

IN POST-TRIAL OPINION, DISNEY COURT REAFFIRMS DEFERENCE GRANTED TO DIRECTORS UNDER BUSINESS JUDGMENT RULE

In a comprehensive opinion issued after a ten-week bench trial, Chancellor William B. Chandler III of the Delaware Court of Chancery held that the directors of The Walt Disney Company, and its general counsel, did not breach their fiduciary duties to stockholders in connection with the hiring and subsequent termination without cause of well-known Hollywood agent Michael Ovitz. In re The Walt Disney Co. Derivative Litig., Cons. C.A. No. 15452 (Del. Ch. Aug. 9, 2005).

While finding that many of the challenged actions of Disney's then-chairman and chief executive officer Michael Eisner and other Disney directors fell "short of the best practices of ideal corporate governance," the Court concluded that none of the challenged conduct was taken in bad faith and that all of the directors' actions were protected from judicial second-guessing by the business judgment rule.

The decision strongly reaffirms the deference accorded to directors' good faith decisions under Delaware law, while articulating the contours of "good faith" within this context. In reaching its conclusions, the Court also took the opportunity to highlight corporate governance weaknesses in the processes surrounding Ovitz's hiring and later non-fault termination, for the benefit of future boards.

The Claims at Issue

The action was filed by Disney stockholders, suing on behalf of the corporation, shortly after Ovitz's termination "without cause" in December 1996. As a result of that termination, Ovitz was paid roughly \$38 million in addition to the vesting of options to acquire 3 million shares of Disney common stock, as provided for under the terms of the employment agreement that Ovitz had entered into with Disney in September 1995.

The stockholder plaintiffs asserted a number of claims for breaches of fiduciary duty against the directors and certain officers of Disney. In several earlier proceedings, the claims at trial were narrowed to: (1) claims against Eisner, the members of the compensation committee of the Disney board and the other directors at the time for breach of fiduciary duty and waste in entering into the employment agreement with Ovitz in 1995; (2) claims against Ovitz for breach of fiduciary duty in connection with his non-fault termination and the resulting payment to him of significant amounts under the employment agreement; and (3) claims against Eisner, the other directors at the time and Disney's general counsel, Sanford Litvack, for breaches of fiduciary duty in connection with Ovitz's non-fault termination.

At trial, plaintiffs contended that the Disney board approved the terms of Ovitz's employment agreement (including the substantial payments that would be owed to Ovitz in the event of a non-fault termination) without adequate information or reasonable deliberation. They also contended that the board failed to give due consideration to the

possibility of a termination of Ovitz for cause, in the event of which the corporation would not have owed Ovitz any further payments under his employment agreement.

Business Judgment Rule Reaffirmed; Duty of Good Faith Defined

The Court rejected all of these arguments, holding that plaintiffs had failed to overcome the presumption of good faith, loyalty and due care that is afforded to directors' decisions under the business judgment rule.

In reaching this conclusion, the Court reaffirmed the rationale for business judgment rule deference -- to encourage directors to take appropriate business risks without fear of personal liability for a bad decision. "The redress for failures that arise from faithful management," the Court observed, "must come from the markets, through the action of shareholders and the free flow of capital, not from this Court."

The Court also reconciled competing strains of thought as to the nature of a director's "duty of good faith" under Delaware law:

To act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation. . . . The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty . . . but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders.

Bad faith, in the Court's view, includes intentionally acting with a purpose other than that of advancing the best interests of the corporation or failing to act in the face of a known duty to act, thereby demonstrating a conscious disregard of the fiduciary's duties.

With regard to Ovitz's hiring in 1995, the Court found that Eisner and the other directors acted in the good faith belief that Ovitz would be a positive addition to Disney's management team and that Eisner and the members of the compensation committee adequately informed themselves of the terms of Ovitz's proposed employment agreement before his hiring. The other directors were also kept informed of the progress and discharged their responsibilities with due care and in good faith.

As to Ovitz's termination, the Court concluded that under the corporation's governing documents, Eisner was empowered to make that decision unilaterally and that he had done so in good faith (after receiving legal advice that a termination for cause was not available). The Court found that the other directors, while generally aware of the possibility of Ovitz's termination, had not breached their fiduciary duty of care by leaving the matter to Eisner's decision.

Lessons for Future Boards

While the Disney directors were relieved of any personal liability for the conduct at issue, the Court was critical of the processes followed in Ovitz's hiring and termination.

Among other specific shortcomings, the Court noted that in announcing Ovitz's hiring before the board had approved it, Eisner had created a situation that effectively dictated the outcome of the board's decision. More particularly, the failure of either the compensation committee or the entire board to receive a presentation from an expert in employment agreements concerning the possible costs of the Ovitz employment agreement, while not giving rise to liability, was less than ideal. Similarly, the Court expressed concern over the failure of Eisner to submit the question of Ovitz's termination to the entire board or to explain for the directors' benefit why a termination for cause was not available under the circumstances.

Finally, the Court criticized Eisner for his "Machiavellian (and imperial) nature as CEO" and extended that criticism to the Disney directors for tolerating Eisner's excesses. Directors reading the Disney decision in search of lessons in corporate governance will likely note this criticism of the directors' passive acceptance of the CEO's conduct and the Court's implied desire for more formalized board processes for the presentation, evaluation and approval of significant corporate decisions. Even if directors ultimately prevail, as they did in Disney, a more developed process and record can help boards avoid litigation and negative publicity for corporate actions that may become subject to scrutiny.

By:

Diane Holt Frankle

John J. Clarke, Jr.

DLA Piper Rudnick Gray Cary US LLP

August 2005

Provided By:

Knox Bell

DLA Piper Rudnick Gray Cary US LLP

Chair of CDF Corporate Governance Committee