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OF THE
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Re: In Re The Student Loan Corp. Derivative Litigation. C.A. No. 17799

Dear Counsel:

Before the court is a motion to dismiss a derivative complaint brought on behalf of The Student Loan Corporation against Student Loan's directors, its corporate parent Citibank (New York), and its corporate grandparent, Citigroup, Inc. Citibank (New York) owns 80% of the common stock of Student Loan, and is a wholly owned subsidiary of Citigroup. For the sake of simplicity, I hereinafter refer to both Citibank (New York) and Citigroup

as Citigroup. All entities with names involving the phrase "Citi" are affiliated with Citigroup.

The grounds for the motion are straightforward. The defendants contend that the complaint fails to plead demand futility and should therefore be dismissed under Court of Chancery Rule 23.1. In the alternative, the defendants argue that the complaint fails to state a claim under Court of Chancery Rule 12(b)(6).

In this opinion, I deny the defendants' Rule 23.1 motion. Because four of the six Student Loan directors cannot impartially consider a demand, an adequate excuse for not making a demand exists. Furthermore, I deny the defendants' motion to dismiss the breach of loyalty claim in the complaint because there are pled facts that suggest that certain transactions between Citigroup and Student Loan were not entirely fair. By contrast, I grant the defendants' motion to dismiss the waste claim pled in the complaint because the facts in the complaint do not support the inference that the transactions were so one-sided that no reasonable person could have believed they were fair to Student Loan. I also dismiss the due care allegation in the complaint,

because the complaint is bereft of factual allegations supporting an inference of gross negligence.

<u>The Allegations In The Complaint</u>

In keeping with its name, Student Loan is one of the nation's largest originators, holders, and servicers of student loans. The overwhelming bulk of the student loans it makes are insured under the Federal Family Education Loan program. The company also makes a much smaller amount of uninsured loans.

According to the complaint, Student Loan's board has caused it to conduct its student loan business in a manner that does not maximize Student Loan's profitability as a stand-alone company, but rather to advantage Citigroup. For example, it is alleged that Student Loan holds and services almost all of its loans. In 1997, Student Loan restructured its operations by outsourcing most of its operational functions, including loan origination and servicing, to Citigroup. At approximately the same time as the outsourcing decision was made, the complaint alleges that Student Loan turned down an offer from SLM Holding Corporation ("Sallie Mae"), to process Student Loan's portfolio for an annual fee of 75 basis points, some

35 basis points lower than Citigroup charges the company. According to the complaint, the restructuring also helped Citigroup by enabling it to reduce its existing overhead for loan servicing functions by shifting some of that overhead to Student Loan.

Likewise, the complaint contends that Student Loan has not securitized its loan portfolio for reasons having to do with Citigroup's interests, rather than Student Loan's. According to the complaint:

> [S]ecuritization is a funding mechanism undertaken by selling a portfolio of student loans to an independent entity which can issue securities often of several classes to fund the purchase of the student loans. Such securitization would result in gains on sales of loan portfolios, lower interest rates, servicing costs, and capital reserve requirements, and increased earnings for the Company. [1]

The complaint asserts that Student Loan has not adopted this business strategy because that strategy would reduce the outstanding debt Student Loans to Citigroup and the interest income Citigroup receives on that debt. This debt is substantial, amounting to over eight billion dollars in long- and short-term borrowings as of year end 1998, generating almost $455 million in annual interest and fees to Citigroup. The complaint alleges that Student Loan also pays Citigroup higher interest and fees than its competitor Sallie

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[1] Compl. ¶ 18.

Mae pays on its liabilities, because Student Loan borrows exclusively from Citigroup and does not seek out more competitive terms from other lenders. Not only that, the complaint contends that Student Loan's failure to securitize has required it to keep excessive capital reserves, stunting its ability to expand and increasing its borrowing requirements and costs from Citigroup.

As a result of these practices, Student Loan allegedly has performed poorly in comparison to its primary competitor, Sallie Mae. Student Loan's stock price, return on equity, and return on assets is materially lower than Sallie Mae's.

The complaint alleges that the transactions between Citigroup and Student Loan were approved by a Student Loan board which was comprised of a majority of directors who were beholden to Citigroup. The six-person Student Loan board is alleged to be controlled by a majority consisting of four individuals who allegedly cannot act independently of Citigroup:

- Defendant Bill Beckmann — Beckmann is Student Loan's Chief Executive Officer and President. Before that, he worked for a decade in various managerial positions for Citigroup. Beckmann receives compensation of over $500,000 annually. As part of his compensation, Beckmann receives options to buy Citigroup, not Student Loan, stock.

- Defendant Peter M. Gallant — Gallant is Citigroup's Treasurer, and has been an employee of Citigroup for most of the last quarter century.

- Defendant Carl E. Levinson — Levinson is Student Loan's former CEO. He is now a division executive of Citicorp's Consumer Assets Division and has been Chairman of Citicorp Mortgage, Inc. since 1992. Levinson has worked for Citigroup entities since 1973.

- Defendant Laura D. Williamson — Since 1982, Williamson has served in senior executive positions with Citigroup entities. She is now a'senior executive in charge of Global Strategic Marketing and head of Institutional Sales for the U.S./Canada region of SSB Citi Asset Management.

The complaint also alleges that Gallant, Levinson, and Williamson all have incentive compensation packages that turn, to some unspecified extent, on the success of Citigroup.

Because the Student Loan board is comprised of four directors who supposedly cannot act independently of Citigroup, the complaint contends that the transactions between Citigroup and Student Loan are subject to the entire fairness standard. The transactions do not meet that standard, according to the complaint, because they were not as favorable as the terms that could have been obtained from a third party. Therefore, the complaint asserts a claim for breach of the fiduciary duty of loyalty.

The complaint also contends that the transactions between Student Loan and Citigroup are so disadvantageous to Student Loan as to constitute a waste of corporate assets. The complaint also says the transactions resulted from an unspecified lack of due care on the part of the Student Loan directors.

Is Demand Excused?

The demand excusal issue in this case turns on whether the complaint pleads facts creating a reasonable doubt that the Student Loan board can impartially consider a demand.[2] The defendants argue that the complaint fails to engender such doubt because it simply sets forth the fact that one member of the board is CEO of Student Loan, and that three others are employees of Citigroup.

I disagree. The complaint alleges that Student Loan has engaged in certain transactions and business strategies so as to benefit Citigroup, at the expense of Student Loan itself. In essence, the complaint contends that Student Loan has been managed to maximize the value Citigroup derives

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[2] *Aronson* v. *Lewis,* Del. Supr., 473 A.2d 805, 814-15 (1984).

from controlling it, rather than the performance of Student Loan as an independent entity with public stockholders.

While the complaint does not contain much, if any, elaboration on the compensation paid to the Citigroup-affiliated directors other than Beckmann, the complaint does plainly state that each of the three other affiliated directors is a full-time managerial employee of Citigroup. That is, each owes his livelihood to Citigroup. Indeed, the complaint alleges facts that suggest that all four of the affiliated directors have committed their careers to Citigroup.

As a result, it is difficult to conceive of how any of them could impartially consider a demand in this case. In the case of Beckmann, to accept such a demand would require him to decide to have Student Loan sue Citigroup, an act that would displease a majority stockholder in a position to displace him from his lucrative CEO position. In the case of the other three Citigroup-affiliated directors, to accept such a demand would require them to decide to have Student Loan sue their employer. I find it improbable that

a reasonable person in the position they occupy would not ponder the effect affirmative action on a demand would have on her future at Citigroup.[3]

As a result, I conclude that demand is excused.[4]

Does The Comnlaint State A Claim?

Because demand is excused, the complaint's sufficiency is measured under the pro-plaintiff notice pleading standard of Court of Chancery Rules 8 and 12(b)(6), rather than the particularity standard of Rule 23.1. In considering the motion, I have of course accepted all the allegations of the complaint as true, and drawn all reasonable inferences in the plaintiffs favor.

Without belaboring the issue, I conclude that the complaint states a claim for breach of duty of loyalty. The complaint pleads that the challenged transactions were approved by a board majority that could not act

[3] ***See Rales v. Blasband,*** Del. Supr., 634 A.2d 927, 937 (1993) (where directors owed their livelihoods to a party that would be adversely affected if demand was accepted, they could not act independently). While it would have been useful for the complaint to have stated the compensation the other three directors earn in their jobs at Citigroup, I do not find that essential. Absent some unusual fact — such as the possession of inherited wealth — the remuneration a person receives from her full-time job is typically of great consequence to her. It is usually the method by which bills get paid, health insurance is affordably procured, children's educations are funded, and retirement savings are accumulated.

[4] The defendants have argued that the complaint needs to create a reasonable doubt that a majority of the Student Loan board cannot act independently on a demand. As stated in ***Beneville*** v. York, Del. Ch., 769 A.2d 80, 85-87 (2000), I believe the correct number is three, because that is the number required to block action on a demand.

independently of Citigroup and that the entire fairness standard will apply, with the burden to prove fairness resting initially with the defendants? Furthermore, the complaint has set forth sufficient facts to support an inference of unfairness, if hardly an overwhelming one.

That the complaint states a loyalty claim does not mean that it also states a claim for waste. As Chancellor Allen has pointed out, the policies that apply to loyalty claims implicating the entire fairness standard are quite different from that those apply to waste claims.[6] Waste claims must be supported by a showing that a transaction was effected on terms "that no person of ordinary, sound business judgment could conclude represent a fair exchange."[7]

Even under the notice pleading standard, the complaint does not state facts that suggest that the transactions complained of were so one-sided that the onerous waste standard is satisfied. In essence, the complaint pleads that

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'See, e.g., Steiner *v. Meyerson,* Del. Ch., C.A. No. 13139, mem. op. at 4, Allen, C. (Jul. 18, 1995).

[6] Id. at l-3, 10-17 (discussing these policy differences, and holding that complaint stated a loyalty claim, but not a waste claim, as to certain transactions); *see also Harbor Fin. Partners v. Huizenga,* Del. Ch., 75 1 A.2d 879,892 (1999) (pleading burden on plaintiff attacking a corporate transaction as wasteful is necessarily higher than that of a plaintiff challenging a transaction on loyalty or due-care grounds).

[7] *Steiner,* mem. op. at 2.

Student Loan receives services and capital from Citigroup at a cost that exceeds what Student Loan would have to pay if it procured those services after a full market check. It does not contend that Citigroup did not perform valuable services or provide substantial financing to Student Loan in exchange for the payments it received. And unexplored in the complaint, of course, is whether Student Loan benefits from certain synergies or other offsetting benefits from its relationship with Citigroup that might close that gap.

Finally, the complaint throws in the cursory allegation that the transactions resulted from a lack of due care by the Student Loan directors. But the complaint does not allege that the process by which the Student Loan board approved of the transactions was tainted by gross negligence of any kind. The complaint is utterly devoid of any pled facts regarding the informedness of the board's deliberations, or the lack thereof. As a result, the due care claim is also dismissed.*

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[8] The Student Loan directors have asserted a defense based on the exculpatory provision in the company's certificate of incorporation. Because this is a case to which the entire fairness standard applies "*ab initio,*" I hesitate to consider this defense at this stage given the recent opinion in ***Emerald Partners v. Berlin,*** Del. Supr., No. 96, 2001, slip. op. at 13-14, __ A.2d __ (Nov. 28,200 1, rev. Dec. 2 1,200 1). That opinion can be read to hold that when the entire fairness standard applies, even an independent director cannot obtain dismissal of damage claims against him until after the fairness of the transaction is determined, regardless of whether the

Conclusion

For the foregoing reasons, the defendants' motion to dismiss under Rule 23.1 is denied. The defendants' motion to dismiss under Rule 12(b)(6) is denied in part, and granted in part. The parties shall submit a conforming order within seven days.

In addition, the parties shall set up a scheduling conference to occur within thirty days. This action has been pending for almost two years now, during most of which time the parties were discussing settlement. Some of this delay may be put down to the fact that the complaint was originally filed, in large measure, to address a potential going private transaction proposed and then withdrawn by Citigroup. At this stage, however, the transactions challenged in the complaint are fast becoming faint in the rearview mirror, and the remainder of this case must therefore proceed at a more brisk pace.

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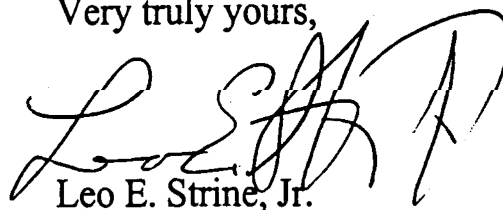
independent director shows, on a Rule 12(b)(6) or Rule 56 motion, that the plaintiffs have submitted no facts or admissible evidence, as the case may be, supporting a finding that the independent director committed a non-exculpated breach of fiduciary duty. *Id.* at 27-30. Before considering the defense, it would be helpful to receive briefing on this new decision.

Furthermore, the director defendants have not addressed this defense on a director-by-director basis. The statute contemplates that the defense is an individual one, belonging to particular directors, rather than the board as a whole. In this regard, the two directors not affiliated with Citigroup may be situated quite differently in terms of their ability to take advantage of the defense than the other directors. Thus, I leave this issue for another day.

Very truly yours,



Leo E. Strine, Jr.

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