DEAL POINTS

The Newsletter of the Committee on Negotiated Acquisitions

Disney for Deal Lawyers

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Front and center on the national legal stage last year was the *Disney* litigation, which consumed thirty-seven trial days in Delaware's Court of Chancery and resulted in a 175 page opinion in which Chancellor William B. Chandler concluded that the defendants had not breached their fiduciary duties in connection with the hiring and termination of Michael Ovitz as the Walt Disney Company's President. While *Disney* dealt primarily with the hiring, termination, and compensation of a key executive and the conduct of directors in connection therewith, many of its teachings are particularly relevant to deal lawyers advising corporate boards or committees about the negotiation, evaluation, and approval of significant transactions.

The litigation involved a derivative suit against Disney's directors and officers for damages allegedly arising out of the 1995 hiring and the 1996 termination of Ovitz as Disney's President. Ovitz was employed by Disney for little more than a year before he was terminated. The termination resulted in a non-fault termination payment to Ovitz of roughly $38 million in cash under the terms of his employment contract, as well as the immediate vesting of 3

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million options to buy Disney stock. The shareholders alleged that the defendant directors had breached their fiduciary duties both in approving Ovitz's employment agreement and in later allowing the payment of the non-fault termination fee.

In an earlier decision, the Court of Chancery had declined to dismiss the plaintiffs' complaint, finding that it adequately alleged facts sufficient at the pleading stage to overcome the presumptions of the business judgment rule by virtue of allegations calling into question the good faith of the directors in making the challenged decisions.[2] In that decision, Chancellor Chandler had held that, if true, the allegations of the complaint "imply that the defendant directors *knew* that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss."[3] If plaintiffs could make such a showing at trial, the Court held, the directors' conduct would fall outside the scope of the Section 102(b)(7) exculpatory provision in Disney's certificate of incorporation, which eliminated the personal liability of directors for monetary damages for breaches of fiduciary duty, subject to certain exceptions, including, most notably, actions not in good faith and intentional misconduct.[4]

The matter thus proceeded to trial. After extensive analysis of the evidence and arguments presented during the lengthy trial, Chancellor Chandler concluded in his post-trial opinion that plaintiffs had failed to prove their claims and entered judgment in favor of defendants on all counts.[5] With respect to the hiring of Ovitz and the approval of his employment agreement, the Court held that the defendants had not acted in bad faith and were at most "ordinarily negligent" and, therefore, had not breached the fiduciary duty of care, which requires a showing of conduct rising to the level of gross negligence.[6] As to the ensuing no-fault termination of Ovitz and the resulting termination payment pursuant to his employment agreement, the Court held that the full board did not (and was not required to) approve Ovitz's termination, that Michael Eisner, Disney's CEO, had authorized the termination, and that neither Eisner, nor Sanford Litvack, Disney's General Counsel, had breached his duty of care or acted in bad faith in connection with the termination.[7]

The Fiduciary Duty of Good Faith

One aspect of the Chancellor's decision of particular relevance to deal lawyers is the Chancellor's clarification of when directors may be deemed to have violated the so-called fiduciary duty of good faith. Deal lawyers have long been well versed in the traditional fiduciary duties of care and loyalty, but the duty of good faith – to the extent such a duty exists separately from the duties of care and loyalty – was less well understood. The Chancellor's earlier decision at the motion to dismiss stage of the *Disney* litigation gave rise to much debate over the contours of the duty of good faith. The resulting uncertainty caused concern for corporate practitioners because a breach of the duty of good faith cannot be subject to exculpation under a

[2] *See In re The Walt Disney Company Deriv. Litig.*, 825 A.2d 275 (Del. Ch. 2003) (hereinafter "*Disney I*"). The *Disney I* opinion focused on an amended complaint filed by plaintiffs after their initial complaint had been dismissed for failure to adequately plead breaches of fiduciary duty. *See Brehm v. Eisner*, 746 A. 2d 244 (Del. 2000). The Supreme Court's decision expressly found that a majority of the Disney board (including Michael Eisner) was disinterested in the challenged transaction, and prohibited plaintiffs from relitigating that issue.

[3] *Id.* at 289.

[4] *Id.* at 289-90 (citing 8 *Del. C.* § 102(b)(7)).

[5] *See In re The Walt Disney Company Deriv. Litig.*, C. A. No. 15452, 2005 Del. Ch. LEXIS 113 (Del. Ch. Aug. 9, 2005) (hereinafter "*Disney II*").

[6] *See id*. at *190.

[7] *See id*. at *235, *241, *244-45.

Section 102(b)(7) charter provision, would deprive a director of the right to be indemnified by the corporation,[8] and might result in the unavailability of D&O insurance coverage.

In his post-trial decision, the Chancellor acknowledged that existing Delaware case law had not clearly defined the scope of the duty of good faith or even provided clear guidance about whether such a duty exists separately from the duties of care and loyalty. In that regard, the Court suggested that good faith is a fundamental, overarching concept that encompasses "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."[9] The Court explained that "[t]o 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."[10] Although the Court declined to "create a definitive and categorical definition of the universe of acts that would constitute bad faith," it observed that a lack of good faith may be shown, for example, when: (1) a fiduciary "intentionally acts with a purpose other than that of advancing the best interests of the corporation;" (2) a fiduciary "acts with the intent to violate applicable positive law;" or (3) the fiduciary "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[11] Notably, each example involves an element of subjective intent. The Court further explained:

> Upon long and careful consideration, I am of the opinion that 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. Deliberate indifference and inaction *in the face of a duty to act* is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.[12]

In applying the facts of the case, the Court concluded that the Disney directors had not acted in bad faith in connection with the hiring of Ovitz and the approval of his compensation arrangement. Although the Chancellor's opinion chastises Eisner and other directors for not acting in accordance with best practices, the Chancellor nevertheless found that Eisner and the other directors had acted in good faith and with the subjective belief that their actions were in the best interests of the Company.

The Business Judgment Rule and Best Practices

In concluding that the defendants had not breached their fiduciary duties, the Chancellor leaned heavily and, to many, reassuringly, on the business judgment rule, as it has been understood traditionally. The Chancellor noted that "the greatest strength of Delaware's corporation law" – and the business judgment rule in particular – is the fact that corporate fiduciaries, although held to "a high standard in fulfilling their stewardship over the assets of others," are granted "wide latitude in their efforts to maximize shareholders' investments" when they act "faithfully and honestly on behalf of those whose interests they represent."[13]

Differentiating between the role of the Court to provide a remedy for breaches of fiduciary duty and the role of the market to provide a remedy for bad business decisions, the Court reasoned as follows:

> Even where decision-makers act as faithful servants, however, their ability and the

[8] *See* 8 *Del. C.* §145(a), (b) (requiring a person to have acted in good faith as a condition to indemnification).

[9] *Disney II*, 2005 Del. Ch. LEXIS 113, at *176.

[10] *Id.*

[11] *Id.* at *176-77.

[12] *Id.* at *175 (emphasis in original).

[13] *Id.* at *5.

> wisdom of their judgments will vary. The redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court. Should the Court apportion liability based on the ultimate outcome of decisions taken in good faith by faithful directors or officers, those decision-makers would necessarily take decisions that minimize risk, not maximize value. The entire advantage of the risk-taking, innovative, wealth-creating engine that is the Delaware corporation would cease to exist, with disastrous results for shareholders and society alike. That is why, under our corporate law, corporate decision-makers are held strictly to their fiduciary duties, but within the boundaries of those duties are free to act as their judgment and duties dictate, free of *post hoc* penalties from a reviewing court using perfect hindsight. Corporate decisions are made, risks are taken, the results become apparent, capital flows accordingly, and shareholder value is increased.[14]

While the Court made clear that Delaware law does not hold fiduciaries liable for a failure to comply with corporate governance "best practices" prevailing at the time a corporate decision is taken,[15] it also indicated throughout the opinion many instances in which, in the Court's view, the defendants did not appear to have complied with "best practices." The Court expressed hope that its observations "may serve as guidance for future officers and directors — not only of The Walt Disney Company, but of other Delaware corporations."[16] The Chancellor stressed that while "best practices" always include compliance with fiduciary duties, the converse is not true.[17] As the Court noted, "[a]spirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards of liability."[18]

The Court's decision in *Disney II* thus resoundingly reaffirms the importance of the business judgment rule, while offering guidance (and some fairly stern warnings) to corporate directors and officers not only with respect to compliance with the fiduciary duties of care and good faith, but also with respect to the importance of corporate governance "best practices."

<u>Lessons for Deal Lawyers</u>

The Court's findings with respect to the fiduciary duties of care and good faith, as well as its observations about "best practices," contain many practical teachings for deal lawyers advising directors in connection with M&A and other significant transactions. Those teachings include the following:

- *<u>Informal Communications With and Among Board Members</u>*: Consultation between an executive and board members, or among board members, that occurs on an individual basis and outside of a formal board or committee meeting is less helpful than consultation in the context of a formal meeting. Although some informal discussions cannot be avoided and may even be somewhat helpful in keeping directors informed in between committee or board meetings,[19] informal consultation on an

14 *Id.* at *7-8.

15 *Id.* at *4-5.

16 *Id.* at *8.

17 *Id.* at *147.

18 *Id.* at *147 n. 399 (quoting *Brehm v. Eisner,* 746 A.2d 244, 256 (Del. 2000)).

19 *See id.* at 202 n. 504 ("Although it would have been ideal if the other members of the compensation committee were more substantively involved in those negotiations, it would

individual basis should not be a substitute for full deliberation at a formal meeting. Consultation outside of a formal board or committee meeting may result in members of the board or a committee being unequally or unevenly informed and may have the effect of diminishing the board's or committee's ability as an institutional body to function together collectively, collegially, and deliberatively.[20] Also, informal consultations outside of a formal meeting are often undocumented, leaving the board or committee with an insufficient record to establish that proper deliberation and care with respect to a matter occurred.

- *Time for Deliberations*: Adequate time should be allotted at scheduled board or committee meetings for consideration of material matters. Chancellor Chandler emphasized that the Disney compensation committee met for only one hour to consider the Ovitz employment agreement,[21] and in his prior decision on the motion to dismiss stressed the complaint's allegations about the failure of the board to spend any significant time deliberating over the employment agreement.[22]

- *Minutes*: If board or committee action is challenged, minutes often become some of the most significant evidence. In both the post-trial decision and the earlier decision on the motion to dismiss, the Court relied on board and committee minutes as evidence of what was and was not discussed at meetings, how long discussions lasted, whether questions were asked, and what advice was given. In the motion to dismiss opinion, Chancellor Chandler expressly noted that the discussion of Mr. Ovitz's hiring took up one and a half pages in the fifteen pages of minutes of the meeting at which it was approved, and that much of that discussion centered on a "finder's fee" to be paid to another director.[23] In the post-trial opinion, the Chancellor expressed some frustration at the difficulty in ascertaining the length of a committee meeting and the amount of time at that meeting devoted to discussion of Ovitz's employment agreement.[24] Thus, meeting minutes should be detailed enough that it is later possible for the directors to establish, or a neutral fact finder to determine, not only the substance of matters discussed, but the approximate length of time spent considering matters of importance. In addition, to the extent directors have engaged in informal consultations outside of a formal meeting to inform themselves of the terms and circumstances surrounding significant matters later considered at a board or committee meeting, the meeting minutes should reference those consultations.

- *Unilateral Action of Officers*: The taking of action by an executive with respect to a matter prior to formal board action may give rise to an inference that the board's later approval is a mere "rubber stamp" of the executive's action. While execution of an employment letter agreement by Mr. Ovitz and Mr. Eisner on behalf of the company prior to board approval was not legally binding upon the company, the Chancellor observed that such action, coupled with the public announcement of Mr. Ovitz' hiring,

certainly be unwieldy as a practical matter to require the entire committee, together as a whole, to negotiate on the Company's behalf"); *id.* at *216 (noting that compensation committee members had understanding of the *bona fides* of Ovitz's employment agreement, in part, due to "more than minimal informal discussions" among committee members before the committee meeting).

20 *See id.* at *135 n. 373 (quoting expert testimony).

21 *See id.* at *215.

22 *Disney I*, 825 A.2d at 287.

23 *Id.*

24 *Disney II*, 2005 Del. Ch. LEXIS 113, at *215.

appeared to have placed inappropriate pressure on the board to approve the action.[25] If an executive has not first consulted with and received appropriate authority from the board, caution should be exercised before the executive executes a letter of intent or other agreement relating to a proposed significant transaction, even if the agreement is not technically binding without board approval.

- *Reviewing Documents and Proposed Agreements*: All board or committee members should have the opportunity to review written materials regarding an important action prior to their decision. Where the action involves execution of an agreement on behalf of the corporation, although not strictly required, the directors should ideally have an opportunity to review the agreement itself. At a minimum, they should review a detailed written summary of the agreement's material terms.[26] Moreover, where further negotiation of an agreement results in a material change in the terms most recently reviewed by the board, those changes should be clearly communicated to the board prior to taking action on behalf of the corporation.

- *Reliance on Experts*: If experts and advisors have been selected with care and directors rely on their advice in good faith, the fault for any errors or flaws in the expert's advice will be laid at the feet of the expert and directors will not be held responsible unless they are shown to have had actual knowledge of such errors.[27] To ensure maximum protection for directors, reliance on the advice of experts or outside counsel, including care in the selection process, should be properly documented. An expert's advice should ideally be memorialized in writing.[28] Also, although it is not necessary for any expert or advisor upon which directors will rely to make a formal presentation at the board or committee meeting at which the action is considered that is generally the better practice.[29]

Conclusion

In addition to reaffirming the importance and continued efficacy of the business judgment rule and providing much needed guidance about the scope and contours of the fiduciary duty of good faith, the Court of Chancery's post-trial decision in *Disney* offers many lessons for deal lawyers about what officers and directors should and should not be doing when negotiating, evaluating, and approving significant corporate transactions. An appeal of the Court of Chancery's decision is currently pending before the Delaware Supreme Court. Briefing and oral argument on that appeal have been completed and the litigants currently are awaiting a decision. One may reasonably expect that the Delaware Supreme Court will offer in its ruling a further explication of the fiduciary duties of care and good faith and perhaps additional guidance on corporate governance "best practices" in the context of evaluating and approving significant corporate transactions.

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[25] *Id.* at *195, *198-99.

[26] *See id.* at *218 (review and discussion of full text of then-existing draft employment agreement not required).

[27] *Id.* at *220-21.

[28] *Id.* at *100-02.

[29] *Id.* at *218.