Corporate Securities

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The Walt Disney Case — Some Lessons On Corporate Governance

Recently, Chancellor William B. Chandler III of the Delaware Court of Chancery released his decision *In re: The Walt Disney Company Derivative Litigation*. The case involved an attack on the Disney board of directors' approval of an executive compensation contract with Michael Ovitz, as well as its implicit approval of a non-fault termination that resulted in a large award to Ovitz (allegedly exceeding US$140 million) after barely one year of employment.

Background

In 1994, the president of Disney died in a helicopter crash and two other senior officers left the company shortly thereafter. Michael Eisner, the Chief Executive Officer of Disney, took it upon himself to hire a new president and chose Michael Ovitz. Ovitz had never been an executive of a publicly-owned entertainment company; however, he had been Eisner's close friend for over twenty-five years. It was at this point that the impugned corporate governance process is alleged to have begun to unfold. In particular:

- Notwithstanding some initial objections by certain board members, Eisner unilaterally pushed forward with the hiring of Ovitz.
- The compensation committee appears to have spent less than 20 minutes considering Ovitz's employment.
- Neither the compensation committee nor the full board was given a copy of the draft employment agreement or any materials showing the potential payout to Ovitz under the contract, the possible cost of his severance package or how the agreement compared with similar agreements in the entertainment industry — instead, they relied upon an incomplete summary of the agreement.
- No expert was retained to assess Ovitz's employment and guide the compensation committee or the board through the process.
- The compensation committee granted Eisner the authority approve the final terms and conditions of the contract, even though certain of the material terms had not been resolved and the agreement was still a "work in progress".
- The board met immediately after the meeting of the compensation committee and, although it appears that the compensation committee did not make any recommendation or report to the board concerning its resolution to hire Ovitz, the board decided to appoint Ovitz president of Disney and left the final negotiation of the employment agreement to Eisner.

With the approval of the compensation committee and the board, Ovitz, Eisner and their attorneys negotiated the final terms of the employment agreement over the next few months. At the time of execution, the final terms of the agreement differed significantly from the drafts summarized for the compensation committee, and those differences were beneficial to Ovitz. Neither the compensation committee nor the board reviewed or approved the final form of Ovitz's employment agreement before it was executed.

Ultimately, Ovitz's tenure with Disney proved unsuccessful. Ovitz did not know his job and "studiously avoided attempts to be educated".

Approximately one year after Ovitz became president, he wanted to leave Disney. However, if Ovitz resigned outright, he might have been liable to Disney for damages and would not have received the benefits of the non-fault termination. Eisner and Ovitz ultimately finalized a non-fault termination. It appears that neither the board of directors nor the compensation committee had been consulted about or gave their approval for a non-fault termination. In addition, no record exists of any action by the board once the non-fault termination became public, nor did any board member raise any question or concern. There is also no record showing that alternatives to a non-fault termination were ever evaluated by the board or any of its committee.

The Decision

The Court had little difficulty deciding that the allegations, if ultimately proved, formed the basis for a claim against the directors of Disney. The Court summarized its decision in the following passage:

> "Stated briefly, plaintiffs' new allegations give rise to a cognizable question whether the defendant directors of the Walt Disney Company should be held personally liable to the corporation for a <u>knowing or intentional lack of due care in the directors' decision-making process</u> regarding Ovitz's employment and termination. It is rare when a court imposes liability on directors of a corporation for breach of the duty of care, and this Court is hesitant to second-guess the business judgment of a disinterested and independent board of directors. But the facts alleged in the new complaint do not implicate merely negligent or grossly negligent decision making by corporate directors. Quite the contrary; plaintiffs' new complaint suggests that the Disney directors <u>failed to exercise *any* business judgment</u> and <u>failed to make *any* good faith attempt to fulfill their fiduciary duties</u> to Disney and its stockholders. Allegations that Disney's directors abdicated all responsibility to consider appropriately an action of material importance to the corporation puts directly in question whether the board's decision-making processes were employed in a good faith effort to advance corporate interests. In short, the new complaint alleges facts implying that the Disney directors failed to "act in good faith and meet minimal proceduralist standards of attention." [emphasis added]

Lessons From the Case

The facts alleged in *Disney* arguably illustrate an extreme example of poor corporate governance — a situation where the directors did not "exercise *any* business judgment or make *any* good faith attempt to fulfill their fiduciary duties". At this point, the decision should not be seen as an erosion of the business judgment rule or a fundamental change in the approach of the courts to evaluating director conduct. Nevertheless, we believe that the following lessons are illustrated by the case:

- in the post-Enron environment, the U.S. courts appear to be applying a high level of scrutiny to allegations of board misconduct — it is reasonable to assume that Canadian courts will take a similar approach in appropriate cases,

- in making decisions — even where there are no real or apparent conflicts of interest — directors must ensure that they have taken all reasonable steps to inform themselves, have devoted sufficient time to consideration of the information and, where appropriate, have sought advice from relevant experts and counsel, and

- directors should keep careful minutes to support their decisions, which appropriately document not only the decisions made, but also the process through which those decisions were reached.

Please do not hesitate to contact any member of the Goodmans corporate/securities team to discuss corporate governance issues.

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