerated entities involved in the transaction;

- Neither Goldman Sachs nor any other enumerated entity "has given to the purchaser (directly or indirectly through any other Person) any assurance, guarantee, or representation whatsoever as to the expected or projected success, profitability, return, performance, result, effect, consequence or benefit (including legal, regulatory, tax, financial, accounting or otherwise) as to an investment in the Notes";

- "[T]he purchaser has consulted with its own legal, regulatory, tax, business, investment, financial and accounting advisers to the extent it has deemed necessary, and it has made its own investment decisions";

- "[T]he purchaser has evaluated the terms and conditions of the purchase and sale of the Notes with a full understanding of all the risks thereof (economic and otherwise), and it is capable of assuming, and willing to assume (financially and otherwise) those risks"; and

- "[T]he purchaser is a sophisticated investor." (*Id.* at 117.)

Putting aside the merits of the SEC's claims against GS & Co., which were never litigated,[9] plaintiffs claim that the ABACUS 2007-AC1 transaction evidenced such supposedly "unethical" conduct as "[c]reating a financial product at the urging of Paulson, a favored client"; selling the product "knowing that Paulson had put an extraordinary amount of research into the likely failure of that product"; selecting ACA as the CDO manager, "knowing that ACA was unwilling, unable or incompetent to assess the synthetic CDO that it was going to manage"; and "urging" or "cajoling" the rating agencies to give certain tranches of the deal a AAA rating. (Am. Compl. ¶ 83.) Without discussing the details of any other transactions, plaintiffs further claim broadly that Goldman Sachs acted "unethically" when it allegedly (1) stated that it was long CDOs when it hedged its investments through proprietary trading and purchased insurance in the form of credit default swaps from AIG; and (2) informed Japanese clients that it did not sell synthetic CDOs in Japan. (*Id*.)

[9] The SEC's Action continues against an individual who was a member of the GS & Co. team on the ABACUS transaction.

D. Plaintiffs' Demand Allegations.

Plaintiffs concede that they have not first demanded that Goldman Sachs' Board of Directors take action as to these matters. Plaintiffs allege three bases to excuse demand. *First*, plaintiffs assert that the outside director defendants "participated in, approved, and/or permitted the wrongs alleged" in the Complaint. (Am. Compl. ¶ 143.) *Second*, plaintiffs contend that certain directors' charitable affiliations or business relationships with Goldman Sachs somehow raise questions about the directors' independence. (*Id.* ¶¶ 153-67.) *Third*, plaintiffs assert that demand is excused because—while conceding that defendants had an active Audit Committee charged with reviewing the Company's "market, credit, liquidity and other financial and operational risks" and the guidelines for managing these risks (*id.* ¶ 78 (internal quotation marks omitted))—plaintiffs nonetheless contend that defendants are subject to liability for failing adequately to oversee Goldman Sachs' CDO business. (*Id.* ¶ 147-52.)

ARGUMENT

I. THE COMPLAINT SHOULD BE DISMISSED FOR FAILURE TO COMPLY WITH RULE 23.1.

A. Plaintiffs Must Comply with Stringent Standards of Factual Particularity in Order to Plead That Demand Is Excused.

Under Delaware Chancery Court Rule 23.1, a shareholder who seeks to sue derivatively on behalf of a company without first demanding that its directors do so must "allege with particularity" the "reasons for the plaintiff's failure to obtain the action or for not making the effort." This threshold demand requirement "is a recognition of the fundamental precept that directors"—not shareholders—"manage the business and affairs of corporations." *Aronson* v. *Lewis*, 473 A.2d 805, 812 (Del. 1984). Thus, shareholders who fail to make this pre-suit demand must meet "stringent requirements of factual particularity" to explain why their failure should be excused. *Brehm* v. *Eisner*, 746 A.2d 244, 254 (Del. 2000).

Plaintiffs can meet these "stringent requirements" in two ways. Where plaintiffs challenge an affirmative board action, they must allege "particularized facts" creating a "reasonable doubt" that "(1) the directors are disinterested and independent" or "(2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Aronson*, 473 A.2d at 814; *see also Brehm*, 746 A.2d at 256 (explaining that the *Aronson* prongs operate disjunctively). Where, on the other hand, a complaint is premised on board inaction, plaintiffs must allege "particularized facts establishing a reason to doubt that 'the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.'" *Wood* v. *Baum*, 953 A.2d 136, 140 (Del. 2008) (quoting *Rales* v. *Blasband*, 634 A.2d 927, 934 (Del. 1993)).

B. Plaintiffs Have Failed to Plead with Particularity That Demand Here Is Excused.

1. Plaintiffs' Conclusory Allegations of Director Interest Do Not Excuse Demand.

Plaintiffs attempt to plead that all of Goldman Sachs' directors have a disqualifying interest because they allegedly "participated in, approved, and/or permitted" both the erroneously-predicted decisions to award supposedly excessive employee compensation in 2009 (as alleged in the original complaint) and in 2008 and 2007 (as alleged in plaintiffs' most recent amendments), as well as the employee misconduct alleged in the SEC action. Those allegations are patently insufficient under Delaware law to excuse demand.

As a threshold matter, as is discussed in section I.B.3.(a), below, plaintiffs have not pleaded any particularized facts creating a reasonable doubt that the directors face a substantial likelihood of personal liability because the Complaint fails to assert a cognizable claim that the directors did not comply with their oversight duties or engaged in any misconduct. Indeed, in light of Goldman Sachs' announcement of the levels of compensation actually approved for 2009, plaintiffs' core allegation underlying their initial Complaint, predicting that defendants would approve greater compensation, is now demonstrably false. In any event, the Delaware Supreme Court has made clear that a director's mere approval of an allegedly wrongful act in which he had no personal interest "does not make that director interested or dependent so as to infringe on his ability to exercise his independent business judgment of whether to proceed with the litigation." *Kaplan* v. *Wyatt*, 499 A.2d 1184, 1189 (Del. 1985).

Moreover, demand is not excused merely because "the directors would have to sue themselves, thereby placing the conduct of the litigation in hostile hands." *Brehm*, 746 A.2d at 257 n.34 (citing *Aronson*, 473 A.2d at 817-18; internal quotation marks omitted); *see also Seminaris* v. *Landa*, 662 A.2d 1350, 1355 (Del. Ch. 1995) (argument that directors cannot be expected to sue themselves is a "discredited refrain"); *Lewis* v. *Fites*, Civ. A. No. 12566, 1993 WL 47842, at *3 (Del. Ch. Feb. 19, 1993) (rejecting argument that demand was excused because director defendants would not sue themselves). The reason for this principle is obvious: if demand were excused whenever, "by mere notice pleading," a shareholder asserted a derivative claim against a corporate board of directors, "the demand requirement of the law would be weakened and the settlement value of so-called 'strike suits' would greatly increase, to the perceived detriment of the best interests of stockholders." *Guttman* v. *Huang*, 823 A.2d 492, 500 (Del. Ch. 2003).

2. Plaintiffs Have Failed to Plead That Any Director Lacks Independence Because of Any Financial or Other Relationship.

Plaintiffs' attempts to impugn the independence of Goldman Sachs' outside directors through vague allegations of past or present affiliations with various charities or with companies that have conducted business with Goldman Sachs also are legally insufficient under Delaware law to excuse demand. Indeed, two federal district courts and the United States Court of Appeals for the Second Circuit recently applied Delaware law to reject virtually identical demand-futility allegations made against essentially the same Goldman Sachs Board. *See LMPERS*, 2009 WL 1422868, at *5-8; *Bader*, 2008 WL 5274442, at *8-9, *aff'd* 356 F. App'x 471 (2d Cir. 2009), *cert. denied*, 130 S. Ct. 3287 (2010); *Bader*, 2010 WL 3938410, at *6-7.

Service on Philanthropic Boards. Plaintiffs allege that six directors' service on charitable organizations that have received donations from the Foundation renders them incapable of objectively evaluating a demand request here.[10] These allegations do not suffice and have already been rejected by other courts.

The Complaint fails to allege any particularized facts to suggest that the directors' alleged affiliations with charitable institutions that received donations from the Foundation could raise a doubt as to any director's independence from Goldman Sachs. Indeed, the courts in both *LMPERS* and *Bader* rejected virtually identical allegations regarding the same directors as grounds to excuse pre-suit demand. *See LMPERS*, 2009 WL 1422868, at *6 (concluding that "[p]laintiff's allegation concerning the Outside Directors' affiliation with charities to which Goldman Sachs has allegedly made contributions is insufficient to excuse the demand requirement"); *Bader*, 2008 WL 527442, at *8 (rejecting allegations of directorial "interest" premised on the Foundation's "charitable contributions to organizations with which these

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[10] Whether the court focuses on the Board's ability to consider a demand request as of the dates of either the commencement of this action or of the filing of the first amended complaint, the result would be the same. That is because, in January and April 2010, when the complaint and first amended complaint were filed, Goldman Sachs' board of directors was comprised of the same 12 members. (Am. Compl. ¶ 145.) At the time of filing of the second amended complaint, the Board had 11 members (Mr. Gupta and Ms. Simmons no longer serve as directors and a new director, H. Lee Scott, Jr., has been elected). Where, as here, the Board at issue had an even number of members, plaintiffs must demonstrate that at least half of the board was interested or not independent in order to establish that a demand would have been futile. *See, e.g.*, *In re The Limited, Inc. S'holders Litig.*, Civ. A. No. 17148-NC, 2002 WL 537692, at *7 (Del. Ch. Mar. 27, 2002). Assuming, *arguendo*, that the two directors who are also Goldman Sachs executives—Lloyd C. Blankfein and Gary D. Cohn—are not independent of Goldman Sachs, plaintiffs are required to plead adequately the compromised interest or dependence of at least four other Goldman Sachs directors.

directors were affiliated"), *aff'd* 356 F. App'x at 474; *see also Bader*, 2010 WL 3938410, at *7 (concluding that plaintiff was collaterally estopped "from relitigating the issue of demand futility"). The Complaint here should meet the same fate because it makes clear that the Foundation is a philanthropic organization with its own Board of Trustees and staff separate from Goldman Sachs (Am. Compl. ¶¶ 153-55), and plaintiffs have not alleged that Goldman Sachs had the ability to control the Foundation's donations unilaterally. *See Bader*, 2008 WL 5274442, at *9.

Plaintiffs also have not adequately alleged that the Foundation's donations could render directors so "beholden" to Goldman Sachs as to undermine the independence of their judgment.[11] *See LMPERS*, 2009 WL 1422868, at *6 (charitable donations by Foundation did not excuse demand because, even if Goldman Sachs itself had made donations, no doubt would be raised as to directors' independence). Of the six directors as to whom plaintiffs plead current charitable affiliations, the Complaint alleges that five sit on advisory boards or serve as voluntary trustees or directors of those charities. (Am. Compl. ¶¶ 157-61.) As in *In re J.P. Morgan Chase & Co. Shareholder Litigation*, plaintiffs here make no particularized allegation of how the donations at issue exerted "any potential influence" on any of these directors; they fail even "to indicate what percentage of the [charities'] overall contributions are made by [the Foundation]." 906 A.2d 808, 822 (Del. Ch. 2005); *see also LMPERS*, 2009 WL 1422868, at *6 ("It is settled law that charitable contributions do not excuse demand without 'many more particularized facts

[11] Plaintiffs similarly do not allege that any director is beholden to an *interested director*, as opposed to the company or its management. *See In re Dow Chem. Co. Deriv. Litig.*, Civ. A. No. 4349, 2010 WL 66769, at *8 (Del. Ch. Jan. 11, 2010). Plaintiffs allege, conclusorily, that the Foundation is "controlled by Goldman management." (Am. Compl. ¶ 153.) The Complaint does not allege, however, that any member of the Foundation's "management" is a current Goldman Sachs director, much less a defendant in this action. (*See* Am. Compl. ¶ 155 (alleging that the Foundation's president is Stephanie Bell-Rose and that the Foundation's board consists of John C. Whitehead, Thomas W. Payzant, Frank H. T. Rhodes, Neil Rudenstine, Josef Joffe, Stuart Rothenberg, John F.W. Rogers, and Glenn Earle).)

about the materiality of the relationship in question that would create a reasonable doubt about the independence of the directors.'") (quoting *J.P. Morgan Chase & Co.*, 906 A.2d at 823 n.48).

Moreover, the Complaint does not allege with respect to any of the six directors that the donations at issue were material to the charity or director, or that the directors used their respective directorships or relationships with a controlling director to obtain a disproportionate donation from the company.[12] This case is thus far removed from those few cases in which directors' solicitations of extraordinary donations through their pre-existing relationships with a controlling director raised legitimate questions regarding their independence. *See*, *e.g.*, *The Limited*, 2002 WL 537692, at *6-7 & n.41 ($25 million donation to university of which director was president represented "extraordinary gift" that could reasonably be viewed "as instilling in [the director] a sense of 'owingness' to [the controlling director and officer]"); *Lewis* v. *Fuqua*, 502 A.2d 962, 966-67 (Del. Ch. 1985) (defendants did not meet their summary judgment burden of showing director's independence where, as a former state governor and current university president, he had "numerous political and financial dealings" with CEO who allegedly controlled the board, including a recent $10 million pledge to the university). At most, plaintiffs' allegations on this issue point out the unremarkable fact that Goldman Sachs and certain of its directors donate their time or money to sometimes overlapping groups of major non-profit

[12] Plaintiffs assert, citing 17 C.F.R. § 229.402(k)(2)(vii) & Instr. 3, that "[t]he SEC views a contribution for each director to be material if it equals or exceeds $10,000 per year." (Am. Compl. ¶ 163.) Setting aside the fact that this SEC rule does not define "materiality" for purposes of Delaware law, plaintiffs' description of this rule is inaccurate. The provision that plaintiffs cite does not mention "materiality" or express a view on the level required under Delaware law to give rise to a conflict, but simply instructs that companies must disclose in certain SEC filings director compensation in the form of "perquisites and personal benefits" with a value over $10,000. In any event, because plaintiffs have alleged that the Foundation provided money to charities, not to the directors themselves, it is irrelevant whether the amounts of the donations would be deemed material to the compensation of an individual director. Plaintiffs have made no attempt to plead materiality *to the charity*. *See J.P. Morgan Chase & Co.*, 906 A.2d at 822-23 & n.48.

organizations. This is not sufficient. *See J.P. Morgan Chase & Co.*, 906 A.2d at 822 (allegations concerning common donations to American Museum of Natural History did not create reasonable doubt concerning director independence).

Alleged Business Relationships. Plaintiffs also allege that one director serves as an advisor to investment funds with which Goldman Sachs has invested, and that another director is the CEO of a company that has retained Goldman Sachs to provide underwriting or other professional services or credit. (*See supra* p. 18.) Not only do these allegations fail to plead the types of relationships that could render these directors "beholden" to any interested director, they do not even suggest that these directors are beholden to Goldman Sachs:

- Plaintiffs do not allege that any fees paid by Goldman Sachs to investment funds advised by defendant Claes Dahlbäck (Am. Compl. ¶ 165) affected Mr. Dahlbäck's personal compensation in any way or, if so, to what extent; nor have plaintiffs alleged that Mr. Dahlbäck was personally involved in the fund's business or investment with Goldman Sachs.[13]

- While plaintiffs allege that Goldman Sachs extended credit or provided or arranged financing to a company for which defendant Lakshmi N. Mittal serves as CEO (Am. Compl. ¶ 166), plaintiffs do not allege that Mr. Mittal was personally involved in Goldman Sachs' engagement or that the services provided by Goldman Sachs were anything other than the ordinary professional services available from various investment banks in the financial markets today.[14]

[13] In addition to this allegation regarding Mr. Dahlbäck, plaintiffs also allege vaguely that Goldman Sachs "has invested at least $670 million in funds managed by Defendant [Stephen] Friedman." (Am. Compl. ¶ 160.) The Court should disregard this wholly unparticularized allegation, which does not even attempt to identify the funds with which Goldman Sachs supposedly invested. *See Katz* v. *Halperin*, No. 13811, 1996 WL 66006, at *6 (Del. Ch. Feb. 5, 1996). In any event, the allegation regarding Mr. Friedman suffers from the same deficiencies as those regarding Mr. Dahlbäck, and does not suffice to establish Mr. Friedman's lack of independence.

[14] Indeed, the Complaint's allegations that a company with which Mr. Mittal is affiliated hired Goldman Sachs to arrange financing or credit—services provided by numerous banks and for which those banks are compensated—refute any suggestion of Mr. Mittal's dependence. At most, under plaintiffs' reasoning, those allegations might support an inference that Goldman Sachs is beholden to Mr. Mittal for that business and compensation, not the converse.

Such allegations of standard business relationships and the provision of customary professional services available from numerous companies in the marketplace could not, without more, establish the "beholdenness" of any Goldman Sachs director. *See, e.g., J.P. Morgan Chase & Co.*, 906 A.2d at 821-22 (bank's participation in loans or financings to companies with which directors had relationships did not establish dependence); *see also Khanna* v. *McMinn*, Civ. A. No. 20545, 2006 WL 1388744, at *16 (Del. Ch. May 9, 2006) (allegations of "ordinary [business] relationships" among directors are of "limited value" due to "heightened strength of relationship required" to excuse demand).

3. Plaintiffs Have Failed to Meet Their Heavy Burden to Plead That the Directors' Conduct Was Not the Product of a Valid Exercise of Business Judgment.

Having failed to show that six directors are "interested" under *Aronson*'s first prong, plaintiffs also fall far short of meeting their heightened pleading burden under *Aronson*'s second prong to demonstrate that the conduct of these otherwise-disinterested directors was not the product of a valid exercise of business judgment. Plaintiffs face—and fail to satisfy—a heightened burden under this pleading standard. *See Aronson*, 473 A.2d at 815 ("[T]he mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors, although in rare cases a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists."); *Guttman*, 823 A.2d at 500 (explaining that *Aronson*'s second prong requires "a heightened pleading standard of particularity" to ensure that demand is not excused by "mere notice pleading" where the board is otherwise "structurally independent and presumptively capable of acting impartially on a demand [request]"). "Indeed, cases where such liability qualifies as an interest for the purpose of excusing demand occur[] only 'rare[ly],' 'where defendants' actions were so egregious that a substantial likelihood of director liability exists.'"[15] *Rahbari* v. *Oros*, ___ F. Supp. 2d ___, 2010 WL 3069632, at *7 (S.D.N.Y. July 30, 2010) (quoting *Seminaris*, 662 A.2d at 1354).

Here, as in *Wood*, "plaintiff[s] attempt[] to create a 'reasonable doubt' that the Board would have properly exercised its business judgment by alleging that the Board was disabled because of a substantial risk of personal liability." 953 A.2d at 140-41; *see* Am. Compl. ¶ 152. Also as in *Wood*, "[i]n evaluating that claim, it must be kept in mind" that Goldman Sachs' certificate of incorporation immunizes its directors for actions taken in good faith.[16] 953 A.2d at 141. Thus, "plaintiff[s] must also plead particularized facts that demonstrate that the directors acted with scienter, *i.e.*, that they had 'actual or constructive knowledge' that their conduct was legally improper." *Id.* Under this standard, the relevant issue is whether the Complaint alleges specific "facts that, if proven, would show that a majority of the defendants knowingly engaged in 'fraudulent' or 'illegal' conduct or breached 'in bad faith' the [implied] covenant of good faith and fair dealing." *Id.*

The Complaint does not meet this challenging standard. Plaintiffs do not "even purport to state a cause of action for fraud, let alone plead the specific facts required to support such a claim." *Wood*, 953 A.2d at 141. Instead, the Complaint includes only generalized allegations of corporate waste and conclusory allegations of deficient oversight over business

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[15] Irrespective of whether consideration of the director defendants' exposure to a "substantial likelihood of liability" is included in an analysis of director disinterestedness under *Aronson*'s first prong (as discussed in Section I.B.1., above), or as part of the analysis of whether the directors exercised valid business judgment under *Aronson*'s second prong, plaintiffs' allegations cannot excuse their failure to comply with the demand requirements of Rule 23.1.

[16] Specifically, Goldman Sachs' certificate of incorporation exculpates Goldman Sachs' directors—as permitted under Delaware law, *see* 8 Del. C. § 102(b)(7)—from liability for breaches of fiduciary duty absent bad faith, willful misconduct, or a breach of the duty of loyalty. (*See* Koch Decl. Ex. K, at Art. 12; Koch Decl. Ex. L, at Art. 12.) The Court may take judicial notice of a certificate of incorporation as a matter of public record. *See In re Baxter Int'l, Inc. S'holders Litig.*, 654 A.2d 1268, 1270 (Del. Ch. 1995) ("The court may take judicial notice of the certificate [of incorporation] in deciding a motion to dismiss.").

activities. "Such assertions are insufficient to state an actionable claim for fraud." *Id.* Nowhere do plaintiffs allege that the directors knew about and ignored "red flags" or plead facts demonstrating that the directors "consciously and in bad faith ignored the improprieties alleged in the complaint." *Id.* at 143.

Under either *Aronson* prong, the Complaint fails to allege any basis on which the director defendants could be subject to liability and, thus, plaintiffs' failure to comply with the pre-suit demand requirement is not excused.

(a) Plaintiffs Fail to Plead Adequately That the Directors Face a "Substantial Likelihood" of Liability for Any Claim Based on Excessive Compensation.

Plaintiffs fail to plead with the requisite particularity facts that would render the directors' compensation decisions ineligible for the "protection[s] of the business judgment rule." *In re Dow*, 2010 WL 66769, at *9 (internal quotation marks omitted).[17] This is particularly so considering that "[i]t is the *essence* of business judgment for a board to determine if a particular individual warrants large amounts of money, whether in the form of current salary or severance provisions." *Brehm*, 746 A.2d at 263 (emphasis added; internal quotation marks and alteration omitted); *see also id.* ("[T]he size and structure of executive compensation are inherently matters of judgment"); *In re AIG Sec. Litig.*, 700 F. Supp. 2d 419, 443 (S.D.N.Y. 2010) ("Under Delaware law, corporate boards have broad discretion to set executive compensation, and courts rarely second-guess directors' compensation and severance decisions

[17] As discussed above (*see supra* pp. 7-9), Goldman Sachs' outside directors are highly sophisticated and experienced business executives, and include a former Chairman of the Federal Reserve Bank of New York (who had also formerly served as the Director of the National Economic Council and Assistant to the President for Economic Policy), and the current or former Chief Executive Officers of some of the world's largest companies, such as PricewaterhouseCoopers LLP, Sara Lee Corp., ArcelorMittal, and Zurich Financial Services. The directors' competence to exercise their collective business judgment to oversee the setting of employee compensation is indisputable.

because the size and structure of executive compensation are inherently matters of judgment." (internal quotation marks omitted)).

The compensation allegations fail to overcome this broad business judgment protection for at least three reasons.

First, the Complaint fails to satisfy even the most basic standards of notice pleading on the subject of executive compensation because it says nothing about the compensation levels of any of Goldman Sachs' thousands of individual employees. Plaintiffs' challenge is not that any particular employee was overcompensated—notwithstanding that such a claim would not be cognizable under the "business judgment" rule. The Complaint does not allege any facts, for instance, showing that a compensation or severance package was given to a specific executive departing a company under inopportune circumstances or following financial reversals. Rather, plaintiffs attack as excessive the aggregate level of compensation paid to thousands of Goldman Sachs personnel without any particulars as to how much any of those employees was paid or why any specific employee's compensation was somehow so excessive as to constitute corporate waste. Plaintiffs, thus, base their allegations on merely a generalized and "bare assertion" that compensation was excessive. *Aronson*, 473 A.2d at 817. Such allegations are legally insufficient. *See id.* ("bare assertion[s]" that an employee "performed 'little or no services'" are not enough to overcome "the directors' broad corporate power to fix the compensation of officers"); *see also Brehm*, 746 A.2d at 253, 263 ($140 million severance package to former CEO did not support claim for waste due to "excessive" compensation).

In fact, a New York court construing Delaware law recently dismissed as "conclusory" parallel allegations that Morgan Stanley's aggregate compensation levels in recent years were "'unconscionably high'" or "excessive in light of the company's performance." *See*

Sec. Police & Fire Prof'ls of Am. Ret. Fund v. *Mack*, ___ N.Y.S.2d ___, 2010 WL 5094348, at *7, *9 (N.Y. Sup. Ct. Dec. 9, 2010); *see also id.* at *11 (holding that plaintiffs failed to allege "particularized facts raising a reasonable doubt that the compensation paid by Morgan Stanley during the relevant years was 'disproportionately' large or 'unconscionable' in light of employee contributions"). The court rejected allegations that a ratio of compensation to net revenues in 2009 of *62%* was improperly excessive—a ratio *substantially higher* than Goldman Sachs' for any year at issue here and in the face of weaker net revenues—and emphasized that it was within the board's discretion to set "compensation levels in light of business considerations such as employee retention and morale." *Id.* at *9. The court reasoned that the plaintiffs there could not raise a reasonable doubt that this discretion was exceeded absent allegations that "any specific employee[]" or "group of employees[]" performed deficiently and that this deficiency was known to the directors "at the time the specific compensation decisions were made." *Id.* at *11 (emphasis omitted).

Neither of plaintiffs' two rounds of pleading amendments has rectified this fundamental absence of allegations regarding the compensation determinations for any individual Goldman Sachs employee or group; to the contrary, the expansion of plaintiffs' claims through the recent amendments to cover the aggregate compensation paid to thousands more employees in 2007 and 2008 has exacerbated the unparticularized nature of the claims. Plaintiffs' recent additions to the Complaint of allegations purporting to compare compensation levels with those at other financial firms also do not cure this defect because plaintiffs improperly continue to lump and compare all compensation decisions in the aggregate and still fail to identify the compensation of any particular employee at Goldman Sachs, much less how that compensation was irrational or improper in light of that employee's contribution to the firm.

(*See* Am. Compl. ¶¶ 9, 119.) Nor do these allegations account for differences among the businesses operated by the various financial institutions with which Goldman Sachs competes for personnel. In all events, plaintiffs' repeated allegations (which they do not attribute to any source) in the new Complaint that Goldman Sachs paid "compensation per employee that is more than two to six times greater than its peers" are flat-out wrong. (*See*, *e.g.*, Am. Compl. ¶¶ 9, 119.) Dividing the aggregate annual compensation amounts specified in the Complaint (Am. Compl. ¶ 123) by the number of employees disclosed in Goldman Sachs' annual reports on Form 10-K results in "per employee" amounts that are far lower than the inflated numbers touted by plaintiffs as justifying their claims.[18] (*See* Koch Decl. ¶¶ 17-20 (providing corrected calculations).)

Second, even plaintiffs' generalized assertions of excessive compensation are refuted by the valuable consideration—acknowledged in the Complaint—that Goldman Sachs received from its employees. *See White* v. *Panic*, 783 A.2d 543, 554 (Del. 2001) ("[A] corporate waste claim must fail if there is *any substantial* consideration received by the corporation, and . . . there is a *good faith judgment* that in the circumstances the transaction is worthwhile." (internal quotation marks omitted; emphases and ellipsis in original)). The Complaint here expressly pleads that Goldman Sachs specifically linked "pay to performance." (Am. Compl. ¶ 87.) In 2009, as the Complaint acknowledges, that performance enabled Goldman Sachs to benefit from a "revenue and profit surge." (*Id.* ¶ 108.) No doubt for this reason, plaintiffs do not even try to assert that Goldman Sachs' thousands of employees performed "little or no services"

[18] For example, plaintiffs assert that, "[i]n 2008, Goldman paid on average $740,000 per employee while Morgan Stanley paid $530,000." (Am. Compl. ¶ 119.) Calculated on the same basis using the publicly-available information in the Complaint and SEC filings, the "per employee" amount for Goldman Sachs should have been $363,000. (*See* Koch Decl. ¶ 18.) Plaintiffs' alleged "per employee" compensation amounts at Goldman Sachs for 2009, 2007 and 2006 are similarly inflated when compared with this publicly-available information. (*See* Koch Decl. ¶¶ 17, 19, 20.)

for the company, and cannot satisfy the requirement to plead that Goldman Sachs' employee compensation for the years 2007 to 2009 was a "gift" for which Goldman Sachs received no reciprocal benefit from its thousands of employees. This is especially so considering plaintiffs' acknowledgment that the firm earned, respectively, $46.0 billion, $22.2 billion and $45.2 billion in net revenues in each of those years. (Am. Compl. ¶ 123.)

Third, plaintiffs do not and cannot allege that the directors failed to set compensation levels in good faith. The Complaint itself alleges that Goldman Sachs' Board has a functioning Compensation Committee—consisting solely of outside directors whose independence plaintiffs do not seriously question—that considered and approved Goldman Sachs' annual employee compensation. (Am. Compl. ¶ 89.) While plaintiffs assert that this committee approved Goldman Sachs' 2007 to 2009 compensation without considering what plaintiffs seek to designate as the appropriate compensation benchmarks—specifically, fees paid to hedge fund managers—plaintiffs concede that defendants' approval was based on a review of detailed information about the firm's financial performance and the compensation metrics used by peer firms operating in the same industry. (*Id*.) Thus, far from being announced "without expla[nation]" (Am. Compl. ¶ 178), the compensation ratio for 2009 varied from the ratios in other years based on these projections and other factors, such as employee retention considerations:

> [C]ompensation expense can vary from year to year . . . based on our performance, prevailing labor markets and other factors. Our record low compensation ratio for 2009 reflects both very strong net revenues and the broader environment in which we currently operate. (Koch Decl. Ex. A, at 79.)

In view of these considerations, plaintiffs' allegations that defendants breached some duty of loyalty or oversight by failing to weigh all factors as plaintiffs would prefer in setting or approving aggregate compensation ignore the relevant, and well-established, legal standard. To sustain a disloyalty claim, plaintiffs must allege an "extreme set of facts" showing that the directors "'*intentionally* fail[ed] to act in the face of a known duty to act, demonstrating a conscious disregard for [their] duties.'" *Lyondell Chem. Co.* v. *Ryan*, 970 A.2d 235, 243 (Del. 2009) (emphasis added); *see also Wayne County Employees' Ret. Sys.* v. *Corti*, Civ. A. No. 3534-CC, 2009 WL 2219260, at *14 (Del. Ch. July 24, 2009) ("bad faith" cannot "be shown by merely showing that the directors failed to do all they should have done under the circumstances"), *aff'd*, 996 A.2d 795 (Del. 2010) (Table); *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 654 (Del. Ch. 2008) ("Courts should . . . be extremely chary about labeling what they perceive as deficiencies in the deliberations of an independent board majority over a discrete transaction as not merely negligence or even gross negligence, but as involving bad faith."). No such extreme facts are alleged here. There are simply no further "legally prescribed steps," *Lyondell*, 970 A.2d at 243, that directors must take when making compensation decisions, determinations that are "inherently matters of judgment," *Brehm*, 746 A.2d at 263.

Fourth, plaintiffs cannot salvage their deficient claims by alleging that the directors improperly approved "a compensation structure that gave management a far greater stake in the firm than that of shareholders." (Am. Compl. ¶ 183.) Plaintiffs' assertion is contradicted by their own allegations that compensation and benefits always have comprised a *minority* of Goldman Sachs' net revenues. (Am. Compl. ¶ 115.) More fundamentally, far from pleading that compensation harmed the shareholders' interest in maximizing returns on the firm's equity, the Complaint implicitly concedes that affording "management" a share of the firm's profits *aligned* its interests with those of shareholders. (*See* Am. Compl. ¶ 3 (recognizing that both "management" and shareholders have an "interest in the profits of the enterprise"); Am. Compl. ¶ 92 (alleged practices "compensate employees for *results produced* by the vast amounts of shareholder equity that Goldman has available to be deployed" (emphasis added)); Am. Compl. ¶ 88 (acknowledging that, according to Goldman Sachs' 2007 proxy statement, the "'shareholder-approved plan'" to pay senior executives bonuses tied to the firm's performance was designed "'to align the interests of senior management with the interests of shareholders and to tie the compensation of [the firm's] senior executives to the success of the firm.'").) This acknowledgement is not surprising, considering that Delaware courts have long recognized that similar forms of incentive-based compensation, such as the stock- and cash-based compensation at Goldman Sachs, are designed to align the interests of directors or officers with those of shareholders.[19] (*See* Am. Compl. ¶ 108 (recognizing that at least a portion of executive compensation was paid in restricted stock).)

Similarly, plaintiffs' allegations regarding Goldman Sachs' conversion to a bank holding company or sale of preferred stock to an affiliate of Warren Buffett, fail reasonably to link those business decisions to Goldman Sachs' compensation structure. (*See* Am. Compl. ¶¶ 131-41.) Plaintiffs assert that, in light of the allegedly stricter capital requirements imposed as a result of the conversion, defendants' decision to grant allegedly "excessive amount[s] of compensation" was "particularly egregious." (Am. Compl. ¶ 146.) But the complaint nowhere alleges that Goldman Sachs' compensation levels caused a deviation from the allegedly stricter capital requirements, and plaintiffs fail to explain why the conversion decision or sale of

[19] *See, e.g.*, *Capital Group Cos.* v. *Armour*, Civ. A. No. 422-N, 2005 WL 678564, at *9 (Del. Ch. Mar. 15, 2005) ("[R]estricting ownership interest in the stock to employees (or their immediate families) clearly aligns the interests of the employees with [the company]. Having an ownership interest in the company gives the employees more of the benefits of the company's success, and more of the risks in the company's failure."); *LC Capital Master Fund, Ltd.* v. *James*, 990 A.2d 435, 452 (Del. Ch. 2010) ("[I]t has been thought that having directors who actually owned a meaningful, long-term common stock stake was a useful thing, because that would align the interests of the independent directors with the common stockholders and give them a personal incentive to fulfill their duties effectively."); *In re Pennaco Energy, Inc.*, 787 A.2d 691, 709 (Del. Ch. 2001) ("[T]he board's grant of options to itself . . . was consistent with a policy of aligning the board's interests with those of the stockholders. This is a permissible purpose.").

preferred stock (which, if anything, bolstered the firm's capital) are not matters within defendants' core business judgment.

Plaintiffs cite additional lawsuits filed "since late 2009" to suggest that Goldman Sachs' "management was compensated for 2005, 2006 and 2007, based upon inflated financial numbers and rewarded for performance that as a result of their risk-laden and overleveraged practices was non-existent." (Am. Compl. ¶¶ 103, 106.) Even if there were some basis to credit the allegations in those lawsuits, plaintiffs' reliance on them here is beside the point, as plaintiffs' claims do not challenge defendants' pre-2007 compensation decisions. Moreover, these lawsuits against "banks and investment firms" market-wide (Am. Compl. ¶ 103) do not support by hindsight any allegation that, when the compensation decisions were made, defendants knew that Goldman Sachs' revenue figures were allegedly "inflated" and yet disregarded that supposed inflation when awarding compensation. *See Sec. Police*, 2010 WL 5094348, at *7 (rejecting as "conclusory" allegations that employee compensation was "excessive because it ignored the quality and source of the company's revenues and net income"). And, "even if the revenues and income were inflated by risky investments, as plaintiffs allege, there is no evidence suggesting that the total compensation paid failed to reflect the underlying risk." *Id.* at *7.

Even putting aside the irrationality of plaintiffs' newly-asserted theory that linking compensation to financial performance or "profits" somehow constitutes a "conflict" (as opposed to the very alignment of interest that investor groups demand), plaintiffs' claims here must fail under the business judgment rule. The Complaint recognizes that, among the many factors "consistently" employed by the directors "to justify Goldman [Sachs'] compensation levels," was "the need to hire and retain personnel." (Am. Compl. ¶ 91.) Nowhere does the

Complaint allege, let alone detail, why it was improper for defendants to decide that the need to hire and retain employees who generated billions of dollars in revenue year after year in a highly competitive industry outweighed any supposed "conflict" introduced by the compensation structure they approved.

In all, the Complaint does not—and could not—allege the extreme misconduct necessary to subject directors to personal liability for approving compensation packages, and therefore excuse demand on that basis. While the Delaware courts recognize that "'there is an outer limit' to the board's discretion to set executive compensation," *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 138 (Del. Ch. 2009), the Complaint lacks any basis to suggest that the compensation here approached that limit or that that compensation was anything other than a product of the board's considered business judgment. To the contrary, the allegations of the Complaint expressly make the case that Goldman Sachs, and its shareholders, received substantial benefit from Goldman Sachs' employees and that the process by which those employees were compensated was informed and deliberative, and that the resulting compensation was generally consistent with prevailing industry norms. These allegations plainly fail to excuse demand under the heightened pleading standards of *Aronson*'s second prong, and, for the reasons discussed in Section II.A., below, fail even to state a claim on the merits.

(b) Plaintiffs Fail Adequately to Plead That the Directors Face a "Substantial Likelihood" of Liability for Any Oversight Claim.

The Complaint alternatively suggests that the directors face a substantial likelihood of liability for alleged failure of oversight of a relatively small segment of Goldman Sachs' global operations. Such assertions present "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment," *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996), and require proof that "(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. 2006) (citing *Caremark*, 698 A.2d 959); (emphasis omitted)).

To satisfy either prong of this test, "imposition of liability requires a showing that the directors *knew* that they were not discharging their fiduciary obligations." *Stone*, 911 A.2d at 370 (emphasis added). This standard does not permit a plaintiff to plead a failure to monitor through hindsight deduction from the occurrence of possible misconduct or corporate liability. Such a pleading approach would impermissibly seek to hold directors liable as guarantors against the possibility of any corporate misconduct or misfortune, and "no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation's compliance with the law." *Caremark*, 698 A.2d at 970; *see also In re HealthSouth Corp. S'holders Litig.*, 845 A.2d 1096, 1107 (Del. Ch. 2003), *aff'd*, 847 A.2d 1121 (Del. 2004). All that is required of directors is that they "exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility." *Caremark*, 698 A.2d at 970. If the law were otherwise, plaintiffs could evade the demand requirement simply by "equat[ing] a bad outcome with bad faith." *Stone*, 911 A.2d at 373.

Plaintiffs here fail to plead sufficiently either that the directors "utterly failed to implement any reporting or information system or controls" or that, "having implemented such a system," they have "consciously failed to monitor or oversee its operations." *Stone*, 911 A.2d at 370. Significantly, there is, and could be, no allegation here that the directors "utterly failed" to implement a reporting system. To the contrary, the Complaint openly pleads that Goldman Sachs had a functioning Audit Committee—consisting solely of outside directors whose independence plaintiffs do not seriously challenge (Am. Compl. ¶ 145)—that was charged with "assisting the Board in its oversight of 'the Company's management of market, credit, liquidity and other financial and operational risks.'" (*Id.* ¶ 78.) In fulfilling that mandate, the Audit Committee members were "required" to, among other things, "'discuss with management periodically management's assessment of the Company's market, credit, liquidity and other financial and operational risks, and the guidelines, policies and processes for managing such risks.'" (*Id.*) This concession alone refutes any suggestion that defendants "failed to implement any reporting or information system or controls." *Stone*, 911 A.2d at 370; *see also id.* at 373 (affirming dismissal of complaint for failure to plead demand futility where documents incorporated in complaint showed that "the Board received and approved relevant policies and procedures, delegated to certain employees and departments the responsibility for filing [Suspicious Activity Reports] and monitoring compliance, and exercised oversight by relying on periodic reports from them"); *see also Kanter* v. *Barella*, 388 F. Supp. 2d 474, 480 (D.N.J. 2005) (rejecting *Caremark* claim; noting that "[p]laintiff concedes that [the company] had an audit committee"), *aff'd*, 489 F.3d 170 (3d Cir. 2007).

Further, there is no allegation of a "conscious[] fail[ure]" to monitor these systems, demonstrating that the directors "knew that they were not discharging their fiduciary obligations." *Stone*, 911 A.2d at 370. The most plaintiffs can manage is the conclusory assertion that the directors "allow[ed] the Firm to manage and conduct the Firm's trading segment in [a] grossly unethical manner." (Am. Compl. ¶ 152.) But these allegations "do not even specify how the board's oversight mechanisms were inadequate or how the director defendants knew of these inadequacies and consciously ignored them." *Citigroup*, 964 A.2d at 128.

The *only* allegation of a violation of law is plaintiffs' reference to the conduct at issue in the settled SEC case. (*See* Am. Compl. ¶¶ 65-74.) The SEC complaint, however, did not allege systemic misconduct that the directors supposedly knew about and ignored. Rather, that complaint was based on an alleged disclosure violation made by GS & Co. and one of its employees in the marketing materials for *one* synthetic CDO transaction, *see supra* at 11-12, as the Complaint here concedes. (Am. Compl. ¶ 72.) Even if an underlying violation had occurred in connection with the ABACUS 2007 AC-1 deal, that would not indicate that the Goldman Sachs' monitoring systems were inadequate, much less that the directors *knew* about such inadequacies at the time of the transaction. "[N]o rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations." *Caremark*, 698 A.2d at 970. Indeed, Delaware courts "routinely reject the conclusory allegation that because illegal behavior occurred, internal controls must have been deficient, and the board must have known so." *Desimone*, 924 A.2d at 940; *see also Fink* v. *Komansky*, No. 03 Civ. 0388 (GBD), 2004 WL 2813166, at *6 (S.D.N.Y. Dec. 8, 2004) (dismissing oversight claims "[w]here plaintiff has 'not pled with particularity that the directors ignored obvious danger signs of employee wrongdoing' but instead base[d] his claim 'on a presumption that employee wrongdoing would not occur if directors performed their duty properly'" (quoting *Baxter*, 654 A.2d at 1270-71)).

Plaintiffs' most recent amendments describe the settlement of the SEC action but, critically, do not point to any specific "red flags" referenced in the settlement or otherwise indicating that defendants knew of alleged monitoring deficiencies at the time of the alleged wrongs and yet failed to take required action. In fact, the most that plaintiffs can allege is the speculative and hindsight-based assertion that the settlement with the SEC concerning representations made in one synthetic CDO transaction "likely" represents "just the tip of the iceberg." (Am. Compl. ¶ 75.)

Plaintiffs cannot advance their claims by pointing out that Goldman Sachs agreed to "comply with specific undertakings" (Am. Compl. ¶ 73) as a result of the settlement. Significantly, that agreement included an acknowledgment that Goldman Sachs was "conducting a comprehensive, firmwide review of its business standards" (Am. Compl. ¶ 79) and certain prospective "undertakings" relating to enhancements to Goldman Sachs' review and approval processes for certain transactions. (Am. Compl. ¶ 73.) Those commitments address only potential enhancements to Goldman Sachs' *existing* systems and controls and, thus cannot demonstrate that "the directors utterly failed to implement any reporting system or controls" or "oversee its operations" prior to the settlement. *Stone*, 911 A.2d at 370. None of plaintiffs' allegations concerning the settlement suggests that the directors knew about and ignored "red flags" at the time of the alleged misconduct, and plaintiffs' attempt to "second-guess[]" the directors' judgment "after the occurrence of employee conduct that results in an unintended adverse outcome" is an impermissible attempt to plead by hindsight. *Id*. at 373.

Nor can plaintiffs save their allegations by relying on their assertions that Goldman Sachs' directors should somehow be held accountable for allowing the firm to "engag[e] in increasingly risky practices in the name of profit" or marketing a financial product (*i.e.*, CDOs) that plaintiffs consider unduly risky. (Am. Compl. ¶ 77; *see also id.* ¶¶ 54, 61, 75, 77, 82, 147.) Such allegations do not seek to hold the directors accountable for failing to prevent an underlying "violation[] of law," but instead for failing to monitor properly a "business risk." *Citigroup*, 964 A.2d at 123; *see also id.* at 128 n.65 ("That plaintiffs are unable to point to specific wrongdoing within the Company that caused Citigroup's losses from exposure to the subprime mortgage market further supports my hypothesis that this case is not truly a *Caremark* case, but rather a straightforward claim of breach of the fiduciary duty of care."); *id.* at 131 ("There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk.").

The "business risk" here is the omnipresent reputational risk that, in a politically charged fallout from the subprime crisis, defendants' business activities—even if perfectly legal—would subject them to "outrage from the general public and government officials" and to "criticism from industry analysts." (Am. Compl. ¶ 187.) This "reputational" risk, as Goldman Sachs explained in its 2009 10-K, was "inherent" in its business (Koch Decl. Ex. A, at 26):

> As a participant in the financial services industry and a bank holding company, we are subject to extensive regulation in jurisdictions around the world. . . . In addition, recent market disruptions have led to numerous proposals in the United States and internationally for changes in the regulation and taxation of the financial services industry, including increased capital or new liquidity or leverage requirements for banks. . . .
>
> Governmental scrutiny from regulators, legislative bodies and law enforcement agencies with respect to matters relating to compensation, our business practices, our past actions and other matters has increased dramatically in the past several years. The financial crisis and the current political and public sentiment regarding financial institutions has resulted in a significant amount of adverse press coverage, as well as adverse statements or charges by regulators or elected officials. Press coverage and other public statements that assert some form of wrongdoing, regardless of the factual basis for the assertions being made, often results in some type of investigation by regulators, legislators and law enforcement officials or in lawsuits. Responding to these investigations and lawsuits, regardless of the ultimate outcome of the proceeding, is time consuming and expensive and can divert the time and effort of our senior management from our business. Penalties and fines

> sought by regulatory authorities have increased substantially over the last several years, and certain regulators have been more likely in recent years to commence enforcement actions or to advance or support legislation targeted at the financial services industry. Adverse publicity, governmental scrutiny and legal and enforcement proceedings can also have a negative impact on our reputation and on the morale and performance of our employees, which could adversely affect our businesses and results of operations. (Koch Decl. Ex. A, at 34-35.)

Plaintiffs here do not allege that the Board was unaware of the general business activities alleged in the Complaint or that the directors had failed to monitor for, or detect, misconduct. To the contrary, they allege that the Board "was fully aware of, or should have been aware" of, "the details of [Goldman Sachs'] trading business," and made the conscious decision "'to not only reduce [the firm's] mortgage risk exposure,'" but to endeavor to earn profits from RMBS and CDO transactions that "generat[ed] billions of dollars in gain" for Goldman Sachs. (Am. Compl. ¶¶ 147, 148, 151.) The essence of plaintiffs' oversight claim is not that the directors were unaware of the basic elements of the commercial activities at issue, but, rather, that plaintiffs do not approve in retrospect of the decisions through which that segment of Goldman Sachs' business operated or reduced risk in an uncertain market environment (again, something that most investors typically support as responsible risk management, rather than a breach of fiduciary duty).

Thus, as in *Citigroup*, the plaintiffs here are "attempting to hold the director defendants personally liable for making (or allowing to be made) business decisions" with which plaintiffs disagree. *Citigroup*, 964 A.2d at 124. (Indeed, in contrast to the situation in *Citigroup*, in which the challenged decisions "turned out poorly for the Company," *id.*, here, plaintiffs concede that the trading activities at issue were highly successful in an unprecedentedly difficult economic environment.)[20] This is precisely the type of claim for which the Delaware Courts "have developed . . . the business judgment rule," which "properly focus[es] on the decision-making process rather than on a substantive evaluation of the merits of the decision." *Id.*

In all, "[t]he presumption of the business judgment rule, the protection of an exculpatory § 102(b)(7) provision, and the difficulty of proving a *Caremark* claim together function to place an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company's business risk." *Id.* at 125. Plaintiffs do not come close to meeting that burden here and thus failed to meet their burden under Rule 23.1 as to those claims.

II. THE COMPLAINT FAILS TO STATE ANY LEGALLY SUFFICIENT CLAIM.

Even if the Court determines that plaintiffs were not obligated here to comply with the pre-suit demand requirements of Ct. Ch. R. 23.1, their claims nonetheless should be dismissed under Ct. Ch. R. 12(b)(6) for failure to state a claim as to which the Court may grant relief.

A. Plaintiffs Have Failed to State a Claim Based on Allegedly "Excessive" Compensation.

As is discussed above, it is well established under Delaware law that a corporate board of directors has broad discretion to set employee compensation and that the balancing of

[20] Plaintiffs' allegations here are far weaker even than those held insufficient to excuse demand in *Citigroup*. Unlike here, the *Citigroup* plaintiffs purported to identify "red flags" putting the directors on notice that the company's disclosures might have understated its subprime exposure. *See* 964 A.2d at 127. The Court, nonetheless, refused to excuse demand in *Citigroup* because the complaint failed to allege particularized facts showing either (a) "what the directors knew and when" to support an inference that they had consciously disregarded their duties, or (b) "sufficient board involvement in the preparation of the disclosures." *Id.* at 133-34; *see also Rattner* v. *Bidzos*, Civ. A. No. 19700, 2003 WL 22284323, at *13 (Del. Ch. Sept. 30, 2003) (alleged false statements in SEC filings did not establish substantial likelihood of liability absent particularized allegations about deficiencies in Audit Committee's review and approval process); *Guttman*, 823 A.2d at 507 (plaintiff must plead specific facts suggesting that board committees' review was limited, or that outside directors were aware of "specific red—or even yellow—flags").

corporate goals in doing so is a core area for the exercise of business judgment with which courts should rarely, if ever, interfere. In *Aronson*, the Delaware Supreme Court held that claims of excessive compensation were protected by the business judgment rule from second-guessing through shareholder litigation, noting that, "given the directors' broad corporate power to fix the compensation of officers," allegations of facially excessive compensation likely could not state a claim. 473 A.2d at 817. As the Delaware Supreme Court later explained in *Brehm*, "the size and structure of executive compensation are inherently matters of judgment" and "[i]t is the essence of business judgment for a board to determine if a particular individual warrants large amounts of money, whether in the form of current salary or severance provisions." 746 A.2d at 263 (internal quotation marks and alteration omitted). *See also In re AIG*, 700 F. Supp. 2d at 443 ("Under Delaware law, corporate boards have broad discretion to set executive compensation, and courts rarely second-guess directors' compensation and severance decisions because the size and structure of executive compensation are inherently matters of judgment." (internal quotation marks omitted)).

This Court, following those decisions, explained in detail why compensation decisions are properly the province of a corporation's Board, and not of courts or shareholders:

> [A] Court cannot declare a grant of executive compensation to be excessive without immediately inviting the subsequent question; "How much is too much?" The answer to that question depends greatly upon context. The acumen of the business executive, the competitive environment in the industry, and the recruitment and retention challenges faced by the hiring corporation all bear heavily on an appropriate level of compensation. "How much is too much?" is a question far better suited to the boardroom than the courtroom. . . .
>
> 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. 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.

In re infoUSA, Inc. S'holders Litig., 953 A.2d 963, 983-84 (Del. Ch. 2007).

Whether labeled as a claim for "waste" or for breach of fiduciary duty, plaintiffs' Complaint fails to satisfy the "extreme test" needed to show that a particular compensation grant was "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." *Brehm*, 746 A.2d at 263 (quoting *In re The Walt Disney Co. Deriv. Litig.*, 731 A.2d 342, 362 (Del. Ch. 1998) (internal quotation marks omitted)); *see also Zupnick* v. *Goizueta*, 698 A.2d 384, 387 (Del. Ch. 1997) (claim of waste requires showing that "[no] reasonable person might conclude that the deal made sense." (internal quotation marks omitted)); *Hampshire Group, Ltd.* v. *Kuttner*, Civ. A. No. 3607, 2010 WL 2739995, at *35 (Del. Ch. July 12, 2010) ("The waste test is just another way to examine whether a fiduciary breach has been committed."); *Criden* v. *Steinberg*, Civ. A. No. 17082, 2000 WL 354390, at *4 (Del. Ch. Mar. 23, 2000) ("Because the plaintiff has failed to make out a claim of waste, there can be no underlying breach of the fiduciary duty of loyalty.").

For the reasons discussed above, *see supra* at 27-35, the Complaint fails to explain why any particular employee's compensation was excessive; concedes that Goldman Sachs employees in fact provided valuable service for, and consideration to, the company by "fueling" the company's recent "profit surge" (Am. Compl. ¶ 108); and fails to show that the directors' compensation decisions reflect anything other than their considered business judgment. Thus, if the Complaint is not dismissed for failure adequately to plead demand futility, plaintiffs' waste claim should be dismissed outright on the merits.

B. Plaintiffs Have Failed to State a Claim Based on Any Failure of Oversight.

Even absent the particularity requirement imposed in the demand context, a failure of oversight claim is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." *Caremark,* 698 A.2d at 967. For the reasons stated above in Section I.B.3.(b), the Complaint fails to plead such a claim, which must allege and ultimately prove "conduct that is qualitatively different from, and more culpable than . . . gross negligence," namely that a defendant "intentionally act[ed] with a purpose other than that of advancing the best interests of the corporation . . . act[ed] with the intent to violate applicable positive law, or . . . intentionally fail[ed] to act in the face of a known duty to act, demonstrating a conscious disregard for [his or her] duties." *Stone*, 911 A.2d at 369 (internal quotation marks omitted). Pleading such conscious malfeasance requires well-founded allegations that defendants "knew that internal controls were inadequate, [and] that the inadequacies could leave room for illegal or materially harmful behavior," yet they "chose to do nothing about the control deficiencies that [they] knew existed." *Desimone*, 924 A.2d at 940; *see also Stone*, 911 A.2d at 370-73.

As is demonstrated in Section I.B.3.(b), above, the Complaint fails to satisfy this demanding standard. Even assuming for purposes of this motion that misconduct occurred at Goldman Sachs, plaintiffs have failed to plead adequately that defendants breached any duty in allegedly not monitoring or preventing that behavior. Contrary to the apparent premise of the Complaint, directors are not shouldered with the unachievable responsibility to insure the company against all misdeeds; rather, their duty is one of good-faith oversight. *See, e.g.*, *Stone*, 911 A.2d at 373 (plaintiffs may not engage in "second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome" because good-faith oversight "may not invariably prevent employees from . . . causing the corporation to incur significant financial liability"); *Desimone*, 924 A.2d at 940 (occurrence of misconduct does not mean that "internal controls must have been deficient, and the board must have known so"); *Caremark*, 698 A.2d at 972 (fact that company incurred criminal liability did not, on its own, establish that directors breached any duty). Plaintiffs' allegations, replete with acknowledgements of Goldman Sachs' profitable financial results and prudent resort to protective trading activities, have pled nothing to suggest that Goldman Sachs' directors breached that duty.

CONCLUSION

For the foregoing reasons, defendants respectfully request that the Court dismiss plaintiffs' Amended Complaint in its entirety, with prejudice, and grant to defendants such other and further relief as the Court may deem just and proper.

OF COUNSEL:

Gandolfo V. DiBlasi
Richard H. Klapper
Theodore Edelman
David M.J. Rein
SULLIVAN & CROMWELL LLP
125 Broad Street
New York, New York 10004-2498
(212) 558-4000

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/s/ Gregory V. Varallo
Gregory V. Varallo (#2242)
Rudolf Koch (#4947)
RICHARDS, LAYTON & FINGER, P.A.
One Rodney Square
920 N. King Street
Wilmington, Delaware 19801-3319
(302) 651-7700

Attorneys for Nominal Defendant The Goldman Sachs Group, Inc. and Defendants Lloyd C. Blankfein, Gary D. Cohn, John H. Bryan, Claes Dahlbäck, Stephen Friedman, William W. George, Rajat K. Gupta, James A. Johnson, Lois D. Juliber, Lakshmi N. Mittal, James J. Schiro, Ruth J. Simmons, David A. Viniar, and J. Michael Evans.