

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

**IN RE CITIGROUP INC. SHAREHOLDER
DERIVATIVE LITIGATION**

Civil Action No. 3338-CC

February 24, 2009

CHIMICLES & TIKELLIS LLP, Wilmington, Delaware; OF COUNSEL: Marvin A. Miller, of MILLER LAW LLC, Chicago, Illinois; Daniel W. Krasner, Peter C. Harrar, and Matthew M. Guiney, of WOLF HALDENSTEIN ADLER FREEMAN & HERZ LLP, New York, New York, Attorneys for Plaintiffs.

RICHARDS, LAYTON & FINGER, P.A., Wilmington, Delaware, Attorneys for Defendants and Nominal Defendant Citigroup Inc.

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP, New York, New York, Attorneys for Defendants Charles Prince, Winfried Bischoff, Robert E. Rubin, David C. Bushnell, John C. Gerspach, Lewis B. Kaden, Sallie L. Krawcheck, and Gary Crittenden.

CRAVATH, SWAINE & MOORE LLP, New York, New York, Attorneys for Defendants C. Michael Armstrong, Alain J.P. Belda, George David, Kenneth T. Derr, John M. Deutch, Roberto Hernandez Ramirez, Andrew N. Liveris, Anne M. Mulcahy, Richard D. Parsons, Judith Rodin, Robert L. Ryan, Franklin A. Thomas, Ann Dibble Jordan, Klaus Kleinfeld, and Dudley C. Mecum.

WACHTELL, LIPTON, ROSEN & KATZ, New York, New York, Attorneys for Nominal Defendant Citigroup, Inc.

CHANDLER, Chancellor

This is a shareholder derivative action brought on behalf of Citigroup Inc. (“Citigroup” or the “Company”), seeking to recover for the Company its losses arising from exposure to the subprime lending market. Plaintiffs, shareholders of Citigroup, brought this action against current and former directors and officers of Citigroup, alleging, in essence, that the defendants breached their fiduciary duties by failing to properly monitor and manage the risks the Company faced from problems in the subprime lending market and for failing to properly disclose Citigroup’s exposure to subprime assets. Plaintiffs allege that there were extensive “red flags” that should have given defendants notice of the problems that were brewing in the real estate and credit markets and that defendants ignored these warnings in the pursuit of short term profits and at the expense of the Company’s long term viability.

Plaintiffs further allege that certain defendants are liable to the Company for corporate waste for *** approving a multi-million dollar payment and benefit package for defendant Charles Prince, whom plaintiffs describe as largely responsible for Citigroup’s problems, upon his retirement as Citigroup’s CEO in November 2007***

Pending before the Court is defendants' motion *** to dismiss the complaint for failure to state a claim under Court of Chancery Rule 12(b)(6) and for failure to properly plead demand futility under Court of Chancery Rule 23.1. *** The motion to dismiss is denied as to the claim in Count III for waste for approval of the November 4, 2007 Prince letter agreement. All other claims are dismissed for failure to adequately plead demand futility pursuant to Rule 23.1.

I. BACKGROUND

A. *The Parties*

Citigroup is a global financial services company whose businesses provide a broad range of financial services to consumers and businesses. Citigroup was incorporated in Delaware in 1988 and maintains its principal executive offices in New York, New York.

Defendants in this action are current and former directors and officers of Citigroup. The complaint names thirteen members of the Citigroup board of directors on November 9, 2007, when the first of plaintiffs' now-consolidated derivative actions was filed. Plaintiffs allege that a majority of the director defendants were members of the Audit and Risk Management Committee ("ARM Committee") in 2007 and were considered audit committee financial experts as defined by the Securities and Exchange Commission.

Plaintiffs Montgomery County Employees' Retirement Fund, City of New Orleans Employees' Retirement System, Sheldon M. Pekin Irrevocable Descendants Trust Dated 10/01/01, and Carole Kops are all owners of shares of Citigroup stock.

B. *Citigroup's Exposure to the Subprime Crisis*

Plaintiffs allege that since as early as 2006, defendants have caused and allowed Citigroup to engage in subprime lending¹ that ultimately left the Company exposed to massive losses by late 2007. Beginning in late 2005, house prices, which many believe were artificially inflated by speculation and easily available credit, began to plateau, and then deflate. Adjustable rate mortgages issued earlier in the decade began to reset, leaving many homeowners with significantly increased monthly payments. Defaults and foreclosures increased, and assets backed by income from residential mortgages began to decrease in value. By February 2007, subprime mortgage lenders began filing for bankruptcy and subprime mortgages packaged into securities began experiencing increasing levels of delinquency. In mid-2007, rating agencies downgraded bonds backed by subprime mortgages.

Much of Citigroup's exposure to the subprime lending market arose from its involvement with collateralized debt obligations ("CDOs")—repackaged pools of lower rated securities that Citigroup created by acquiring asset-backed securities, including

¹ "Subprime" generally refers to borrowers who do not qualify for prime interest rates, typically due to weak credit histories, low credit scores, high debt-burden ratios, or high loan-to-value ratios.

residential mortgage backed securities (“RMBSs”),² and then selling rights to the cash flows from the securities in classes, or tranches, with different levels of risk and return. Included with at least some of the CDOs created by Citigroup was a “liquidity put”—an option that allowed the purchasers of the CDOs to sell them back to Citigroup at original value.

According to plaintiffs, Citigroup’s alleged \$55 billion subprime exposure was in two areas of the Company’s Securities & Banking Unit. The first portion totaled \$11.7 billion and included securities tied to subprime loans that were being held until they could be added to debt pools for investors. The second portion included \$43 billion of super-senior securities, which are portions of CDOs backed in part by RMBS collateral.³

By late 2007, it was apparent that Citigroup faced significant losses on its subprime-related assets, including the following as alleged by plaintiffs:

- *October 1, 2007:* Citigroup announced it would write-down approximately \$1.4 billion on funded and unfunded highly leveraged finance commitments.
- *October 15, 2007:* Citigroup issued a press release reporting a net income of \$2.38 billion, a 57% decline from the Company’s prior year results.
- *November 4, 2007:* Citigroup announced significant declines on the fair value of the approximately \$55 billion in the Company’s U.S. subprime-related direct exposures, and estimated that further write downs would be between \$8 and \$11 billion.
- *November 6, 2007:* Citigroup disclosed that it provided \$7.6 billion of emergency financing to the seven SIVs the Company operated after they were unable to repay maturing debt. The SIVs drew on the \$10 billion of so-called committed liquidity provided by Citigroup. On December 13, 2007 Citigroup bailed out seven of its affiliated SIVs by bringing \$49 billion in assets onto its balance sheet and taking full responsibility for the SIVs’ \$49 billion worth of assets.
- *January 15, 2008:* Citigroup announced it would take an additional \$18.1 billion write-down for the fourth quarter 2007 and a quarterly loss of \$9.83 billion. Citigroup also announced that the Company lowered its dividend to \$0.32 per share, a 40% decline from the Company’s previous dividend disbursement.
- By March 2008, Citigroup shares traded below book value and the Company announced that it would lay off an additional 2,000 employees, bringing Citigroup’s total layoff since the beginning of the subprime market crisis to more than 6,000.

² RMBSs are securities whose cash flows come from residential debt such as mortgages.

³ Rights to cash flows from CDOs are divided into tranches rated by credit risk, whereby the senior tranches are paid before the junior tranches.

- *July 18, 2008*: Citigroup announced it lost \$2.5 billion in the second quarter, largely caused by \$7.2 billion of write-downs of Citigroup's investments in mortgages and other loans and by weakness in the consumer market.

Plaintiffs also allege that Citigroup was exposed to the subprime mortgage market through its use of SIVs. Banks can create SIVs by borrowing cash (by selling commercial paper) and using the proceeds to purchase loans; in other words, the SIVs sell short term debt and buy longer-term, higher yielding assets. According to plaintiffs, Citigroup's SIVs invested in riskier assets, such as home equity loans, rather than the low-risk assets traditionally used by SIVs.

The problems in the subprime market left Citigroup's SIVs unable to pay their investors. The SIVs held subprime mortgages that had decreased in value, and the normally liquid commercial paper market became illiquid. Because the SIVs could no longer meet their cash needs by attracting new investors, they had to sell assets at allegedly "fire sale" prices. In November 2007, Citigroup disclosed that it provided \$7.6 billion of emergency financing to the seven SIVs the Company operated after they were unable to repay maturing debt. Ultimately, Citigroup was forced to bail out seven of its affiliated SIVs by bringing \$49 billion in assets onto its balance sheet, notwithstanding that Citigroup previously represented that it would manage the SIVs on an arms-length basis.

C. Plaintiffs' Claims

Plaintiffs allege that defendants are liable to the Company for breach of fiduciary duty for (1) failing to adequately oversee and manage Citigroup's exposure to the problems in the subprime mortgage market, even in the face of alleged "red flags" and (2) failing to ensure that the Company's financial reporting and other disclosures were thorough and accurate.⁴ As will be more fully explained below, the "red flags" alleged in the eighty-six page Complaint are generally statements from public documents that reflect worsening conditions in the financial markets, including the subprime and credit markets, and the effects those worsening conditions had on market participants, including Citigroup's peers. By way of example only, plaintiffs' "red flags" include the following:

⁴ Plaintiffs also assert a claim for "reckless and gross mismanagement." Consol. Second Am. Derivative Compl. (hereinafter, "Compl.") ¶¶ 219 -25. Delaware law does not recognize an independent cause of action against corporate directors and officers for reckless and gross mismanagement; such claims are treated as claims for breach of fiduciary duty. Delaware fiduciary duties are based in common law and have been carefully crafted to define the responsibilities of directors and managers, as fiduciaries, to the corporation. In defining these duties, the courts balance specific policy considerations such as the need to keep directors and officers accountable to shareholders and the degree to which the threat of personal liability may discourage beneficial risk taking. These common law standards thus govern the duties that directors and officers owe the corporation as well as claims such as those for "reckless and gross mismanagement," even if those claims are asserted separate and apart from claims of breach of fiduciary duty. Plaintiffs seem to agree that Count IV's claims for "reckless and gross mismanagement" do not assert a separate cause of action against defendants. In the two sentences of their answering brief on the motion to dismiss that address Count IV, plaintiffs equate Count IV to their *Caremark* claim in Count I. Because I find that Count I fails, it follows that Count IV also fails.

- *May 27, 2005*: Economist Paul Krugman of the *New York Times* said he saw “signs that America’s housing market, like the stock market at the end of the last decade, is approaching the final, feverish stages of a speculative bubble.”
- *May 2006*: Ameriquest Mortgage, one of the United States’ leading wholesale subprime lenders, announced the closing of each of its 229 retail offices and reduction of 3,800 employees.
- *February 12, 2007*: ResMae Mortgage, a subprime lender, filed for bankruptcy. According to *Bloomberg*, in its Chapter 11 filing, ResMae stated that “[t]he subprime mortgage market has recently been crippled and a number of companies stopped originating loans and United States housing sales have slowed and defaults by borrowers have risen.”
- *April 18, 2007*: Freddie Mac announced plans to refinance up to \$20 billion of loans held by subprime borrowers who would be unable to afford their adjustable-rate mortgages at the reset rate.
- *July 10, 2007*: Standard and Poor’s and Moody’s downgraded bonds backed by subprime mortgages.
- *August 1, 2007*: Two hedge funds managed by Bear Stearns that invested heavily in subprime mortgages declared bankruptcy.
- *August 9, 2007*: American International Group, one of the largest United States mortgage lenders, warned that mortgage defaults were spreading beyond the subprime sector, with delinquencies becoming more common among borrowers in the category just above subprime.
- *October 18, 2007*: Standard & Poor’s cut the credit ratings on \$23.35 billion of securities backed by pools of home loans that were offered to borrowers during the first half of the year. The downgrades even hit securities rated AAA, which was the highest of the ten investment- grade ratings and the rating of government debt.

Plaintiffs also allege that the director defendants and certain other defendants are liable to the Company for waste for *** approving a multi-million dollar payment and benefit package for defendant Prince upon his retirement as Citigroup’s CEO in November 2007

III. THE MOTION TO DISMISS UNDER RULE 23.1

A. The Legal Standard for Demand Excused

In evaluating whether demand is excused, the Court must accept as true the well pleaded factual allegations in the Complaint. The pleadings, however, are held to a higher standard under Rule 23.1 than under the permissive notice pleading standard under Court of Chancery Rule 8(a). To establish that demand is excused under Rule 23.1, the pleadings must comply with “stringent requirements of factual particularity” and set forth “particularized factual statements that are essential to the claim.” *Brehm v.*

Eisner, 746 A.2d 244, 254 (Del. 2000). “A prolix complaint larded with conclusory language...does not comply with these fundamental pleading mandates.” *Id.* ***

Demand is not excused solely because the directors would be deciding to sue themselves. Rather, demand will be excused based on a possibility of personal director liability only in the rare case when a plaintiff is able to show director conduct that is “so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.” *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984).

B. Demand Futility Regarding Plaintiffs’ Fiduciary Duty Claims

Plaintiffs’ argument is based on a theory of director liability famously articulated by former-Chancellor Allen in *In re Caremark. In re Caremark Int Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996). *** In *Caremark*, the plaintiffs alleged that the directors were liable because they should have known that certain officers and employees were violating the federal Anti-Referral Payments Law. In analyzing these claims, the Court began, appropriately, by reviewing the duty of care and the protections of the business judgment rule.

With regard to director liability standards, the Court distinguished between (1) “a board decision that results in a loss because that decision was ill advised or ‘negligent’ and (2) “an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss.” *Caremark*, 698 A.2d at 967. In the former class of cases, director action is analyzed under the business judgment rule, which prevents judicial second guessing of the decision if the directors employed a rational process and considered all material information reasonably available—a standard measured by concepts of gross negligence. *Id.*; see *Brehm*, 746 A.2d at 259. As former-Chancellor Allen explained:

What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director’s duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith *or* rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through “stupid” to “egregious” or “irrational”, provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests. To employ a different rule—one that permitted an “objective” evaluation of the decision—would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions. *Caremark*, 698 A.2d at 967-68 (footnotes omitted).

In the latter class of cases, where directors are alleged to be liable for a failure to monitor liability creating activities, the *Caremark* Court, in a reassessment of the holding in *Graham*, stated that while directors could be liable for a failure to monitor, “only a sustained or systematic failure of the board to exercise

oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.” *Id.* at 971.

In *Stone v. Ritter*, 911 A.2d 362 (Del. 2006), the Delaware Supreme Court approved the *Caremark* standard for director oversight liability and made clear that liability was based on the concept of good faith, which the *Stone* Court held was embedded in the fiduciary duty of loyalty and did not constitute a freestanding fiduciary duty that could independently give rise to liability. *Stone*, 911 A.2d at 370. As the *Stone* Court explained:

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. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith. *Id.*

Thus, to establish oversight liability a plaintiff must show that the directors *knew* they were not discharging their fiduciary obligations or that the directors demonstrated a *conscious* disregard for their responsibilities such as by failing to act in the face of a known duty to act.⁵ The test is rooted in concepts of bad faith; indeed, a showing of bad faith is a *necessary condition* to director oversight liability.⁶

1. Plaintiffs’ *Caremark* Allegations

Plaintiffs’ theory of how the director defendants will face personal liability is a bit of a twist on the traditional *Caremark* claim. In a typical *Caremark* case, plaintiffs argue that the defendants are liable for damages that arise from a failure to properly monitor or oversee employee misconduct or violations of law. For example, in *Caremark* the board allegedly failed to monitor employee actions in violation of the federal Anti-Referral Payments Law; in *Stone*, the directors were charged with a failure of oversight that resulted in liability for the company because of employee violations

⁵ See *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003) (“[T]he [*Caremark*] opinion articulates a standard for liability for failures of oversight that requires a showing that the directors breached their duty of loyalty by failing to attend to their duties in good faith. Put otherwise, the decision premises liability on a showing that the directors were conscious of the fact that they were not doing their jobs.”) (footnote omitted).

⁶ *Stone*, 911 A.2d at 369; *Desimone v. Barrows*, 924 A.2d 908, 935 (Del. Ch. 2007) (“*Caremark* itself encouraged directors to act with reasonable diligence, but plainly held that director liability for failure to monitor required a finding that the directors acted with the state of mind traditionally used to define the mindset of a disloyal director—bad faith—because their indolence was so persistent that it could not be ascribed to anything other than a knowing decision not to even try to make sure the corporation’s officers had developed and were implementing a prudent approach to ensuring law compliance. By reinforcing that [an intent] based standard applies to claims in the delicate monitoring context, *Stone* ensured that the protections that exculpatory charter provisions afford to independent directors against damage claims would not be eroded.”) (footnotes omitted).

of the federal Bank Secrecy Act.

In contrast, plaintiffs' *Caremark* claims are based on defendants' alleged failure to properly monitor Citigroup's *business risk*, specifically its exposure to the subprime mortgage market. In their answering brief, plaintiffs allege that the director defendants are personally liable under *Caremark* for failing to "make a good faith attempt to follow the procedures put in place or fail[ing] to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Citigroup's risk to the subprime mortgage market." Plaintiffs point to so-called "red flags" that should have put defendants on notice of the problems in the subprime mortgage market and further allege that the board should have been especially conscious of these red flags because a majority of the directors (1) served on the Citigroup board during its previous Enron related conduct and (2) were members of the ARM Committee and considered financial experts.

Although these claims are framed by plaintiffs as *Caremark* claims, plaintiffs' theory essentially amounts to a claim that the director defendants should be personally liable to the Company because they failed to fully recognize the risk posed by subprime securities. When one looks past the lofty allegations of duties of oversight and red flags used to dress up these claims, what is left appears to be plaintiff shareholders attempting to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company. Delaware Courts have faced these types of claims many times and have developed doctrines to deal with them—the fiduciary duty of care and the business judgment rule. These doctrines properly focus on the decision-making process rather than on a substantive evaluation of the merits of the decision. This follows from the inadequacy of the Court, due in part to a concept known as hindsight bias, to properly evaluate whether corporate decision-makers made a "right" or "wrong" decision.

The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson*, 473 A.2d at 812. The burden is on plaintiffs, the party challenging the directors' decision, to rebut this presumption. Thus, absent an allegation of interestedness or disloyalty to the corporation, the business judgment rule prevents a judge or jury from second guessing director decisions if they were the product of a rational process and the directors availed themselves of all material and reasonably available information. The standard of director liability under the business judgment rule "is predicated upon concepts of gross negligence." *Id.*

Additionally, Citigroup has adopted a provision in its certificate of incorporation pursuant to 8 *Del. C.* § 102(b)(7) that exculpates directors from personal liability for violations of fiduciary duty, except for, among other things, breaches of the duty of loyalty or actions or omissions not in good faith or that involve intentional misconduct or a knowing violation of law. Because the director defendants are

“exculpated from liability for certain conduct, ‘then a serious threat of liability may only be found to exist if the plaintiff pleads a *non-exculpated* claim against the directors based on particularized facts.’” *Wood v. Baum*, 953 A.2d 136, 141 (Del. 2008) Here, plaintiffs have not alleged that the directors were interested in the transaction and instead root their theory of director personal liability in bad faith.

The Delaware Supreme Court has stated that bad faith conduct may be found where a director “intentionally acts with a purpose other than that of advancing the best interests of the corporation, ...acts with the intent to violate applicable positive law, or...intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.” *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 67 (Del. 2006). *** A plaintiff can thus plead bad faith by alleging with particularity that a director *knowingly* violated a fiduciary duty or failed to act in violation of a *known* duty to act, demonstrating a *conscious* disregard for her duties.

Turning now specifically to plaintiffs’ *Caremark* claims, one can see a similarity between the standard for assessing oversight liability and the standard for assessing a disinterested director’s decision under the duty of care when the company has adopted an exculpatory provision pursuant to § 102(b)(7). In either case, a plaintiff can show that the director defendants will be liable if their acts or omissions constitute bad faith. A plaintiff can show bad faith conduct by, for example, properly alleging particularized facts that show that a director *consciously* disregarded an obligation to be reasonably informed about the business and its risks or *consciously* disregarded the duty to monitor and oversee the business.

The Delaware Supreme Court made clear in *Stone* that directors of Delaware corporations have certain responsibilities to implement and monitor a system of oversight; however, this obligation does not eviscerate the core protections of the business judgment rule—protections designed to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly. Accordingly, the burden required for a plaintiff to rebut the presumption of the business judgment rule by showing gross negligence is a difficult one, and the burden to show bad faith is even higher. Additionally, as former-Chancellor Allen noted in *Caremark*, director liability based on the duty of oversight “is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.” *Caremark*, 698 A.2d at 967. The presumption of the business judgment rule, the protection of an exculpatory § 102(b)(7) provision, and the difficulty of proving a *Caremark* claim together function to place an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company’s business risk.

To the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting Courts to perform a hindsight evaluation of the reasonableness or prudence of directors’ business decisions. Risk has been defined as the chance that a return on an investment will be

different than expected. The essence of the business judgment of managers and directors is deciding how the company will evaluate the trade-off between risk and return. Businesses—and particularly financial institutions—make returns by taking on risk; a company or investor that is willing to take on more risk can earn a higher return. Thus, in almost any business transaction, the parties go into the deal with the knowledge that, even if they have evaluated the situation correctly, the return could be different than they expected.

It is almost impossible for a court, in hindsight, to determine whether the directors of a company properly evaluated risk and thus made the “right” business decision. In any investment there is a chance that returns will turn out lower than expected, and generally a smaller chance that they will be far lower than expected. When investments turn out poorly, it is possible that the decision-maker evaluated the deal correctly but got “unlucky” in that a huge loss—the probability of which was very small—actually happened. It is also possible that the decision-maker improperly evaluated the risk posed by an investment and that the company suffered large losses as a result.

Business decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future. To impose liability on directors for making a “wrong” business decision would cripple their ability to earn returns for investors by taking business risks. Indeed, this kind of judicial second guessing is what the business judgment rule was designed to prevent, and even if a complaint is framed under a *Caremark* theory, this Court will not abandon such bedrock principles of Delaware fiduciary duty law. With these considerations and the difficult standard required to show director oversight liability in mind, I turn to an evaluation of the allegations in the Complaint.

a. The Complaint Does Not Properly Allege Demand Futility for Plaintiffs’
Fiduciary Duty Claims

In this case, plaintiffs allege that the defendants are liable for failing to properly monitor the risk that Citigroup faced from subprime securities. While it may be possible for a plaintiff to meet the burden under some set of facts, plaintiffs in this case have failed to state a *Caremark* claim sufficient to excuse demand based on a theory that the directors did not fulfill their oversight obligations by failing to monitor the business risk of the company.

The allegations in the Complaint amount essentially to a claim that Citigroup suffered large losses and that there were certain warning signs that could or should have put defendants on notice of the business risks related to Citigroup’s investments in subprime assets. Plaintiffs then conclude that because defendants failed to prevent the Company’s losses associated with certain business risks, they must have consciously ignored these warning signs or knowingly failed to monitor the Company’s risk in accordance with their fiduciary duties. Such conclusory allegations, however, are not sufficient to state a claim for failure of oversight that would give rise to a substantial

likelihood of personal liability, which would require particularized factual allegations demonstrating bad faith by the director defendants.

Plaintiffs do not contest that Citigroup had procedures and controls in place that were designed to monitor risk. Plaintiffs admit that Citigroup established the ARM Committee and in 2004 amended the ARM Committee charter to include the fact that one of the purposes of the ARM Committee was to assist the board in fulfilling its oversight responsibility relating to policy standards and guidelines for risk assessment and risk management. The ARM Committee was also charged with, among other things, (1) discussing with management and independent auditors the annual audited financial statements, (2) reviewing with management an evaluation of Citigroup's internal control structure, and (3) discussing with management Citigroup's major credit, market, liquidity, and operational risk exposures and the steps taken by management to monitor and control such exposures, including Citigroup's risk assessment and risk management policies. According to plaintiffs' own allegations, the ARM Committee met eleven times in 2006 and twelve times in 2007.

Plaintiffs nevertheless argue that the director defendants breached their duty of oversight either because the oversight mechanisms were not adequate or because the director defendants did not make a good faith effort to comply with the established oversight procedures. To support this claim, the Complaint alleges numerous facts that plaintiffs argue should have put the director defendants on notice of the impending problems in the subprime mortgage market and Citigroup's exposure thereto. Plaintiffs summarized some of these "red flags" in their answering brief as follows:

- the steady decline of the housing market and the impact the collapsing bubble would have on mortgages and subprime backed securities since as early as 2005;
- December 2005 guidance from the FASB staff—"The FASB staff is aware of loan products whose contractual features may increase the exposure of the originator, holder, investor, guarantor, or servicer to risk of nonpayment or realization.";
- the drastic rise in foreclosure rates starting in 2006;
- several large subprime lenders reporting substantial losses and filing for bankruptcy starting in 2006;
- billions of dollars in losses reported by Citigroup's peers, such as Bear Stearns and Merrill Lynch.

Plaintiffs argue that demand is excused because a majority of the director defendants face a substantial likelihood of personal liability because they were charged with management of Citigroup's risk as members of the ARM Committee and as audit committee financial experts and failed to properly oversee and monitor such risk. As explained above, however, to establish director oversight liability plaintiffs would ultimately have to prove bad faith conduct by the director defendants. Plaintiffs fail to plead any particularized factual allegations that raise a reasonable doubt that the director defendants acted in good faith.

The warning signs alleged by plaintiffs are not evidence that the directors consciously disregarded their duties or otherwise acted in bad faith; at most they evidence that the directors made bad business decisions. The “red flags” in the Complaint amount to little more than portions of public documents that reflected the worsening conditions in the subprime mortgage market and in the economy generally. Plaintiffs fail to plead “particularized facts suggesting that the Board was presented with ‘red flags’ alerting it to potential misconduct” at the Company. That the director defendants knew of signs of a deterioration in the subprime mortgage market, or even signs suggesting that conditions could decline further, is not sufficient to show that the directors were or should have been aware of any wrongdoing at the Company or were consciously disregarding a duty somehow to prevent Citigroup from suffering losses. Nothing about plaintiffs’ “red flags” supports plaintiffs’ conclusory allegation that “defendants have not made a good faith attempt to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Citigroup’s risk to the subprime mortgage market.” Indeed, plaintiffs’ allegations do not even specify how the board’s oversight mechanisms were inadequate or how the director defendants knew of these inadequacies and consciously ignored them. Rather, plaintiffs seem to hope the Court will accept the conclusion that since the Company suffered large losses, and since a properly functioning risk management system would have avoided such losses, the directors must have breached their fiduciary duties in allowing such losses. ***

The Complaint and plaintiffs’ answering brief repeatedly make the conclusory allegation that the defendants have breached their duty of oversight, but nowhere do plaintiffs adequately explain what the director defendants actually did or failed to do that would constitute such a violation. Even while admitting that Citigroup had a risk monitoring system in place, plaintiffs seem to conclude that, because the director defendants (and the ARM Committee members in particular) were charged with monitoring Citigroup’s risk, then they must be found liable because Citigroup experienced losses as a result of exposure to the subprime mortgage market. The only factual support plaintiffs provide for this conclusion are “red flags” that actually amount to nothing more than signs of continuing deterioration in the subprime mortgage market. These types of conclusory allegations are exactly the kinds of allegations that do not state a claim for relief under *Caremark*.

To recognize such claims under a theory of director oversight liability would undermine the long established protections of the business judgment rule. It is well established that 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. That there were signs in the market that reflected worsening conditions and suggested that conditions may deteriorate even further is not an invitation for this Court to disregard the presumptions of the business judgment rule and conclude that the directors are liable because they did not properly evaluate business risk. What plaintiffs are asking the Court to conclude from the presence of these “red flags” is that the directors failed to see the extent of

Citigroup's business risk and therefore made a "wrong" business decision by allowing Citigroup to be exposed to the subprime mortgage market.

This Court's recent decision in *American International Group, Inc. Consolidated Derivative Litigation*, C.A. No. 769-VCS, 2009 WL 366613 (Del. Ch. Feb. 10, 2009), demonstrates the stark contrast between the allegations here and allegations that are sufficient to survive a motion to dismiss. In *AIG*, the Court faced a motion to dismiss a complaint that included "well-pled allegations of pervasive, diverse, and substantial financial fraud involving managers at the highest levels of AIG." *Id.* at *3. In concluding that the complaint stated a claim for relief under Rule 12(b)(6), the Court held that the factual allegations in the complaint were sufficient to support an inference that AIG executives running those divisions knew of and approved much of the wrongdoing. The Court reasoned that huge fraudulent schemes were unlikely to be perpetrated without the knowledge of the executive in charge of that division of the company. Unlike the allegations in this case, the defendants in *AIG* allegedly failed to exercise reasonable oversight over pervasive *fraudulent* and *criminal* conduct. Indeed, the Court in *AIG* even stated that the complaint there supported the assertion that top AIG officials were leading a "criminal organization" and that "[t]he diversity, pervasiveness, and materiality of the alleged financial wrongdoing at AIG is extraordinary."

Contrast the *AIG* claims with the claims in this case. Here, plaintiffs argue that the Complaint supports the reasonable conclusion that the director defendants acted in bad faith by failing to see the warning signs of a deterioration in the subprime mortgage market and failing to cause Citigroup to change its investment policy to limit its exposure to the subprime market. Director oversight duties are designed to ensure reasonable reporting and information systems exist that would allow directors to know about and prevent wrongdoing that could cause losses for the Company. There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk. Directors should, indeed must under Delaware law, ensure that reasonable information and reporting systems exist that would put them on notice of fraudulent or criminal conduct within the company. Such oversight programs allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct. While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing *Caremark-type* duties on directors to monitor business risk is fundamentally different. Citigroup was in the business of taking on and managing investment and other business risks. To impose oversight liability on directors for failure to monitor "excessive" risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors. Oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk.⁷

⁷ If defendants had been able to predict the extent of the problems in the subprime mortgage market, then they would not only have been able to avoid losses, but presumably would have been able to make significant gains for Citigroup by taking positions that would have produced a return when the value of subprime securities dropped.

Instead of alleging facts that could demonstrate bad faith on the part of the directors, by presenting the Court with the so called “red flags,” plaintiffs are inviting the Court to engage in the exact kind of judicial second guessing that is proscribed by the business judgment rule. In any business decision that turns out poorly there will likely be signs that one could point to and argue are evidence that the decision was wrong. Indeed, it is tempting in a case with such staggering losses for one to think that they could have made the “right” decision if they had been in the directors’ position. This temptation, however, is one of the reasons for the presumption against an objective review of business decisions by judges, a presumption that is no less applicable when the losses to the Company are large. ***

C. Demand Futility Allegations Regarding Plaintiffs’ Waste Claims

Count III of the Complaint alleges that certain of the defendants are liable for waste for (1) approving the Letter Agreement dated November 4, 2007 between Citigroup and defendant Prince; *****

Demand futility is analyzed under *Aronson* when plaintiffs have challenged board action or approval of a transaction. With regard to the claims based on the approval of the Letter Agreement and the repurchase of Citigroup stock, plaintiffs do not argue that a majority of the director defendants were not disinterested and independent. Rather, plaintiffs argue that demand is excused under the second prong of the *Aronson* analysis, which requires that the plaintiffs plead particularized factual allegations that raise a reasonable doubt as to whether “the challenged transaction was otherwise the product of a valid exercise of business judgment.” *Aronson*, 473 A.2d at 814.

Delaware law provides stringent requirements for a plaintiff to state a claim for corporate waste, and to excuse demand on grounds of waste the Complaint must allege particularized facts that lead to a reasonable inference that the director defendants authorized “an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.” *Brehm*, 746 A.2d at 263 The test to show corporate waste is difficult for any plaintiff to meet; indeed, “No prevail on a waste claim . . . the plaintiff must overcome the general presumption of good faith by showing that the board’s decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation’s best interests.” *White v. Panic*, 783 A.2d 543, 554 n.36 (Del. 2001). ***

Plaintiffs allege that the board’s approval of the November 4, 2007 letter

Compl. ¶ 78. Query: if the Court were to adopt plaintiffs’ theory of the case—that the defendants are personally liable for their failure to see the problems in the subprime mortgage market and Citigroup’s exposure to them—then could not a plaintiff succeed on a theory that a director was personally liable for failure to predict the extent of the subprime mortgage crisis and profit from it, even if the company was not exposed to losses from the subprime mortgage market? If directors are going to be held liable for losses for failing to accurately predict market events, then why not hold them liable for failing to profit by predicting market events that, in hindsight, the director should have seen because of certain red (or green?) flags? If one expects director prescience in one direction, why not the other?

agreement constituted corporate waste. Because approval of the letter was board action, demand is evaluated under the *Aronson* standard. Plaintiffs claim that demand is excused under the second prong of *Aronson* because the particularized factual allegations in the Complaint raise a reasonable doubt as to whether the approval was “the product of a valid exercise of business judgment.” *Aronson*, 473 A.2d at 814.

The directors of a Delaware corporation have the authority and broad discretion to make executive compensation decisions. The standard under which the Court evaluates a waste claim is whether there was “an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.” *Brehm*, 746 A.2d at 263. It is also well settled in our law, however, that the discretion of directors in setting executive compensation is not unlimited. Indeed, the Delaware Supreme Court was clear when it stated that “there is an outer limit” to the board’s discretion to set executive compensation, “at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste.” *Id.* at 262 n.56

According to plaintiffs’ allegations, the November 4, 2007 letter agreement provides that Prince will receive \$68 million upon his departure from Citigroup, including bonus, salary, and accumulated stockholdings. Additionally, the letter agreement provides that Prince will receive from Citigroup an office, an administrative assistant, and a car and driver for the lesser of five years or until he commences full time employment with another employer. Plaintiffs allege that this compensation package constituted waste and met the “so one sided” standard because, in part, the Company paid the multi-million dollar compensation package to a departing CEO whose failures as CEO were allegedly responsible, in part, for billions of dollars of losses at Citigroup. In exchange for the multi-million dollar benefits and perquisites package provided for in the letter agreement, the letter agreement contemplated that Prince would sign a non-compete agreement, a non-disparagement agreement, a non-solicitation agreement, and a release of claims against the Company.⁸ Even considering the text of the letter agreement, I am left with very little information regarding (1) how much additional compensation Prince actually received as a result of the letter agreement and (2) the real value, if any, of the various promises given by Prince. Without more information and taking, as I am required, plaintiffs’ well pleaded allegations as true, there is a reasonable doubt as to whether the letter agreement meets the admittedly stringent “so one sided” standard or whether the letter agreement awarded compensation that is beyond the “outer limit” described by the Delaware Supreme Court. Accordingly, the Complaint has adequately alleged, pursuant to Rule 23.1, that demand is excused with regard to the waste claim based on the board’s approval of Prince’s compensation under the letter agreement.

⁸ The Court takes judicial notice of the letter agreement, a publicly available document that was integral to plaintiffs’ waste claim and incorporated into the Complaint. *See Vanderbilt Income & Growth Assocs., L.L.C. v. Arvida/JMB Managers, Inc.*, 691 A.2d 609, 613 (Del. 1996).

D. The Motion to Dismiss under Rule 12(b)(6)

***The standard for pleading demand futility under Rule 23.1 is more stringent than the standard under Rule 12(b)(6), and “a complaint that survives a motion to dismiss pursuant to 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.” *McPadden v. Sidhu*, C.A. No. 3310-CC, 2008 WL 4017052, at *7 (Del. Ch. Aug. 29, 2008). Accordingly, for the same reasons stated in the demand futility analysis, the Complaint contains well-pleaded factual allegations regarding the claim for waste for the approval of the Prince letter agreement that make it impossible for me to conclude with reasonable certainty that the plaintiff could prevail on no set of facts that could be reasonably inferred from the allegations in the Complaint.⁹

IV. CONCLUSION

Citigroup has suffered staggering losses, in part, as a result of the recent problems in the United States economy, particularly those in the subprime mortgage market. It is understandable that investors, and others, want to find someone to hold responsible for these losses, and it is often difficult to distinguish between a desire to blame *someone* and a desire to force those responsible to account for their wrongdoing. Our law, fortunately, provides guidance for precisely these situations in the form of doctrines governing the duties owed by officers and directors of Delaware corporations. This law has been refined over hundreds of years, which no doubt included many crises, and we must not let our desire to blame someone for our losses make us lose sight of the purpose of our law. Ultimately, the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses. This doctrine also means, however, that when the company suffers losses, shareholders may not be able to hold the directors personally liable.

For the foregoing reasons, ***Defendants’ motion to dismiss is denied as to the claim in Count III of the Complaint for waste for approval of the November 4, 2007 Prince letter agreement. All other claims in the complaint are dismissed for failure to adequately plead demand futility pursuant to Court of Chancery Rule 23.1. ***

⁹ I am also not convinced that defendants would be exculpated under Citigroup’s certificate for committing waste. See *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005) (“The Delaware Supreme Court has implicitly held that committing waste is an act of bad faith.”) (citing *White v. Panic*, 783 A.2d 543, 553-55 (Del. 2001)).