IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

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

PLAINTIFFS' ANSWERING BRIEF IN OPPOSITION TO DEFENDANTS' MOTION TO DISMISS THE SECOND AMENDED COMPLAINT

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TABLE OF CONTENTS

TABLE OF AUTHORITIES iii

PRELIMINARY STATEMENT 1

STATEMENT OF FACTS 2

ARGUMENT 16

I. Defendants' Motion to Dismiss Should Be Denied Because Any Pre-Suit Demand on the Board Would Have Been Futile 16

A. Legal Standards 16

1. The *Aronson* Standard 16

2. The *Rales* Standard 17

B. Plaintiffs' Complaint Adequately Alleges That Demand is Futile Because a Majority of the Goldman Board is Interested or Lacks Independence 17

1. Demand is Futile Because a Majority of the Goldman Board Is Interested or Lacks Independence 18

a) The Complaint Sets Forth Particularized Allegations that Defendants Blankfein and Cohn are Interested 20

b) The Complaint Sets Forth Particularized Allegations that Defendants Friedman, Dahlback, Mittal, Bryan, Gupta, Juliber, Simmons and Johnson Lack Independence from Goldman Management 21

i. Defendants Friedman, Dahlback and Mittal 21

ii. Defendants Bryan, Gupta, Juliber, Simmons and Johnson 24

C. Plaintiffs' Complaint Adequately Alleges Demand is Futile Because The Goldman Board's Excessive Allocation of Net Revenues to Compensation Was Not the Product of a Valid Exercise of Business Judgment 27

1. Duty of Loyalty Requires Faithfulness to the Best Interest of the Company and its Stockholders 28

2. The Board's Consistent Excessive Allocation of Net Revenues To Employees Could Not Have Been a Good Faith Decision to Advance The Best Interests of Goldman and Its Shareholders 30

3. Defendants' Arguments Do Not Support Dismissal of Plaintiffs' Loyalty Claims Regarding the Excessive Allocation of Net Revenues to Compensation 34

4. The Complaint's Particularized Allegations Regarding The Board's Consistent Excessive Allocation of Net Revenues To Employees Constitute Waste Excusing Demand 36

D. Plaintiffs' Complaint Adequately Alleges Demand Futility of Claims Involving The Director Defendants' Failure of Oversight 39

1. A Majority of the Director Defendants Were Charged With Oversight of Goldman's Risk 40

2. A Majority of the Director Defendants Systematically Failed to Oversee the Unethical and Excessively Risky Practices of Goldman's Trading Segment by Ignoring Red Flags 42

a) The Director Defendants (Defendants Blankfein, Cohn, Bryan, Dahlback, Friedman, George, Gupta, Juliber, Johnson, Mittal, Schiro and Simmons) 42

b) Defendants Blankfein and Cohn 44

3. The Director Defendants Were Not Permitted to Make Decisions Causing the Company to Become Involved in Practices Which Created Excessive Risk to the Company's Long-Term Financial Viability and Reputation 46

II. Plaintiffs' Complaint States a Claim Pursuant to Rule 12(b)(6) 49

CONCLUSION 50

TABLE OF AUTHORITIES

FEDERAL CASES	PAGE(S)
Bader v. Blankfein, 2008 U.S. Dist. LEXIS 102698 (S.D.N.Y. Dec. 19, 2008)	24, 26
Kanter v. Barella, 388 F. Supp. 2d 474 (D.N.J. 2005)	44
Louisiana Municipal Police Employees Retirement System v. Blankfein, 2009 U.S. Dist. LEXIS 42852 (S.D.N.Y. May 19, 2009)	24, 26
Rogers v. Hill, 289 U.S. 582 (1933)	32
STATE CASES	
Am. Int'l Group, Inc. v. Greenberg, 965 A.2d 763 (Del. Ch. 2009)	28
Andreae v. Andreae, 18 Del. J. Corp. L. 197, 1992 WL 43924 (Del. Ch. 1992)	38
Aronson v. Lewis, 473 A.2d 805 (Del. 1984)	*passim*
Avacus Partners, L.P. v. Brian, 1990 WL 161909 (Del. Ch. 1990)	37
In re Baxter Int'l, 654 A.2d 1268 (Del. Ch. 1995)	39
Brehm v. Eisner, 746 A.2d 244 (Del. 2000)	*passim*
In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996)	39, 40, 41, 46
In re Career Educ. Corp. Deriv. Litig, 2007 Del. Ch. LEXIS 184 (Feb. 22, 2006)	39, 40
In re Citigroup Inc. S'holders Deriv. Litig., 964 A.2d 106 (Del. Ch. 2009)	*passim*
Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963 (Del. Ch. 2000)	29

David B. Shaev Profit Sharing Account v. Armstrong,
2006 Del. Ch. LEXIS 33 (Feb. 13, 2006) 44

Desimone v. Barrows,
924 A.2d 906 (Del. Ch. 2007) 42

In re Dow Chem. Co. Deriv. Litig.,
2010 Del. Ch. LEXIS 2 (Jan. 11, 2010) 26, 27

Fink v. Komansky,
2004 U.S. Dist. LEXIS 24660 (Dec. 8, 2004) 42

Forsythe v. ESC Fund Manangment Co. (U.S.), Inc.,
2007 Del. Ch. LEXIS 140 (Oct. 9, 2007) 41

In re Freeport-McMoRan Sulphur, Inc. S'holder Litig.,
2005 WL 1653923 (Del. Ch. June 30, 2005) 24

Friedman v. Beningson,
1995 Del. Ch. LEXIS 154 (Dec. 4, 1995) 21, 22

In re Fuqua Indus. S'holders Litig.,
1997 Del. Ch. LEXIS 72 (May 13, 1997) 18

Grimes v. Donald,
673 A.2d 1207 (Del. 1996) 18

Guth v. Loft,
5 A.2d 503 (Del. 1939) 28

Guttman v. Huang,
823 A.2d 492 (Del. Ch. 2003) 28, 29, 39, 47

Harris v. Carter,
582 A.2d 222 (Del. Ch. 1990) 18, 19

In re J.P. Morgan Chase & Co. S'holder Litig.,
906 A.2d 808 (Del. Ch. 2005) 23, 26

Katz v. Halperin,
1996 Del. Ch. LEXIS 13 (Feb. 5, 1996) 22

Kaufman v. Beal,
1983 Del. Ch. LEXIS 391 (Feb. 25, 1983) 32, 33

Khanna v. McMinn,
2006 Del. Ch. LEXIS 86 (Del. Ch. May 9, 2006) 23, 24

Kovacs v. NVF Co.,
1987 WL 758585 (Del. Ch. Sept. 16, 1987) 38

McPadden v. Sidhu,
964 A.2d 1262 (Del. Ch. 2008) 49, 50

Mizel v. Connelly,
1999 Del. Ch. LEXIS 157 (July, 22 2009) 20, 21

In re Ply Gem Indus., Inc. S'holders Litig.,
2001 Del. Ch. LEXIS 123 (Sept. 28, 2001) 24

Rales v. Blasband,
634 A.2d 927 (Del. 1993) *passim*

Rattner v. Bidzos,
2003 Del. Ch. LEXIS 103 (Sept. 30, 2003) 47

Ryan v. Gifford,
918 A. 2d 341 (Del. Ch. 2007) 49

Saito v. McCall,
2004 Del. Ch. LEXIS 205 (Dec. 20, 2004) 45

Sample v. Morgan,
914 A.2d 647 (Del. Ch. 2007) 37

Saxe v. Brady,
40 Del. Ch. 474 (1962) 37

Sec. Police & Fire Prof'ls of Am. Ret. Fund v. Mack,
2010 WL 5094348 (N.Y. Sup. Ct. Dec. 9, 2010) 35, 36

Seminaris v. Landa,
662 A.2d 1350 (Del. Ch. 1995) 39

Steiner v. Meyerson,
1995 Del. Ch. LEXIS 95 (July 19, 1995) 22, 23

Stone v. Ritter,
911 A.2d 362 (Del. 2006) 29, 39, 44, 46

In re The Limited, Inc. S'holders Litig.,
2002 Del. Ch. LEXIS 28 (Mar. 27, 2002) 19, 24, 25, 26

In re The Student Loan Corp. Deriv. Litig.,
2002 Del. Ch. LEXIS 7 (Jan. 8, 2002) 21

In re Walt Disney Company Derivative Litig.,
906 A.2d 27 (Del. 2006) 28, 29, 36, 37

Weiss v. Samsonite Corp.,
741 A.2d 366 (Del. Ch. 1999) 10

White v. Panic,
93 A.2d 356 (Del. Ch. 2000) 16, 17

Wood v. Baum,
953 A.2d 136 (Del. 2008) 28

RULES AND STATUTES

8 *Del. C.* §102(b)(7) 28

Ch. Ct. R. 12 (b)(6) 49

Ch. Ct. R. 23.1 16, 39, 49

PRELIMINARY STATEMENT

As this Court noted in *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106, 138 (Del. Ch. 2009), "there is an outer limit" to a board's discretion to set compensation. In this case, where the management of The Goldman Sachs Group, inc. ("Goldman" the "Company," or the "Firm") has consistently been allocated compensation more than double that of their peers, there is reasonable doubt that such limit has been passed. Indeed, where, as here, management takes over 95 cents of every dollar paid out by the Firm, leaving shareholders with less than a nickel, it is difficult to conceive how such "outer limit" could be any higher. In short, if the compensation structure at issue in this case is not subject to review, what is?

Defendants' Brief[1] is silent on this issue as well as on many others. Indeed, it is written as if the events of the past few years did not occur. It ignores the fact that management was initially able to generate profits, not by outperforming its peers, but by taking huge risks with the capital of shareholders to leverage its own sub-standard performance; that management sought to mitigate the consequences of such risk-taking by engaging in unethical and unlawful conduct that resulted in fines and other potential liability totaling billions of dollars; that, notwithstanding such conduct, management's efforts to save the Firm from bankruptcy were unsuccessful, and that, but for the intervention of the Federal Government, Goldman would no longer exist, joining Lehman Brothers and Bear Stearns as ruined victims of their managers' excesses.

Throughout this dynamic and eventful period, there has been one constant: the determination of Goldman's board of directors (the "Board") to award almost half of the Firm's revenues to management. Whether the Firm is reaping the benefits of its wild speculation, whether it is courting with disaster, whether it is the beneficiary of corporate welfare, the determination of the Board remains the same: business as usual. Nothing could more forcefully

[1] Defendants' Brief in Support of Their Motion to Dismiss the Second Amended Complaint ("Defendants' Brief") is cited herein as "Def. Br. at __."

demonstrate that the determinations of the Board are not tied to any reasoned deliberation. For this reason, and the reasons set forth more fully below, Defendants' motion to dismiss should be denied.

STATEMENT OF FACTS

The Parties

Defendant Goldman is a Delaware corporation that, prior to its initial public offering, was a private partnership. At that time, all of Goldman's partners provided all of the equity capital, took all of the financial risks, and shared in all of the Company's profits. (¶ 34).[2] Since the public offering, Goldman's insiders have sold an increasing share of the business, so that now such insiders own just over 11% of the Company's outstanding shares, and the public owns just over 88%. (¶35).

Defendant Lloyd C. Blankfein ("Blankfein") has served as the Chairman and CEO of Goldman since June 2006. (¶15). Defendant Gary D. Cohn ("Cohn") has served as a director and as President and Co-Chief Operating Officer of the Company since April 2006. (¶16). Defendants John H. Bryan ("Bryan"), Claes Dahlback ("Dahlback"), Stephen Friedman ("Friedman"), William W. George ("George"), Rajat K. Gupta ("Gupta"), James A. Johnson ("Johnson"), Lois D. Juliber ("Juliber"), Lakshmi N. Mittal ("Mittal"), James J. Schiro ("Schiro"), and Ruth J. Simmons ("Simmons") constituted the Board during the relevant period.[3] (¶¶17-26). Defendants Bryan, Dahlback, Friedman, George, Gupta, Johnson, Juliber, Mittal, Schiro, and Simmons constituted the Compensation Committee of the Goldman Board (the "Compensation Committee") during the relevant period. (*Id.*). Defendants Bryan, Dahlback,

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[2] The Second Amended Shareholder Derivative Complaint (the "Complaint") is cited herein as "(¶ _).").

[3] Defendants Blankfein, Cohn, Bryan, Dahlback, Friedman, George, Gupta, Johnson, Juliber, Mittal, Schiro, and Simmons shall be referred to as the "Director Defendants."

Friedman, George, Gupta, Johnson, Juliber, Mittal and Schiro constituted the Audit Committee of the Goldman Board (the "Audit Committee") during the relevant period. (¶¶17-25, 145).

The Business of Goldman

Goldman operates in three business segments: investment banking, trading and principal investments, and asset management and securities services. By far the largest business segment, and the segment to which Goldman commits the largest amount of its capital, is the trading and principal investment segment (the "Trading Segment").

In the year ended December 2009, the Trading Segment generated net revenues of $34.37 billion, including $5.49 billion in net interest income, and had pre-tax earnings of $17.32 billion. The Trading Segment employed $662.75 billion of the Firm's $849 billion in assets as of December 2009. (¶43). The Trading Segment generated the overwhelming majority of Goldman's net revenues - 76.1% - in the year ending December 2009, just as it had in previous years. (¶44).

Assets held by Goldman pursuant to its Trading Segment's strategy are valued on a mark-to-market basis, meaning the market value of the assets is continually assessed. Where the asset increases in value, revenue for Goldman increases, and where the asset decreases in value, Goldman must book a loss. (¶110).

Goldman's revenue in its Trading Segment, therefore, is a function of the amount of assets that Goldman has available to commit to the segment, which is in turn determined by the leveraging of Goldman's shareholder equity. Goldman has been able to increase its revenues in its Trading Segment by increasing its shareholder equity and correspondingly increasing the assets that are committed to that segment. In 2009, almost all of the Company's assets - $662.75 - were committed to the Trading Segment. (¶111). Goldman is able to generate increasing net revenues and compensation from its Trading Segment by deploying an ever-increasing amount of shareholder capital to the segment, and by leveraging that capital to an increasingly greater degree. (*Id.*). The risk that this leverage entails is borne, not by management, but exclusively by shareholders.

The Directors' Allocation of Net Revenue

Total compensation to be allocated to management is determined by the Compensation Committee. Although the Compensation Committee purports to assess the compensation of a handful of the senior executives, its decision-making with respect to the overwhelming bulk of the billions of dollars in compensation paid to Goldman's employees at-large is far more nebulous. The Compensation Committee receives information from Goldman's management concerning the management's projections of net revenues and suggested ratio of compensation and benefits expense to net revenues. (¶89). Management, not the Compensation Committee, determines that ratio, and the Compensation Committee merely rubber stamps suggested ratios as to how to divide the Company's net revenues between the Company's owners, the shareholders, and their agents, Goldman management. Goldman's senior executives set the ratio, which ultimately provides the basis for the available bonus pool for those senior executives. (¶90).

The only "analysis" the Compensation Committee makes is a review of information from Company management relating to the compensation ratio of the Company's "core competitors that are investment banks (Bear Stearns, Lehman Brothers, Merrill Lynch, and Morgan Stanley)." (¶89). No analysis is made by the Compensation Committee of the extent to which those firms' earnings are derived from activities comparable to the Trading Segment. Nor does the Compensation Committee receive information or consider the extent to which Goldman's net revenues and earnings are the result of availability of the Firm's capital, as opposed to the efforts of management, in appropriately allocating it. Finally, in setting the compensation ratio, the Compensation Committee does not compare the cost of managing the Firm's capital to the management costs of hedge funds or other enterprises that similarly generate the majority of their revenues and earnings by taking trading and principal risks with their investors' capital. (*Id.*) Thus, the Compensation Committee does not make the very analysis which Defendants fault Plaintiffs for failing to make: measuring the value of the services received as compared to the benefits obtained. It merely makes a broad determination as to how to divide the Company's net revenues between the Company's owners, shareholders, and their agents, management. Even the bonuses of senior executives appear to be made, not on the basis of any analysis of what any particular executive is worth, but upon what should be his relative share of the bonus pool determined by management. (*See* ¶90)

The Compensation Committee's lack of analysis is demonstrated by the fact that, although an increasing amount of Goldman's net revenues and earnings result from the increasing and risky deployment of shareholder capital and assets in the Trading Segment, Goldman has consistently taken between 44% and 48% from net revenues to compensate the managers of the shareholder capital in both good years and bad years. (¶112). Thus, for example, in 2007, when the Company generated record revenues by taking excessive risks with shareholders' equity, the managers and officers of Goldman were paid 44% of net revenue. (*Id.*). In 2008, as the consequences of this speculative risk-taking manifested itself, with the value of Goldman's investments having plummeted, its share price having fallen, at one point by 75%, and the Firm rescued from certain bankruptcy only by the intervention of the Federal Government, the Firm's managers and officers were paid almost the identical percentage, 48% of revenue. (*Id*.). In 2009, with an increasing amount of net revenues and earnings resulting from the employment of shareholder capital, including capital provided by the taxpayers, in Goldman's Trading Segment, the Company initially allocated 47% of net revenue to compensation. (¶113). Only in the face of intense public outcry did the Compensation Committee alter its reflexive decision to award 47%. (*Id.).* The amount of profit that Goldman allocated to compensation was even higher after taking into account non-compensation expenses. Taking such expenses into account, the percentage of net revenues allocated to Goldman's management has ranged from 53% to 82%. (¶116).

Even in 2010, when Goldman's management agreed to reduce its 2009 compensation from 47% to 36%, (¶¶ 113, 173), it did so grudgingly, only after Defendant Blankfein first attempted to defend Goldman's enormous profits and intended compensation by asserting that Goldman "was doing God's work." A week later, he apologized for Goldman, stating "[w]e participated in things that were clearly wrong and have reason to regret…we apologize." As part of that apology, Goldman committed to spending $500 million to help small businesses recover from the recession. (¶125). That $500 million was returned by employees voluntarily out of the compensation pool, (¶127), without any negative effect on the Company's ability to hire and retain employees.

Compensation Paid for Comparable Services

Viewed in isolation, the compensation paid to Goldman's managers is extraordinary. Throughout the relevant period, the Compensation Committee has determined to award such managers approximately 50% of net revenues, and up to 82% of revenues after deducting non-compensation expenses. In contrast, shareholders have received dividends generally amounting to less than 2% of these net revenues. (¶123).

The excessiveness of Goldman's management's compensation is drawn into even sharper contrast when compared with what is paid to others performing the same or similar services at Goldman's competitors. Although the Compensation Committee purports to reference compensation paid at other investment banking firms, in reality, the compensation paid to each employee at Goldman dwarfs that paid to those performing comparable services at other firms.

From 2006 through 2009, the compensation paid to Goldman employees was anywhere from two to six times that paid by its peers on a per employee basis.[4]

A more apt comparison is the compensation paid to hedge fund managers. As noted, the majority of Goldman's revenue producing activity in its Trading Segment is similar to that of a hedge fund. Hedge fund managers are compensated (or overcompensated) pursuant to the "2 and 20" compensation scheme – 2% of net assets plus 20% of the net income that they produce. Goldman's compensation allocation is equivalent to compensating hedge fund managers at 2% of net assets plus 45% of net income. (¶117). Moreover, unlike hedge fund managers, Goldman's managers do not have to deduct their own overhead from that compensation. Goldman shareholders pay for that separately, including all of the perquisites that management receives in addition to its compensation. Stated another way, Goldman is managing the shareholder's capital at the equivalent annual rate of 30% of net assets. Thus, Goldman's management is compensated at a rate double that paid to comparable hedge fund managers. (*Id.)*.

Management's Performance

Had Goldman's performance over the past years been exceptional, an argument might be made that the payment of such excessive compensation bore some reasonable relation to services that Goldman's management provides. However, the managers and officers of Goldman have not performed at a level sufficient to justify such a share in Goldman's profits. To the contrary, since

[4] While Plaintiffs acknowledge that the specific numbers setting forth the respective compensation per employee for Goldman, Morgan Stanley, Bear Stearns, Merrill Lynch, Citigroup and Bank of America for 2006, 2007, 2008 and 2009 in paragraphs 115 and 119 of the Complaint reflect an inadvertent computational error, the Complaint's allegation that "Goldman's allocation [of net revenues to compensation] made before any specific compensation decision for individual employees at the Firm are determined, resulted in compensation per employee that is more than two to six times greater than its peers," (¶119), is still correct and is supported by the numbers set forth in the Declaration of Rudolf Koch, which accompanied the Defendants' Brief. *See* Cramer Aff. Ex. A, Declaration of John F. Harnes; Def. Br. at 30; Koch Aff. at ¶¶17-20. Submitted herewith is the Transmittal Affidavit of Tiffany J. Cramer ("Cramer Aff."). Citations to documents relied upon herein are cited by reference to "Cramer Aff. Ex. ___."

its initial public offering in 1999, Goldman has been able to outperform the hedge fund indices only by engaging in excessive leverage. On a risk adjusted basis, during this period, Goldman's performance has, in fact, been inferior to the indices of hedge funds. (¶120). In short, far from being exceptional, Goldman's managers have been less than mediocre. Indeed, the biggest boast that Defendants can make about their performance is that they "recorded a profit" in each of the years at issue in this litigation.[5] *See* Def. Br. at 7.

Goldman's managers have been able to generate this "profit" only by taking excessive risks with shareholder capital. Thus, the prime ingredients for Goldman's profitability are: (1) the capital provided by shareholders, and (2) the risks to which shareholder capital is placed by Goldman's managers. (¶6). Goldman's managers provide no capital and assume no risk; yet, they take the lion's share of the profits, or more than 95%. (¶7). Put simply, shareholders receive pennies for every dollar that Goldman management receives. Under any analysis, such a division is unconscionable and demonstrates that the compensation has granted Goldman's management an interest in the business of Goldman that dwarfs the interest of its shareholders.

The consequences of Goldman's excessive risk-taking have been well-documented. As alleged in the Complaint, Goldman was weeks, if not days, from bankruptcy and was only able to survive by borrowing from the Federal Reserve pursuant to its primary dealer credit facility, which was created as the equivalent of the discount window for dealers in treasury securities such as Goldman's. (¶98). Goldman's overnight borrowings grew from $2.5 billion to $10.25 billion on September 22, 2008, the day it announced its intention to transition to a bank holding company. Its overnight borrowings under the primary dealer credit facility increased to as high as

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[5] Of course, this boast ignores the fact that this "profit," resulted not from management's efforts, but as a result of the intervention of the Federal Government. To the extent management can take credit, such "profit" resulted from management's taking advantage of conflicts with the Firm's clients. For example, Goldman has already been required to repay $550 million of such "profits" in connection with its Abacus transaction, discussed more fully below.

$23.2 billion on October 10, 2008. At the same time, Goldman was also taking advantage of the Federal Reserve's security lending program, pursuant to which Goldman exchanged mortgaged backed securities in its portfolio for Treasury securities, thereby substantially enhancing its ability to post collateral. (*Id.*).

During Goldman's transition to a bank holding company, it was allowed to borrow money from the Federal Government at advantageous rates through, among other things, the discount window. In addition, the Federal Deposit Insurance Company ("FDIC") enabled Goldman to generate $29 billion in cash by issuing FDIC-insured debts through the Temporary Liquidity Guarantee Program. That program sought to create liquidity by insuring debt issued by certain financial institutions such as the bank holding company into which Goldman was permitted to convert. More directly, in the fall of 2008, Goldman appealed to the Federal Government and accepted a $10 billion TARP loan to ensure its survival.[6] (¶99).

Goldman's conversion to a bank holding company was not the only step required to stave off bankruptcy. At or about the same time, Goldman was forced to sell to investor Warren Buffett $5 billion shares of preferred stock that paid an annual dividend of 10% callable at a 10% premium. (¶133). Buffett also received warrants to purchase another $5 billion at a below market price of $115 per share. Accounting for the warrants, Buffett was paying $3.2 billion for preferred shares, which paid him $500 million per year and were callable at $5.5 billion, the effect of which was to dilute the interests of the existing shareholders. (*Id.*).

In the aftermath of these events, the price of Goldman's common stock declined

[6] Because corporations such as Goldman that accepted TARP dollars were subject to oversight by the Federal Government, were restricted on their ability to pay out generous compensation, and were required to provide shareholders with an advisory vote on compensation policies (so-called "say-on-pay"), Defendants announced the Company's intention to pay back the TARP loan as soon as it could do so. (¶99).

precipitously in 2008 and has never reached the level at which it was trading at the beginning of relevant period for which the Company's managers have been compensated. On January 3, 2007, the Company's common stock opened at $200.60 and closed on December 31, 2009, at $166.90. The most recent closing price was even lower, at $160.27 per share.[7] Indeed, the performance of Goldman's stock price during this period has not even matched that of the Dow Jones Industrial average, or that of the Standard and Poor's index.

Moreover, the final results for Goldman's performance are still not yet completely known, and the complete fallout from the conduct of the Trading Segment has yet to be determined. Purchasers of mortgage backed securities issued by banks and investment firms, including Goldman, from 2005 through 2007 are now seeking to "put back" such securities based upon breaches of the sellers' representations and warranties. (¶103). An independent research firm has estimated Goldman's worst case loss from "put back" lawsuits as approximately $15.1 billion, or $16.77 per share, representing 15% of Goldman's tangible book value, and in Goldman's base case scenario, losses would total $11.2 billion, or $12.43 per share, representing 11% of tangible book value. (¶104). As a consequence, Goldman having already incurred billions of dollars in liabilities as a result of its conduct, not reflected or accounted for in the revenue figures that formed the basis of management's bonus pool, still faces potentially billions more in liabilities.

The Interests of Management Diverge From Those of Shareholders

As a consequence of the allocation of profits by the Board, the interests of Goldman management not only outweigh those of shareholders, but they diverge markedly. As a public company Goldman's management is free to take excessive risks with shareholder capital without

[7] A chart of Goldman's stock prices from January 3, 2007 through March 10, 2011, is attached as Exhibit B to the Cramer Aff. The Court may take judicial notice of the trading price of a listed stock. *See Weiss v. Samsonite Corp.*, 741 A.2d 366, 275 n.26 (Del. Ch. 1999).

any risk that they will suffer the consequences if shareholder equity is destroyed. The divergence between the interest of Goldman's shareholders and that of its management provided a powerful incentive to engage in excessive risk, principally by leveraging shareholder capital, and in conduct that crossed over into the unethical, if not unlawful.

This divergence between the interests of Goldman's management and that of its shareholders is further exploited by the substantial financial connections between Goldman and its management and nearly all of the Director Defendants. As members of Goldman management, Defendants Blankfein and Cohn receive compensation from Goldman. (¶¶10, 15, 16, 50, 52, 145). In addition, Goldman invests hundred of millions of dollars in funds managed by Defendants Friedman and Dahlback and has arranged or provided billions of Euros of financing to Defendant Mittal's company. (¶¶165, 166). Defendants Friedman, Bryan, Gupta, Juliber, Johnson and Simmons have also all repeatedly and successfully solicited funds from Goldman and Goldman management for charitable institutions of which they are either the head or sit as part of the governing body. (¶¶157-162).

The Misconduct Resulting From the Divergence of Interests.

As set forth in the Complaint, high leverage, inadequate capital, and short-term funding made many financial institutions extremely vulnerable to the downturn in the market in 2007. (¶95). In 2007, Goldman engaged in leverage of 25%, a level that exceeded even that of two firms that failed, Lehman Brothers and Bear Stearns. (*Id.*).

Goldman executives sought to increase their bonuses not merely by engaging in excessive leverage, but they engaged in conduct that conflicted with the interests of the Firm's clients, as well as its shareholders. More specifically, they developed a system of counter-party trading that pitted Goldman against its clients and those to whom it dispensed investment advice. (¶51). Defendants Blankfein, Cohn, and the Director Defendants all embraced this idea, promoting the idea, in annual reports and elsewhere, that the Company's goal should be to wear several hats at once and "manage conflicts" rather than avoid them. (¶52). Yet Goldman continued to advise a client, finance that client, invest in that client's deal, yet all the while betting against that client, often at the same time through the same division. (*Id.*).

One means Goldman used to accomplish this goal was through the structuring of synthetic collateralized debt obligations ("CDOs"). (¶54). A synthetic CDO is a security that contains no actual assets, but merely derivatives, or contracts referencing the performance of other financial assets. (¶55). A synthetic CDO is little more than a bet on the future value of certain mortgages backed by securities without actually owning them. When the defaults spread and the bond plunged, it generated billions of dollars of losses for the synthetic CDO investors and billions in profit for the investors betting against them through credit default swaps. (¶56).

Because a synthetic CDO is not tethered to actual assets, the ability to create them is virtually limitless. By 2007, Goldman's mortgage department was feverishly generating them. (¶54). The ability to create derivatives gave Goldman's management an easy way to hedge its massive long position in mortgage securities, which it had recklessly amassed; it designed them to fail and unloaded them on its clients. (¶57).

Goldman further altered the playing field by going to the rating agencies to persuade them to give these deals an investment rating. Goldman hired the rating agencies, who began as market researchers selling assessments of corporate debt to people considering whether to buy that debt, to give the debt Goldman was selling – these synthetic CDOs – a seal of approval. Goldman used its economic muscle to direct its business to whichever agency was most likely to give a favorable verdict and to threaten to pull business from an agency that tried too hard to do its job. A Standard & Poor's ("S&P") analyst stated that, "[t]he bankers [at Goldman] would say anything to get what they needed in their deals." (*Id.*).

Three examples demonstrate how Goldman sold mortgage related products to its clients, while profiting from the decline of the mortgage market:

- Hudson Mezzanine 2006-1 ("Hudson 1") was a synthetic CDO that referenced $2 billion in subprime BBB-rated RMBS securities, underwritten and sold by Goldman in December 2006. Goldman, working with its proprietary traders, selected the referenced assets from the Company's own inventory. Goldman executives have publicly conceded that the Company was trying to remove BBB assets from its books during this period of time. Goldman Sachs was the sole short investor in this proprietary deal, buying protection on all $2 billion in referenced assets and essentially placing a bet that the assets would lose value. Less than 18 months later, the AAA securities had been downgraded to junk status; Goldman profited from the loss in value of the very CDO securities it had sold to its clients.

- Anderson Mezzanine Funding 2007-1 was a synthetic CDO referencing about $300 million in subprime RMBS BBB securities. Goldman structured and underwrote the deal, and also participated as one of the short investors, buying loss protection for $140 million, or nearly 50 percent, of the referenced assets, betting that the securities would collapse. Goldman senior managers directed their sales force to sell the Anderson securities quickly due to "poor subprime news." Indeed, so anxious was Goldman to unload these securities that, in another instance of putting its own interests ahead of those of its clients, Goldman rushed this to market ahead of deals it was underwriting for clients. Goldman manager Jonathan Egol advised Company personnel to sell the Anderson securities before completing an Abacus deal: "Given risk priorities, subprime news and market conditions, we need to discuss side-lining this deal ([Abacus 2007-]AC1) in favor of prioritizing Anderson in the short term." About 7 months after the securities were sold, Anderson was downgraded to junk status.

- Timberwolf I, a hybrid cash/synthetic $1 billion CDO squared, which Goldman Sachs underwrote and sold in the first calendar quarter of 2007. Timberwolf referenced assets consisted of 94 percent CDO securities, including about $15 million in Abacus CDO securities. Goldman Sachs was the short investor for many of the Timberwolf referenced assets, including the Abacus securities, betting that they would decline in value. Within five months of issuance, the CDO lost 80 percent of its value, and was later liquidated in 2008. The AAA securities issued in March 2007, were downgraded to junk status in just over a year. The Goldman trader responsible for managing the deal later characterized the day that Timberwolf was issued as "a day that will live in infamy." A senior Goldman executive described the deal as follows: "Boy that timberwof [sic] was one shi**y deal."

(¶75).

Goldman also structured deals to assist favored clients. The best known deal was executed by the name of ABACUS 2007-AC1 ("Abacus") in early 2007. In Abacus, Goldman helped one of its clients, hedge fund Paulson & Co., to design a CDO whose assets the fund and founder John Paulson helped select. Paulson then placed a "short" bet that the Abacus deal would fall in value at the same time Goldman marketed long positions to other clients without disclosing Paulson's involvement in creating the portfolio. (¶65).

The Abacus deal, one of 25 totaling $10.9 billion that Goldman created so the Firm and select clients could bet against the housing market, was presented to and quickly approved by the committee of Goldman's senior executives which oversaw the mortgage department in a routine meeting. (¶66). As the Abacus deals plunged in value, Goldman and certain hedge funds made money on their negative bets, while the Goldman clients who bought the $10.9 billion in investments lost billions of dollars. Goldman's clients who took long positions in Abacus lost their entire $1 billion investment. (*Id.*).

On April 16, 2010, the Securities and Exchange Commission ("SEC") charged Goldman and 31 year-old vice president Fabrice Tourre, a London-based Goldman trader, with fraud in their roles in creating and marketing the Abacus financial instruments. (¶72). Goldman settled the SEC case on July 14, 2010, pursuant to which Goldman agreed to disgorge its profits on the Abacus transaction of $15,000,000, to pay a civil penalty of $ 535,000,000 (some of which was used to compensate injured investors), and to be permanently enjoined against violations of Section 17(a) of the Securities Act of 1933. Goldman also agreed to comply with specific undertakings for three years, including: (1) greater involvement by Goldman's Firmwide Capital Committee in the vetting and approval process of its mortgage securities transactions, as well as in reviewing marketing materials; (2) legal and compliance review of the written materials related to those transactions; (3) internal auditing of these procedures; and (4) education and training on the disclosure requirements of the Federal securities laws for employees in Goldman's mortgage department. (¶73).

In its consent to judgment in the SEC proceeding on July 14, 2010, Goldman admitted that its failure to disclose the conflicted nature of the transaction, a failure which pervaded its Trading Segment, was wrong: Goldman acknowledged that the marketing materials for the Abacus transaction contained incomplete information. In particular, it was a mistake for the Goldman marketing materials to state that the reference portfolio was selected by ACA Management LLC without disclosing the role of Paulson & Co. Inc. in the portfolio selection process and that Paulson's economic interests were adverse to CDO investors. (¶74).

Goldman Suffers Damage

As a result of the Director Defendants' excessive allocation of Goldman's net revenues to its employees and the Director Defendants' failure to monitor Goldman's operations, allowing the Trading Segment to engage in excessively risky and unethical conduct, the Company suffered damages, including, *inter* alia, the following:

- Goldman granting to management an excessive portion of the Firm's profits (¶¶112-16, 173);
- Goldman losing over 12% of it market capitalization in one day (¶¶72, 77, 187);
- Goldman suffering from a loss in social and reputational capital due to the outrage and criticism of the general public, government officials and industry analysts (¶¶11, 75, 77, 84, 187);
- Goldman being rendered insolvent and only surviving due to billions of dollars of government funding (¶¶96, 132, 188);
- Goldman paying $500 million to a small business program as an apology for the over-compensation of management in light of the Company's Trading Segment's risky and unethical business practices (¶88);
- Goldman having to pay a fine of $550 million to settle litigation with the SEC related to the Abacus transaction (¶¶73, 75, 126, 188);[8]

[8] While, as Defendants assert, the SEC complaint stemmed from only one synthetic CDO transaction, (Def. Br. at 37-38), it was one of $10.9 billion worth of such deals Goldman created,

- Goldman needing the capital requiring the sale of preferred stock, callable at a price of $5.5 billion, for an effective price of $3.2 billion (¶¶133, 188);

- Goldman facing liability of up to approximately $15.1 billion to satisfy pending claims that it buy back billions of dollars of mortgages (¶¶103, 104, 188); and

- Goldman facing civil liability from investors that lost money on the unethical and risky mortgage securities transactions, including the $10.9 billion worth of such deals Goldman created (¶¶ 11, 65-67, 69, 70, 73, 75, 76, 83, 84).

ARGUMENT

I. Defendants' Motion to Dismiss Should Be Denied Because Any Pre-Suit Demand on the Board Would Have Been Futile

Defendants assert that Plaintiffs' Complaint should be dismissed for failure to plead demand futility in accordance with Chancery Court Rule 23.1. The Supreme Court decisions in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), and *Rales v. Blasband*, 634 A.2d 927 (Del. 1993), provide the standards to determine whether demand is excused in this case.[9]

A. Legal Standards

1. The *Aronson* Standard

A plaintiff demonstrates demand futility, excusing demand, where, "under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested or independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Aronson*, 473 A.2d at 814 (Del. 1984), *overruled on other grounds*, *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000); *White v. Panic*, 793 A.2d 356, 364 (Del. Ch. 2000) ("If

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including Hudson Mezzanine 2006-1, Anderson Mezzanine Funding 2007-1 and Timberwolf I, (¶¶ 11, 65-67, 69-70, 73, 75-76, 83-84), and thus Goldman is also subject to civil liability from investors that lost money on these unethical and risky mortgage securities transactions.

[9] Plaintiffs submit that the standard set forth in *Aronson* applies to the Complaint's claims involving loyalty and waste regarding the Goldman Board's decision to allocate excessive amounts of net revenue to compensation, (*see* ¶¶170-179), and that the *Rales* standard applies to the Complaint's claims involving the Board's failure of the duty of oversight, (*see* ¶¶180-191). *See Citigroup*, 964 A.2d at 120.

either prong is satisfied, the Court will infer that the board of directors is incapable of exercising its authority to pursue the derivative claims directly and the objecting shareholder will be allowed to pursue the derivative claim notwithstanding the failure to make a presuit demand.").

Plaintiffs need not demonstrate a reasonable probability of success on the merits to establish demand futility. *Rales*, 634 A.2d at 934. Rather, the Court must accept as true all particularized allegations and all reasonable inferences that logically flow from them. *Brehm*, 746 A.2d at 255.

2. The *Rales* Standard

The Delaware Supreme Court articulated that one of the three circumstances in which the *Rales* standard applies to an allegation that demand is futile, is where the subject of the derivative suit is not a business decision of the board. *Rales*, 634 A.2d at 934. In this situation, the Court must determine "whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations." *Id*. Under *Rales,* a court must therefore determine whether "the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. If the derivative plaintiff satisfies this burden, then demand will be excused as futile." *Id*. Reasonable doubt under the *Rales* standard is the same as under *Aronson*.

B. Plaintiffs' Complaint Adequately Alleges That Demand is Futile Because a Majority of the Goldman Board is Interested or Lacks Independence

Whether the demand allegations are considered under *Aronson*, relating to the claims involving loyalty and waste regarding the Board's excessive allocation of net revenue to compensation, or *Rales*, relating to the claims of the Board's failure of oversight, a particular director is disqualified from considering a demand where there is a reasonable doubt that he or she is either interested in the transaction at issue or lacks independence from a party who is so interested. *Aronson*, 473 A.2d at 814; *Rales*, 634 A.2d at 935-37.

1. Demand is Futile Because a Majority of the Goldman Board Is Interested or Lacks Independence

Directors are disinterested when they "neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." *Aronson*, 473 A.2d at 812 (citation omitted). Directors lack independence if their impartiality is compromised by a financial interest or other considerations such as relationships. *Grimes v. Donald*, 673 A.2d 1207, 1216 (Del. 1996), *overruled on other grounds*, *Brehm*, 746 A.2d at 254; *Aronson*, 473 A.2d at 816 ("Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."). Whether directors are sufficiently independent is determined by an analysis of the facts surrounding the challenged action or inaction. *See Rales*, 634 A.2d at 933 ("The question of independence flows from an analysis of the factual allegations pertaining to influences upon the directors' performance of their duties generally, and more specifically in respect to the challenged transaction.").

Here, the facts alleged demonstrate that ten members (a majority) of Goldman's twelve directors,[10] were either (1) members of Goldman management and thus interested in the Trading

[10] While Defendants assert that Defendants Gupta and Simmons should not be considered for purposes of demand due to their departure from the Goldman Board after the filing of the initial Shareholder Derivative Complaint on January 19, 2010, but before the filing of the Amended Consolidated Shareholder Derivative Complaint on April 28, 2010, (*see* Def. Br. at 21 n.10), the qualification of the Board to consider a demand is to be determined as of the time of the filing of the original complaint. *See e.g., Rales.* 634 A.2d at 934; *In re Fuqua Indus. S'holders Litig.*, 1997 Del. Ch. LEXIS 72, at *50-51 (May 13, 1997); *Harris v. Carter*, 582 A.2d 222, 230 (Del. Ch. 1990). Further, derivative plaintiffs are permitted to amend or supplement the original complaint upon a change in the board without having to demonstrate that demand is futile as to the newly-constituted board if the material that is added merely "elaborates upon facts relating to acts or transaction alleged in the original pleading, or asserts new legal theories of recovery based

Segment's risky and unethical conduct to increase revenues in the short-term and the Compensation Committee's consistent allocation of 44% to 48% of net revenues to compensation based on those revenues (Defendants Blankfein and Cohn – two of the twelve Board members); or (2) lacked independence from Goldman management due to their conflicting financial and professional interests (Defendants Bryan, Dahlback, Friedman, Gupta, Juliber, Johnson, Mittal and Simmons – eight of the twelve Board members), preventing them from exercising their objective judgment in determining whether to bring suit on behalf of Goldman, and thus demand is futile.

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upon the acts or transactions that formed the substance of the original pleading." *Harris*, 582 A.2d at 231.

First, the claims asserting breach of the duty of loyalty and waste concerning the Director Defendants' excessive allocation of net revenues were "validly in litigation" in the original complaint and each amendment merely elaborated upon facts relating to the allegations asserted in the original pleading, and thus it would be proper to consider Defendants Gupta and Simmons for demand purposes as to those claims. *See id*. Second, the claims asserting breach of fiduciary duties stemming from the Director Defendants' failure of oversight of the Trading Segment's excessively risky and unethical practices, naturally flow from the allegations asserted in the original complaint that the growth of the Trading Segment, when combined with the Board's excessive allocation of net revenues to the compensation pool, ensured that management would operate Goldman for its own benefit and put Goldman at significant risk, and merely elaborates upon facts and asserts new legal theories of recovery based on these allegations. *See id*.

However, even if this Court determines that Plaintiffs' failure of oversight claim is a new corporate claim against the Director Defendants requiring that plaintiffs demonstrate that demand is futile with respect to the newly-constituted Board, Plaintiffs are only required to demonstrate that demand is futile as to half (or six) of the twelve-member Goldman Board. *See Harris*, 582 A.2d at 231; *In re The Limited, Inc. S'holders Litig.*, 2002 Del. Ch. LEXIS 28, at *13 (Mar. 27, 2002) (finding that demand was futile when plaintiffs alleged sufficient particularized facts to raise a reasonable doubt as to the interestedness or independence of at least six of the company's twelve directors). Thus, even if Gupta and Simmons are not considered for purposes of demand with respect to Plaintiffs' failure of oversight claims, the Complaint sets forth particularized allegations that Defendants Blankfein, Cohn, Friedman, Dahlback, Mittal, Bryan, Juliber and Johnson, eight members (or a majority) of the twelve-member Goldman Board (a majority) are interested or lack independence.

a) The Complaint Sets Forth Particularized Allegations that Defendants Blankfein and Cohn are Interested

The Complaint sets forth particularized allegations that two of Goldman's twelve-member Board, Defendants Blankfein and Cohn, were interested in maximizing their compensation as executive officers of Goldman through the excessive allocation of the Firm's net revenues, which were inflated due to the Trading Segment's unethical practices, and thus demand against them is futile. *See Rales*, 634 A.2d at 936 ("A director is considered interested where he or she will receive a personal financial benefit from a [business decision] that is not equally shared by the stockholders") (*citing Aronson*, 473 A.2d at 812). The Complaint sets forth particularized allegations that Defendants Blankfein and Cohn are named executive officers, serving as CEO and President and Co-Chief Operations Officer, respectively, and receive compensation as employees of Goldman, which compensation is determined by the contributions of the Trading Segment's risky and unethical practices to the Firm's net revenue and the excessive allocation of such net revenues to compensation.[11] (¶¶10, 15, 16, 145). The Complaint also sets forth particularized allegations that Defendants Blankfein and Cohn promoted the corporate mentality of taking excessive risks and conflicted positions in the Trading Segment in pursuit of huge profits and that they also took an active role in overseeing the Trading Segment, including its mortgage unit, which employed an unethical trading strategy for Goldman's benefit and to the detriment of its clients. (¶¶ 50, 52, 145).

Additionally, Cohn's financial stake in maintaining his office at Goldman, and Blankfein's ability as Goldman CEO to affect the continued employment of Cohn, renders Cohn unable to consider impartially a stockholder demand that, if granted, would have resulted in a suit adverse to Goldman's managements' financial interests. *See Mizel v. Connelly*, 1999 Del. Ch.

[11] Defendants do not even attempt to argue as to the interestedness or lack of independence of Defendants Blankfein and Cohn. (*See* Defs. Br. at 21 n.10).

LEXIS 157, at *9 (July, 22 2009) (finding that since the directors at issue derived their principal income from their employment at the company, "it is doubtful that they can consider the demand on its merits without also pondering whether an affirmative vote would endanger their continued employment"). *In re The Student Loan Corp. Deriv. Litig.*, 2002 Del. Ch. LEXIS 7, at *8-9 (Jan. 8, 200) (observing that where the compensation in question constitutes the director's principle source of income, it should be assumed to be of 'great consequence' to the director.'); *Limited*, 2002 Del. Ch. LEXIS 28, at *20-21 (same).

b) The Complaint Sets Forth Particularized Allegations that Defendants Friedman, Dahlback, Mittal, Bryan, Gupta, Juliber, Simmons and Johnson Lack Independence from Goldman Management

The Complaint sets forth allegations that eight of the twelve Director Defendants have significant financial relationships with Goldman, including with the private Goldman Sachs Foundation (the "Foundation"), which is funded solely by the Company and controlled by Goldman management, and therefore they cannot act independently of management in making determinations concerning the compensation of management or decisions that ultimately affect the compensation of management, including the Trading Segment's risky and unethical trading practices. (¶¶153, 156, 163). *See Friedman v. Beningson*, 1995 Del. Ch. LEXIS 154, *12 (Dec. 4, 1995) (stating that the strong influence of a party with a material financial interest in the decision under attack, which interest is adverse to that of the corporation, can be sufficient to raise a reasonable doubt that directors in such a situation could exercise judgment on behalf of the corporation concerning the decision involving such influential party).

i. Defendants Friedman, Dahlback and Mittal

The Complaint sets forth allegations that the Company and the Foundation, both controlled by Goldman management, have significant financial business ties with the respective main occupations, and thus the livelihoods, of Defendants Friedman, Dahlback, and Mittal, rendering them not independent. *See Steiner v. Meyerson*, 1995 Del. Ch. LEXIS 95, *30-31 (July 19, 1995) (holding that a director whose small law firm billed the company for substantial fees during the course of the preceding year was potentially beholden to the chief executive officer of the corporation by reason of the latter's authority to hire and fire the company's legal counsel, raising a reasonable doubt as to the director's independence); *Friedman*, 1995 Del. Ch. LEXIS 154, at *14-15 (finding that Chairman, President and CEO's alleged ability to affect the consulting fees of $48,000 per year paid to director defendant sufficiently cast doubt over director defendant's independence); *Brehm*, 746 A.2d at 254 (holding that reasonable doubt was created as to independence of director whose architectural firm had received millions of dollars in fees to design buildings for company). *See also Rales*, 634 A.2d at 937 (where directors owed their livelihoods to a party that would be adversely affected if demand was accepted, they could not act independently). Specifically:

- **Defendant Friedman:** The Complaint sets forth allegations that Defendant Friedman's livelihood depends on his occupation as a manager of funds, and that Goldman has invested at least $670 million in funds managed by Defendant Friedman (¶165).[12] The Foundation has also aided Defendant Friedman in his job to raise money as an emeritus trustee of Columbia University by donating at least $765,000 to Columbia University, (¶160), which as discussed below, also casts reasonable doubt as to his independence. Taken together, the Complaint's allegations that Goldman has invested in Friedman-managed funds and the Foundation's contributions to Columbia University casts reasonable doubt that Friedman would exercise objective judgment in considering a demand concerning the compensation of management or decisions ultimately affecting such compensation. *See, e.g. Steiner*, 1995 Del. Ch. LEXIS 95, at *30-31.

- **Defendant Dahlback**: The Complaint sets forth allegations that Defendant Dahlback's livelihood depends on his full-time job as an advisor and Goldman has invested more than $600 million in funds to which Defendant Dahlback is an advisor. (¶165). That Dahlback's relationship with Goldman and Goldman management has a direct and substantial impact on his livelihood casts

[12] Plaintiffs are not required to identify the funds with which Goldman invested to establish such investment would render Defendants Friedman and Dahlback (discussed herein) not independent, and Defendants citation to *Katz v. Halperin*, 1996 Del. Ch. LEXIS 13 (Feb. 5, 1996), does not set forth such a requirement. *See* Def. Br. at 24 n.13.

reasonable doubt that Dahlback would exercise objective judgment in considering a demand concerning the compensation of management or decisions that ultimately affect the compensation of management. *See id.*

- **<u>Defendant Mittal</u>**: The Complaint sets forth allegations that Defendant Mittal's livelihood depends on his full-time job as Chief Executive Officer (and Chairman) of ArcelorMittal and that the Company has arranged or provided billions of Euros in financing to Defendant Mittal's company, ArcelorMittal (¶166).[13] That Mittal's relationship with Goldman and Goldman management has a direct and substantial impact on his livelihood casts reasonable doubt that Mittal would exercise objective judgment in considering a demand concerning the compensation of management or decisions that ultimately affect the compensation of management. *See id.*

Thus, the Complaint sets forth particularized allegations that Defendants Friedman's, Dahlback's, and Mittal's livelihoods are significantly and directly impacted by the business relationships, worth hundreds of millions of dollars or more, that Goldman has with the businesses and funds which they manage, and are incapable of acting independently when making decisions effecting the compensation of Goldman management.[14]

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[13] While Defendants argue that because Goldman provides services to Mittal's company, any suggestion of Mittal's dependence is refuted, (Def. Br. at 24 n.14), it is reasonable to infer that because Goldman controls the billions of dollars (Euros) of present and future loans and financing that Mittal's company has, that Mittal would not want to act contrary to the material interests of Goldman's management.

[14] Defendants' citations to *J.P. Morgan* and *Khanna v. McMinn*, are inapposite, *See* Def. Br. at 20-21, 25. Far from the allegations of attenuated business relationships set forth in *J.P. Morgan* and *Khanna*, the Complaint here alleges that Defendants Friedman, Dahlback and Mittal do not have mere standard business relationships with Goldman, but that their livelihoods are significantly and directly impacted by the business relationships, worth hundreds of millions of dollars or more, that Goldman has with the businesses and funds which they manage. *See J.P. Morgan*, 906 A.2d at 821-22 (only allegations are that challenged directors were directors; former directors; and in the case of one director, a former consultant, of several large corporations (in which they had personal wealth invested) and that the company participated in loans or financing with these large corporations); *Khanna*, 2006 Del. Ch. LEXIS 86, *62-90 (Court found allegations insufficient to demonstrate a lack of independence when: (1) director was also a board member of a company with which challenged company did business and noting that "no allegations [have] been made that [director's] responsibilities [as director of other company] include[d] managing the Firm's relationship with [challenged company]; (2) director derived the benefits of being on the challenged company's board and an additional advisory board by virtue of unspecified "business dealings" with other directors; and (3) that director's company was a customer of challenged company producing over $1 million in yearly revenues for the previous

ii. Defendants Bryan, Gupta, Juliber, Simmons and Johnson

The Complaint also sets forth particularized factual allegations that the Company and the Foundation, controlled by Goldman management, have made significant contributions to the organizations of which Defendants Bryan, Gupta, Juliber, Simmons and Johnson are either the head or sit as part of the governing body, rendering them incapable of acting independently in decisions which affect the compensation of Goldman management. *See Limited*, 2002 Del. Ch. LEXIS 28, at *27 (holding that it was a reasonable inference that gift of $25 million to educational institution of which director was the head, while not a gift to the director personally, "was a positive reflection on him and his fundraising efforts as university president to have successfully solicited such a gift, which can reasonably be considered to instill a sense of 'owingness' raising reasonable doubt as to the director's independence"). *See also In re Freeport-McMoRan Sulphur, Inc. S'holder Litig*., 2005 WL 1653923, at *3, 13 (Del. Ch. June 30, 2005) (denying motion for summary judgment in stockholder class action based, in part, on issues of director independence where directors and entities made charitable contributions to university); *In re Ply Gem Indus., Inc. S'holders Litig.*, 2001 Del. Ch. LEXIS 123, at * 4 (Sept. 28, 2001) (stating that "past benefits conferred by [the allegedly dominating director], or conferred as the result of [that director's] position with [the company], may establish an obligation or debt (a sense of owingness) upon which a reasonable doubt as to a director's loyalty to a corporation may be premised") (internal quotations and citation omitted). Specifically:

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two years to challenged company).

Additionally, in both *LMPERS* and *Bader*, also cited by Defendants, the Court declined to reach any conclusion as to the independence of certain Goldman directors based on allegations that they had significant business relationships with Goldman Sachs beyond their capacity as directors. *Louisiana Municipal Police Employees Retirement System v. Blankfein*, 2009 U.S. Dist. LEXIS 42852, at *18-19 n.9 (S.D.N.Y. May 19, 2009); *Bader v. Blankfein*, 2008 U.S. Dist. LEXIS 102698, at *29 (S.D.N.Y. Dec. 19, 2008).

- **Defendant Bryan:** The Complaint alleges that Goldman made substantial contributions to Defendant Bryan's chairing of a campaign to raise $100 million to renovate the Chicago Lyric Opera House and Orchestra Hall. (¶157). As a co-Chair of the World Economic Forum, the substantial contribution to the $100 million campaign would reflect well on Bryan's fundraising ability, and like the director in *Limited*, it is reasonable to infer that this instilled a sense of owingness to Goldman's management. Additionally, the Foundation has aided in Bryan's job as life trustee of the University of Chicago to raise money, by donating $400,000, (¶157), which combined with Goldman's other contributions to Bryan-chaired funds, casts reasonable doubt that Bryan would exercise objective judgment in considering a demand concerning the compensation of management or decisions that ultimately affect the compensation of management. *See Limited*, 2002 Del. Ch. LEXIS 28, at *27.

- **Defendant Gupta**: The Complaint alleges that the Foundation, controlled by Goldman management, made substantial contributions of millions of dollars to each of several institutions on which Gupta chaired or of which he sat on the governing body. (¶157). The Foundation donated at least $1.6 million to the Friends of the Indian School of Business in Hyderbad, India, of which Gupta is chairman of the board; at least $3.5 million to the Friends of Tsinghui School of Economics and Management in Beijing, China, of which Gupta is a member of the dean's advisory board; and at least $1.665 million to the Model UN program, of which Gupta is a member of the United Nations Commission on the Private Sector and Development and is a special advisor to the UN Secretary General on UN Reform. (¶159). As head or a member of the governing body of these institutions, the substantial contribution of millions of dollars to not just one, but each of these institutions, would reflect well on Gupta's fundraising ability, and it is reasonable to infer that this instilled a sense of owingness to Goldman's management, which casts reasonable doubt that Gupta would exercise objective judgment in considering a demand concerning the compensation of management or decisions that ultimately affect the compensation of management. *See id*.

- **Defendant Juliber**: The Complaint alleges that the Foundation paid $200,000 in donations to Girls Incorporated in multiple years, aiding Defendant Juliber in his job as a member of the board of Girls Incorporated. (¶161). It is reasonable to infer that Juliber's ability to solicit funds on multiple occasions from Goldman management for a charitable institution, the governing body of which he is a part, reflects well on his ability to fundraise for his institution, casting reasonable doubt that Juliber would exercise objective judgment in considering a demand concerning the compensation of management or decisions that ultimately affect the compensation of management. *See id.*

- **Defendant Simmons**: The Complaint sets forth particularized allegations that the Foundation pledged an undisclosed amount (of which at least $100,000 has been paid) to Brown University to share in support of a position of Program Director at the Swearer Center for Public Service at Brown University, aiding Defendant Simmons as President of Brown University to raise money. (¶162). It is reasonable to infer that Simmons' ability to solicit funds from Goldman management for an institution, of which she is the head, casts reasonable doubt that Simmons would exercise objective judgment in considering a demand concerning the compensation of management or decisions that ultimately affect the compensation of management. *See id.*

- **<u>Defendant Johnson</u>**: The Complaint sets forth particularized allegations that the Foundation donated $100,000 to Brookings Institution, aiding Defendant Johnson in his job as honorary trustee to raise money for the Brookings Institution. (¶158). It is reasonable to infer that Johnson's ability to solicit funds from Goldman management for a charitable institution, the governing body of which he is a part, reflects well on his ability to fundraise for his institution, casting reasonable doubt that Johnson would exercise objective judgment in considering a demand concerning the compensation of management or decisions that ultimately affect the compensation of management. *See id.*

Therefore, Defendants Bryan, Gupta, Juliber, Simmons, and Johnson cannot act independently in decisions affecting management's compensation or decisions that ultimately affect the compensation of management. (¶¶153, 155).

Defendants cite no case which necessitates a holding to the contrary. *See J.P. Morgan*, 906 A.2d at 814-15, 822-23 (noting that the only allegations of lack of independence were two directors' affiliation with a museum to which the company was a significant benefactor and that allegations need "more particularized facts about the materiality of the relationship in question" in case involving claims regarding the acquisition of another bank); *LMPERS*, 2009 U.S. Dist. LEXIS 42852, at *2, 20-21 (finding that the mere fact of charitable contributions without more was insufficient to establish a lack of independence in case involving claims concerning Goldman's manipulation of the market for auction-rate securities); *Bader*, 2008 U.S. Dist. LEXIS 102698, at *2, 28-29 (determining that there was no link between the interested Goldman executives and the charitable contributions sufficient to establish a lack of independence in case involving the backdating of stock options).[15]

[15] Defendants' citation to *In re Dow Chem. Co. Deriv. Litig.*, 2010 Del. Ch. LEXIS 2 (Jan. 11, 2010) is similarly unavailing. In *Dow*, the Court found that regardless of whether the allegations of various business or personal relationships with the allegedly controlling director established that the directors were not independent of that director, because no interest was

Unlike in *J.P. Morgan*, *LMPERS* and *Bader*, the Complaint alleges not only significant contributions were made to the organizations of which Defendants Bryan, Gupta, Juliber, Simmons and Johnson are either the head or sit as part of the governing body, but also that it was Goldman management (who control Goldman and the Foundation) who controlled those donations, and who, as employees of Goldman, all have a material financial interest in the excessive allocation of net revenues to compensation and the excessively risky and unethical conduct which inflates those revenues, which interest is adverse to that of the Company. Unlike in the cases cited by Defendants, the Complaint has alleged the beholdenness or dominance of these directors to an interested Goldman management through their financial ties to Goldman and the Foundation, raising a reasonable doubt as to their independence.

C. Plaintiffs' Complaint Adequately Alleges Demand is Futile Because The Goldman Board's Excessive Allocation of Net Revenues to Compensation Was Not the Product of a Valid Exercise of Business Judgment

Defendants' argument that Plaintiffs cannot meet the second prong of the *Aronson* test -- that there is reasonable doubt that "the challenged transaction was otherwise the product of a valid exercise of business judgment," is wrong. *See* Def. Br. at 25, *citing Aronson*, 473 A.2d at 815. The Complaint sets forth particularized factual allegations that the Director Defendants' consistent and excessive allocation of net revenue to compensation was not done in good faith and thus states cognizable non-exculpable claims for breach of the duty of loyalty to act faithfully under Delaware law.[16] These allegations and the inferences therefrom excuse demand, because

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alleged as to the allegedly controlling director, there was no basis to assert that the board would do anything contrary to the best interest of the company and its stockholders. *Id*. at *29-30. As set forth more fully herein, the Complaint contains allegations that Goldman management was interested in maximizing their compensation, the basis of which was the allocation to compensation of excessive amounts of Goldman's net revenues and the undertaking of risky and unethical practices in pursuit of larger revenues to inflate compensation, and was contrary to the best interest of the Company and its stockholders.

[16] Goldman's Certificate of Incorporation includes a director protection provision pursuant

"the threat of liability to the [Goldman] directors required to act on the demand is sufficiently substantial to cast reasonable doubt over their impartiality." *Guttman v. Huang*, 823 A.2d 492, 500 (Del. Ch. 2003); *Am. Int'l Group, Inc. v. Greenberg*, 965 A.2d 763, 811 (Del. Ch. 2009) ("board faces a sufficiently real threat of liability that it cannot act objectively on the demand").

1. Duty of Loyalty Requires Faithfulness to the Best Interest of the Company and its Stockholders

The Goldman Board owed a fiduciary duty of loyalty to act faithfully in the best interest of Goldman and its stockholders:

> While technically not trustees, [officers and directors] stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexcusably, the most scrupulous observance to his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation or to deprive it of profit of advantage which his skill and ability might properly bring to it, or enable it to make in the reasonable and lawful exercise of its powers.

Guth v. Loft, 5 A.2d 503, 510 (Del. 1939). The Supreme Court has recently emphasized that the touchstone of a director's duty of loyalty is faithfulness to the *best* interest of the company and its stockholders.[17] *In re Walt Disney Company Derivative Litig.*, 906 A.2d 27, 67 (Del. 2006). In

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to 8 *Del. C.* §102(b)(7).

[17] Defendants' citation to *Wood v. Baum*, 953 A.2d 136 (Del. 2008), a case that turned on the unique contractual language of the operating agreement of a limited liability company, is unavailing. *See* Def. Br. at 25-27. In *Wood*, the operating agreement specifically eliminated all liabilities for breach of fiduciary duties, except in cases where the directors knowingly engaged in "fraudulent" or "illegal" conduct. A limited liability company, unlike a Delaware corporation, is permitted by statute to eliminate all fiduciary duty liability other than for breaching in bad faith the implied covenant of good faith and fair dealing. *Wood*, 953 A.2d at 139, 141. Accordingly, the standard applied in *Wood* – that the Complaint must allege "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" – is applicable only in that case, and cannot be extended to this one where the directors are not exculpated from liability for conduct that would constitute a breach of the duty of loyalty. *See id*.

Disney, the Supreme Court upheld this Court's definition of "good faith" as appropriate although "not exclusive," where the Court of Chancery stated as follows:

> The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense . . ., but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, *where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation . . .*

Id. at 67 (emphasis added). The Supreme Court reaffirmed this aspect of *Disney* in *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006).[18] Thus, the Supreme Court found that there is a category of fiduciary conduct that falls between conduct motivated by subjective bad intent and conduct resulting from gross negligence that "is properly treated as a non-exculpable, non-indemnifiable violation of the fiduciary duty to act in good faith." *Disney*, 906 A.2d at 66.

Importantly, in this type of case, there is fiduciary liability for disloyalty, even though the "corporate directors have no conflicting self-interest." *Id.* at 66. Furthermore, in *Disney*, the Supreme Court explained that this Court's definition of bad faith was not exclusive, but that the Court would not "engage in an effort to craft … 'a definitive and categorical definition of the universe of acts that would constitute bad faith.'" *Id.* The Supreme Court, thus, left open the possibility of a broader set of circumstances on which a disloyalty claim could be based, where the [non-self-interested] directors' conduct "is more culpable than simple inattention or failure to be informed of all facts material to the decision." *Id. See also Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 981 (Del. Ch. 2000) (presumption of good faith can be rebutted by pleading facts showing directors' "indifference to their duty to protect the interests of the corporation.").

[18] The Supreme Court also cited with approval this Court's decision in *Guttman*, wherein this Court observed "[t]he reason for the disloyalty (the faithlessness) is irrelevant, the underlying motive (be it venal, familial, collegial, or nihilistic) for conscious action not in the corporation's best interest does not make it faithful, as opposed to faithless." 823 A.2d at 506 n.34.

2. The Board's Consistent Excessive Allocation of Net Revenues To Employees Could Not Have Been a Good Faith Decision to Advance The Best Interests of Goldman and Its Shareholders

Defendants seek to take cover under the "business judgment rule" by ignoring the basic allegations and mischaracterizing the issue as simply involving overcompensation. *See* Def. Br. at 28. But, the allegations are not merely that one or a number of employees were paid too much for their services, but that Goldman was and continues to be operated to enrich management at the expense of the Company and its shareholders and that the Director Defendants' consistent decision to allocate a staggering proportion of Goldman's net revenues to be distributed to employees, before any compensation determination was made with respect to them, was neither a loyal nor a good faith exercise of their authority. This claim is supported by a number of particularized allegations, including the following:

- Year after year, the Director Defendants allocated to Goldman employees, at the close of each year, almost half of the Company's net revenues (a measure unrelated to employee performance) (¶115);
- While Goldman employees received almost 50% of net revenues, the Firm's shareholders have consistently, with few exceptions, received less than 2% of net revenues as dividends, and the undistributed revenues were in turn used to create future net revenues so that management could take almost 50% again and again, in a never-ending cycle (¶¶10, 123);
- The Board's allocation decision put the cart before the horse -- first allocating a huge sum of money away from the Company and its shareholders, without ever considering or deciding what the appropriate compensation for the Company's employees individually or as a whole should be, in light of the well accepted considerations for making such decisions, such as the contributions of employees, competitive considerations, and the risk that management caused the Company to assume. As a result, compensation determinations were ultimately driven by the huge sums made available by the Board, not on the merits of the employees' performance and competitive issues (¶114);
- The Board's allocation of an enormous proportion of net revenues has been consistently and enormously excessive on a per employee basis, far exceeding Goldman's peers in its industry (¶119);
- The Board consults with management who recommends a percentage allocation of net revenues, which the Board rubber stamps (¶¶89-91);

- Although Goldman's business principally revolves around managing and investing shareholder capital, much like a hedge fund, the compensation allocation is the equivalent of compensating 2% of net assets plus 45% of net income, which far exceeds the highly-compensated hedge fund industry, for which typical high compensation is 2% of net assets plus 20% of net income, a rate which includes the non-employee operating costs that Goldman shareholders pay in addition to employee compensation (¶¶117-18); and on a risk-adjusted basis, Goldman's managers' performance has lagged far behind hedge fund indices (¶7);

- The Board annually allocated an enormous proportion of net revenue to employees, even though the Company's ability to generate revenue was principally derived from shareholder capital, the leverage available by virtue of that capital, and ultimately government infusions of capital, rather than the efforts of its employees (¶9);

- The Board consistently allocated excessive net revenue to employees, regardless of whether the Company had a profitable year (as in 2009) or required government intervention to keep it going (as in 2008) (¶¶112-16, 173);

- The Board consistently allocated excessive net revenue to employees, without making any adjustment for the later hits to net revenue, necessitated by "put-backs" of fraudulent trades that contributed to the net revenues (¶¶103-106);

- The Board approved this allocation structure even though it understood that its Trading Segment's substantial growth was attributable mostly to derivatives trading, and even though it understood that the derivatives trading resembled more of a gambling operation than a legitimate market-making business; and this business created perverse incentives, with profits from lucky bets (accentuated by extreme leverage) going to lucky employees, and losses from bad bets (also accentuated by leverage) falling on the shareholders, and, when the bets got big enough, on taxpayers (¶¶6,44-46,85,96,102); and

- The Board set up this allocation structure without implementing sufficient controls to rein in the obvious consequences of employee excesses, ultimately causing Goldman to suffer civil liability, which was borne by its shareholders rather than its employees (¶¶52-77).

These allegations demonstrate that the Board's arbitrary and excessive allocation of Goldman's assets to its employees was not designed to attain competitive compensation, and bore no relationship to the employees' efforts. Company revenues, principally derived from the use of shareholder capital and associated leverage, belonged to Goldman and its shareholders, not the employees; yet those employees were consistently given the biggest portion of the revenues.

Rather than rewarding and incentivizing employees to work to increase Goldman's profits, these payments were structured to have the opposite effect – to encourage employees to lever up shareholder capital and place bets that would either make them rich or result in correspondingly large losses requiring more shareholder and taxpayer capital, so that the employees would be able to roll the dice again the next year.

Importantly, Plaintiffs are not objecting simply to a specific employee's overcompensation but to the fact the Board arbitrarily and excessively reserved a huge portion of Company revenues for employees, without considering or knowing what the appropriate compensation of the employees should be in light of the efforts of those employees, competitive pressures, or the Company's financial position. This Court has recognized that "when directors' actions are arbitrary or when a gross abuse of discretion has occurred, personal liability will attach to the directors." *Kaufman v. Beal*, 1983 Del. Ch. LEXIS 391, at *16 (Feb. 25, 1983). Indeed, demand may be excused where there are "allegations, with particularity, of facts from which an inference of arbitrariness . . . can be drawn." *Id*. *See also Rogers v. Hill*, 289 U.S. 582, 591 (1933) (holding that compensation arrangement based on percentage of profits, though validly adopted by disinterested directors and reasonable at the outset, could nonetheless become inequitable where the formula over time produced a very high level of compensation not reasonably related to the value of the services being rendered by the recipients). The Goldman Board's revenue allocation decision improperly favored employees over shareholders and was not calculated in a manner that would advance the best interests of the Company and its stockholders.

Because the affirmative decision that Plaintiffs challenge here is the net revenue allocation – not a particular employee's compensation, the Complaint need not allege specifics regarding the compensation of any particular employee. *See* Def. Br. at 29-30. Nor is the Complaint deficient because it does not "account for differences among the businesses operated by the various financial institutions with which Goldman Sachs competes for personnel." *See* Def. Br. at 30. The *Board's methodology* was arbitrary and failed to account for those differences by simply making available almost half of the Company's net revenues to Goldman's managers to distribute among themselves. The purported compensation decisions by Goldman's Board were unrelated to the very factors that Defendants now argue are important in setting compensation. Moreover, the process relied heavily on management, who were undoubtedly conflicted, to set the compensation pool, and the Board, year after year, rubber-stamped management's recommended allocation. (¶¶89-91).[19]

The events in 2009 make it even more obvious that the Goldman Board's revenue allocation decision has never been designed to produce appropriate compensation, and that the Board understands that the allocation gives employees far more than is necessary for compensation. At the end of 2009, the Board was under extreme pressure from an outpouring of public anger as well as shareholder lawsuits objecting to net revenue allocation *that continued to be disproportionately large* despite the necessity of Government support. In response to that pressure and for no other reason, the Board reduced its expected and usual allocation percentage from 47% down to 36%. Essentially, the Director Defendants did not begin to consider reclaiming a portion of the net revenues that it was simply handing to management until they were forced to do so. By reducing the percentage from 47% to 36%, the Board simply scrapped $*3.5 billion* from the allocation that it had planned for much of 2009. (¶113). It did so without negatively affecting employee retention and recruitment. In addition, the employees themselves

[19] That Goldman had a Compensation Committee has no bearing on the fact that the Board made a bad faith decision to allocate net revenues and otherwise operate Goldman for the benefit of its employees rather than to advance the interests of the Company and its shareholders. Regardless of whether the Board's decision was made with or without the involvement of the Compensation Committee, the Board's consistent allocation of nearly 50% of net revenues to compensation was arbitrary and not made in good faith, thereby exposing the Director Defendants to liability. *See Kaufman*, 1983 Del. Ch. LEXIS 391, at *16.

offered up yet another $500 million to donate to charity, essentially acknowledging that another half a billion dollars that had been allocated to them was simply not necessary to compensate them adequately. (¶¶126-27). These last minute reductions in the allocations, reductions which in themselves represent an enormous proportion of net revenues, illustrate that the Board understood the absence of any relationship whatsoever between its allocation of revenues and appropriate compensation.

3. Defendants' Arguments Do Not Support Dismissal of Plaintiffs' Loyalty Claims Regarding the Excessive Allocation of Net Revenues to Compensation

Defendants' first argument that pay was linked to performance is unavailing, given the "backwards" manner in which compensation was determined—by first dividing up net revenue, rather than by considering the financial condition of the Company and what amount would adequately compensate and retain employees in a given field. Moreover, net revenues were fueled by shareholder capital, leverage and Government and third party infusions of capital; there is no basis for the Board to conclude that Goldman's employees' efforts accounted for these revenues, especially when employees' decisions put the Company on the brink of collapse. Finally, the claim that pay was linked to performance is belied by the Compensation Committee's actual determinations. It determined to award virtually the same percentage whether Goldman reported record profits (2007), whether Goldman was on the verge of bankruptcy (2008), or, at least initially, whether its "profits" were due to the receipt of Federal funds (2009). There is no "link" with respect to any of these determinations.

Additionally, Defendants cannot refute the allegation that the compensation structure gave "management a far greater stake in the firm than that of shareholders." (¶3). Employees were allocated a majority of net profits (a greater percentage than net revenues): in 2007 and 2008, compensation as a percentage of profit was 53% and 82%, respectively; and in 2009, the initial allocation of compensation as a percentage of profit was 57% (which was later reduced when the Board faced public pressure to do so). (¶16). Further, the bulk of the remaining net profit (not allocated to employees) was not made available to shareholders but was instead used to produce ever-increasing net revenues and compensation for employees. The percentage of net revenues that shareholders actually received as dividends in 2007, 2008, and 2009, was 1.4%, 2.9%, and 1.2%, respectively. (¶123). Further, from January 1, 2007 through the date of this brief, Goldman's common stock price has continued to decline. (¶122). *See* Cramer Aff. Ex. B.

But while upside potential was allocated to employees, shareholders retained their stake in the Company's downside risk. In 2008, when Goldman had to convert to a bank holding Company and called on Warren Buffett for a preferred stock investment to keep the Company afloat, the burden of Goldman's losses from the employees' bad bets was placed exclusively on shareholders – not its employees. And, shareholder exposure to losses is not limited to those incurred each year, but includes losses that might materialize in future years as a result of employee risk-taking, including civil liability to the government or to Goldman's clients. (¶¶55-77, 103-106, 131-33).

Defendants' citation to a recently dismissed shareholder derivative case in New York against Goldman's competitor, Morgan Stanley, is also unavailing. *See* Def. Br. at 28-29 (*citing Sec. Police & Fire Prof'ls of Am. Ret. Fund v. Mack,* 2010 WL 5094348 (N.Y. Sup. Ct. Dec. 9, 2010). The Court in *Morgan Stanley* dismissed the plaintiffs' claim for several reasons, none of which is applicable here.

In *Morgan Stanley*, the plaintiffs asserted that the directors "simply followed a policy of matching what the Company's competitors paid its employees." *Id*. at *10. The Court was unconvinced by that argument, because "what other employees similarly situated received is relevant to determining the reasonableness of a particular compensation." *Id.* Unlike in *Morgan*

Stanley, the Goldman Board's allocation decision resulted in pay that *consistently exceeded* its competitors on a per employee basis by a wide margin. (¶¶5, 117-120). Furthermore, the allocation decision was arbitrary; it was not structured to incentivize, reward or retain employees by setting pay based on pay offered by others in the industry, but was a fixed, consistently excessive percentage allocation of the Company's net revenues. (¶¶114-117).

The Court in *Morgan Stanley* also found it significant that there was "no specific evidence that Morgan Stanley's *total* compensation was approved by the Board." 2010 WL 5094348, at *10. By contrast, this case involves the Goldman Board's decision to set total compensation and not merely a bonus pool. (¶¶114-117).

Furthermore, in *Morgan Stanley*, there were no allegations "that the Board was or should have been aware of [the connection between the employee contributions and the losses suffered by the company from sub-prime mortgage investments] *at the time* the specific compensation decisions were made." *Id.* at *10-11 (emphasis in original). By contrast, here, the Board made its allocation decision at the end of the year, when it should have been able to consider the contributions of its employees and the financial position of the Company. Yet, in each of 2007 and 2008, regardless of the change in the Company's financial stability when the subprime crisis was unfolding and the Company was on the verge of collapse in large part due to the Trading Segment, the Board allocated close to 50% of net revenues, and it would have continued that practice in 2009 were it not for public outrage and shareholder lawsuits. (¶¶9, 52-77, 113, 115).

4. The Complaint's Particularized Allegations Regarding The Board's Consistent Excessive Allocation of Net Revenues To Employees Constitute Waste Excusing Demand

The Complaint also asserts a claim for waste. Waste is defined as an exchange that is "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." *Disney*, 906 A.2d at 74. Waste can be shown in cases where "directors irrationally squander or give away corporate assets;" in other words where a board decision cannot be "attributed to any rational business purpose." *Id*. *See also Avacus Partners, L.P. v. Brian*, 1990 WL 161909 at *1440-41 (Del. Ch. 1990) (plaintiffs stated a valid waste claim, even though there was no allegation that the company received no consideration in the exchange, where corporation paid over 10 times fair market value of stock of one company and 100 times the price paid a year earlier for control of a second company); *Sample v. Morgan*, 914 A.2d 647, 669-70 (Del. Ch. 2007) (concluding that stock option grants to three executives was not a good faith exercise of business judgment and constituted waste when the grants could result in 200,000 shares, comprising one-third of the voting power and dividends, going to the three executives for a tenth of a penny a share).

It is well-settled Delaware law "that the discretion of directors in setting executive compensation is not unlimited," *Citigroup*, 964 A.2d at 138, and that "compensation payments may grow so large that they are unconscionable," *Saxe v. Brady*, 40 Del. Ch. 474, 487 (1962). "[T]here is an outer limit to that discretion, at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste." *Brehm*, 746 A.2d at 262.

The same particularized facts that support the Complaint's claims that the Board's actions lack good faith also demonstrate that the Board committed waste when it adopted its excessive allocation of net revenue in 2007, 2008 and 2009. In each of those years, even though the sub-prime crisis unfolded and the Company was on the verge of collapse, requiring taxpayer money due to highly risky leveraged trading, the Board blindly and consistently allocated nearly 50% of net revenues to compensation. (¶¶9, 52-77, 115). Although the Board reduced its initial 2009 allocation by $3.5 billion (as a result of public pressure), the allocation was still so excessive that the employees voluntarily *gave up* another half a billion dollars. Rather than reclaiming that half a billion dollars for shareholders, the Board allowed the employees to give it to charity, without even considering whether the "give back" was an indication of excessiveness. (¶¶113, 126-27).

Citigroup is instructive here. In *Citigroup*, the Court denied a motion to dismiss an excessive compensation claim for paying multi-million dollar compensation to a departing CEO in exchange for certain promises by the CEO, where the directors were not interested and were independent. *Citigroup*, 964 A.2d at 139. By all accounts, Goldman's bonus plan surpassed the "outer limit" – in good times and in bad – allocating to its employees average compensation that was multiple times that paid by its peers. (¶¶117-120). Like the claim in *Citigroup*, demand would be futile in this case, simply based on this egregious excess. *See also Kovacs v. NVF Co*., 1987 WL 758585, at *4 (Del. Ch. Sept. 16, 1987) (reasoning that although *Aronson* "may have made it more difficult to attack executive compensation, it may still be done" and concluding, in the context of a settlement approval, that had the executive compensation been before the court, the court would have found the compensation excessive and "so disproportionate to the executive compensations of the heads of many of the largest and best managed corporations in this country").

Moreover, the allegations in this case are not vague and conclusory; they specifically quantify the extent of the waste. *See, e.g.*, *Andreae v. Andreae*, 18 Del. J. Corp. L. 197, 207, 210, 1992 WL 43924 (Del. Ch. 1992) (reduction of sale price by $500,000, which was diverted to an individual instead of the corporation, could not have been "the product of a valid exercise of business judgment"). Goldman paid its employees many more times what was paid by its peers. (¶119). And, Goldman's allocation was the equivalent of 2% of assets and 45% of profits, far more than the 2% of assets and 20% of profits (calculated net of expenses) paid in the highly compensated hedge fund industry. (¶¶117-18). Because the Complaint quantifies the excess in this manner and given the early procedural stage of the case, the Complaint properly states a non-exculpated claim for waste under Ch. Ct. Rules 23.1.

D. Plaintiffs' Complaint Adequately Alleges Demand Futility of Claims Involving The Director Defendants' Failure of Oversight

This Court has consistently held that "a 'substantial likelihood' of personal liability prevents a director from impartially considering a demand" under Court of Chancery Rule 23.1. *Seminaris v. Landa*, 662 A.2d 1350, 1354 (Del. Ch. 1995), *quoting Rales*, 634 A.2d at 936. *See Guttman*, 823 A.2d at 500. Thus, where the face of a complaint pleads a claim of breach of fiduciary duty "with sufficient particularity to permit the court to *reasonably* reach the required conclusion," courts will conclude that defendants face a substantial likelihood of liability and the complaint will survive a motion to dismiss pursuant to Rule 23.1. *In re Baxter Int'l*, 654 A.2d 1268, 1270 (Del. Ch. 1995) (emphasis added). Only a reasonable inference is required. *See id*.

"*Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (emphasis in original). Thus, for a derivative complaint to withstand a motion to dismiss, it must allege "a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists – [thereby] establish[ing] the lack of good faith that is a necessary condition to liability." *Stone*, 911 A.2d at 372, (quoting *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996)). Plaintiffs must allege facts that show "(1) that the directors knew or (2) should have known the alleged, pervasive, imprudent … activity was occurring or had occurred; and made no good faith effort to remedy such misconduct." *In re Career Educ. Corp. Deriv. Litig*, 2007 Del. Ch. LEXIS 184, *25 (Feb. 22, 2006), (quoting *Caremark*, 698 A.2d at 971).

Here, the Complaint sets forth particularized allegations that a majority of the Director Defendants, by virtue of their having acquiesced in management's proposed compensation structure created a conflicted compensation structure and/or by virtue of their membership on the Audit Committee, were responsible for overseeing and monitoring the Company's exposure to risk, (¶¶2, 17-25, 84, 144-145), and, as a consequence, since at least as early as September 2007, the Director Defendants were aware or should have been aware of the many red flags concerning the risk-laden growth of the Trading Segment in pursuit of huge profits in order to maximize management's compensation. Nevertheless, the Directors Defendants failed to take any steps to remedy the misconduct and unethical practices of the Trading Segment, of which they had knowledge or should have been aware, resulting in, among other things, having to pay $550 million in fines, suffering billions of dollars of loss in market capitalization, being rendered insolvent, loss of reputational capital, and facing civil liability and government scrutiny.[20] (¶¶11, 65-67, 69, 70, 72, 73, 75-77, 83, 84, 88, 96, 103, 104, 126, 132, 133, 187, 188). Accordingly, these Director Defendants, comprising a majority of the Company's Board members, (¶145), face a substantial likelihood of liability for their breaches of fiduciary duty, making any demand upon them futile. *See Career*, 2007 Del. Ch. LEXIS 184, at *25.

1. A Majority of the Director Defendants Were Charged With Oversight of Goldman's Risk

Directors have an obligation to "assur[e] themselves that information and reporting systems exist . . . that are reasonably designed . . . to allow management and the board, each

[20] Contrary to Defendants' assertions, Plaintiffs have not conceded that Goldman's excessively risky and unethical trading practices were "highly successful," (*see* Def. Br. at 41-42), but rather that Goldman's excessively risky and unethical trading practices were aimed in the pursuit of increases in short-term revenue at the expense of the Company's long-term financial viability, resulting in potential and actual liability.

within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance." *Caremark*, 698 A.2d at 970.

As set forth *supra* in Section I.C., from 2007 through 2009 the Goldman Board acquiesced in Goldman's management's proposed compensation structure, creating a structure that ensured Goldman's senior management would operate the Firm for their own benefit by taking on additional risk and engaging in unethical behavior to achieve short-term revenue and thereby increase Goldman's employees' compensation, rather than working for the benefit of the shareholders, whom they purported to serve and ensuring the long-term financial viability of the Firm. (¶¶2, 84, 144). By creating a conflict between the interest of Goldman management and that of its shareholders and faced with evidence that those conflicts were harming the Company, the Director Defendants had a duty to oversee such conflicted employees. *See Forsythe v. ESC Fund Manangment Co. (U.S.), Inc.*, 2007 Del. Ch. LEXIS 140, *26-30 (Oct. 9, 2007) (finding demand was excused as to oversight claims because in the face of a drop in value of funds managed by conflicted managers, the allegations in the complaint were sufficient to support an inference that the fiduciary exercised no oversight and took no steps to remedy the misconduct).[21]

Additionally, the Complaint alleges facts that the Audit Committee members, consisting of nine of the twelve Board members - Defendants Bryan, Dahlback, Friedman, George, Gupta, Johnson, Juliber, Mittal, and Schiro - were specifically charged with assisting the Board in fulfilling its oversight responsibility of "the Company's management of market, credit, liquidity and other financial and operational risks" by "review[ing] generally with management the type and presentation of any financial information and earnings guidance provided to analysts and

[21] Unlike *Caremark* and *HealthSouth*, relied on by Defendants (Def. Br. at 36), the Complaint relies on allegations of knowledge and/or red flags which put the Board members on notice regarding the occurrence of misconduct and not simply through "hindsight deduction" where directors failed reasonably to detect such occurrence.

rating agencies" and "discuss[ing] with management periodically management's assessment of the Company's market, credit, liquidity and other financial and operational risk, and the guidelines, policies and processes for managing such risks." (¶¶ 17-25, 145).

2. A Majority of the Director Defendants Systematically Failed to Oversee the Unethical and Excessively Risky Practices of Goldman's Trading Segment by Ignoring Red Flags

a) The Director Defendants (Defendants Blankfein, Cohn, Bryan, Dahlback, Friedman, George, Gupta, Juliber, Johnson, Mittal, Schiro and Simmons)[22]

Despite Defendants assertions to the contrary, (*see* Def. Br. at 37-38, 41), the Complaint sets forth numerous allegations that the entire Goldman Board knew or should have been aware of the Trading Segment's unethical and risky trading practices and the ramifications that could and did follow.[23]

First, the Complaint sets forth allegations that as early as September 2007, the Board, including the nine-member Audit Committee, was made fully aware that the Trading Segment's activities involved intensive shorting of the residential mortgage and synthetic financial products market, with CDO transactions involving tens of billions of dollars and that the Firm's activities,

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22 As discussed above, Plaintiffs submit that the relevant Board for purposes of demand with respect to Plaintiffs' failure of oversight claim includes Defendants Gupta and Simmons, but even if they were not considered, the Complaint contains particularized allegations sufficient to demonstrate that the remaining ten members of the Goldman Board, a majority, face a substantial likelihood of liability rendering them incapable of considering a demand.

23 Defendants' reliance on cases rejecting failure-of-oversight derivative claims for demand futility that were based on nothing more than conclusory allegations that, because of some unfavorable outcome, "internal controls must have been deficient, and the board must have known so," is unavailing. *See* Def. Br. at 38; *Desimone v. Barrows*, 924 A.2d 908, 940 (Del. Ch. 2007) (no allegations directors had reason to suspect occurrence of misconduct (*i.e.*, no red flags)); *Fink v. Komansky*, 2004 U.S. Dist. LEXIS 24660, at *11-12 (Dec. 8, 2004) (same). However, Plaintiffs have alleged more than just mere "bad results" at Goldman. In stark contrast to the cases cited by Defendants, the Complaint contains particularized allegations that excuse demand. As discussed herein, the Complaint details the Director Defendants' sustained, systemic failure of oversight of the Trading Segment's excessively risky and unethical practices over an extended period of time, despite knowledge or constructive knowledge.

including those of its Trading Segments, had widespread and increasing conflicts of interest, which were acknowledged repeatedly in Company filings. (¶¶52, 147-149). Having made the determination to "manage" conflicts of interest rather than eliminate them, (¶52), the Director Defendants could not abdicate their responsibility to ensure that such conflicts were "managed" properly. The Board was also aware that these efforts involved a large amount of Goldman's capital, which exceeded the Company's value at risk, and that the Company's value at risk steadily rose from Goldman's 1Q 2007 until Goldman's 2Q 2009. (¶¶136, 149).

Second, the Complaint sets forth allegations that at least as early as September 2008, the Goldman Board was aware or should have been aware that as a result of the Trading Segment's practices, the Company was rendered insolvent, leading the Board to take actions to stave off bankruptcy, including taking actions to be converted to a bank holding company. With the majority of Goldman's business over-dependent on leverage and Goldman not setting aside enough cash against the bets it made, as subprime mortgages financed by the mortgage backed securities sold by Goldman began to default, Goldman was hit with losses, facing a liquidity crisis, and Goldman stock price began to plummet. (¶¶96, 131, 137). In fact, in 2007 and 2008, Goldman was more highly leveraged, due in large part to the risky and conflicted practices of its Trading Segment, than Lehman Brothers or Bear Stearns, whose speculative leveraging was responsible for both of their eventual bankruptcies in September 2008. (¶¶8, 97). Goldman was then required to borrow billions of dollars from the Federal Reserve and convert to a bank holding company, which then gave the Company access to additional tens of billions of dollars in borrowed money from the Federal Government. (¶¶96, 98, 99, 131, 137).

In addition, the Complaint sets forth particularized allegations that in the fall of 2008, and necessitated by the fallout from the Trading Segment's practices, Goldman appealed to the Federal Government and accepted a $10 billion TARP loan to ensure its survival. (¶¶99, 101, 132). Goldman was also forced to sell investor Warren Buffet shares of preferred stock for $3.2 billion, which paid Buffett $500 million per year and which was callable at $5.5 billion. (¶133). Notwithstanding the claimed risk controls in place and numerous red flags regarding the Firm's excessively risky and grossly unethical trading practices, which increased the Firm's short-term revenues, but harmed the Firm's long-term financial viability, the Director Defendants either consciously remained ignorant of the Company's increased risk exposure at the hands of the Trading Segment, which was a multi-billion dollar part of Goldman's business, or failed to investigate and/or take steps to remedy to the misconduct and the risks related to the same.[24] *See David B. Shaev Profit Sharing Account v. Armstrong*, 2006 Del. Ch. LEXIS 33, at *19 (Feb. 13, 2006) (stating that a "director could be found liable for remaining ignorant of a large fraud occurring in plain sight, even if the director is able to show that the company had established a full set of supervisory controls").

b) Defendants Blankfein and Cohn

The Complaint also sets forth numerous particularized allegations that because Defendants Blankfein and Cohn had direct involvement in and knowledge of the Trading

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24 While Plaintiffs have alleged that Goldman had supervisory mechanisms in place, Plaintiffs have in no way "conceded" that Goldman had *proper* oversight mechanisms in place, and certainly have not conceded that the Director Defendants complied with even their mandated charge as Audit Committee members. The Complaint alleges that despite their responsibilities and qualifications and given the red flags discussed herein, the Audit Committee members either did not make a good faith attempt to follow the procedures put in place or failed to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Goldman's risks. Instead, the Audit Committee members failed to adequately scrutinize (or turned a blind eye to) Goldman's exposure to risk and liability based on the Trading Segment's practices, including the steps being taken to monitor the risk and control of such exposure in breach of their fiduciary duties. *David B. Shaev*, 2006 Del. Ch. LEXIS 33, *15 ("[a] claim that an audit committee or board had notice of serious misconduct and simply failed to investigate, for example, would survive a motion to dismiss, even if the committee or board was well constituted and was otherwise functioning"). Defendants' citation to *Stone v. Ritter*, and *Kanter v. Barella* are thus unavailing. *See* Def. Br. at 37; *Stone*, 911 A.2d 362, 373 (2006) (dismissing plaintiffs' failure of oversight claims based on the establishment of a reporting system and the absence of red flags regarding the alleged misconduct); *Kanter v. Barella*, 388 F. Supp. 2d 474, 480-81 (D.N.J. 2005) (same).

Segment's practices, they knew or should have been aware of the Trading Segment's unethical and risky trading practices and the ramifications that could and did follow. (*See* ¶¶50, 52, 59-61, 66). Not only was Blankfein instrumental in institutionalizing a Firm-wide pursuit of huge profits, giving rise to an exponential expansion of the Trading Segment's conflicts of interest and increasingly fuzzy ethical lines, but both Blankflein and Cohn consistently supported Goldman's engaging in trading practices which view Goldman's clients as both clients and trading counterparties. (¶¶50, 52).

Additionally, as the housing market began to fracture in early 2007, Defendants Blankfein and Cohn became members of a committee of senior Goldman executives who took an active role in overseeing the Firm's mortgage unit, a part of the Trading Segment, via routine multi-hour visits to the mortgage unit, during which they vetted potential new products and transactions and reviewed the risks, including the Abacus deal, Goldman's involvement in which exposed Goldman to, among other things, government inquiry and ultimately a $535 million disgorgement of profits and $15 million in civil penalties. (¶¶59, 66, 73). As members of this committee, Blankfein and Cohn took part in and acknowledged the Company's decision to make negative bets against Goldman's clients in order to profit, and knew or should have known that Goldman's expanded Trading Segment bundled toxic and risky mortgages into complex financial instruments in such a way that they were designed to fail, got the credit-rating agencies to give the securities investment-grade ratings, marketing long positions to the majority of its clients, and taking positions that bet against the majority of their clients for itself and certain select clients. (¶¶4, 50, 52, 53, 54, 57, 60, 61, 63, 82, 83, 151).

Thus, Blankfein and Cohn had direct knowledge of the misconduct and a reasonable inference can be drawn that they, having a fiduciary duty to speak, brought the misconduct to the attention of Goldman's outside directors (including those who served on the Audit Committee), and the Court is entitled to infer, at the procedural stage of this case, that the knowledge of Defendants Blankfein and Cohn can be imputed to the entire Board. *See Saito v. McCall*, 2004 Del. Ch. LEXIS 205, at *36 n.71 (Dec. 20, 2004) (A "committee of the board, acting in good faith, would have openly communicated with each other concerning the accounting problems [uncovered] and would have shared the information with the entire [ ] board.").

* * *

Despite knowledge of the Firm's excessively risky and unethical trading practices and warnings regarding the same and the ramifications that would ultimately follow, the full Board took no steps to remedy the Trading Segment's practices that led to the Firm's near miss with bankruptcy, nor did it take steps to ensure that management reduced the company's risk, including by deleveraging assets. (¶¶137, 152). In fact, despite converting to a bank holding company in September 2008 in order to avoid bankruptcy, Blankfein stated that the Company's strategy would not change and the Firm went on to assume even greater risks than in previous years, with its average daily value at risk increasing steadily from at least Goldman's 1Q 2007 through 2Q 2009. (¶¶135-137). Further, Goldman only began investigating the fundamental issues of conflict inherent in its trading business in July 2010, in connection with the Firm's settlement with the SEC in the proceeding related to Abacus, demonstrating that no effective mechanism was in place, nor had the Firm previously taken any steps to ensure such a mechanism was in place. (¶¶79-80).[25] These practices illustrate a sustained and systematic failure of the full Board to exercise oversight of the Company's practices, establishing the lack of good faith that is a necessary condition to liability. *See Citigroup*, 964 A.2d at 121 ("To establish oversight

[25] While the allegations regarding the settlement of the SEC action and the resulting specific undertakings in connection therewith were not red flags alerting the Director Defendants to misconduct, (*see* Def. Br. at 39), these allegations do establish that faced with the red flags, as alleged in the Complaint, the Director Defendants did not take any steps to remedy the misconduct until the time of the settlement in July 2010, nearly three years after their first such red flag. *See* (¶¶52, 62, 147-148).

liability a Plaintiff must show that the directors *knew* they were not discharging their fiduciary obligation or that the directors demonstrated a *conscious* disregard for their responsibility, such as by failing to act in the face of a know duty to act."). These allegations are precisely the type necessary to sustain a claim for a breach of the duty of oversight.

3. The Director Defendants Were Not Permitted to Make Decisions Causing the Company to Become Involved in Practices Which Created Excessive Risk to the Company's Long-Term Financial Viability and Reputation

Defendants' discussion of the permissibility of directors and officers to make aggressive decisions regarding risk and their assertion that reputational risk is inherent in Goldman's business misses the mark. *See* Def. Br. at 39-42. While Delaware law allows directors and officers to make decisions regarding risk, such an allowance assumes that "the process employed was either rational or employed in a *good faith* effort to advance corporate interests." *Caremark*, 698 A.2d at 967 (emphasis in original). However, as discussed above, it was the Director Defendants' failure of oversight, which is a failure to discharge their fiduciary obligations in good faith, which allowed this behavior to continue within Goldman. *See Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (citations omitted).

Defendants' discussion of *Citigroup* does not necessitate a finding to the contrary.[26] First, the Court in *Citigroup* only concluded that based on the allegations before it, the directors would not face liability for failure to properly monitor the business risk of the company, but acknowledged that "it may be possible for a plaintiff to meet the burden [to have alleged facts sufficient to excuse demand based on a theory that the directors did not fulfill their oversight

[26] Additionally, unlike the other cases cited by Defendants, Plaintiffs have alleged particularized facts identifying "red flags" which put the directors on notice of the Company's excessively risky and unethical trading practices. *See* Def. Br. at 42 n.20; *Rattner v. Bidzos*, 2003 Del. Ch. LEXIS 103 (Sept. 30, 2003) (no red flags alleged); *Guttman*, 823 A.2d 492 at 507 (same).

obligations by failing to monitor the business risk of the company] under some set of facts." 964 A.2d at 126.

Second, unlike the allegations of red flags here, in *Citigroup*, the Court stated that the allegations of red flags of the business risk facing Citigroup were based solely on reports of general problems in the subprime mortgage market at large, as opposed to within Citigroup itself, and concluded that such "red flags" did not alert the board members to potential misconduct at Citigroup. *Citigroup*, 964 A.2d at 124-125, 127-28, 130 ("the mere fact that a company takes on business risk and suffers losses—even catastrophic losses—does not evidence misconduct, *and without more*, is not a basis for personal director liability"). By contrast, here, the Complaint sets forth particularized allegations that not only did the Director Defendants have actual knowledge of these practices based on presentations made to the Board and Defendants Blankfein's and Cohn's oversight of Goldman's mortgage department, (¶¶59-62, 66, 136, 147-149), but that there also existed red flags which should have alerted the Director Defendants of the inadequacies within Goldman. Indeed, Goldman's directors should have been especially conscious of such warning signs in light of the circumstances necessitating the Company's transfer to a bank holding company. (¶¶96, 98, 99, 131, 137).

Third, in *Citigroup*, in determining that the directors would not face liability for failure to properly monitor the business risk of the company, the Court found significant that the plaintiffs were unable to point to specific wrongdoing within Citigroup which caused Citigroup's losses from exposure to the subprime mortgage market. 964 A.2d at 128 n.65. The Complaint here, however, contains factual allegations that the Trading Segment was grown by taking substantially greater risks, principally by leveraging the Firm's assets to speculative levels and investments in risky mortgage backed securities and other related financial instruments. (¶¶4, 7, 94-96). The claim herein is not merely that Goldman management took too many risks, but that management engaged in unethical, if not unlawful, conduct to mitigate the consequences of such risk-taking. Goldman's expanded Trading Segment sought to profit at the expense of their clients, bundling toxic and risky mortgages into complex financial instruments in such a way that they were designed to fail, got the credit-rating agencies to give the securities investment-grade ratings, marketed long positions to the majority of its clients, and took positions that bet against the majority of their clients for itself and certain select clients, creating at least $10.9 billion worth of such deals. (¶¶4, 50, 52, 53, 54, 57, 63, 65-67, 69, 70, 73, 82, 83, 151).

Thus, with the knowledge of such misconduct within Goldman, the Director Defendants should have intervened to prevent further wrongdoing, and the failure to do so establishes the lack of good faith that is a necessary condition to liability. *See Citigroup*, 964 A.2d at 121.

II. Plaintiffs' Complaint States a Claim Pursuant to Rule 12(b)(6)

Defendants also seek dismissal under Ch. Ct. R. 12 (b)(6), arguing that Plaintiffs have failed to state claims upon which relief can be granted. In fact, as discussed above, Plaintiffs have pled non-exculpated claims for breach of duty of loyalty and waste under the stricter pleading standard applicable under Ch. Ct. R. 23.1.[27] Plaintiffs submit that the claims, *a fortiori*, survive scrutiny under the Rule 12(b)(6) standard. *Ryan v. Gifford*, 918 A. 2d 341, 357 (Del. Ch. 2007) ("[W]here [the] plaintiff alleges particularized facts sufficient to prove demand futility under the second prong of *Aronson*, that plaintiff *a fortiori* rebuts the business judgment rule for the purpose of surviving a motion to dismiss pursuant to Rule 12(b)(6)."); *McPadden v. Sidhu*, 964 A.2d 1262, 1270 (Del. Ch. 2008) ("[b]ecause the standard under Rule 12(b)(6) is less stringent than that under Rule 23.1, a complaint that survives a motion to dismiss pursuant to

[27] While Plaintiffs' claims against Defendants David A. Viniar and J. Michael Evans are not addressed by Defendants' Brief, Plaintiffs will voluntarily dismiss Defendants Viniar and Evans from this action without prejudice.

Rule 23.1 will also survive a 12(b)(6) motion to dismiss, assuming that it otherwise contains sufficient facts to state a cognizable claim.").

CONCLUSION

For all of the foregoing reasons, Plaintiffs respectfully submit that the Defendants' Motion to Dismiss should be denied.

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