Executive Compensation and the Disney Decision

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By Donald A. Glazier

Executive compensation has received considerable attention since former Senator Christopher Cox, now head of the United States Securities and Exchange Commission (SEC), indicated that his staff is looking into reforms in that area. On a related front, the Delaware Court of Chancery recently ruled on the legal propriety of a huge severance package awarded to a company's former president after his failed tenure in the position. The scrutiny of executive compensation issues has opened new concerns in the assessment of executive protections.

In a recent *Wall Street Journal* (*WSJ*) interview, Cox asserted that executive compensation disclosure required new attention because "compensation packages have changed dramatically since 1992 when the commission last addressed this topic."

Last year alone, executive compensation rose an average of 14.5% according to a *WSJ* study. Large payments to executives are not only made to those who have steered companies to success, but are also granted upon the departure of those who have not. *WSJ* cited Carly Fiorina's $45 million departure package from Hewlett Packard and Phil Purcell's $110 million after leaving Morgan Stanley as notable examples of failed CEOs who nonetheless receive large rewards.

Not mentioned in the article was the $140 million severance paid to Michael Ovitz when he was dismissed by The Walt Disney Company in 1996. The Ovitz package was the subject of a well publicized, decade-long lawsuit in the Delaware Court of Chancery, whose ultimate decision:

- Affirmed that the court would not second-guess a board's decisions after the fact in the absence of a breach of the fundamental duties imposed on the board members. This reaffirmation of the "business judgment rule" allows companies to take the types of risks inherent in business without being held liable for those business decisions that do not succeed as planned.

- Sharply criticized the poor corporate governance practiced at Disney by its CEO and board. The Disney court's dim view of the board's actions, or more accurately its inactions, indicates the degree to which corporate governance has changed since Michael Ovitz's brief tenure as President of Disney in the mid 1990s.

Background of the Disney Case

When Disney's President, Frank Wells died in a helicopter crash in 1994, its board and CEO Michael Eisner set out to find a new president for the company. Eisner offered his friend Michael Ovitz the position and an employment agreement that included an impressive compensation package and a provision providing for a significant severance payment if he was terminated not for cause.

After less than a year on the job, Eisner decided that Ovitz was not the right person for the role. Unable to fire Ovitz for cause, Eisner informed the board in the fall of 1996 that he intended to terminate Ovitz without cause.

When triggering of the terms of Ovitz's contract entitling him to $140 million in severance became public, shareholders filed suit in Delaware alleging that the Disney board breached its fiduciary duties by failing to adequately review Ovitz's compensation package, especially the provision relating to termination not for cause. Though filed in 1996, the suit did not proceed to trial until the fall of 2004. The proceedings, which lasted three months, were closely followed in the press with extensive coverage of Michael Eisner's testimony concerning Orvitz's Disney tenure and termination.

Court's Ruling

Business Judgment Rule

In August 2005, the Delaware Chancery court entered judgment in favor of the Disney board and against the plaintiffs. In its 175-page opinion, the court reaffirmed the well established business judgment rule as a protection for corporate board decisions. It stated that while corporate boards must comply strictly with their fiduciary responsibilities, they are "free to act as their judgment and abilities dictate, free of *post hoc* penalties from reviewing courts using perfect hindsight."

The court went on to state that the rules relating to liability were different from those standards of "best practices." The court said it "strongly encourages directors and officers to employ best [corporate governance] practices," but, it would not hold them "liable for a failure to comply with the aspirational ideal of best practices. . . ." Instead, the market would decide whether directors met the standard of best practices "through the action of shareholders and the free flow of capital, and not from this court."

Duty of Good Faith

The court's opinion also discussed the requirement that corporate boards act in good faith. While not imposing a separate duty of good faith in addition to the basic duties of care and loyalty, the court noted that "[in] the concept of

intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith." An actionable lack of good faith could be found if a corporate fiduciary "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."

Criticism of the Disney Board

While finding in favor of the Disney defendants, the court was highly critical of how the Disney board dealt with the Ovitz matter, and highlighted particular deficiencies. Among the corporate governance issues noted in regard to compensation in the court's decision were:

- **Role of Compensation Committee:** The compensation committee should be involved early in executive employment negotiations. In Disney, half the compensation committee was active in negotiations; the other half came in "very late in the game."

- **Board Participation**: The board of directors cannot cede its responsibility for hiring senior management to the CEO, or risk exposing itself to liability. This is especially true when the CEO is someone like Michael Eisner, whom the court described as having "enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom."

- **Solicit Expert Advice**: When the board committee does not have expertise or proper information, it should seek expert advice.

- **Pre-Meeting Materials and Notice**: Notice and materials should be provided to all directors well in advance of any meeting at which an executive employment agreement is to be discussed.

- **Time for Discussion**: The board should allocate sufficient time to consider the issue before them and, again, not defer to a CEO's preferences.

- **Quality of the Paper Trail**: In reviewing the actions leading up to a decision relating to compensation or, for that matter, any issue before the board, it is important that the minutes contain enough detail regarding the extent of discussion and those issues considered in arriving at a decision.

Impact

The court's opinion makes clear that corporate boards should not take comfort in the "win" awarded to the Disney board in its ruling.

The court stated that, "in this era of Enron and WorldCom debacles, and the resulting legislative focus on corporate governance, it is perhaps worth pointing out that the actions (and the failures to act) of the Disney board that gave rise to this lawsuit took place ten years ago, and that applying 21st century notions of best practices in analyzing whether those decisions were actionable would be misplaced." The court implies that these same actions would not pass muster in today's environment of corporate governance. This implication may embolden plaintiffs' attorneys, who might apply these words as evidence that suits against corporate boards relative to executive compensation in today's environment may not result in defense verdicts.

Regardless of whether the Delaware courts will look more favorably on suits of this type in the future, ten years of litigation in the Disney case underscores the cost and adverse publicity associated with such matters.

These developments have important implications concerning executive protection. We encourage you to review the efficacy of your D&O program in light of this decision. For further discussion of this matter, please feel free to contact any member of Integro's Management Risk Practice group.

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