

CORPORATE LAW — FIDUCIARY DUTIES OF DIRECTORS — DELAWARE COURT OF CHANCERY FINDS DISNEY DIRECTORS NOT LIABLE FOR APPROVAL OF AN EMPLOYMENT AGREEMENT PROVIDING \$140 MILLION IN TERMINATION PAYMENTS. — *In re Walt Disney Co. Derivative Litigation*, No. Civ. A. 15452, 2005 WL 2056651 (Del. Ch. Aug. 9, 2005).

The problem of outsized executive compensation in the face of poor shareholder returns has in recent years been one of the most salient issues in both corporate governance scholarship¹ and the business media.² Some observers — indeed, even some corporate executives themselves — have suggested that this phenomenon is partly due to a lack of care on the part of corporations’ directors, who set executive pay and are not deterred from treating the corporate treasury as “play-money.”³ Recently, in *In re Walt Disney Co. Derivative Litigation*⁴ (*Disney IV*), the Delaware Court of Chancery determined that the officers and directors of the Walt Disney Company (Disney) did not breach their fiduciary duties by offering, after only cursory consideration, an employment agreement to an executive that ultimately provided him with a compensation package worth more than \$140 million — despite decidedly less-than-stellar performance during the fifteen months of his employment.⁵ The decision reaffirmed the Delaware courts’ “reluctance to second-guess ill-advised management decisions,” even those resulting from “a thoroughly inadequate board process,”⁶ and will thus do little to curb the corporate abuses and the “imperial CEO”⁷ mentality that have generated such widespread disapproval among commentators.

Michael Ovitz cofounded Creative Artists Agency (CAA) in the mid-1970s and built it into one of the most successful Hollywood tal-

¹ See, e.g., LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE (2004); Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 847–50 (2002); Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 569 (2001).

² See, e.g., Claudia H. Deutsch, *My Big Fat C.E.O. Paycheck*, N.Y. TIMES, Apr. 3, 2005, § 3, at 1; Ben White & Carrie Johnson, *Executives Cash In, Regardless of Performance*, WASH. POST, Mar. 22, 2005, at E1.

³ See, e.g., BERKSHIRE HATHAWAY INC., 2003 ANNUAL REPORT 8 (2004) (internal quotation marks omitted), available at <http://www.berkshirehathaway.com/2003ar/2003ar.pdf>; see also *id.* at 7 (stating that, in compensation negotiations, “too often one side — the [executive’s] — has cared far more than the [compensation committee’s side] about what bargain is struck”).

⁴ No. Civ. A. 15452, 2005 WL 2056651 (Del. Ch. Aug. 9, 2005).

⁵ See *id.* at *1.

⁶ Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1680 (2001).

⁷ *Disney IV*, 2005 WL 2056651, at *40 n.487.

ent agencies.⁸ In 1995, Michael Eisner, Ovitz's longtime friend and Disney's CEO,⁹ approached Ovitz to discuss Ovitz's joining Disney as a senior member of its management team.¹⁰

Irwin Russell, who served as a Disney director and as the chairman of the board's compensation committee, negotiated Ovitz's employment agreement on behalf of Disney.¹¹ The negotiations proved contentious because Disney, a publicly traded company, was unable to offer Ovitz the rich cash compensation that he earned at privately held CAA.¹² Russell and Ovitz compromised, agreeing that Disney would grant Ovitz stock options to supplement his salary and, if the options were not worth at least \$50 million by the end of the vesting period, would pay Ovitz cash to account for the difference.¹³ Russell and Ovitz also agreed to termination provisions: notably, if Disney terminated Ovitz's employment without cause,¹⁴ Ovitz was entitled to large cash payments and immediate vesting of certain stock options.¹⁵

At this point, the only members of Disney's board who were aware of the agreement's terms were Eisner, Russell, and another compensation committee member.¹⁶ In August 1995, before obtaining board approval for the hire, Eisner and Russell contacted the remaining directors and caused Disney to issue a press release regarding Ovitz's hiring.¹⁷ The compensation committee convened six weeks later and formally approved the term sheet during a one-hour meeting in which the committee also addressed several other substantive compensation

⁸ See *id.* at *3-4.

⁹ *Id.* at *3.

¹⁰ *Id.* at *5. Eisner's motivation to hire Ovitz stemmed primarily from Disney's need to identify a successor to Eisner, who was having health problems, *id.* at *3, Eisner's desire to ensure that Ovitz would not work for a competitor, *id.* at *5 & n.19, and the support of two of Disney's largest shareholders, *id.* at *5.

¹¹ See *id.* at *5.

¹² See *id.* at *5-6. Ovitz's annual compensation at CAA exceeded \$20 million. *Id.* at *5.

¹³ *Id.* at *6. In subsequent communications to shareholders, Disney stated that stock options "directly relate . . . remuneration to stock price appreciation," Walt Disney Co., Definitive Proxy Statement (Form DEF 14A), at 9 (Jan. 9, 1997), and that Disney "declined to pay Mr. Ovitz any . . . form of compensation not dependent *solely* upon [Disney's] future growth," *id.* at 14 (emphasis added).

¹⁴ The employment agreement defined a cause for termination as either "gross negligence or malfeasance." *Disney IV*, 2005 WL 2056651, at *6.

¹⁵ See *id.*

¹⁶ *Id.* at *7.

¹⁷ *Id.* at *7-9. Eisner did not, however, inform the other directors that Disney's general counsel and its chief financial officer had expressed concern that Ovitz would disrupt leadership cohesiveness. *Id.* at *8, *10.

issues.¹⁸ Following the committee meeting, the full board voted unanimously to elect Ovitz as Disney's president.¹⁹

Although the board's approval of Ovitz's contract was a simple process, Ovitz's transition into his new role did not go as smoothly. In addition to "difficulties . . . assimilating to Disney's culture,"²⁰ Ovitz clashed with Eisner and other Disney executives over business strategy, management style, and expense policy.²¹ By late 1996, it became clear that Ovitz had no future with Disney.²² Eisner sought advice regarding the obligations that would arise out of Ovitz's termination, and Disney's general counsel informed him that Ovitz's conduct would not support a termination for cause.²³ Thus, when Disney formally terminated Ovitz in December 1996,²⁴ the absence of cause triggered its obligation to pay Ovitz a severance package allegedly valued at approximately \$140 million.²⁵

Shortly thereafter, a group of stockholders brought a derivative action on behalf of Disney, alleging breach of the fiduciary duty of loyalty against Ovitz and both corporate waste and breach of fiduciary duties against the directors who approved Ovitz's employment agreement and the directors who classified Ovitz's termination as without cause.²⁶ After surviving the defendants' motion to dismiss²⁷ and Ovitz's motion for summary judgment as to the claims against him,²⁸ the case proceeded to a trial that lasted for three months and resulted

¹⁸ See *id.* at *9. The committee also discussed, among other things, compensation packages and stock option grants for over 100 Disney employees, as well as an employment agreement for another arriving executive. *Id.* Additionally, although Russell did summarize the findings of an executive compensation expert whom he had hired to consult on Ovitz's pay package, he did not share with the other committee members the expert's report. See *id.*

¹⁹ *Id.* at *10.

²⁰ *Id.* at *11.

²¹ See *id.* at *14–16.

²² See *id.* at *17–19.

²³ See *id.* at *20.

²⁴ See *id.* at *24–26. Neither Disney's compensation committee nor its full board discussed Ovitz's termination or sought independent legal advice as to whether the termination could have been classified as one for cause. See *id.* at *24–25.

²⁵ See *Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000); *In re Walt Disney Co. Derivative Litig. (Disney II)*, 825 A.2d 275, 279 (Del. Ch. 2003).

²⁶ See *Disney IV*, 2005 WL 2056651, at *1 (describing the causes of action); *id.* at *37, *39, *47 (describing the defendant groups); see also *Disney II*, 825 A.2d at 278 n.2 (explaining the distinction between the two groups of director defendants).

²⁷ See *In re Walt Disney Co. Derivative Litig. (Disney I)*, 731 A.2d 342, 380 (Del. Ch. 1998) (granting the defendants' motion to dismiss), *aff'd in part and rev'd in part sub nom., Brehm*, 746 A.2d at 248–49, *remanded to Disney II*, 825 A.2d at 291 (denying the remanded portion of the motion to dismiss).

²⁸ See *In re Walt Disney Co. Derivative Litig. (Disney III)*, No. Civ. A. 15452, 2004 WL 2050138, at *1 (Del. Ch. Sept. 10, 2004) (denying in part and granting in part Ovitz's motion for summary judgment).

in a verdict, delivered by Chancellor Chandler, in favor of the defendants on all causes of action.²⁹

The court first concluded that Ovitz did not breach his fiduciary duty of loyalty by accepting his severance payment because Ovitz did not negotiate the terms of his employment during his tenure as a fiduciary and played no role in the decision to trigger the severance payment through a termination without cause.³⁰ Next, the court found that the directors did not commit waste because Disney was indeed better off without Ovitz as its president.³¹ In a similarly straightforward finding, the court determined that the directors did not breach any fiduciary duty related to their service at the time of Ovitz's dismissal.³²

The court's most difficult conclusion was that, in approving Ovitz's compensation package, none of the directors breached his or her fiduciary duty of due care. Ordinarily, directors are entitled to a presumption, known as the business judgment rule, that prevents courts from "engag[ing] in a *post hoc* substantive review of business decisions."³³ Directors lose the rule's protection, however, if they violate their fiduciary duties.³⁴ As formulated by the Delaware courts, "[t]he fiduciary duty of due care requires that directors . . . 'use that amount of care which ordinarily careful and prudent men would use in similar circumstances' and 'consider all material information reasonably avail-

²⁹ *Disney IV*, 2005 WL 2056651, at *1. The derivative plaintiffs have appealed the decision. *Shareholders Appeal Ruling on Disney*, L.A. TIMES, Sept. 9, 2005, at C2.

³⁰ *Disney IV*, 2005 WL 2056651, at *37. The fiduciary duty of loyalty requires that a fiduciary refrain from substantively unfair self-dealing, which occurs "when [the fiduciary] deals directly with the corporation" by being "on both sides of a transaction." *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1169 (Del. 1995) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)); see also *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939) (explaining the public policy that the duty of loyalty embodies), quoted in *Disney IV*, 2005 WL 2056651, at *33; ROBERT CHARLES CLARK, CORPORATE LAW 159–89 (1986) (describing the doctrines that prohibit executive self-dealing).

³¹ See *Disney IV*, 2005 WL 2056651, at *38–39. Fiduciaries commit waste when they "exchange . . . corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade," such as when a transaction "serves no corporate purpose" or is conducted in exchange for "no consideration at all." *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997).

³² *Disney IV*, 2005 WL 2056651, at *47–49 (explaining that because Disney's bylaws granted Eisner, as CEO, the unilateral authority to terminate Ovitz, the board did not have an obligation "to act in connection with Ovitz's termination").

³³ *Id.* at *31. See generally CLARK, *supra* note 30, at 123–25 (describing the business judgment rule).

³⁴ At least one commentator has criticized the business judgment rule for its circularity. See, e.g., Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 288 (1994) (characterizing the rule as a statement that "directors are not liable for their decisions unless there is a reason to hold the directors liable").

able.”³⁵ This formulation is often understood to equate with gross negligence,³⁶ and the *Disney IV* court’s inquiry reduced to whether the directors’ behavior reached that standard. Although the court admonished the defendants for demonstrating “many lessons of what not to do,”³⁷ it concluded that their actions were not grossly negligent. In addition, the court determined that the directors believed their actions were in Disney’s best interests and therefore had not acted in bad faith.³⁸

Not only did the *Disney IV* court fail to resolve inconsistencies and logical fallacies in an already confusing doctrine, but it also misapplied precedent. Its unfortunate articulation of the applicable law will ensure that poor conduct, as well as the large-scale corporate abuses it begets, will go unchecked by the Delaware courts. Indeed, although the court acknowledged that its opinion would “serve as guidance for future officers and directors,”³⁹ this guidance may well be that directors will continue to be free from consequences even when their actions “do[] not comport with how fiduciaries of Delaware corporations are expected to act.”⁴⁰

By focusing on the duty of care, the court missed an opportunity to heighten scrutiny of a director’s actions: it should have also inquired into the Disney directors’ duty of loyalty and recognized that this duty can be implicated absent a financial interest in the transaction at issue. If Delaware were to acknowledge that collateral and nonpecuniary benefits from directorial decisions could pose a conflict that may implicate the duty of loyalty, certain aspects of the Disney directors’ conduct may have been reviewed with stricter scrutiny.⁴¹ Indeed, Russell

³⁵ See *Disney IV*, 2005 WL 2056651, at *32 (footnote omitted) (quoting *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963); *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000)); see also *Brehm*, 746 A.2d at 264 (noting that the due care standard applies only to the directors’ decisionmaking process and that courts “do not even decide if [directors’ substantive judgments] are reasonable”).

³⁶ See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *Disney IV*, 2005 WL 2056651, at *32.

³⁷ *Disney IV*, 2005 WL 2056651, at *39.

³⁸ See *id.* at *39–41 (*Eisner*); *id.* at *42 (*Russell*); *id.* at *43–47 (other members of the compensation committee); *id.* at *47 (other members of the board at the time of Ovitz’s hiring). Delaware law is ambiguous regarding whether the duty to act in good faith is an independent fiduciary duty or is instead merely one aspect of the fiduciary duty of loyalty. See *id.* at *35 (calling the distinction “far from clear”). Compare *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001) (remarking that “[t]he directors of Delaware corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith”), with *In re Gaylord Container Corp. S’holders Litig.*, 753 A.2d 462, 475 n.41 (Del. Ch. 2000) (calling the duty of good faith a “subsidiary requirement” of the duty of loyalty).

³⁹ *Disney IV*, 2005 WL 2056651, at *2.

⁴⁰ *Id.* at *41.

⁴¹ Notably, courts are more than willing to consider such factors when assessing the independence of special litigation committees. See, e.g., *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 937–48 (Del. Ch. 2003).

received a bonus for his work in connection with Ovitz's hiring,⁴² and Eisner may have made his decision to hire Ovitz with an eye toward enhanced social status and a closer friendship with arguably "the most powerful man in Hollywood."⁴³ Accordingly, it may be naïve to conclude summarily that Disney's directors were not susceptible to divided loyalties. Recognizing this possibility would undoubtedly complicate the appropriate standard of review, but the concept of conducting limited substantive review is not altogether foreign to Delaware law.⁴⁴ Failing to consider the potential effects of such competing loyalties simply perpetuated an inconsistency between the duty of loyalty and the duty of care that the court itself bemoaned.⁴⁵

The court also implied that the large size of the directors' potential liability should militate against a finding for the plaintiffs.⁴⁶ Yet this line of reasoning leads to a troubling paradox: it implies that courts should be loath to impose liability on directors when the amount at stake is large, but investors should expect directors to exercise their greatest level of diligence, and thus be subjected to the highest standard of due care, precisely when the amount at stake is large. If Delaware precedent dissuades courts from finding a breach of fiduciary duty in those contexts in which directors' due care is needed most, the level below which directors' care constitutes a breach of duty will increasingly diverge from sound business practices, and the courts will do little to curb corporate abuses. Effective deterrence of corporate abuse requires that the punishment fit the offense, particularly when the stakes are high for investors. It is inevitable — and preferable — that some divergence will exist between ideal director behavior and the applied standard of judicial review,⁴⁷ but the court should not ex-

⁴² *Disney IV*, 2005 WL 2056651, at *9.

⁴³ *Id.* at *46 (internal quotation marks omitted); *see also id.* at *40 n.488 (noting that Eisner's unquestioned control might be due to his close personal relationships with many of the directors).

⁴⁴ *See, e.g., Zapata Corp. v. Maldonado*, 430 A.2d 779, 789 (Del. 1981) (holding that a lower court, when assessing a special litigation committee's decision to dismiss a derivative lawsuit, should exercise limited independent business judgment).

⁴⁵ *See Disney IV*, 2005 WL 2056651, at *31 n.402 (noting that "[p]erhaps [the duties] of care and loyalty . . . are really just different ways of analyzing the same issue"). Commentators have also noted that divided loyalties can arise even when no financial interest exists. *See CLARK, supra* note 30, at 147 (stating that self-dealing can occur when a fiduciary has a "personal interest in the welfare of the other person involved in the transaction, or in certain collateral consequences of the transaction," but making no mention that the interest must be financial); Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. (forthcoming Apr. 2006) (arguing that the analysis of "the private benefits of control" must consider "non-pecuniary benefits" such as "social and political access").

⁴⁶ *See Disney IV*, 2005 WL 2056651, at *31 n.408.

⁴⁷ *See* William T. Allen et al., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 450–57 (2002) (describing the divergence between "the standard

acerbate this gap. Although the law should encourage directors to take risks that may result in future rewards, it should not condone doing so haphazardly.

Furthermore, the *Disney IV* decision misapplied past precedent and created a new standard of laxity for directors. The court gave considerable attention to distinguishing *Disney IV* from the landmark Delaware case *Smith v. Van Gorkom*.⁴⁸ In *Van Gorkom*, the Delaware Supreme Court found that a corporation's directors breached their duty of care by agreeing — against the wishes of senior management — to a merger transaction valued at \$734 million⁴⁹ after they met on short notice, for only two hours, and without the benefit of all relevant and material documentation.⁵⁰ By way of comparison, the members of Disney's compensation committee similarly met for less than an hour, had not all received the report prepared by Disney's executive compensation consultant, and were not informed about senior executives' displeasure with Eisner's choice of Ovitz⁵¹ — facts that led the court to admit that “the parallels [with] *Van Gorkom* . . . at first appear striking.”⁵² But the court's efforts to distinguish *Van Gorkom* were unconvincing. Most importantly in this regard, the court noted that Delaware law mandates greater duties in the context of a merger, the transaction presented in *Van Gorkom*, than with respect to executive compensation.⁵³ However, the court neglected to consider other sources of policy that create, or at least strongly suggest, heightened directorial duties relating to executive compensation.⁵⁴ Accordingly, the *Disney IV* court failed to recognize that executive compensation is, like mergers, within the special province of the board of directors and amenable to a heightened obligation.⁵⁵

of conduct” to which directors *should* conform and “the standard of judicial *review*” to which they *must* conform, as well as the reasons for the divergence).

⁴⁸ 488 A.2d 858 (Del. 1985).

⁴⁹ See *id.* at 864 n.3 (number of shares outstanding); *id.* at 869 (price per share); see also *Disney IV*, 2005 WL 2056651, at *44 n.532 (discussing the value of the *Van Gorkom* transaction).

⁵⁰ See *Van Gorkom*, 488 A.2d at 867–69.

⁵¹ See *Disney IV*, 2005 WL 2056651, at *8–9; *supra* notes 18–19 and accompanying text.

⁵² *Disney IV*, 2005 WL 2056651, at *44.

⁵³ See *id.* at *44 & n.527 (citing DEL. CODE ANN. tit. 8, § 251(b) (2001 & Supp. 2004)).

⁵⁴ See, e.g., 17 C.F.R. § 228.402 (2005) (requiring disclosure of executive compensation arrangements to shareholders); NYSE, Inc., Listed Company Manual § 303A.05(a) (2004), available at http://www.nyse.com/lcm/lcm_section.html (requiring that listed companies “have a compensation committee composed entirely of independent directors”).

⁵⁵ It is for this reason that the court's analogy to a big-budget movie, which typically involves an expense similar in size to that of Ovitz's severance package but which does not require express director approval, see *Disney IV*, 2005 WL 2056651, at *44 n.533, was misplaced. Various forms of regulation imply that executive compensation is a matter especially within the province of directors' responsibility, but no such pronouncement has been made with respect to movies.

The court's effort to distinguish *Van Gorkom* based on the higher sum at stake in that transaction, see *id.* at *44, was similarly unpersuasive. As discussed previously, the court argued else-

Delaware's law should reflect the state's unique role as the primary regulator of substantive corporate behavior.⁵⁶ Because the federal securities regulations make it difficult for shareholders to nominate alternate directors,⁵⁷ the Delaware courts are, in many ways, the last resort for shareholders of corporations that have suffered from their directors' inattentiveness.⁵⁸ If Delaware continues to turn its back on aggrieved investors, however, federal authorities — to Delaware's dismay — may have no other choice but to impose substantive corporate regulation.⁵⁹ The *Disney IV* court was correct to refrain from imposing liability merely because a directorial decision resulted in a substantively unfavorable outcome. Yet if courts continue to hold directors to inconsistent standards and apply fiduciary law in an inconsistent manner, “conduct that [falls] significantly short of the best practices of ideal corporate governance”⁶⁰ may be doomed to perpetuate itself.

where in its decision that larger potential damages counsel against imposition of director liability. The amount at stake in a merger deal could easily exceed the company's worth, but an employee will presumably never receive a compensation package that large. Thus, under the court's earlier logic, compensation cases should receive *stricter* review than merger cases because the amount at stake is smaller.

⁵⁶ See Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2494 (2005) (remarking that “Delaware writes most state corporate law” because even though “[f]ederal authorities . . . can crush Delaware,” they refrain from doing so); see also Note, *The Case for Federal Threats in Corporate Governance*, 118 HARV. L. REV. 2726, 2747 (2005) (arguing that state law, rather than federal law, is the proper mechanism through which to accomplish substantive corporate regulation).

⁵⁷ The Securities and Exchange Commission has proposed a rule that would grant shareholders the right to nominate directors directly. See Security Holder Director Nominations, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274); see also Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 43–44 (2003) (advocating adoption of the rule). However, such direct nominations are prohibited by current law. See 17 C.F.R. § 240.14a-8(i)(8) (2005).

⁵⁸ See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1102 (1997) (stating that shareholders “depend on the courts to fill out the details of proper behavior in the corporate community”).

⁵⁹ See, e.g., Protection Against Executive Compensation Abuse Act, H.R. 4291, 109th Cong. (2005) (proposing an amendment to the federal securities laws that would require companies to disclose and obtain shareholder approval for executive officer compensation plans).

⁶⁰ *Disney IV*, 2005 WL 2056651, at *1.