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On August 9, 2005, the Delaware Court of Chancery issued its opinion in *In re The Walt Disney Company Derivative Litigation*, Consol. C.A. No. 15452 (August 9, 2005) (Chandler, C.). This decision followed a well-publicized 37-day trial on the merits of claims raised in connection with the 1995 hiring and subsequent termination of Michael Ovitz as President of The Walt Disney Company. As a result of his no-fault termination after fourteen months in the job, Ovitz received severance pay valued at approximately \$140 million. The resulting shareholder lawsuit alleged that the Disney board members, including Ovitz, breached various fiduciary duties in connection with the approval of Ovitz' initial hiring, employment agreement and compensation package, as well as his subsequent termination and severance package.

Chancellor Chandler's 175-page opinion analyzes in painstaking detail the facts surrounding Ovitz' tenure at Disney, from the events leading to his hiring to the determination of the terms of his employment and compensation to his ultimate demise, and the decision-making process followed by Michael Eisner, Disney's CEO, and Disney's board of directors and compensation committee each step of the way. Highly critical of Eisner's and the Board's conduct - Chancellor Chandler notes that "many lessons of what not to do can be learned from defendants' conduct here" - the court nevertheless forcefully held that each of Disney's directors fulfilled his or her fiduciary duties of care and good faith.

Our Take. The Disney opinion has been, and will continue to be, subject to much analysis in the weeks and months ahead. Following is our take on how this decision should guide the conduct of corporate directors and officers:

1. ***Traditional fiduciary duty principles establish the standards of director and officer liability, not "the aspirational ideal of best practices."*** The court states in its decision that the fiduciary duty of due care "requires that directors of a Delaware corporation 'use that amount of care which ordinarily careful and

prudent men would use in similar circumstances' and 'consider all material information reasonably available' in making business decisions." The court further emphasizes that that "[u]nlike ideals of corporate governance, a fiduciary's duties do not change over time." Thus, the decision affirms that traditional corporate governance principles establish the standards for liability and that directors will not be found liable based on a failure, even a material failure, to act as "perfect" directors should.

2. ***At some point, aspects of today's "aspirational notions of best practices" will become so embedded in corporate governance culture that the view of how an "ordinary and prudent" director would act will also change.*** The court determined that the Disney directors conducted themselves in a fashion that was within the realm of ordinary, mid-1990s board practice, and thus that they should be shielded from liability based on "21st century notions of best practices." But while the duty of care standard of liability may not change, the court does allow that "[h]ow we understand those duties may evolve and become refined." In 2005, our understanding of how the "ordinarily careful and prudent" director conducts himself or herself has evolved and likely will continue to do so over time. It is conceivable, if not likely, that a Delaware court, presented with a Disney set of facts occurring in the post-Enron, post-Sarbanes Oxley period, would find a duty of care violation.

3. ***While not legally required, aspiring to follow best practices is still the best practice.*** Granted, the defendants in the Disney case won on all counts. But this "victory" came only after 10 years of litigation, thousands of depositions and other exhibits and a 37-day trial following which the defendants' conduct

was parsed in embarrassing detail and excoriated in a written decision currently being analyzed and written about by thousands of lawyers and other commentators. Continually seeking to improve one's corporate governance practices, as defined and refined in the context of each particular company, remains the best way to avoid costly litigation and potential liability.

4. A director's loyalty must be to the corporation, not the CEO. In a telling section of the opinion, the court highlighted what may become the next avenue available to plaintiffs' attorneys. Describing how Eisner "stacked" his board "with friends and acquaintances" who allowed him to act on many things without specific board direction or involvement, the court notes that "[i]t is precisely in this context - the imperial CEO or controlling shareholder with a supine or passive board - that the concept of good faith may prove highly meaningful." In other words, directors who fail to think and act independently, who bend to the will of the CEO rather than determining for themselves what is in the best interests of the corporation, may find themselves vulnerable to duty of loyalty or good faith claims.

5. Don't be afraid to cut your losses if an executive is not working out. The plaintiffs alleged that the Disney board committed corporate waste by treating Ovitz' termination as a no-fault termination under his contract, even though it had grounds to fire him for cause and avoid paying out the full severance package. The court explained that corporate waste is rarely found, insofar as a plaintiff must prove that there occurred an "exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." While, by the standards of many, Ovitz performed his job poorly, the court agreed with the company's judgment that his poor performance did not rise to the level of "cause" as defined under his employment agreement. Therefore, once it made the

business judgment that the company would be better off without Ovitz, the board did not commit waste by simply honoring the terms of Ovitz' contract. In this regard, the court's message appears twofold: (i) when paying out a material severance package based on a no-fault termination, a company should document its analysis as to why the termination does not constitute cause, seeking outside legal advice if necessary, and (ii) don't be afraid to cut your losses and pay out a large, no-fault severance package if the removal of a particular executive is in the company's best interests.

6. Good corporate governance should be exercised on all matters brought to the board or a committee for action. The Disney court distinguished the Ovitz matter from a situation involving a sale of the company and indicated that the Disney directors' performance, while not ideal, was sufficient under the facts of this case, and was not financially material to Disney (much of the value of Ovitz' severance package came in the form of options that Disney did not expense at the time). This last point - the "immateriality" of Ovitz' termination package to Disney - is one that has been overlooked in most written commentaries on the Disney decision. One can conceive, however, of situations in which the termination of a senior executive and payout of a large severance package could have material ramifications, financial or otherwise, to a company. Accordingly, good corporate governance should be exercised in all matters brought to the board for action, even those, like employment matters, that may be more routine in nature.

7. Delaware corporations should ensure that they have Section 102(b)(7) provisions. Section 102(b)(7) enables Delaware corporations to adopt provisions prohibiting directors from being held personally liable for duty of care claims. With such a provision in place, directors will be protected unless a plaintiff can establish duty of loyalty or good faith violations, which are more difficult to prove.

8. **A good director operating within a poorly functioning board will be protected.** The court followed precedent in holding that director liability determinations must be made on a director-by-director basis. A director now has even greater incentive to fulfill his or her duties in the best manner possible, even if his or her colleagues are derelict.

9. **Keeping good minutes of board and committee meetings is critical.** The Disney trial occurred nearly 10 years after the actions in question took place. Due to fading memories of the players involved, the court relied heavily on the written minutes of the board and the Disney compensation committee in making its findings as to how the directors performed, including how long matters were considered, who was involved in the discussions, the depth of these discussions, etc. Minutes should adequately and accurately reflect a board or a committee's informed and good faith consideration of the material issues brought before it and the process that the board or committee follows in reaching its ultimate decision.

10. **Compensation committees will remain in the spotlight.** With so much focus today on executive compensation, we offer the following recommendations to compensation committees:

- **Get the full picture.** Directors who serve on compensation committees need to understand the numerous elements that make up executive compensation, the role each plays in motivating short-term and long-term performance and the cost of each element to total cost, including understanding option-pricing models like Black-Scholes, indexed options and performance-accelerated stock options. With the increased scrutiny being given to equity and other types of compensation, compensation committee members must understand and calculate each component of each senior executive's compensation prior to approving a pay package.
- **Legal compliance.** A compensation committee is responsible for ensuring that all aspects of executive compensation, particularly

perquisites and fringe benefits, are clearly, comprehensively and promptly disclosed. In addition, the committee should obtain assurances from management and the company's legal advisors that all compensation and benefits are proper and legal, and that shareholder approval is being sought when appropriate.

- **Pay for performance.** Institutional investors want compensation committees to promote meaningful and well-articulated relationships between compensation and company performance by tying compensation to the true drivers of corporate performance. In this regard, committees should consider whether their company's compensation structure does – or should – reward moderate but sustained growth, as opposed to creating incentives for inappropriately risky behavior. Among the current institutional investor “hot buttons” are the need for compensation committees to focus on performance-based stock options or other performance-based equity incentives and to rethink golden parachute arrangements, particularly when an executive is rewarded in a change-of-control situation after he or she has “run the business into the ground.”

- **Outside advisors.** Compensation committees must inform themselves in a thoughtful manner regarding the best compensation techniques to use to achieve optimal long-term results for the corporation and its shareholders. Outside benefits advisors should be used as just that – advisors – and their advice, particularly if based on survey data, should not be a substitute for the exercise of informed business judgment and common sense.

- **Fiduciary responsibility.** The manner in which fiduciary responsibility for a company's employee benefit plans is allocated and exercised should be reviewed to ensure that the relevant fiduciaries (which include those who appoint, and must monitor, the fiduciaries who have day-to-day responsibilities for plans) are aware of their status as such, understand their responsibilities and carry out their fiduciary duties in compliance with the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). Particular attention should be paid to the special fiduciary and conflict-of-interest issues raised when a corporation requires or permits 401(k) plan assets to be invested in company stock.

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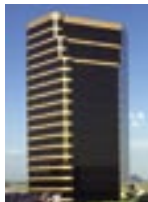
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