Journal of Business & Technology Law

Volume 6 | Issue 1 Article 7

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Recommended Citation

Joseph W. Cooch, *In re Citigroup Inc. Shareholder Derivative Litigation: In the Heat of Crisis, Chancery Court Scrutinizes Executive Compensation*, 6 J. Bus. & Tech. L. 169 (2011)
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Joseph W. Cooch*

In re Citigroup Inc. Shareholder Derivative Litigation: In the Heat of Crisis, Chancery Court Scrutinizes Executive Compensation

I. Introduction

In *In re Citigroup, Inc. Shareholder Derivative Litigation*,[1] the Delaware Court of Chancery considered whether Citigroup directors ("the Defendants") were liable under a *Caremark*[2] claim for failing to monitor business risk and a waste claim for approving a compensation package for its outgoing CEO Charles Prince.[3] The court granted the defendant's motion to dismiss on all counts except for the waste claim.[4] While refusing to dismiss the waste claim, the court enunciated a more lenient waste standard than the rule it typically followed, signaling a willingness to scrutinize excessive executive compensation packages.[5] Such scrutiny will raise the possibility of strike suits and impact executive compensation decisions by instilling a level of concern over litigation that is currently not present in other business judgments.[6]

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1. 964 A.2d 106 (Del. Ch. 2009).

2. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996). A *Caremark* claim is a shareholder derivative action in which directors can be held liable for loss based on 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. *See id.*

3. *Citigroup*, 964 A.2d at 124, 135.

4. *Id.* at 112.

5. *See infra* Part V.A (arguing that the court failed to afford the Citigroup board business judgment deference typically associated with compensation decisions by failing to place the burden of establishing a complete failure of consideration on the Plaintiff and by ignoring precedent that even consideration that is difficult to value is sufficient to avoid a claim of waste).

6. *See infra* Parts V.B.–C. (arguing that the decision will negatively impact board decision-making by raising the threat of strike suits and unnecessarily influencing compensation decisions).

II. THE CASE

A. Factual Background

Citigroup is an international financial services company that conducts a range of business, including consumer credit and commercial securities, banking, and transactional services.[7] Citigroup's formation was the result of a merger between Travelers and Citicorp, in the wake of the 1999 Gramm-Leach-Bliley Act,[8] which removed depression-era barriers between commercial and investment banking and led to the emergence of several financial services conglomerates.[9] Among its variety of services, Citigroup invested heavily in the real estate market.[10] Like other financial services giants, Citigroup participated in a real estate market that began to change dramatically in the early 1980s, parting with the traditional model of lending in which there were social ties between the debtor and creditor in favor of a securitized debt market.[11] Many extremely profitable years followed for Citigroup and its competitors in the financial services, and executives of those firms were compensated in an unprecedented manner. In 2007, the collapse of the housing market caused a financial crisis, which led to major losses for financial institutions such as Citigroup and an

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7. *Citigroup*, 964 A.2d at 112. *See also* Citigroup 2007 annual report, *available at* http://www.citigroup.com/citi/fin/data/ar07c_en.pdf.

8. The 1999 Gramm-Leach-Bliley Act is also known as the Financial Services Modernization Act of 1999. Pub. L. 106-102, 113 Stat. 1338 (Nov. 12, 1999). Some commentators name this legislative act as a major contributor to the financial crisis because it allowed the biggest banks to speculate heavily in the stock markets. *See* LAWRENCE G. MCDONALD & PATRICK ROBINSON, A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS 6 (Crown Business 1st ed. 2009); *see also* Michael Siconolfi, *Big Umbrella: Travelers and Citicorp Agree to Join Forces in $83 Billion Merger*, WALL ST. J., Apr. 7, 1998, at A1.

9. *See* ANDREW ROSS SORKIN, TOO BIG TO FAIL 74–75 (Viking Penguin 2009).

10. *See* Plaintiffs' Consolidated Second Amended Derivative Complaint at 4, *In re* Citigroup, 964 A.2d 106 (Del. Ch. 2009) (No. 3338-CC) ("[A] staggering 43% of Citigroup's equity was tied up in subprime related assets, including $43 billion in credit derivative products."). Those products included collateralized debt obligations collateralized by asset–backed securities. *Id.* at 5.

11. *See generally* NIALL FERGUSON, THE ASCENT OF MONEY 246–61 (Penguin Press 1st ed. 2008). Real estate purchases, both commercial and residential, had historically been financed by banks who lent to borrowers that met certain underwriting standards. Standards typically included credit approval, down-payment of a significant percentage of the purchase price, and other techniques meant to manage risk. Securitization of mortgages was also much less common. *See id. See also* Christine Richard & David Feldheim, *Mortgage-Backed Deals are Taking a Novel Turn: Bond Issuance Supported by Unconventional Loans is Rising on Wall Street*, WALL ST. J., Aug. 17, 2004, at C2.

ensuing recession that has been described as the worst since the Great Depression.[12]

B. Procedural History

In November 2007, Citigroup announced that declines in its $55 billion in subprime related exposure amounted to losses between $8 billion and $11 billion.[13] Shareholders responded by filing a derivative action in the Delaware Court of Chancery on November 9, 2007.[14] The shareholder-plaintiffs alleged that Citigroup's directors and officers breached their fiduciary duties by failing to monitor the risk in their subprime assets and for failing to properly disclose the corporate exposure to the subprime assets owned by Citigroup.[15]

The basis for the shareholders' claims was that the Citigroup board ignored a number of "red flags"[16] that signaled likely problems in the subprime mortgage market in pursuit of short term profits.[17] By doing so, the directors and managers risked the long term viability of the company.[18]

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12. Barbara Crane et al., *Year-End Review of Markets & Finance 2009*, WALL ST. J., Jan. 4, 2010, at R10. *See Fortune 500 2006*, *available at* money.cnn.com/magazines/fortune/fortune500/snapshots/309.htm (demonstrating $24.5 billion in profits in 2006 and an annual growth rate of 17.9% from 1995–2005).

13. For a discussion of the rise of subprime real estate investment, *see infra* Part III.A.

14. Plaintiffs' Derivative Complaint at 12, *In re* Citigroup, 964 A.2d 106 (Del. Ch. 2009) (No. 3338-CC).

15. *In re* Citigroup, 964 A.2d 106, 114 (2009). The court dedicated the bulk of its opinion to analysis of the plaintiffs' *Caremark* claims. It described the traditional *Caremark* claim as a breach of the duty of loyalty based on a systemic failure to monitor liability creating activities — typically employee misconduct or violations of law. It described the plaintiffs' claim as a twist on the typical *Caremark* claim because it sought to hold the defendants liable for failure to monitor its business risk. The court recognized that although the plaintiffs framed the issue as a *Caremark* claim, it was essentially an attempt to hold directors liable for business decisions that turned out poorly for Citigroup. The court adhered to the business judgment rule, which presumes that in making business decisions, directors act on an informed basis, in good faith and in an honest belief that the action is in the best interest of the company. Because the plaintiffs did not overcome this presumption by alleging interestedness or disloyalty, the bad investments enjoyed the protection of the business judgment rule. *Id.* 121–25.

16. The "red flags" referred to by the plaintiffs were events from May 27, 2005 to October 18, 2007, including a New York Times article warning of a speculative bubble in the housing market, the decline and failure of certain subprime lenders, Freddie Mac's announcement that it would refinance borrowers unable to afford their resetting adjustable-rate mortgages, credit rating agency downgrades of subprime bonds, and warnings of spreading mortgage defaults. *See id*. at 115.

17. *Id.* at 114 –15.

18. *Id.*

The shareholders' complaint took the form of a *Caremark*[19] claim, which creates liability for directors' failure to monitor based on "a sustained or systemic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists."[20] A sustained failure of this kind creates the presumption of bad faith.[21]

In addition to making *Caremark* claims, the shareholders also attacked Citigroup's subprime risk-taking with a waste claim.[22] They alleged that the directors committed waste by allowing Citigroup to purchase $2.7 billion in subprime loans from the failing banks Accredited Home Lenders and Ameriquest Home Mortgage, to invest in structured investment vehicles ("SIVs"),[23] and to repurchase stock at "artificially inflated prices."[24]

The shareholders also alleged that the executive compensation package for CEO Charles Prince constituted waste.[25] A November 4, 2007 letter agreement between Prince and Citigroup established that upon his departure from the company, he would receive $68 million, including bonus, salary, and accumulated stockholdings.[26] In addition, Prince would receive an office, an administrative assistant, a car, and a driver for five years until he began full-time employment with another company.[27] In exchange, Prince would sign a non-compete agreement, a non-disparagement agreement, a non-solicitation agreement, and a release of claims against Citigroup.[28]

On March 7, 2009, the Delaware Court of Chancery considered the defendants' motion to dismiss the *Caremark* and waste claims for failure to state a claim under Rule 12(b)(6), and a motion to dismiss for failure to plead demand futility under Rule 23.1.[29]

19. 698 A.2d 959 (Del. Ch. 1996).

20. *Id.* at 122 (quoting *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996)).

21. *Id.*

22. *Citigroup*, 964 A.2d at 115.

23. A structured investment vehicle is an "entit[y] set up to invest in a wide range of assets, including subprime mortgage securities, with money they raise by selling short-term commercial paper." MARK ZANDI, FINANCIAL SHOCK, 22 (FT Press 2009).

24. *Citigroup*, 964 A.2d at 111–12.

25. *Id.* at 115.

26. *Id.* at 138.

27. *Id.*

28. *Id.*

29. *Id.* at 112.

III. BACKGROUND

A. Market Overview

Although the nationwide liquidity crisis has been abated through both private and public action,[30] the economy continued to struggle through 2010, and unemployment remains a major problem.[31] A number of factors contributed to the crisis and its severity, including banking deregulation,[32] a bubble in the residential real estate market, increased diffusion of risk, and a compensation scheme on Wall Street that encouraged short-term risk taking.[33] The bursting of the global bubble[34] in the residential real estate market is one of the clearest contributions to the current financial crisis.[35]

Easily available credit, among other factors, inflated housing prices.[36] Subprime lending[37] became common, and included risky loans such as

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30. The federal government employed a variety of strategies to prevent a complete collapse of financial markets. *See generally* Sorkin, *supra* note 9 (detailing strategies taken by Federal Agencies in to address the financial crisis of 2008). In dealing with the first major bank failure, the Federal Reserve guaranteed JP Morgan against losses it might incur by purchasing the collapsing investment bank Bear Stearns for $2.00 per share. *Id.* at 10. In September 2008, the Department of the Treasury developed the Troubled Asset Relief Program in order to purchase toxic assets that were wreaking havoc on the financial system. *Id.* at 446.

31. *See* Sara Murray, *Orders Grow for Durables; Jobs Still Lag*, WALL ST. J., Jan. 29, 2010, at A2 (stating that "[t]he labor market . . . has been slow to rebound from the global economic crisis" and that "[t]he December jobs report found that unemployment remained at 10%").

32. *See supra* notes 9–11 and accompanying text.

33. Sorkin, *supra* note 9, at 534.

34. A market "bubble" is an irrational market condition characterized by exuberance that causes a surge in market prices. Ferguson, *supra* note 11, at 120–22. It typically forms after a change in economic circumstances creates new opportunities, which is followed by euphoria and overtrading, and then participation by inexperienced investors and those ready to take advantage of them. *Id.* at 121–22. A "bubble" will burst when insiders realize that prices are inflated to the point where profit is unlikely and begin to exit the market. *Id.* at 122. Outsiders then follow, leaving the market and causing prices to fall dramatically. *See id*. Additional features shared by bubbles are that there is typically an asymmetry of information, free flow of capital between countries, and easy credit creation. *Id.*

35. *Id.* at 273 ("The subprime butterfly had flapped its wings and triggered a global hurricane").

36. Since the New Deal, the government has acted to expand the number of homeowners in the United States. *See generally* Ferguson, *supra* note 11, at 248–53 (discussing the government's increasing assistance to homeowners since the 1930s). This political momentum was largely fueled by the cultural importance of homeownership that has developed in the American psyche. *See* ZANDI, *supra* note 23, at 45 (stating that "[t]he roots of the subprime financial shock begin in the American psyche. . . no other country values hearth and home more highly"). In 2001, the Federal Reserve lowered interest rates in order to stimulate the economy to aid recovery from the collapse of the dot-com bubble and the impact of the terror attacks of September 11 on the economy. *See* SORKIN, *supra* note 9, at 4. Low interest rates made borrowing cheap, which

adjustable rate mortgages ("ARMs"),[38] negative amortization ARMs,[39] and "NINJA" (no income no job no assets) loans.[40] A variety of financial innovations allowed the diffusion of the risk associated with subprime lending,[41] and as a result many financial institutions believed that subprime investments were essentially risk-free.[42] In the years leading up to the collapse, executives of the largest companies, and financial institutions in particular, were compensated in an unprecedented manner.[43] The

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encouraged risk taking. *Compare* ZANDI, *supra* note 23, at 63 (identifying easy credit as the biggest factor driving the home-buying binge that peaked in 2005 and stating that Fed Chairman Alan Greenspan failed to see the risk in his interest rate-cutting approach to central banking), *with* FERGUSON, *supra* note 11, at 266–67 (rejecting criticism of Chairman Greenspan as failing to properly regulate mortgage lending). Many who would not typically be able to afford real estate entered the property market. *See id.* at 264–65. These factors combined to increase property ownership from 64% to 69% of all U.S. households from 1995 to 2005, while housing prices rose 180%. *Id.* at 266.

37. "Subprime" refers to mortgages for borrowers who do not qualify for prime interest rates because of weak credit history, as demonstrated by delinquency, judgments, bankruptcy, low credit score, or high loan-to-value ratios. *See* Plaintiffs' Derivative Complaint at 61, *In re* Citigroup, 964 A.2d 106 (Del. Ch. 2009) (No. 3338-CC).

38. An adjustable rate mortgage is a mortgage loan in which the interest rate is variable and changes periodically in relation to an index. THE FEDERAL RESERVE BOARD, CONSUMER HANDBOOK ON ADJUSTABLE-RATE MORTGAGES, (AUG. 6, 2009) *available at* http://www.federalreserve.gov/pubs/arms/arms_english.htm.

39. A negative amortization ARM is an adjustable rate mortgage in which the customer makes monthly payments at a rate below the actual interest rate for a certain period of time, during which time the unpaid interest is added to the principal balance. *Id*.

40. Ramsey Su, *Why Be a Nation of Mortgage Slaves?*, WALL ST. J., Jan. 31, 2009, at A9. "NINJA" is a slang term for a mortgage in which the lender ignores standard verification involved in mortgage lending such as income, employment, and asset verification. See *NINJA Loan*, INVESTOPEDIA, http://www.investopedia.com/terms/n/ninja-loan.asp (last visited Sept. 21, 2010).

41. Securitization allowed financial institutions to transform illiquid debt into a security, and sell the security to Wall Street Banks who would convert the security into Residential Mortgage-Backed Securities ("RMBSs"), Collateralized Debt Obligations ("CDOs"), and other instruments that were marketed and sold to other investors. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 573 (Aspen, 3d ed. 2003). Although these instruments often contained very risky elements, they were frequently given triple-A ratings by Moody's and other ratings agencies. *See* FERGUSON, *supra* note 11, at 268–69. This process diffused risk, and allowed banks, pension funds, and even individuals to invest in the real estate debt market. *Id.* at 269. Credit default swaps further diffused risk by allowing institutions holding these instruments to insure themselves from losses. See MCDONALD & ROBINSON, *supra* note 8, at 168–69. Many institutions were eager to sell such insurance because they failed to see the likelihood that the instruments would result in loss. *Id.*

42. SORKIN, *supra* note 9, at 5.

43. Charles Elson, *What's Wrong with Executive Compensation?*, MOTIVATING PEOPLE, Jan. 2003, *available at* http://www.carlospitta.com/Courses/Gestion%20Financiera%20Internacional/Cases/Executive%20Compensation.pdf.

seemingly reliable upward trajectory of property values plateaued and began to decrease by 2007.[44] The "teaser rates" that tempted borrowers into adjustable rate mortgages began to reset at significantly higher interest rates, and many fell behind on their payments.[45] Default rates on subprime assets proved to be higher than expected by underwriters, so the variety of subprime investments revealed themselves to be overpriced.[46] The previously-admired[47] diffusion of risk throughout the market meant that the global financial market in its entirety was susceptible.[48] In August 2007, it became clear that the collapse of the subprime market would affect global markets when a pair of Bear Stearns-owned hedge funds lost $1.6 billion on subprime investments.[49] The collapse of Bear Stearns itself, followed by Lehman Brothers and many other banks unleashed the financial crisis.[50] Some banks survived as a result of the Troubled Asset Relief Program ("TARP"), which sought to stabilize financial markets by injecting hundreds of billions of dollars into the nation's largest banks.[51]

Some commentators believe that executive compensation schemes that developed during this time contributed to the financial crisis.[52] In the wake of the collapse, public outcry over executive compensation reached fever pitch as people witnessed the same financial services executives that they

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44. FERGUSON, *supra* note 11, at 270.

45. *Id.* By May 2008, approximately 11% of subprime ARMs fell into foreclosure. *Id.* at 271.

46. *Id.* at 271.

47. As described above, many thought diffusion of risk created an investment era nearly immune from risk. *See supra* note 38 and accompanying text. Notably, Secretary of the Treasury Timothy Geithner, then acting as Chairman of the Federal Reserve Bank of New York, expressed concern that it actually created a systemic problem. *See* SORKIN, *supra* note 9, at 65.

48. FERGUSON, *supra* note 11, at 271–73.

49. *See* SORKIN, *supra* note 9, at 5–6.

50. *See id.*

51. *See id.* at 524. Citigroup itself received $25 billion in initial TARP funding, but required an additional $20 billion in November 2008. *Id.* at 524, 530. Furthermore, Treasury insured hundreds of billions of Citigroup assets. *Id.* at 530. By February 2009, the government was a 36% stakeholder in the company. *Id.* Whether TARP stabilized financial markets remains a topic of debate. *See id.* (discussing the purpose of the program to stabilize the financial system versus the view of consumers and small business owners that the credit markets continued to malfunction).

52. *See* Editorial, *Bankers and their Salaries*, N. Y. TIMES, Sept. 19, 2008, at A18 (arguing that bankers should have more of their own money at risk because the compensation schemes of some firms "exacerbated the weaknesses and contributed to market turmoil." (quoting the Institute of International Finance)).

blamed for the faltering economy receiving lavish bonuses as a result of guaranteed-pay schemes.[53]

B. Legal Background

Compensation of executives of Delaware Corporations is affected by numerous laws, including Delaware statutory law, federal regulation, and the common law developed by the Delaware Court of Chancery.[54] Delaware law grants corporations the power to "[a]ppoint such officers and agents as the business of the corporation requires and to pay or otherwise provide for them suitable compensation."[55] Federal law requires that compensation of certain executives of publicly traded corporations be disclosed and reported to the Securities Exchange Commission.[56] Much substantive regulation of executive compensation is left to the marketplace, where corporations are free to pay executives based on their perceived value.[57] Executive compensation can also be challenged in the Delaware Court of Chancery through claims of breach of the duty of care,[58] duty of loyalty,[59] and waste.[60] This section describes a plaintiff's cause of action for waste. Part 1 describes the requirement for stockholder plaintiffs to make pre-suit demand on the corporation and circumstances where such demand is excused.[61] Part 2 describes the standard that must be met to establish a claim of waste.[62] Part 3 describes the heightened pleading standards required to make claim of waste.[63]

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53. *See* Jonathan D. Glater, *A.I.G. Agrees to Suspend Millions in Executive Bonus Payments*, N.Y. TIMES, Oct. 23, 2008, at B4 (describing the compensation to former A.I.G. executives as an example of excessive greed in corporate America).

54. *See infra* notes 84–88 and accompanying text.

55. 8 DEL. CODE ANN. §122(5) (2009).

56. 17 C.F.R. § 229.402.

57. *See* Elson, *supra* note 43 ("CEOs get paid a lot because they are perceived by boards of directors as worth a lot.").

58. *See In re* The Walt Disney Co. Derivative Litig., 906 A.2d 27, 55–61 (2005) (analyzing whether the process of approval of Ovitz's compensation package fell below the standard of due care or simply failed to follow "best practices").

59. *See In re* The Limited, Inc. S'holders Litig., No. 17148-NC, 2002 Del. Ch. LEXIS 28, at * 1 (Del. Ch. Mar. 28, 2002).

60. *See infra* Part III.B.2.

61. *See infra* Part III.B.1.

62. *See infra* Part III.B.2.

63. *See infra* Part III.B.3.

1. The Pre-Suit Demand Requirement and Demand Futility

Corporate directors, not stockholders, manage the affairs of the corporation, including the decision to sue in the name of the corporation.[64] Stockholders may file a derivative suit, which is essentially an action to compel the corporation to sue whoever may be liable to it, including the directors of the corporation.[65] To encourage intra-corporate remedies and prevent strike suits,[66] Chancery Rule 23.1 requires that the stockholder first make demand on the corporation to initiate the lawsuit itself.[67] A board typically considers the demand and declines to sue, and this decision enjoys the protection of the business judgment rule.[68] If a stockholder-plaintiff does make demand, and in the likely event that the corporation declines to sue, the derivative suit can continue only upon a showing that refusal of demand was improper, which is very difficult to accomplish.[69]

As a result, shareholder-plaintiffs typically avoid making demand, and instead try to establish that they are excused from the demand requirement because demand would have been futile.[70] The Court of Chancery developed the *Aronson* test to assess demand futility.[71] The court held that demand is futile where, "under the particularized facts alleged,[72] a reasonable doubt is created that: (1) the directors are disinterested and independent[73] [or][74] (2) the challenged transaction was otherwise the

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64. 8 DEL. CODE ANN. §141(a) (2010).

65. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

66. A strike suit is defined as "[a] suit (esp. a derivative action), often based on no valid claim, brought either for nuisance value or as leverage to obtain a favorable or inflated settlement." BLACK'S LAW DICTIONARY 1572 (9th Ed. 2009).

67. *Aronson*, 473 A.2d at 811 (citing Chancery Rule 23.1).

68. *Id.* at 813 (citing Zapata v. Maldonado, 430 A.2d 779, 784 n.10). For a discussion of the business judgment rule, see *infra* notes 90–91 and accompanying text.

69. 8 DEL. CODE ANN. § 141(a) (2010) gives the corporation power to initiate or refrain from litigation. *See Zapata Corp.*, 430 A.2d at 782 n.6 and accompanying text. *See id.* at 784 n.10 and accompanying text (stating that "the board's decision [to refuse demand] falls under the 'business judgment' rule and will be respected if the requirements of the rule are met"). Only a showing of bad faith or interestedness on the part of those making the decision to dismiss the suit can establish that refusal of demand is improper. *See id.* at 783.

70. *See Aronson*, 473 A.2d at 814.

71. *See id*. at 815–16.

72. A shareholder-plaintiff, in attempting to establish demand futility, is subject to a heightened pleading standard imposed by Del. Ch. 23.1. Del. Ch. Ct. R. 23.1 (2010). *See also infra* Part III.B.3.

73. The first prong of the *Aronson* test, which is typically used to challenge interested transactions and self-dealing, is not invoked in *In re* Citigroup. *In re* Citigroup, Inc. S holder Derivative Litig., 964 A.2d 106, 136 (Del. Ch. 2009). In the context of compensation, the first

product of a valid exercise of business judgment."[75] Because demand on the corporation will typically terminate a shareholder's case, establishing that demand as excused is critical to a plaintiff's claim.[76]

A plaintiff may establish that demand is futile, and therefore excused, based on the first prong of the *Aronson* test by pleading facts that create a reasonable doubt whether the directors are disinterested and independent.[77] In the context of executive compensation, the first prong of the *Aronson* test can be met where directors receive some material benefit not enjoyed by shareholders of such significance that it is reasonable to question "whether that director objectively considered the advisability of the challenged transaction to the corporation and its shareholders," or whether "a director stands on both sides of the challenged transaction."[78] In *London v. Tyrrell*,[79] for example, the plaintiffs effectively established that demand was futile by showing that the directors granted stock options to themselves, and were therefore on both sides of their compensation transaction.[80]

A plaintiff proceeding under the second prong of the *Aronson* test must establish that demand is futile, and therefore excused, by creating a reasonable doubt that the challenged transaction was a product of the valid exercise of business judgment.[81] The business judgment rule is the presumption enjoyed by corporate boards that their actions are presumed to

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prong is invoked where corporate directors award themselves excessive payment for their services. MCG Capital Corp. v. Maginn, 2010 WL 1782271, at *18 (Del. Ch. 2010). In *Citigroup*, the challenged compensation is to a departing executive, Charles Prince, rather than compensation of directors themselves, leaving the plaintiffs to proceed on the second prong of the *Aronson* test. *In re* Citigroup, 964 A.2d at 136.

74. Although the original *Aronson* test states a conjunctive test, it was later clarified that the two prongs were distinct, and demand would be futile where either could be established. Levine v. Smith, 591 A.2d 194, 206 (Del. 1991) ("The point is that in a claim of demand futility, there are two alternative hurdles, either of which a derivative shareholder complainant must overcome to successfully withstand a Rule 23.1 motion.").

75. *Aronson*, 473 A.2d at 814.

76. Grimes v. Donald, 673 A.2d 1207, 1220 (Del. 1996) ("[A] shareholder who makes a demand can no longer argue that demand is excused . . . the Board is entitled to have its decision [regarding the demanded action] analyzed under the business judgment rule unless the presumption of that rule can be rebutted." (quoting Spiegel v. Buntrock, 571 A.2d 767, 775 (Del. Sup. 1990))).

77. *Aronson*, 473 A.2d at 814.

78. London v. Tyrrell, No. 3321-CC, 2008 Del. Ch. LEXIS 75, at *13–14 (Del. Ch. June 24, 2008) (quoting Orman v. Cullman*,* 794 A.2d 5, 25 n.50 (Del. Ch. 2002)).

79. *Id.*

80. *Id.* at 15–16.

81. *Aronson*, 473 A.2d at 814.

be made on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.[82] The business judgment rule is a rebuttable presumption, however, and it may be overcome by a showing of a lack of good faith,[83] gross negligence,[84] failure to monitor,[85] or lack of a rational business purpose (waste).[86]

2. Standard for Establishing a Claim of Waste

A party challenging executive compensation with a claim of waste in the absence of director interestedness must prove demand futility based on the second prong of *Aronson*.[87] In the context of waste, "the judicial standard is. . . well developed."[88] A claim of waste can overcome the business judgment presumption where corporate assets are exchanged for consideration so disproportionately small as to lie beyond the range where any reasonable person would be willing to trade.[89] A wasteful transaction is one that serves no corporate purpose or one which "is so completely bereft of consideration that it effectively constituted a gift."[90] Typically, the Chancery Court acknowledges that waste claims must meet an extreme test which is rarely satisfied,[91] and that its purpose is to "smoke out shady, bad faith deals" rather than create license for judicial scrutiny of arm's

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82. *See* Dodge v. Ford, 170 N.W. 668, 682 (Mich. 1919) (describing the high threshold which must be met in order to trigger the court's intervention in the discretion of the directors of a corporation).

83. A lack of good faith can be established if a director is fraudulent or consciously disregards his responsibilities. *See* Malone v. Brincat, 722 A.2d 5 (Del. 1998); *In re* The Walt Disney Co. Deriv. Litig., 906 A.2d 27, 66–67 (Del. 2006). For example, directors were found to be fraudulent, and therefore demand was excused based on the second prong of *Aronson* where directors intentionally manipulated a valuation by withholding positive information and allowing negative information to be known in order to increase the value of their stock options. *London*, No. 3321-CC, 2008 Del. Ch. LEXIS, at *17–18.

84. *See* Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).

85. *See In re* Caremark Int'l Inc., 698 A.2d 959, 967–68 (Del. Ch. 1996).

86. Even business decisions that in hindsight were extremely unwise receive the protection of the business judgment rule. *See, e.g.* Shlensky v. Wrigley, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968) (protecting Chicago Cubs owner from liability for significant losses due to his refusal to build lights and schedule baseball games at night).

87. *See* Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).

88. Brehm v. Eisner, 746 A.2d 244, 263 (Del. Ch. 2000) (quoting Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997)).

89. *Id.*

90. Ash v. McCall, No. 17132, 2000 Del. Ch. LEXIS 144, at *23 (Del. Ch. Sept. 15, 2000).

91. Weiss v. Swanson, 948 A.2d 433, 450 (Del. Ch. 2008) (quoting Zupnick v. Goizueta, 698 A.2d 384, 387 (Del. Ch. 1997)).

length bargains.[92] Indeed, the extreme standard for waste "is a corollary of the proposition that where business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be 'attributed to any rational business purpose.'"[93]

In making the determination of whether a waste claim will survive a motion to dismiss for failure to make demand, the court will make a substantive review of the challenged transaction,[94] and determine whether the complaint sufficiently alleges that no consideration was made.[95] The plaintiff is required to plead facts that raise a reasonable doubt that there was a complete failure of consideration.[96] What constitutes sufficient consideration can be a difficult question in the case of executive compensation, and in rejecting motions to dismiss, the Chancery Court has noted its discretionary function in analyzing facts.[97]

Executive compensation creates particularly difficult analysis given the often "ephemeral" nature of the consideration received by a corporation in executive compensation packages, especially in stock option plans and severance agreements.[98] Even in light of this difficulty of valuation in dollar terms, the Chancery Court still requires plaintiffs to plead facts showing that the corporation "failed to receive *any* benefit."[99] The Chancery Court has recognized even unquantifiable agreements to be sufficient consideration in various contexts. In *Grobow v. Perot*,[100] General

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92. *In re* Lear Corp. S'holder Litig., 967 A.2d 640, 656–57 (2008) (stating the rule that judicial scrutiny of a claim of corporate waste may not proceed if given the facts pled in the complaint, "any reasonable person might conclude that the deal made sense") (quoting Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 892 (Del. Ch. 1999)).

93. *In re* The Walt Disney Co. Derivative Litig., 906 A.2d 27, 73 (Del. 2006) (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

94. *See* Lewis v. Hett, No. 6752, 1984 Del. Ch. LEXIS 546, at *8–11 (Del. Ch. 1984) (analyzing the facts alleged in the complaint surrounding the compensation of Hett, a board member, and refusing to consider an affidavit).

95. *In re* 3Com Corp. S'holders Litig., No. 16721, 1999 Del. Ch. LEXIS 215, at *13 (Del. Ch. 1999).

96. *Id.*

97. Lewis v. Vogelstein, 699 A.2d 327, 339 (Del. Ch. 1997) (stating that "[s]ince what is a 'well-pleaded' fact and what is a 'mere conclusion' is not always clear, there is often and inevitably some small room for the exercise of informed judgment by courts in determining motions to dismiss under the appropriate test"). In *Lewis*, the Court was also willing to consider the fact that one-time option grants were unusual, which led to the conclusion that the compensation was sufficiently unusual to dismiss the motion to dismiss in the interest of acquiring more evidence. *Id.* at 339.

98. *See In re 3Com Corp.*, 1999 Del. Ch. LEXIS at *14–15.

99. *Id.* (emphasis in original).

100. 539 A.2d 180 (Del. Ch. 1988).

Motors purchased all of its shares owned by H. Ross Perot, who had become a vocal critic of the GM management.[101] He received $745 million in exchange for his stockholdings and made commitments to General Motors to stop criticizing its management, not compete with a GM subsidiary, and not purchase GM stock or engage in a proxy contest for five years.[102] The court rejected the plaintiffs' claim that buying Perot's silence, and various other commitments, constituted waste.[103]

3. The Plaintiff's Pleading Burden Under Chancery Rule 23.1

A shareholder-plaintiff seeking to establish a claim of waste must overcome the deferential business-judgment prong of the *Aronson* test, and create a reasonable doubt that the transaction meets the extremely stringent standard for waste.[104] The requirements of Chancery Rule 23.1 make this task even more difficult.[105] The demand requirement of Chancery Rule 23.1 creates a heightened pleading standard that is more stringent than Chancery Rule 8(a), the general notice pleading standard.[106] Although a plaintiff is not expected to plead evidence, Rule 23.1 requires greater "particularity" of factual detail than the typical notice pleading standard, however, and conclusory allegations unsupported by such factual allegations are not taken as true.[107] While analyzing a motion to dismiss for failure to make demand, the Chancery Court will take all well-pleaded facts as true and make inferences in favor of the plaintiff that logically flow from the

101. *Id.* at 184.

102. *Id.* at 184–85.

103. *Id.* at 189.

104. Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).

105. *Compare* Del. Ch. Ct. R. 8(a) (2009) (stating general rules of pleading, which require a "short and plain statement of the claim showing that the pleader is entitled to relief"), *with* Del. Ch. Ct. R. 23.1 (2010) (stating that in derivative actions by shareholders, "[t]he complaint shall also allege. . . with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort").

106. Chancery Rule 8(a) states that

> [a] pleading which sets forth a claim for relief, whether an original claim, counterclaim, cross-claim or third-party claim shall contain (1) a short and plain statement of the claim showing that the pleader is entitled to relief and (2) a demand for judgment for the relief to which the party deems itself entitled. Relief in the alternative or of several different types may be demanded.

De1. R. Ch. Ct. 8(a) (2009).

107. Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000).

particularized facts alleged.[108] The court will not consider affidavits or other materials not included in the complaint.[109]

In *Lewis v. Hett*,[110] the shareholders alleged waste, and pleaded particularized facts showing that the directors approved a severance agreement with an executive who had voluntarily resigned, had no employment contract, and served at the will of the board.[111] The shareholders' complaint alleged that no consideration had been received in exchange for the severance agreement.[112] The Chancery Court found the pleadings to be sufficiently particularized and to raise a reasonable doubt "that the severance payments constitute a gift or waste of corporate assets and, therefore, that 'the challenged transaction was. . . the product of a valid exercise of business judgment.'"[113]

The Court of Chancery faces a highly factual analysis when considering a motion to dismiss for failure to make demand.[114] A plaintiff in shareholder derivative cases often faces problems pleading the necessary facts because Rule 23.1 motions precede discovery, so a the Chancery Court's ability to find for the plaintiff is often based on the amount of information a plaintiff has *before* discovery.[115]

A lack of information is not always dealt with consistently.[116] For example, efforts by plaintiffs to overcome a lack of particularized facts with

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108. *Id.* at 255.

109. Spiegel v. Buntrock, 571 A.2d 767, 774 (Del. Ch. 1990).

110. No. 6752, 1984 Del. Ch. LEXIS 546 (Del. Ch. May 31, 1984).

111. *Id.* at 10.

112. *Id.* at 10–11. Although an affidavit provided by the defendant added undisputed facts that the executive's resignation was not voluntary and that there was consideration to the corporation, the court refused to consider the affidavit, citing *Pogostin v. Rice*, 480 A.2d 619 (Del. Ch. 1984) for the rule that the court may only consider the facts alleged within the complaint.

113. *Id.* at 11 (quoting [citation unavailable]).

114. Grobow v. Perot 539 A.2d 180, 186 (1988); Lewis v. Vogelstein, 699 A.2d 327, 338–39 (Del. Ch. 1997) (stating that because what is a "well pleaded" fact and what is a "mere conclusion" is not always clear, there is some small room for the exercise of informed judgment). In *Lewis*, the court considered an executive compensation agreement that had been ratified by the shareholders. *Id.* at 329. The court refused to dismiss the claim of waste because one time grants to directors seemed sufficiently unusual to require evidence before making an adjudication of their consistency with fiduciary duty. *Id.* at 339.

115. *See Lewis*, 699 A.2d at 339 (reasoning that although it is difficult to make an inherently factual determination on a motion to dismiss, a court cannot allow a waste claim to go forward where there is simply an allegation of the facts of the case coupled with a statement that the transaction constitutes a waste of assets).

116. *Compare* Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 892 (Del. Ch. 1999) (refusing to consider excerpts from newspaper articles about problems in the used car business because the plaintiff failed to plead that the articles were relevant to the allegedly wasteful transaction), *with*

industry news about the value of an investment have been deemed an insufficient method of overcoming such a lack of facts.[117] On the other hand, the Chancery Court has acknowledged that because the difference between a well pleaded fact and a mere conclusion can be unclear, there is some small room for the court to exercise "informed judgment" in determining motions to dismiss.[118] In *Lewis v. Vogelstein*,[119] the Chancery Court refused to dismiss a claim of waste where a stock option plan was alleged to have failed to give the corporation assurance that it would receive adequate value in exchange for the grant of stock options.[120] The court was influenced by its intuition that a one-time option grant was sufficiently unusual, and refused to dismiss the case because it required more evidence before ruling on the claim.[121]

IV. THE COURT'S REASONING

In *In re Citigroup, Inc. Shareholder Derivative Litigation*,[122] the Delaware Court of Chancery rejected the plaintiffs' *Caremark* claims,[123] and then assessed whether each of the four following claims of waste would survive a motion to dismiss under Delaware law: (1) the compensation agreement between Citigroup and Charles Prince (2) Citigroup's purchase of over $2.7 billion of subprime assets (3) approving the buyback of stock at inflated stock price, and (4) allowing the company to invest in special investment vehicles ("SIVs") that were unable to pay off maturing debt.[124]

Lewis, 699 A.2d at 338–39 (Del. Ch. 1997) (noting that because it is unclear what the difference is between a "well pleaded" fact and a "mere conclusion," there is "some small room for the exercise of informed judgment by courts in determining motions to dismiss" and considering the one-time nature of an option grant in ruling on a Motion to Dismiss.).

117. *Harbor Fin.*, 751 A.2d at 892 (finding that the plaintiff had not *pled facts* to support the conclusion that no rational person could find the transaction sensible where the plaintiff's complaint included snippets of news articles and quotes from industry competitors describing the poor prospects for investors in used car businesses).

118. *Lewis*, 699 A.2d at 338–39.

119. 699 A.2d 327 (Del. Ch. 1997).

120. *Id.* at 339.

121. *Id.*

122. 964 A.2d 106 (Del. Ch. 2009).

123. The court dedicated the bulk of the decision to plaintiffs *Caremark* claims, and refused to allow claims that a failure to monitor business risk could create liability under *Caremark*. *See In re Citigroup*, 964 A.2d at 123–35. The focus of this case note is the claim of waste, however, so the details of the court's decision regarding the *Caremark* claims will not be discussed in this section.

124. The court quickly dismissed the claims of waste based on the investment in SIVs at the outset of its discussion of the waste claims. *Id.* It pointed out that the plaintiffs failed to adequately

The Court of Chancery began its analysis by noting that the plaintiffs sought to argue demand futility based on the second prong of the *Aronson* test, which requires a plaintiff to plead particularized facts that raise a reasonable doubt whether "the challenged transaction was otherwise the product of a valid exercise of business judgment."[125] The court also enunciated the standard for excusing demand on a claim of waste, stating that a plaintiff must "plead 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."[126] To overcome the presumption of good faith, a plaintiff must show 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."[127]

The Chancery Court first considered whether Citigroup's repurchase of stock constituted waste.[128] The plaintiff argued that the Citigroup directors' buyback of stock constituted waste because it approved the stock purchase when it was trading at an average price of $53.37, which the directors would have known was an inflated price but for their reckless failure to consider impending subprime losses.[129] The court rejected this argument as an "utter [] fail[ure] to state a claim for waste."[130] The court emphasized the fact that a purchase of stock at *market value* was a clearly a rational act of business that fell well below the standard for waste.[131] The court allowed Citigroup's failure to recognize various "red flags" in the

plead that the challenged corporate activity was the result of board action, as opposed to inaction, which is required to excuse demand for a claim of waste. *Id.* The court alternately pointed out that these claims do not create a substantial likelihood of liability for the director defendants because the complaint fails to establish the bad faith which would be required to overcome the business judgment rule. *Id.* The court, referring to its discussion of the *Caremark* claims that it dismissed, reasserted that the "red flags" alleged by the plaintiff did not support an inference of bad faith, and that the ultimately failing investments fell squarely within the business judgment rule. *In re Citigroup*, 964 A.2d at 135 n.96 (citing Highland Legacy Ltd. v. Singer, No. 1566-N, 2006 WL 741939, at *7 (Del. Ch. Mar. 17, 2006)).

125. *Id.* at 136 (quoting Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984)).

126. *Id.* (quoting Brehm v. Eisner, 746 A.2d 244, 263 (Del. Sup. 2000)) (quoting *In re* The Walt Disney Co. Derivative Litig., 731 A.2d 342, 362 (Del. Ch. 1998))).

127. *Id.* (quoting White v. Panic, 783 A.2d 543, 554 n. 36 (Del. Ch. 2001).

128. *Id.* at 136–37.

129. *Id.* at 137.

130. *Id.*

131. The court implied that purchasing stock at market value was not, by definition, waste because "the market price–the price at which presumably ordinary and rational businesspeople were trading the stock–could [not] possibly be so one sided that no reasonable and ordinary business person would consider it adequate consideration." *In re Citigroup*, 964 A.2d at 137.

subprime market to fall within the protection of the business judgment rule, as it had for the plaintiff's *Caremark* claims.[132]

The court then began its analysis of the Letter Agreement, which reflected the compensation agreement between Citigroup and its CEO Charles Prince, by stating that although corporations generally have broad discretion to determine compensation of their executives, the outer limit of the discretion was the point at which the compensation "is so disproportionately large as to be unconscionable and constitute waste."[133] The court then considered whether the multimillion dollar compensation package, contingent on Mr. Prince signing a non-compete agreement, a non-disparagement agreement, a non-solicitation agreement, and a release of claims against Citigroup was "so one sided" as to constitute waste.[134] The court noted that it had very little information about how much additional compensation Mr. Prince received based on the Letter Agreement and the actual value of the agreements signed by Mr. Prince.[135] It stated that, as a result of the lack of information, and because it was required to take the plaintiffs' allegations as true, a reasonable doubt existed that the agreement was so one sided that no business person of ordinary, sound judgment could concluded that the corporation received adequate consideration.[136] The court did not provide any reasoning as to *why* the Letter Agreement created such a reasonable doubt, and instead apparently relied on the premise that "the discretion of directors in setting executive compensation is not unlimited."[137] As a result, the court held that the plaintiffs' adequately alleged that demand was futile based on the second prong of *Aronson*, and refused to dismiss the claim of waste.[138]

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132. The bulk of the decision was dedicated to an analysis of the plaintiff's attempt to use a *Caremark*-style claim to essentially circumvent the business judgment rule. *Citigroup*, 964 A.2d at 123–31. The plaintiff argued that the director's failure to recognize "red flags" in the subprime market constituted a failure to monitor. *Id.* at 124. The court flatly rejected this argument, reasoning that if it were to hold directors liable for suffering losses for failure to foresee market downturns, then it would also be required to hold directors liable for failing to foresee market downturns and *profit* from them. *Id.* at 131 n. 78.

133. *Id.* at 138 (quoting Brehm v. Eisner, 746 A.2d 244, 262 n.56 (Del. Sup. 2000).

134. *Id.*

135. *Id.*

136. *Id.*

137. *See id.* (restating the terms of the compensation transaction and simply concluding that there is a reasonable doubt as to whether the transaction constituted waste).

138. *See id.* The court then rejected the Defendant's Motion to Dismiss under Rule 12(b)(6) for failure to state a claim. *Id.* at 139. It reasoned that the pleading demand futility is a higher standard than that required to survive a 12(b)(6) motion and cited the rule that "a complaint that survives a motion to dismiss pursuant to Rule 23.1 will also survive a 12(b)(6) motion to dismiss,

V. ANALYSIS

Despite a conclusory affirmation of the importance of the business judgment rule and a statement that "we must not let our desire to blame someone for our losses make us lose sight of the purpose of our law,"[139] the Chancery Court's decision in *In re: Citigroup* creates confusion regarding shareholder complaints that executive compensation amounts to waste.[140] The court, in an apparent attempt to vindicate popular anger over executive compensation,[141] created confusion about directors' ability to make compensation decisions by: (1) enunciating a weakened standard for waste;[142] (2) raising the threat of strike suits;[143]and (3) creating unnecessary concern over tying executive compensation to long-term measures of risk.[144]

A. The Court Failed to Afford the Citigroup Board Business Judgment Deference Typically Associated with Compensation Decisions

The court's decision failed to enunciate the typically strict standard for waste and, in doing so, undermined the previous understanding that claims of waste in executive compensation decisions receive the same business judgment deference as other disinterested board decisions.[145] Although the court properly stated the standard for determining demand futility on the second prong of *Aronson*,[146] it failed to include the strict language typically associated with the rule.[147]

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assuming that it otherwise contains sufficient facts to state a cognizable claim." *Id.* (quoting McPadden v. Sidhu, 964 A.2d 1262 (Del. Ch. 2008)).

139. *Id.* The court had rejected all of the plaintiffs' claims based on the directors failures to respond to "red flags" that signaled the impending subprime financial meltdown. *See also supra* note 132 and accompanying text.

140. *See infra* Parts V.A–C.

141. *See* Michael J. Biles & Kimberly G. Davis, *Keeping Current: Corporate Compensation*, 19 BUSINESS LAW TODAY 1 (Sept./Oct. 2009), *available at* http://www.abanet.org/buslaw /blt/2009-09-10/keepingcurrent-corpcomp.shtml (stating that "[c]ourts are not immune to political zeitgeist" in reference to the chancery decision in *Citigroup*)

142. *See infra* Part V.A.

143. *See infra* Part V.B.

144. *See infra* Part V.C.

145. *See In re* Citigroup Inc. Derivative Litig., 964 A.3d, 136 (Del. Ch. 2009).

146. The second prong of *Aronson* requires showing that "under the particularized facts alleged, a reasonable doubt is created that: . . . the challenged transaction was otherwise the product of a valid exercise of business judgment." Aronson v. Lewis, 473 A.2d 805, 814 (Del. Ch. 1984).

147. *See infra* notes 148–53 (demonstrating that the standard stated in *Citigroup* failed to include rigorous language typically associated with analysis of waste claims).

The court did not misstate the standard for waste, and much of the rule it enunciated was the same rigorous language it had used in previous cases.[148] Still, it failed to include language that demonstrates that waste is an extreme test[149] meant to "smoke out shady, bad faith deals"[150] that are "so completely bereft of consideration that [they] effectively constituted a gift."[151] While the court acknowledged the wide discretion given to compensation decisions, it focused on the "'outer limit' [of] the board's discretion to set executive compensation, 'at which point a decision is so disproportionately large as to be unconscionable and constitute waste.'"[152] Although the court was not incorrect that such an "outer limit" exists, it failed to recognize that the outer limit begins where a compensation agreement demonstrates a complete failure, rather than an imbalance, of consideration.[153]

In applying this weakened standard, the court did not grant Citigroup's directors the protection of the business judgment rule in its executive compensation agreement, although it had done so for all of Citigroup's other investment decisions.[154] Its failure to do so is inconsistent with the court's previous understanding of waste as a "corollary of the proposition

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148. *See In re Citigroup*, 964 A.2d at 136 (stating that the plaintiff 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'" (quoting Brehm v. Eisner, 746 A.2d 244, 263 (Del. Sup. 2000) (quoting *In re* The Walt Disney Co. Derivative Litig., 731 A.2d 342, 362 (Del. Ch. 1998))), and stating that the plaintiff must show that the board's decision was "so egregious or irrational that it could not have been based on a valid assessment of the the corporation's best interests" (quoting White v. Panic, 783 A.2d 543, 554 n.36 (Del. 2001)).

149. *See* Weiss v. Swanson, 948 A.2d 433, 450 (2008) (quoting Zupnick v. Goizueta, 698 A.2d 384, 387 (Del. Ch. 1997)) (finding that the plaintiffs' claim that, based on the facts alleged by the plaintiffs, the grant by the corporation to the defendants meets the extreme test for waste because it served no valid corporate purpose).

150. *In re* Lear Corp. S'holder Litig., 967 A.2d 640, 656–57 (2008) (stating the rule that judicial scrutiny of a claim of corporate waste may not proceed if given the facts pled in the complaint, "any reasonable person might conclude that the deal made sense").

151. Ash v. McCall, No. 17132, 2000 Del. Ch. LEXIS 144, at *23 (Del. Ch. Sept. 15, 2000).

152. *Citigroup*, 964 A.2d at 138 (quoting Brehm v. Eisner 746 A.2d, 244, 262 n.56 (Del. Sup. 2000) (citing Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962))).

153. *Compare infra* note 154 and accompanying text, *with In re* 3Com Corp. S'holders Litig., No. 16721, 1999 Del. Ch. LEXIS 215, at *13 (Del. Ch. 1999).

154. *Compare In re Citigroup*, 964 A.2d at 124 (protecting the directors' unwise decision to invest heavily in subprime assets because the business judgment rule protects decisions made on an informed basis in good faith and with an honest belief that the decision was in the best interests of the company), *with id.* at 138 (failing to protect the directors' decision with regards to Charles Prince's compensation package despite the plaintiffs' failure to allege a complete lack of consideration or business purpose).

that where business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be 'attributed to any rational business purpose.'"[155] The court dismissed the plaintiffs' claims of waste for other investment decisions,[156] but singled out the severance agreement with Charles Prince.[157] In doing so, it failed to recognize that the burden is on the plaintiff to establish a complete failure of consideration, and that even ephemeral consideration is valid under the waste standard.[158]

1. The Court Failed to Place the Burden of Establishing a Complete Failure of Consideration on the Plaintiff

The court noted that it had "very little information regarding. . . the real value, if any, of the various promises given by Prince."[159] Because it had little information, and taking the plaintiffs' allegations at true, it determined that a reasonable doubt existed that the transaction was so one sided that "no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[160] In doing so, the court failed to place the burden of "establish[ing] a complete *failure* of consideration, and not merely the insufficiency of the consideration received," on the plaintiffs.[161]

The plaintiffs alleged the following in regards to Charles Prince's Letter Agreement:

155. *In re* Disney, 906 A.2d 27, 74 (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

156. *In re Citigroup*, 964 A.2d at 136–37.

157. *Id.* at 138.

158. *See infra* Parts V.A.1–2.

159. *In re Citigroup*, 964 A.2d at 138.

160. *Id.* at 136–38.

161. *Compare In re* 3Com Corp. S'holder Litig., No. 16721, 1999 Del. Ch. LEXIS 215, at *13 (Del. Ch. 1999) (requiring that the plaintiff allege facts that establish a complete *failure* of consideration), *with In re Citigroup*, 964 A.2d at 138 (quoting Brehm v. Eisner, 746 A.2d 244, 263 (Del. Sup. 2000) (requiring an exchange so disproportionate that no reasonable person would be willing to trade). The *Citigroup* court failed to recognize the language from *Brehm* that immediately followed the quoted statement, which clarified its meaning to be that

> Most often the claim is associated with a transfer of corporate assets that serves no corporate purpose; or for which no consideration at all is received. Such a transfer is in effect a gift. If, however, there is *any substantial* consideration received by the corporation, and if there is a *good faith judgment* that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude *ex post* that the transaction was unreasonably risky.

Brehm, 746 A.2d at 263.

> *212. The Director Defendants are liable to the Company for waste for having approved the Letter Agreement dated November 4, 2007 between Citigroup and Prince. Under the terms of the Letter Agreement, Prince, who is largely responsible for Citigroup's problems, will still receive a $12.5 million cash bonus only $1.3 million less than his 2006 bonus where Prince was employed as CEO for the entire year and Citigroup's stock price never dipped below $45.05.*
> *213. The terms of the Letter Agreement are so one-sided so that no person acting in a good faith pursuit of the Company's interests could have approved the terms of the Letter Agreement.*[162]

The plaintiff failed to establish that the Letter Agreement with Charles Prince was a one-sided transaction completely devoid of consideration.[163] Facts outside the complaint demonstrate that there was consideration in the case: Prince signed non-compete, non-disparagement, non-solicitation agreements, and a release of claims.[164] Even if the court considered only the facts in the Plaintiffs' complaint, nothing in the complaint shows that the compensation package symbolized by the Letter Agreement suffered a complete *failure* of consideration.[165]

The *Lewis v. Hett*[166] decision provides an example of how a severance agreement with a departing executive can constitute a complete failure of consideration.[167] In *Lewis*, the complaint alleged that, according to the terms of a severance package, significant sums would be paid to Hett, a retiring executive, despite the fact that he had voluntarily resigned, had no employment contract, and served at the will of the board.[168] Such a purposeless severance agreement created a reasonable doubt that the transaction was the product of a valid exercise of business judgment.[169] In

162. Plaintiffs' Consolidated Second Amended Derivative Complaint at 212–13, *In re* Citigroup, 964 A.2d 106 (Del. Ch. 2009) (No. 3338-CC).

163. *See id.*

164. *In re Citigroup*, 964 A.2d at 138.

165. *See* Plaintiffs' Consolidated Second Amended Derivative Complaint at 212–13, *In re* Citigroup, 964 A.2d 106 (Del. Ch. 2009) (No. 3338-CC) (alleging that the terms of Prince's compensation package were high despite a decline in the stock value of Citigroup, but failing to state facts that there was a complete failure of consideration).

166. No. 6752, 1984 Del. Ch. LEXIS 546 (Del. Ch. 1984).

167. *Id.* at *10–11.

168. *Id.* at *10.

169. *Id.* at *10–11.

contrast, the plaintiffs in *In re Citigroup* failed to demonstrate that the severance agreement was without purpose, and unlike Hett, Charles Prince did not depart from Citigroup on a voluntary basis.[170] Nothing in the complaint creates a doubt that the Letter Agreement between Citigroup and Prince was a complete failure of consideration.[171]

2. The Court Ignored Precedent that Demonstrates that Even Difficult to Value Consideration is Sufficient to Avoid a Claim of Waste

The court acknowledged that although Citigroup, under the terms of the Letter Agreement with Charles Prince, would receive certain promises including a non-compete, non-disparagement, non solicitation agreement, and a release of claims.[172] Regardless, it held that there was still a reasonable doubt that the Letter Agreement was "so one sided" as to constitute waste.[173] In doing so, the court ignored precedent that demonstrates that even where consideration is "ephemeral [and]. . .not susceptible to identification and valuation in dollar terms," the plaintiff is not excused from demonstrating facts that the corporation failed to receive *any* benefit.[174] For example, paying a premium during a stock repurchase was not waste where the corporation received an agreement from an outspoken shareholder/director who criticized management to cease from doing so and not to compete with the company.[175] In addition, the Delaware Court of Chancery noted that consideration for a stock option plan, namely "continued and greater efforts by employees," is ephemeral in nature, but such ephemeral consideration still must be overcome with a

170. *See* Plaintiffs' Consolidated Second Amended Derivative Complaint at 212–13, *In re* Citigroup, 964 A.2d 106 (Del. Ch. 2009) (No. 3338-CC) (failing to establish that Citigroup received no consideration in exchange for Charles Prince's severance agreement).

171. *See id.* (alleging that Prince would receive a $12.5 million cash bonus (only $1.3 million less than his 2006 bonus), despite being "largely responsible for Citigroup's problems," and stating the conclusion that the transaction was so one-sided that no one acting in good faith could have approved the terms of the agreement, but failing to allege that there was a complete failure of consideration.).

172. *In re* Citigroup v. S'holder Derivative Litig., 964 A.2d 106, 138 (Del. Ch. 2009).

173. *Id.*

174. *In re* 3Com Corp. S'holders Litig., No. 16721, 1999 Del. Ch. LEXIS 215, at *14–15 (Del. Ch. 1999).

175. Grobow v. Perot, 539.2d 180, 181, 184–85 (Del. 1988) (finding that GM's repurchase of all of vocal minority shareholder's stock in exchange for his agreement to stop criticizing GM management, not to engage in a proxy contest, and not to compete was not waste and a decision protected by the business judgment rule).

specific factual allegation that the company has failed to receive any benefit.[176]

The consideration received by Citigroup is ephemeral in nature.[177] Although the the financial collapse made compensation agreements such as these repugnant to the public, corporations need to be free to negotiate with their executives, many of whom leave during periods of corporate loss.[178] The *In re: Citigroup* court failed to give such negotiations the deference of the business judgment rule.[179]

B. The Court's Decision Raises the Threat of Strike Suits

Although the court's decision afforded Citigroup the protection of the business judgment rule when it came to the variety of risk taken by the corporate directors and managers,[180] the court demonstrated its willingness to scrutinize executive compensation packages despite the judicial deference they typically enjoy.[181] The court's refusal to dismiss the plaintiffs' claim of waste will raise the threat of strike suits because it undermines Chancery Rule 23.1 and enables shareholder plaintiffs to survive a motion to dismiss, raising the settlement value of their claim.[182]

The demand requirement of Chancery Rule 23.1 and *Aronson* exists to provide a safeguard against strike suits, which can unnecessarily distract directors from their duties to manage the corporation.[183] The Chancery Court views claims of waste for executive compensation in the same light, emphasizing that if simply alleging the facts of a transaction and stating that

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176. *In re 3Com*, 1999 Del. Ch. LEXIS at *14–15.

177. *Compare In re Citigroup*, 964 A.2d at 138 (describing Charles Prince's non-disparagement, non-compete, and non-solicitation agreements), *with Growbow*, 539 A.2d at 184 (describing H. Ross Perot's silence and non-compete provisions of a repurchase of his stock).

178. SORKIN, *supra* note 9, at 161 (demonstrating the need for companies to keep executives on noncompete agreements).

179. *In re Citigroup*, 964 A.2d at 138.

180. *See supra* note 132 and accompanying text.

181. *See supra* Part V.A.

182. See *supra* note 67 and accompanying text. Postorivo v. AG Paintball Holdings, Inc., 2008 WL 553205, at *4–5 (Del. Ch. 2008) ("Because a derivative action, by its very nature, impinges on the managerial freedom of directors, Chancery Rule 23.1 operates as a threshold to insure that plaintiffs exhaust intracorporate remedies and protect against strike suits."). *See also* Lewis v. Vogelstein, 699 A.2d 327, 339 (Del. Ch. 1997) ("[I]t cannot be the case that allegations of the facts of any (or every) transaction coupled with a statement that the transaction constitutes a waste of assets, necessarily states a claim upon which discovery may be had; such a rule would, in this area, constitute an undue encouragement to strike suits.").

183. Aronson v. Lewis, 473 A.2d 805, 811–12 (Del. 1984).

the transaction constitutes waste meets the pleading standard, strike suits would be unduly encouraged.[184] Although it is unclear whether the holding of *Citigroup* changed the waste standard for good or whether this more relaxed approach was a rare exception,[185] lawsuits over executive compensation have been on the rise.[186] The language of the plaintiffs' complaint simply states that a departing CEO will receive a large bonus despite major problems within the company, and that such a compensation agreement is so one-sided that it could not have been made in good faith.[187] Given that many CEOs lost their jobs during the financial crisis and were paid significant severance packages,[188] there will be ample opportunity for shareholders of other corporations to draft similar complaints against CEOs with severance agreements.[189] Shareholders will surely take notice of the *In re Citigroup* decision and be encouraged to file derivative actions.[190]

184. *Lewis*, 699 A.2d at 339.

185. Broc Romanck & Dave Lynn, *Delaware Dismisses* Caremark *Claims against Citigroup: CEO Pay "Waste" Claim Survives*, THE CORPORATE COUNSEL.NET BLOG (Mar. 3, 2009), http://www.thecorporatecounsel.net/blog/archive/002030 html.

186. Paul R. Bessette et al., *Executive Bonuses Triggering Lawsuits Nationwide*, THE NATIONAL LAW JOURNAL, (Apr. 6, 2009), http://www.law.com/jsp/article.jsp?id=1202429689471 (last visited Nov. 20, 2009). *See also Executive Compensation Under Fire*, GREENBERG TRAURIG, LLP, http://www.gtlaw.com/NewsEvents/Publications/Alerts?find=115034 (last visited September 16, 2010) (warning clients in an online memo discussing *Citigroup*: "don't be surprised if many more companies face similar challenges to executive compensation decisions in the near future").

187. Plaintiffs' Consolidated Second Amended Derivative Complaint ¶ 212–13, Aug. 21, 2008.

188. *See, e.g.*, Craig Harris, *Fired CEO to get cash payout from Starbucks*, SEATTLE PI (Jan. 28, 2008), http://www.seattlepi.com/business/349081_sbux29 html; Jonathan Berr, *Before Getting Fired, Wachovia CEO Thompson Got Gobs of Money*, (June 2, 2008), http://www.bloggingstocks.com/2008/06/02/before-getting-fired-wachovia-ceo-thompson-got-gobs-of-money.

189. Indeed, many corporations fire their executives (or pressure them to step down) *because* the company has suffered losses. Dan Fitzpatrick et. al., *Thain Ousted in Clash at Bank of America*, WALL ST. J., Jan. 23, 2009, at A1 (describing the ouster of John Thain from Merrill Lynch due to large losses). If they are unable to negotiate agreements with those executives during that process for fear of shareholder suits, they will likely be limited in their ability to find better management at the *most* critical times in the life of the corporation. *Cf.* Jonathan Weisman & Joann S. Lublin, *Obama Lays Out Limits on Executive Pay*, WALL ST. J., Feb. 5, 2009, at A1 (reporting on concerns that government intervention into corporate boardrooms might have blocked the filling of vital jobs in troubled companies).

190. *See* Bessette, *supra* note 186 (warning clients in an online memo discussing *Citigroup*: "don't be surprised if many more companies face similar challenges to executive compensation decisions in the near future").

C. The Court's Apparent Preference for Compensation Tied to Long-Term Corporate Gain is an Unnecessary Intrusion on Board Decision-Making

Corporate advisors have taken notice of this decision,[191] and have been advising the corporate world to ensure that they make a reasonable, well-documented process for making compensation decisions and tie compensation to long-term performance rather than short-term performance metrics.[192] If the Chancery Court intended to influence corporate behavior or vindicate popular opinion,[193] its holding in *Citigroup* was unnecessary[194] and problematic.[195]

Although executive compensation grew to unprecedented levels in the years leading up to the credit crisis,[196] the court's holding was an unnecessary step toward correcting those perceived problems, particularly in light of the negative impact the decision will have on the business community.[197] The credit crisis and ensuing recession were precipitated by a massive bubble in the housing market.[198] The risks taken during that period, and the profits reported during those periods, revealed themselves to be the result of irrational and irresponsible market behavior rather than real gains in market value.[199] It is only logical that executive compensation would reach unprecedented heights during a period where financial markets reach similarly unprecedented levels. The court's decision, which will create new fear of liability and intrude on board decision making, was

191. *See* Biles & Davis, *supra* note 141.

192. *Washington's New Limits on Executive Compensation*, PAUL HASTINGS STAY CURRENT (Paul Hastings, Washington, D.C.) Feb. 2009, at 1–4, *available at* http://www.paulhastings.com/assets/publications/1205.pdf?wt mc_ID=1205.pdf (advising clients to be proactive in order to placate the American public, Congress, and the public by avoiding short-term incentive compensation, among other things).

193. *See* Biles, *supra* note 141 (stating that "[c]ourts are not immune to political zeitgeist" in reference of the Chancery decision in *Citigroup*).

194. *See infra* notes 201–03 and accompanying text (demonstrating that corporations are being advised to address executive compensation issues in response to pressure from the public, Congress, and the executive branch).

195. *See supra* Part V.B.

196. *See supra* note 43.

197. *See supra* Part V.B. (demonstrating that the *Citigroup* decision will raise the threat of strike suits).

198. *See supra* Part III.A.

199. *See* Elson, *supra* note 43 ("The value that many superpaid CEO superstars supposedly created has largely disappeared. . . the very profits that many of the companies reported appear to have been the product more of auditors' imaginations than of any CEO's strategy for seizing or creating value.").

unnecessary in light of the fact that the corporate executive labor market is itself a bubble that is apparently popping.[200] Mounting political pressure,[201] changes in corporate culture,[202] and the deflated market are bringing down levels in executive pay.[203] Before undermining the business judgment rule, the court should have considered those factors and recognized that its contribution to the deflation of executive pay was not necessary.

The court's ruling, which will have the effect of influencing corporations to tie compensation to longer-term measures of corporate success,[204] raises a number of questions: what kind of compensation structure will satisfy the court? Should the court have such an impact on compensation decisions? Will that effect have an adverse impact on executive willingness to take risks? Will tying compensation to long-term corporate success help prevent another crisis?

It is unclear what kinds of compensation structures will satisfy the Delaware Court of Chancery after its decision in *Citigroup*.[205] The court allowed a claim to survive a motion to dismiss where Citigroup paid a departing CEO despite his alleged responsibility for the failures of the company, and corporate advisers now recommend that compensation agreements should tie reward to long-term measures of corporate success.[206] The problem with this recommendation is that the same stock

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200. *See* Don Pittis, *Popping the Executive Compensation Bubble*, CBCNEWS, Feb. 5, 2009, http://www.cbc.ca/money/story/2009/02/05/f-pittis-ceocompensation html ("The collapse of the Wall Street banks has poked an enormous hole in the idea of merit pay and perquisites."); James Saft, *Is the Executive Pay Bubble Popping?*, REUTERS BLOG (Jan. 28, 2009, 7:59 PM), http://blogs reuters.com/great-debate/2009/01/28/is-the-executive-pay-bubble-popping (demonstrating the link between the housing bubble and executive compensation).

201. *See* Poerio, *supra* note 192 (noting pressure from Washington on TARP and non-TARP executive pay).

202. In the late 1990s the attitude toward executive compensation was that

> The best bargain is an expensive CEO. . . You cannot overpay a good CEO and you can't underpay a bad one. The bargain CEO is one who is unbelievably well compensated because he's creating wealth for the shareholders. If his compensation is not tied to the shareholders' returns, everyone's playing a fool's game.

Elson, *supra* note 43.

203. *See e.g.*, Susanne Craig & Matthias Rieker, *Goldman Bows on CEO Pay—Blankfein's Take for 2009 is Half of Rival's at J.P. Morgan, Amid Public Uproa*r, WALL ST. J., Feb. 6, 2010, at A1 (reporting that Goldman Sachs CEO Lloyd Blankfein would be getting a significantly smaller annual bonus in response to public pressure over pay).

204. *See* Biles & Davis, *supra* note 141.

205. *See id.* ("The Citigroup decision may mark the beginning of a new era in Delaware business jurisprudence.").

206. *See id.*

option[207] plans that attempted to tie executive payment to corporate success are now being blamed for encouraging executives to take too much risk.[208] The irony of this result is that stock option plans were favored because they aligned the interests of executives, who were typically risk-averse, and shareholders, whose appetite for risk is high.[209] Some commentators suggest tying a higher proportion of bonuses to longer term measures of success and to allow "clawbacks" of bonuses earned on deals that later reveal themselves to be unsuccessful.[210]

The impact of the court's decision is contrary to a key purpose of the business judgment rule, which is to recognize that managers and directors should decide how their company will "maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable."[211] The business judgment rule seeks to protect risk takers, not consider how much risk they should have taken.[212] Ultimately, the financial crisis was less likely caused by the fact the corporate executives took on too much risk and more likely caused by the fact that so many took the *same* risk, as is characteristic in market bubbles.[213] In irrational market conditions, even the prospect of going uncompensated has proven to not be enough to stop extreme risk taking.[214] Lehman Brothers provides a powerful example of a highly-respected investment bank with an extreme appetite for risk going bankrupt despite the fact that the company compensated its executives (and all of its employees) based on long-term

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207. A stock option is the right to purchase shares of a company at a certain price at a certain date in the future. *See* ZANDI, *supra* note 23, at 1554.

208. *See* SORKIN, *supra* note 9, at 534. *See also* Editorial, *Bankers and their Salaries*, *supra* note 52, at A18 (quoting the Institute of International Finance) (arguing that bankers should have more of their own money at risk because the compensation schemes of some firms "exacerbated the weaknesses and contributed to the market turmoil").

209. Roshan Sonthalia, Comment, *Shareholder Voting on All Stock Option Plans: An Unnecessary and Unwise Proposition*, 51 UCLA L. REV. 1203, 1207 (2004).

210. Roy C. Smith, *Greed is Good*, WALL ST. J., Feb. 7, 2009, at W1. *But see* Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 96 MINN. L. REV. 368, 390–91 (2009).

211. *In re* Citigroup, 964 A.2d 106, 139 (Del. Ch. 2009).

212. *See id.* at 122 (quoting *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d at 967–68) (noting that the business judgment rule does not look to the content of the board decision apart from consideration of the good faith or rationality of the process employed and that degrees of substantive error in the decision are not relevant).

213. *See* FERGUSON, *supra* note 11, at 121–22, 271 (demonstrating that the housing bubble and subsequent financial crisis were the result of a typical bubble).

214. *See, e.g., infra* notes 215–16 and accompanying text.

measures of success.[215] Such a payment scheme was not enough to stop the company's executives from being a major participant in leveraged and risky speculative investment in real estate securities.[216]

VI. CONCLUSION

By denying Citigroup's motion to dismiss, the Delaware Court of Chancery strayed from the typically rigorous pleading requirements and substantive rule for making a claim of waste for corporate executive compensation decisions.[217] This holding has signaled to corporate directors that the court will not always afford executive compensation decisions the same level of deference that it does other business decisions.[218] This departure will lead to an increase in strike suits,[219] and the court's efforts to encourage corporations to tie compensation more closely to long-term performance will do more harm than good.[220]

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215. *See* McDonald & Robinson, *supra* note 8, at 318 (demonstrating the impact of the failure of Lehman Brothers on its employees, whose bonuses came in the form of stock). *See also* William D. Cohan, *Inside Dick Fuld's Bunker*, THE DAILY BEAST, (Dec. 3, 2009, 12:52 AM), http://www.thedailybeast.com/blogs-and-stories/2009-12-03/inside-dick-fulds-bunker (noting that Dick Fuld, CEO of Lehman Brothers, lost approximately $1 billion in net worth as a result of the Lehman collapse).

216. *See* McDonald & Robinson, *supra* note 8, at 135–36 (demonstrating Lehman Brothers' participation in the highly risky CDO market in the midst of the real estate boom).

217. *See supra* Part V.A.

218. *See supra* Parts V.B–C.

219. *See supra* Part V.B.

220. *See supra* Part V.C.