Legal Backgrounder

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202.588.0302

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DELAWARE'S *DISNEY* DECISION: A STAR IS BORN?

by

Rolin P. Bissell

Nine years in the making, with a running length of 174 pages, coming after 37 days of testimony by a star studded cast of witnesses, and the admission of 1033 exhibits, the recent *Disney* decision was expected to be the summer blockbuster of Delaware corporate law.[1] But despite its sizzling plotlines and the skillful direction of Chancellor Chandler, the *Disney* decision is at the core a stylish and highly satisfying remake of that classic boardroom story: Directors make informed decision; decision turns out badly; the business judgment rule protects directors from legal liability.

So why is this remake getting such boffo box office from legal commentators? As discussed below, there are two reasons. First, the advanced buzz on the *Disney* decision was big, and in retrospect perhaps a little bit over-hyped. Previews suggested that the decision would be a breakout role for a potential new star on the corporate law scene — the fiduciary duty of good faith. But the Court left the duty of good faith's character hazily defined and at times elusive. Thus, a determination of whether the duty of good faith has real star power will have to await its casting in future cases. Second, although thought by some to be over the hill in the post-Enron and Sarbanes-Oxley era, the business judgment rule turned in a show-stopping performance, demonstrating again why it has been the superstar of Delaware corporate law for forty-plus years. By adding the plot twist of being highly critical of the conduct of several of the Disney board members, its corporate governance practices, and its corporate culture, but finding no liability, the *Disney* decision freshens up a timeless classic and delivers a cautionary tale the whole corporate family can enjoy.

Plot Summary. The claims against the Disney directors stemmed from the hiring, and subsequent firing, of Michael Ovitz as President of Disney. Considered before his hiring to be the leading talent agent in the entertainment industry, involved in mergers and acquisitions of major entertainment companies, and as one of the owners and the driving force behind the Creative Artist Agency, Ovitz's stature and pre-existing earnings meant he could command a substantial pay package to join Disney. Despite his impressive experience and his long time friendship with Disney chairman and CEO Michael Eisner, Ovitz did not gel

[1]A copy of the slip opinion *In re Walt Disney Co. Derivative Litig.*, C.A. No. 15452 (Aug. 9, 2005) (Chandler, V.C.) can be found at the Court's website (http://courts.delaware.gov/opinions/) or on LEXIS *In re Walt Disney Co. Derivative Litig.*, 2005 Del. Ch. LEXIS 113 (Aug. 9, 2005) Citations to the decision herein use the slip opinion pagination (Op. at __).

Rolin P. Bissell is a partner in the Corporate Counseling and Litigation Section of the Wilmington, Delaware law firm of Young Conaway Stargatt & Taylor, LLP. Others at Young Conaway represented Mr. Ovitz in the *Disney* litigation, but the views expressed in this article are the personal views of Mr. Bissell and may not reflect the views of Young Conaway Stargatt & Taylor LLP, other of its lawyers, and its clients.

with Eisner and other senior management at Disney. Within 16 months of Ovitz's arrival at Disney, Eisner decided that Ovitz and Disney needed to part ways. Under the termination provisions of Ovitz's employment contract, this obligated Disney to pay Ovitz benefits he would have received if Disney had not terminated the contract. The disputed value of those benefits was estimated to be between $70 million and $140 million.

Derivative shareholder plaintiffs sued on a number of theories, but the crux of their position was that Eisner and the Disney board had been too careless in approving Ovitz's pay package when hiring him and then too careless again in his termination, contending that Ovitz should have been terminated for cause. Plaintiffs contended that these lapses had cost Disney and its shareholders, and that the Disney board should pay.

The Stars of the Show: The "Duty of Good Faith" and the "Business Judgment Rule." The real stars of the of the *Disney* decision are not Eisner, Ovitz, or the other Disney directors, but two judge-made concepts under Delaware corporate law: the business judgment rule and the fiduciary duty of good faith.

The business judgment rule provides that if a director acts in an informed manner and is disinterested and independent, a court will not second guess the director's decision, even if that decision turns out in hindsight to be a bad one. As discussed below, although the concept of "good faith" has a long history in Delaware corporate law, the existence of a separate "fiduciary duty of good faith" and the contours of that duty, if it does exist, has been an emerging concept in Delaware jurisprudence.

The Duty of Good Faith Gets Ready for its Close-Up. As originally cast, it appeared that the duty of good faith would have little more than a cameo role in the *Disney* drama and that the *Disney* case would be a short subject rather than a full length feature. The plaintiffs in *Disney* first filed suit in 1997, and the Court of Chancery dismissed these claims with prejudice in 1998. *In re Walt Disney Co. Derivative Litig*., 731 A.2d 342 (Del. Ch. 1998).

In December 2000, the Delaware Supreme Court upheld the dismissal, but allowed the plaintiffs to replead their complaint. *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). In May 2003, the Court of Chancery denied the Disney directors' motion to dismiss an amended complaint, finding that, accepting plaintiffs' allegations as true, the plaintiffs had stated a claim because they had alleged that the Disney directors had shown a "conscious indifference" to their duties in connection with Ovitz's hiring and termination and this breached a duty of "good faith." *In re Walt Disney Co. Derivative Litig*., 825 A.2d 275 (Del. Ch. 2003). Thus, from the previews, it looked like the "duty of good faith" might steal the show and upstage the business judgment rule.

The revival of the plaintiffs' claims also meant that the *Disney* drama would be acted out against very different scenery than the scenery of the late 1990's. By May 2003, the corporate governance landscape had changed dramatically from when the plaintiffs' first filed suit in 1997. Enron, WorldCom, and Tyco had become poster children for board dereliction and corporate governance failure. Despite the fact none of these corporations were governed by the laws of Delaware,[2] commentators suggested that Delaware corporate law was inadequate and that more federal oversight was required to ensure the integrity of our corporate governance system. The Sarbanes-Oxley Act was nine months old, and there was talk of a greater federal intervention into areas traditionally left to state corporate law. In this environment, the decision to allow the *Disney* suit go forward touched off a cottage industry of law review articles, seminars, and theoretical speculation that through the *Disney* decision the Delaware courts might announce an era of greater director scrutiny and increased exposure to liability. Was the Court creating a new separate fiduciary duty of good faith that could be a stand-alone cause of action separate from the traditional, recognized duty of care and duty of loyalty? Did the denial of the motion to dismiss presage a shift in Delaware's traditional jurisprudence away from the business judgment rule's deferential treatment of board action? These

[2]Enron, WorldCom, and Tyco were incorporated under the laws of Oregon, Georgia, and Bermuda respectively.

questions would be answered by the Court's post-trial decision.

Although the duty of good faith was not an ingénue on the corporate stage, its depth and range were not well defined. The concept of "good faith" had played a number of supporting roles in Delaware corporate law. The issue of good faith is imbedded in claims based on the breach of the fiduciary duty of care through Section 102(b)(7) of the Delaware General Corporation Law ("DGCL"), which allows a corporation to exculpate its directors for monetary damages for breaches of the duty of care so long as the decision was made in "good faith." A determination of a director's "good faith" is often required before a corporation may decide to indemnify a director under Section 145 of the DGCL. Additionally, one of the requirements of Section 144 of the DGCL, which provides a method for a majority of disinterested directors to approve a transaction between a corporation and its officers or directors, requires that the disinterested directors act in "good faith" in approving the interested transaction.

Despite this long history of distinguished roles, there remained a persistent dispute within the Delaware courts about whether a breach of the duty of good faith could carry a case by itself, or could only play supporting roles where a breach of the duty of care or loyalty were also present. Some opinions had held that the fiduciary duty of good faith was a stand alone duty from the duties of loyalty and due care; other opinions had suggested that the duty of good faith could never appear alone and that the duties of loyalty and due care must always be in any scene in which the duty of good faith appeared. Based on the duty of good faith's past appearances, no one was sure how the Court of Chancery might use the duty in a leading role in the *Disney* decision and how good faith would share the stage with Delaware corporate law's longstanding and most bankable star, the business judgment rule.

Although the *Disney* decision gives the duty of good faith plenty of screen time (Op. at 119-26), the Court of Chancery borrows the film technique of "deliberately unresolved ambiguity," giving the duty a continuing sense of mystery. First, the Court of Chancery acknowledges and discusses the debate concerning whether there is a separate and distinct fiduciary duty of good faith or whether good faith is merely a sub-species of the duty of care or the duty of loyalty, but it does not come down on either side of the debate. (Op. at 119 n.447.) Second, the Court acknowledges that there is an unresolved issue of what level of scienter or motive a breach of good faith requires or how a plaintiff must prove that motive. (Op. at 123 fns.456, 457.) Again, the Court expressly decides to leave that for a later case.

Third, the Court does not give much additional precision about how a director may or may not be acting in good faith. After grappling with various definitions of good faith, the Court acknowledges that "it is probably easier to define bad faith rather than good faith." (Op. at 120 n.449.) After discussing various examples of bad faith, the Court reaffirms that the standard it set forth in its decision denying the motion to dismiss the amended complaint — that "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." (Op. at 123.)

Although it is helpful, thoughtful, and provides a comprehensive view of good faith jurisprudence to date, the Court intentionally leaves the "good faith" definition open-ended and free for further elaboration in later cases. (Op. at 124.)

Whatever the exact contours of the duty of good faith might be, the plaintiffs in *Disney* did not show that the Disney directors had acted with this type of disregard. Although the Court was highly critical of the Disney directors who had participated in the hiring and termination of Ovitz, suggesting at points that their conduct was well below what good corporate governance would require and might even in some instances have been negligent, that conduct would not give rise to liability because it did not amount to gross negligence. The saving grace for the Disney directors in light of the more problematic aspects of their conduct turned out to be the venerable business judgment rule.

The Business Judgment Rule Hits its Mark. In contrast to the duty of good faith's ambiguity and nuances, the Court cast the business judgment rule as a character of towering and unequivocal strength, even

at its advanced age. The business judgment rule presumes that absent evidence of "fraud, bad faith, or self dealing," in making a business decision the directors of a corporation acted on an informed basis and that the action taken was in the corporation's best interest. When the presumption is in place, a plaintiff simply has no remedy unless the transaction constitutes waste. The presumption can be rebutted only if the directors have made an "unintelligent or unadvised judgment."

Significantly, the opinion devotes six pages to distinguishing the conduct of certain Disney directors from the conduct of the directors of the Trans Union board that the Delaware Supreme Court condemned in its 1985 *Van Gorkom* decision. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). In *Van Gorkom*, the Trans Union board agreed to a merger transaction after a board meeting of two hours and without so much as reviewing a term sheet of that transaction as contemplated. Although the conduct of the Trans Union board was extreme, the *Van Gorkom* decision raised fears of an undesired expansion of director liability arising out of claims for negligence. The fear was so great that that the Delaware legislature passed Section 102(b)(7) of the DCGL in 1986 to provide Delaware corporations and their stockholders with a means to limit their directors' liability for breaches of the duty of due care through charter amendment.

The *Disney* decision distinguishes *Van Gorkom* on four bases:

(1) The merger transaction in *Van Gorkom* was different than the hiring decision in *Disney*, both because a merger is a fundamental transaction and because the order of magnitude of the merger transaction in *Van Gorkom* was far more material to Trans Union than was Ovitz's pay to Disney. (Op. at150-51.)

(2) The Disney board members spent more adequate time on the Ovitz hiring than Trans Union board spent on the proposed merger. (Op at 151-53.)

(3) The Trans Union board had no documentation concerning the merger; there was documentation the Disney board members considered in deciding to hire Ovitz. (Op. at 154.)

(4) Trans Union's senior management opposed the merger and Disney's senior management favored Ovitz's hiring. (Op. at 155.)

Although the Court of Chancery cannot overrule or limit the Delaware Supreme Court's decision in *Van Gorkom*, the *Disney* decision suggests that the Court of Chancery will pursue a strict construction of *Van Gorkom*. It will not read *Van Gorkom* expansively to weaken the business judgment rule in a wide variety of transactions.

Along the way, the Court clarified several unresolved issues about the business judgment rule. Not only does the gross negligence standard rebut its presumptions in cases where a board has actively exercised its judgment, but it also most likely applies in cases of director inaction, even though a few opinions had suggested that simple negligence would suffice. (Op. at 110, nn.417, 418.) The Court made clear that a Court should apply this standard on a director by director basis, not to the board's decision as a group. (Op. at 109-10 n.414.) Finally, the Court made clear that "the standards used to measure fiduciaries under Delaware law are not the same standards used in determining good corporate governance." (Op. at 104-05, 161.)

Although the retention and dismissal of Ovitz ultimately caused significant expense to Disney, the decision was not in bad faith, uninformed, or grossly negligent. Just like the high-risk decisions Disney frequently makes to invest in film projects, the decision to bring in Ovitz was a high-stakes business decision that just did not work out as expected and hoped. As such, the Disney directors were not subject to liability under Delaware corporate law.

The lessons of the *Disney* decision are now playing in an executive suite near you. Rated "LG," legal guidance is strongly advised.

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