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DELAWARE CHANCERY COURT IN DISNEY AFFIRMS BUSINESS JUDGMENT RULE DEFERENCE; FAILURE TO ABIDE BY BEST PRACTICES NOT TANTAMOUNT TO FIDUCIARY DUTY BREACH

On August 9, 2005, Chancellor William B. Chandler III issued the much anticipated opinion of the Delaware Court of Chancery in *In re The Walt Disney Company Derivative Litigation*, a matter described by the court as "something of a public spectacle." Chancellor Chandler held that each director of The Walt Disney Company fulfilled his or her obligation to act in good faith and with honesty of purpose consistent with his or her fiduciary duties under Delaware law in connection with the hiring and termination of Michael Ovitz as the President of Disney. The plaintiff has indicated its intention to appeal.

Importantly, the court articulated that while boards of directors should be encouraged to embrace "best practices" of ideal corporate governance as those practices evolve from time to time, Delaware law does not hold fiduciaries liable for a failure to comply with what the court termed "aspirational ideals." The court noted that fiduciary duties, unlike best practices, do not change over time. Perhaps most significantly, the court resisted the temptation and opportunity, presented by a set of arguably "bad facts" in a politically charged environment, to abrogate the traditional protections afforded directors of Delaware corporations under the doctrine of the "business judgment rule," and stressed that while it is easy to fault a decision that ends in failure, redress for such missteps must come from the markets and the free flow of capital, and not from the courts.

The case stemmed from the celebrated hiring in 1995 and the "no fault" termination scarcely one year later of Ovitz. Although Ovitz had been highly compensated as the co-founder and half owner of privately-held Creative Artist Agency, with his annual compensation estimated at $20-25 million, the financial package Ovitz obtained from publicly-traded Disney (particularly for a non-chief executive officer) was regarded at the time as extraordinary – valued at approximately $24 million per year. The "no fault" termination of Ovitz by Disney entitled Ovitz under the terms of his employment agreement to a severance package that included an immediate cash payment of

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approximately $38 million and acceleration of Ovitz's stock options and was reported by the press to be worth approximately $140 million. Plaintiffs alleged derivatively on behalf of Disney that the directors breached their fiduciary duties in connection with the hiring and firing.

Soon after Ovitz's termination plaintiff's commenced the subject derivative action claiming, among other things, that the Disney board of directors breached their fiduciary duties by "rubber stamping" the hiring of, and exorbitant financial package given to, Ovitz in a *fait accompli* orchestrated by Eisner and publicly announced by Disney before the compensation committee or the full board had even been convened to consider it, by failing to act in connection with the termination of Ovitz's employment by Eisner and by committing corporate waste by permitting severance obligations to be paid to Ovitz who rightly either should have been terminated by Disney for cause or regarded as having resigned.

In describing the applicable legal standards, Chancellor Chandler noted at the outset that "the best practices of corporate governance include compliance with fiduciary duties. Compliance with fiduciary duties, however, is not always enough to meet or satisfy what is expected by the best practices of corporate governance." Failing to satisfy those best practices is not actionable under Delaware law.

The court next explained that under well-settled Delaware law the business judgment rule affords the directors of a corporation the presumption that in making a business decision the directors acted on an informed basis and that the action taken was in the best interests of the corporation and its shareholders and, unless the presumption is rebutted by the plaintiff, that accordingly the board's decision will be upheld unless it cannot be attributed to any rational business purpose or unless the conduct constitutes corporate waste. The presumption can be rebutted if the plaintiff demonstrates that the board violated one of its fiduciary duties in connection with the challenged transaction. The court explained that the applicable fiduciary duties for the directors are the traditional duties of loyalty and care as well as what the court referred to as "the so-called third fiduciary duty" -- the duty to act in good faith. The duty of loyalty largely was not implicated in the case (other than with respect to allegations against Ovitz), and the court's opinion centered on a discussion of the duties of care and good faith. The court observed that the liability of directors must be determined on an individual basis because the conduct of the directors can vary by individual.

Furthermore, Chancellor Chandler explained that where the challenged conduct involves inaction rather than affirmative action by the board, as was in part the case in the matter before the court, the business judgment rule does not apply and the appropriate standard for determining liability is gross negligence (although the court observed that one Delaware case – curiously not cited by the plaintiffs, the court noted – had held that ordinary negligence was sufficient to find liability). Finally, the court explained that there is such an onerous burden on plaintiffs to demonstrate corporate waste – proving that an irrational squander of assets occurred in a context that otherwise didn't involve a breach of the duty of loyalty – that corporate waste very rarely is found by a Delaware court to have occurred.

Applying these legal standards to the facts, the court noted that in determining whether the duty of care has been met involves an assessment of whether the challenged decision was the product of a process that was deliberately considered in good faith or otherwise was rational and not an assessment of whether the content of the decision was unsound or even "stupid." Moreover, the court noted that in determining whether the duty of good faith has been met involves an inquiry beyond whether the duties of care and loyalty have been met and extends to a determination that there has been an overarching true faithfulness to and devotion to the interests of the corporation and its shareholders.[1]

Although the court observed that Eisner's lapses were many, including the fact that he "stretched the outer boundaries of his authority as CEO by acting without specific board direction or involvement" in announcing the hiring of Ovitz, that his premature issuance of a press release placed significant pressure on the board to accept Ovitz and approve Ovitz's employment terms and that he stacked the board with friends and other acquaintances who were "certainly more than willing to accede to his wishes," the court ultimately concluded that Eisner had acted in good faith and without gross negligence. The court determined that other directors who had been members of the compensation committee that approved Ovitz's employment agreement but who had played almost no role in its negotiation and spent little time deliberating, nonetheless acted in the good faith and without gross negligence. In distinguishing this case from *Smith v. Van Gorkom*[2], where the Delaware Supreme Court condemned the Trans Union board for agreeing to a material transaction after a perfunctory board meeting of about two hours and without so much as a term sheet of the transaction as contemplated (and in the face of management opposition to the transaction), the court focused on the materiality of the matter under consideration as being partially determinative of the process to be employed by the board or the applicable committee thereof. The court noted that the although the compensation committee of Disney's board met for no more than one hour before approving Ovitz's hiring, it had been provided with advance notice and a detailed term sheet and that the materiality of the matter at hand was significantly less than the amount of commitments that Disney's head of film production was authorized to enter into without obtaining any further approvals.

While Chancellor Chandler's decision affirms the presumption afforded directors under the business judgment rule, it does highlight the importance of the elements of the duty of good faith and need for boards of directors and committees thereof to employ processes that are appropriately tailored to the materiality of the matter under consideration. Moreover, in the current environment (with its particular emphasis on executive compensation), it is not inconceivable that the court could have found differently had the facts been slightly different.

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1 The court noted that it is precisely in the context of an imperial CEO – like Eisner – with a supine or passive board that the concept of good faith may prove most meaningful because the fiduciary duties of care and loyalty, as traditionally defined, may not adequately protect shareholder interests and the concept of good faith serves to fill the gaps.

2 488 A.2d 858 (Del. 1985)

Finally and perhaps most importantly, the valuable lesson to be learned from the *Disney* matter is that, while acting in good faith may insulate a director from legal liability, acting through a robust, deliberative process can help insulate a director from criticism and the distraction of a highly publicized and protracted litigation.

In Re The Walt Disney Company Derivative Litigation, Del. Ch., C.A. No. 15452, August 9, 2005.

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This memorandum constitutes only a general description of the *Disney* opinion. It is not intended to provide legal advice and no legal or business decision should be based on its content. Any questions concerning the foregoing should be addressed to any of the following members of our Mergers & Acquisitions Group:

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