June 26, 2006

CORPORATE GOVERNANCE ALERT

DELAWARE SUPREME COURT AFFIRMS *DISNEY* DECISION

On June 8, 2006, a unanimous Delaware Supreme Court affirmed the Chancery Court's opinion in the Michael Ovitz compensation case, confirming that Disney directors did not violate their fiduciary duties or act in bad faith in connection with the hiring and subsequent termination of Ovitz, which resulted in a severance package worth close to $130 million after only 14 months of employment. The Supreme Court upheld all factual and legal conclusions of the Chancery Court's "well-crafted" decision, affirming the strength of the business judgment rule in Delaware and elaborating on the duty of good faith to provide much needed "conceptual guidance to the corporate community."[1]

INITIAL RULING: BACKGROUND FROM THE CHANCERY COURT DECISION

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 $130 million. The Chancery Court concluded that despite the failure of the union between Disney and Ovitz and the significant severance pay, Disney's directors did not breach their fiduciary duties or waste Disney's assets.[2]

THE SUPREME COURT REAFFIRMS BUSINESS JUDGMENT RULE, ARTICULATES DUTY OF GOOD FAITH

In affirming the Chancery Court's ruling, the Supreme Court reaffirmed the strength of the business judgment rule and the protection it affords directors in their decision-making. The Court also clarified the concept of the duty of good faith and re-emphasized the lessons provided by the initial ruling with respect to corporate governance "best practices."

[1] *See In re The Walt Disney Co. Deriv. Litig.*, Del. No 411, 2005 (June 8, 2006).
[2] *See In re The Walt Disney Co. Deriv. Litig.*, Del. No. 15452 (August 9, 2005) (Chandler, C.).

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The Business Judgment Rule

The Supreme Court's *Disney* decision upholds the traditional protections afforded directors of Delaware corporations under 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; 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.

The plaintiffs in the Chancery Court 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 Supreme Court's affirmation of the Chancery Court's ruling further held that:

> [T]he Court of Chancery correctly determined that the decisions of the Disney defendants to approve the [employment agreement], to hire Ovitz as President, and then to terminate him on [a non-fault termination] basis, were protected business judgments, made without any violations of fiduciary duty.

Duty of Good Faith

The Supreme Court in *Disney* recognized a separate fiduciary duty of good faith, which is closely tied to the traditional fiduciary duties of care and loyalty owed by directors of Delaware corporations. Many Delaware corporations, The Walt Disney Company being no exception, include in their charter 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. The Supreme Court, to clarify the "relatively uncharted" good-faith standard, discussed three categories of director conduct that are often implicated in a breach of the duty of good faith, being careful to note that the list was not by any means exhaustive.

- First, at one end of the spectrum, a breach of the duty to act in good faith occurs when there is "subjective bad faith," that is, "fiduciary conduct motivated by an actual intent to do harm." Such conduct represents the "classic, quintessential bad faith" well-accepted in fiduciary law.

- At the other end of the spectrum is action on the part of directors that is grossly negligent, but without malevolent intent. The Supreme Court clarified that gross negligence by itself "does not and cannot constitute a breach of the fiduciary duty to act in good faith." To find otherwise, the court noted, would render the protections offered by Section 102(b)(7) illusory.

- Finally, in between the extremes of subjective bad faith and gross negligence is directorial conduct that involves no conflicting self-interest yet is more culpable than simple inattention or failure to be informed of all facts material to a decision. The Supreme Court clarified that this type of conduct can constitute a breach of the duty of good faith when there is an "intentional dereliction of duty" and a "conscious disregard for one's responsibilities" — as the Chancery Court's non-exclusive definition stated before.

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While the Supreme Court elaborated on the concept of the fiduciary duty to act in good faith, it did not address the issue of whether the fiduciary duty to act in good faith is a duty that can "serve as an independent basis for imposing liability upon corporate officers and directors."

FAILURE TO IMPLEMENT BEST PRACTICES: A COSTLY MISTAKE, BUT NOT GROUNDS FOR LIABILITY

The Supreme Court affirmed the dismissal of the claims against the *Disney* defendants, though the Court recognized the defendants' decision-making process fell short of corporate governance "best practices." The Supreme Court echoed the prior decision of Chancellor Chandler, which 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." The Supreme Court agreed with this logic and declined to impose emerging best practices as the appropriate standard for evaluating director conduct, instead upholding the traditional protections afforded directors of Delaware corporations under the business judgment rule. 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. Redress for such situations, as the Chancery Court noted, "must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court."

With respect to best practices, the Supreme Court indicated that in a "best case" scenario all of the compensation committee members would have been more informed and more involved in the hiring of Mr. Ovitz. Had such procedures been followed, and had there been better communication, disclosure and documentation of the entire process, the Supreme Court noted that there would have been "no basis for litigation."

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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