

In re The Walt Disney Company Derivative Litigation

**Delaware's Supreme Court Affirms That The Defendants Did Not Breach
Their Fiduciary Duties In The Hiring And Firing of Michael Ovitz**

In *In re The Walt Disney Company Derivative Litigation*, No. 411, 2005 (Del. June 8, 2006), the Delaware Supreme Court (*en banc*) affirmed the Court of Chancery's decision, issued following a 37 day, highly-publicized trial, that the directors of The Walt Disney Company (the "Company" or "Disney") did not breach their fiduciary duties in connection with the hiring, and even more spectacular firing, of Michael Ovitz a mere fourteen months later. With his termination, Ovitz left the Company with a package of benefits valued at more than \$100 million. The case had been followed closely both for its Hollywood status and because of its potential implications for director liability and focus on the not well-developed duty to act in "good faith" under Delaware corporate fiduciary law. In its 89 page opinion, the Delaware Supreme Court concluded that Chancellor Chandler's "factual findings and legal rulings were correct and not erroneous in any respect."

Plaintiffs' Claims of Error

In considering the stockholder-plaintiffs' numerous arguments on appeal, the Court first analyzed their claims that Ovitz breached his duties of care and loyalty by negotiating for and accepting the non-fault termination ("NFT") provisions of his employment agreement ("OEA") and negotiating a full NFT severance in connection with his departure from the Company. The Court observed that plaintiffs' contention that Ovitz had become a *de facto* fiduciary before he formally assumed the title of president and therefore was subject to fiduciary duty standards was procedurally barred because it had not been presented to the Court of Chancery, but held in any event that the argument lacked merit, both legally and factually. It similarly rejected the claim that because the OEA was not final until December 1995, Ovitz was subject to fiduciary duties on the grounds that the terms at issue in the lawsuit had been agreed to before Ovitz assumed office. As to their claims that Ovitz breached his fiduciary duties in connection with his departure from Disney, the Court ruled that the record clearly established that Ovitz did not leave voluntarily and played no role in his "without cause" termination, and that both factually and legally, the plaintiffs' claim that Ovitz had a duty to call a board meeting to consider terminating him "for cause" was without merit.

The Court separately considered each of plaintiffs' five specific claims that Disney's directors had breached their duties of care and good faith by approving the OEA and electing Ovitz as president. First, the Court rejected the stockholders' argument that the Chancellor had erred by "conflating" their attempt to rebut the presumptions of the business judgment rule with analysis of whether the directors' conduct was outside the exculpation provision of Section 102(b)(7) of the Delaware General Corporation Law ("DGCL"), holding that Delaware law permits consideration of good faith for both purposes. Second, the Court rejected the stockholders' claims that the Disney board was required to approve the OEA, either as a matter of Delaware corporate law or as a matter of law of the case. Third, the Court rejected the stockholders' "about-face" argument that the Court of Chancery erred in evaluating the directors' care on a director by director, rather than collective basis, on the grounds that it had not been presented to the trial court and because any supposed

error could not have prejudiced their case. Fourth, continuing the Chancellor’s approach of contrasting the actual “not so tidy” process and a record that “leaves much to be desired” with “best practices,” the Court concluded the members of the compensation committee were not grossly negligent in understanding the NFT provisions and ruled that Section 141(e) of the DGCL permitted two members of the compensation committee to rely upon information provided by an outside consultant, as well as by two of the other committee members. Fifth, the Court rejected the challenge to the full board’s decision to elect Ovitz as president, noting that the stockholders’ arguments related to a different decision, delegated to the compensation committee, to approve the terms of the OEA and that the record did not support the conclusion that the board had been grossly negligent.

With respect to the NFT payout, plaintiffs asserted that only the full board could terminate Ovitz, that Litvack (the Company’s general counsel) and Eisner (its CEO) breached their fiduciary duties, and that the remaining directors were not entitled to rely upon Eisner’s and Litvack’s advice that Ovitz could not be terminated for cause. Concluding that the Company’s corporate instruments were ambiguous with respect to the question of whether Eisner could terminate Ovitz without board action, the Court held that the relevant extrinsic evidence clearly supported the conclusion that the power to terminate Ovitz was vested in Eisner and the board concurrently. It also affirmed the Chancellor’s conclusion that Ovitz had not engaged in conduct that would have permitted the Company to terminate him for cause and that, in arriving at that conclusion in 1996, Litvack and Eisner had not breached their fiduciary duty of care or duty to act in good faith. The Court further held that the advice the directors had received was correct and that all the directors supported the decision to terminate Ovitz.

Finally, as to the stockholders’ waste claim, the Supreme Court observed that the “payment of a contractually obligated amount cannot constitute waste, unless the contractual obligation is itself wasteful.” With that focus, the Court rejected plaintiffs’ “fanciful” argument that the NFT provisions were wasteful because they created an incentive for Ovitz to perform poorly, noting that the NFT provisions clearly had a rational business purpose: inducing Ovitz to leave his business to join Disney.

Good Faith and Lessons from Disney

In one of the more anticipated portions of its decision, the Supreme Court carefully considered the Chancellor’s analysis of the directors’ good faith. The Court rejected the stockholders’ claim that the Chancellor had substantively modified his earlier definition of good faith. Noting that good faith was a “relatively uncharted” concept, the Court provided helpful conceptual guidance to the corporate community, expressly endorsing the Chancellor’s appropriate and *non-exclusive* definition of good faith, which focuses upon “intentional dereliction of duty, a conscious disregard for one’s responsibilities.” Elaborating, the Court discussed three categories of conduct: (1) instances where directors act with subjective bad faith or are “motivated by an actual intent to do harm”, an “axiomatic” breach of good faith; (2) instances at the opposite end of the spectrum where directors act with gross negligence, without more, in which case they do not breach the duty to act with good faith; and (3) instances in between the categories of subjective bad intent and simple gross negligence, in which the concept of intentional disregard of duty or conscious disregard for one’s responsibilities is intended to capture misconduct that does not involve a conflicting self interest but is “qualitatively more culpable” than gross negligence.

The Court endorsed the examples of bad faith cited by the Chancellor, and also agreed that it would be “unwise” and “unnecessary” to attempt to adopt a categorical definition of bad faith.

In addition to providing doctrinal clarity to the concept of “good faith” under Delaware corporate law, the Supreme Court’s decision reflects the continuing vitality of the business judgment rule and fundamental doctrines such as delegation and reliance on others as to matters directors reasonably believe to be within such person’s professional or expert competence. As a practical matter, considerations of good faith will first be evaluated in the context of an effort to rebut the presumptions of the business judgment rule, in which case the plaintiffs have the burden and, if the plaintiffs are unsuccessful in rebutting the presumption, the courts need not reach the question of good faith for Section 102(b)(7) purposes. Only in those cases where plaintiffs successfully rebut the presumptions of the business judgment solely on the basis of due care will it be necessary for the courts to evaluate good faith for purposes of Section 102(b)(7), in which instance defendants will bear the burden of proving that they acted in good faith.

Practitioners and directors also should take heed of the Supreme Court’s decision to echo many of the trial court’s more detailed criticisms of the defendants’ numerous deviations from best case practices and procedures. The Court noted, for example, Eisner’s imperial nature as CEO, as well as the many flaws in the process by which the compensation committee had evaluated the NFT provisions of the OEA. Among those practices which could help minimize litigation risks for directors with respect to significant transactions are ensuring that minutes of board and committee meetings are taken by a skilled professional and, where appropriate, reflect the amount of time devoted to each issue. Likewise, board and committee meetings should be scheduled so as to provide sufficient time for deliberations, and draft minutes should be circulated promptly after the conclusion of meetings. Directors and corporate counsel also should have an explicit understanding that counsel will advise them if board or committee action is required or advisable. Finally, directors should control senior management so that the board’s options are not curtailed with respect to significant matters, should engage in active discussion regarding all important issues, should retain expert advisors when appropriate, and include formal presentations with the relevant minutes to establish their reasonable reliance on such expert advice.

A. Gilchrist Sparks, III
302-351-9276
asparks@mnat.com

S. Mark Hurd
302-351-9354
shurd@mnat.com

Messrs. Sparks and Hurd were counsel to director-defendants Roy Disney and Stanley Gold.

Morris, Nichols, Arsht & Tunnell LLP combines a broad national practice of corporate, intellectual property, bankruptcy and commercial law and litigation with a general business, tax, estate planning and real estate practice within the State of Delaware. The firm’s clients include Fortune 500 companies, smaller firms and partnerships, financial institutions, government agencies, law firms and not-for-profit organizations.

About this E-Mail:

You received this email because you are part of the Morris, Nichols, Arsht & Tunnell Clients and Friends mailing list. If you do not wish to continue receiving emails and mailings from us, please respond to newsletter@mnat.com or contact us at 302-351-9241.