

## CORPORATE GOVERNANCE ALERT

### THE *DISNEY* DECISION: DELAWARE CHANCERY COURT FINDS DIRECTORS DID NOT BREACH FIDUCIARY DUTIES IN CONNECTION WITH HIRING AND FIRING OF MICHAEL OVITZ



On August 9, 2005, the Delaware Court of Chancery ruled in favor of The Walt Disney Company's board of directors in the shareholder derivative action challenging the controversial hiring in 1995 and subsequent termination in 1996 of Michael Ovitz as president of Disney. Disney's stockholders claimed that the members of Disney's board at the time those decisions were made did not properly evaluate Ovitz's employment contract and the subsequent no-fault termination, which resulted in a severance package to Ovitz valued at approximately \$140 million after only 14 months of employment. In a 175-page opinion, the court concluded that despite the "spectacular failure" of the union between Disney and Ovitz and the "breathtaking amounts of severance pay," Disney's directors did not breach their fiduciary duties or waste Disney's assets. *See In re The Walt Disney Company Derivative Litigation*, No. 15452 (August 9, 2005) (Chandler, C.).

The court's decision offers a detailed analysis of Delaware law on the subject of the business judgment rule and the fiduciary duty of directors, as well as an instructive tutorial on corporate governance. Significantly, the court emphasized that, while boards of directors should be encouraged to adopt the best practices of corporate governance as they develop over time, "Delaware law does not – indeed the common law cannot – hold fiduciaries liable for a failure to comply with the aspirational ideals of best practices." Instead, the court noted, fiduciary duties – unlike best practices – do not change over time, and, accordingly, the court applied the traditional protections afforded directors of Delaware corporations under the business judgment rule, which shields directors from liability for decisions made by them so long as they do not violate their fiduciary duties and are deemed to have acted in good faith. The court found that, although many aspects of the Disney directors' conduct in connection with the decision to hire and terminate Mr. Ovitz did not comport with much of the currently prevailing wisdom on corporate governance practices, their conduct did not violate their fiduciary duties of care and loyalty and, therefore, did not support a finding of liability under Delaware law. Indeed, as the court pointed out, in a case where directors have complied with their fiduciary duties with respect to a particular action but the outcome of their decision proved to be damaging to the corporation, "[t]he redress ... must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court."

## **THE BUSINESS JUDGMENT RULE AND FIDUCIARY DUTIES**

### ***The Business Judgment Rule***

The business judgment rule is a common-law doctrine which presumes that, absent evidence of fraud, bad faith (including waste of corporate assets) or self dealing, the directors of a corporation act on an informed basis and with the good faith belief that their actions are in the best interests of the corporation. To defeat the presumption, it must be proven that the directors violated one of their fiduciary duties to the corporation, which are typically classified as the duty of care and the duty of loyalty; if that can be demonstrated, then the burden shifts to the directors to prove that the action taken was “entirely fair” to the corporation and the stockholders. If the presumption is not rebutted, then the rule will continue to apply and operate to uphold the directors’ action, so long as the action can be attributed to any “rational business purpose.” As such, the rule is designed to prevent courts from imposing themselves unreasonably on the conduct of the business of a corporation, and to encourage directors to take actions that may entail an element of risk without fear of legal liability that will turn on the outcome of the action.

### ***Duty of Care and Duty of Loyalty***

The fiduciary duties owed by directors of a Delaware corporation are the duties of care and loyalty. The fiduciary duty of care requires that directors of a Delaware corporation “use that amount of care which ordinarily careful and prudent men would use in similar circumstances, and consider all material information reasonably available in making decisions.” A violation of the duty of care will be found if the directors’ actions are determined to be “grossly negligent,” which, as indicated by the court in *Disney*, means “reckless indifference to or a deliberate disregard” for the stockholders as a group or actions that are “without the bounds of reason.” The fiduciary duty of loyalty, on the other hand, requires that “the best interest of the corporation and its shareholders take precedence over any interest possessed by a director, officer or controlling shareholders and not shared by the stockholders generally.” As indicated by the court, the duty is typically implicated when a fiduciary “appears on both sides of a transaction or receives a personal benefit not shared by all the shareholders.” The court also noted that “deliberate indifference and inaction in the face of a duty to act” constitutes an act of disloyalty to the corporation.

### ***Duty of Good Faith***

The court in *Disney* addressed the issue of whether there is an independent fiduciary duty of good faith, in addition to the duties of due care and loyalty, noting that the case law on this issue is unclear. While the court did not conclude that a separate duty of good faith exists, stating instead that such a duty was effectively inherent in the two traditional duties of due care and loyalty, it nevertheless analyzed what it means for a director to act in “good faith” because, as is the case with many other Delaware corporations, the charter of The Walt Disney Company included a provision (authorized under Section 102(b)(7) of the Delaware General Corporation Law) that exculpates directors from monetary liability for breaches of the duty of care, so long as the directors act in good faith. According to the court, the appropriate (although not the only) standard for determining whether a director acted in good faith (or, more accurately, “bad faith”) is whether the director evinced an “intentional dereliction of duty, a conscious disregard for one’s responsibilities.” By way of example, the court cites authorization of a transaction for some purpose other than advancing the best interests of the corporation, an intentional violation of positive law or an intentional failure to act in the face of a known duty to act as instances in which bad faith should be found. Furthermore, the court noted that bad faith can “be the result of any emotion that may cause a director to intentionally place his own interests, preferences or appetites before the welfare of the corporation.” However, the court expressly rejected the notion that gross negligence, extreme carelessness or even recklessness is sufficient to support a finding of bad faith; it requires a finding of intentional, deliberate or conscious misconduct.

## THE COURT'S ANALYSIS WITH RESPECT TO THE CLAIMS AGAINST THE INDIVIDUAL DEFENDANTS

The court concluded with respect to each defendant (which included each member of the board of directors at the time the decisions with respect to Mr. Ovitz were made, as well as the general counsel of Disney at the time) that the plaintiffs had failed to rebut the presumption of the business judgment rule since none of the defendants violated the duty of care (or, as only applicable to Mr. Ovitz, the duty of loyalty) or had acted in bad faith. The court ruled that the actions of the directors in connection with the hiring of Mr. Ovitz were “at most ordinarily negligent,” which was insufficient to violate the duty of care. It further ruled that, since the directors had no duty under Disney’s certificate of incorporation or bylaws to act in connection with the termination of Mr. Ovitz – which was effected by Mr. Eisner without a board vote – the directors did not breach any fiduciary duty by failure to prevent that action.

The court, in the course of analyzing the decision-making process by which Mr. Ovitz was appointed as president and his employment agreement was approved and the subsequent move to terminate his employment, found significant deficiencies in that process that, while not actionable, were certainly less than model examples of corporate behavior and hindered the board’s decision-making abilities. It noted in particular that Mr. Eisner had stacked his board with friends and acquaintances (for instance, Eisner’s personal attorney was chairman of Disney’s compensation committee, and that director was principally responsible for negotiating Ovitz’s employment agreement for Disney), and that he had failed to keep the board as informed as it should have been with respect to the hiring of Ovitz. Indeed, the court noted that Eisner effectively pushed “the outer boundaries of his authority” by hiring Ovitz as president without specific board direction or involvement, and only sought after-the-fact ratification of that action by the full board. It also criticized the members of the compensation committee (other than the chairman) for not doing more to inform themselves of the terms of Ovitz’ employment agreement and to become involved in the review and approval process. Nevertheless, the court found that all of the individual defendants, including Eisner, had acted without gross negligence and in good faith, believing that they were acting in the best interests of the company.

The court specifically distinguished *Disney* from *Smith v. Van Gorkom*<sup>1</sup>, the seminal Delaware case finding a violation of the duty of care by directors. In that case, the Delaware Supreme Court ruled that the board of directors, in agreeing to the sale of the company after a perfunctory board meeting called without prior notice during which the directors were unable to review any documentation with respect to the transaction, had violated the duty because they had acted in an uninformed manner. In contrast, the court noted that the Disney board had been provided with advance notice of the board meeting at which the Ovitz employment agreement would be considered and had been furnished with a detailed term sheet regarding the agreement (although the court did observe that the meeting lasted only about an hour and involved the consideration of a number of other items, so that the thoroughness of the review accorded the employment agreement at the meeting was somewhat unclear). The court also noted that the materiality of the matter being considered in the *Van Gorkom* case, the sale of the company, was “fundamentally different, and orders of magnitude more important” than the hiring of Ovitz.

## LESSONS FROM THE CASE

Although the court ruled that the conduct of the Disney board members was not sufficient to create liability, the court’s critique of their conduct provides useful guidance for boards seeking to adopt corporate governance best practices. Indeed, had best practices been followed by the Disney board, it is likely the defendants would have been spared years of protracted litigation and adverse publicity. Among other things, the case highlights the importance of active participation by outside directors in the board’s decision-making process and the need to ensure that the company’s executive officers keep the directors fully informed on a timely basis of significant corporate

<sup>1</sup> 488A.2n 858 (Del. 1985)

developments. Although the court acknowledged that a board cannot be expected to manage the everyday affairs of a corporation, it warned that the board should not be put in a position where it is asked to ratify an important corporate action, such as the hiring of a second-in-command, when as a practical matter the action is a *fait accompli*. Furthermore, the opinion emphasized the need for a board to be sufficiently independent to say “no” to a chief executive, particularly one that tends to act in an imperial manner, such as (according to the court) Mr. Eisner.

The case also underscores the importance of process in corporate governance and board decisions. The court was critical of the failure of those outside directors who were directly involved in the review of Mr. Ovitz’s employment contract to investigate thoroughly the circumstances surrounding his hiring and analyze the terms of the contract. In that regard, boards should consider the need to retain their own independent experts, and, if retained, those experts should be asked to make formal presentations to the board or the relevant committee where directors can question them directly, rather than rely on management to summarize their conclusions (in *Disney*, the court noted that, although the company did retain a prominent executive compensation specialist to review the proposed terms of Ovitz’s contract, his work product was not distributed to all the members of the compensation committee and he was never asked to present his conclusions directly to the members of the committee). In a somewhat related point, the court also noted the significance of comprehensive minutes and written legal opinions in evidencing the thoroughness of a board’s deliberations, indicating that it would have been helpful to the defendants’ case had the minutes regarding the compensation committee’s meeting at which it considered Mr. Ovitz’s employment contract been clearer and had there been written evidence that the company’s general counsel had considered whether Ovitz could have been terminated for cause so as to avoid the enormous termination payment. Although improved documentation would not necessarily avoid a legal challenge to board action, it may have some influence on whether such a lawsuit would proceed far in Delaware courts.

## CONTACT INFORMATION

If you have questions or would like to learn more about this topic, please contact the partner who represents you, or:

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