



2006

Corporate Law - Fiduciary Breach - The Delaware Court of Chancery Employed a Gross Negligence Standard in a Case of Director Inaction and Held That the Directions of the Walt Disney Company Did Not Breach Their Fiduciary Duty of Due Care

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Recommended Citation

Leslie Mattingly, *Corporate Law - Fiduciary Breach - The Delaware Court of Chancery Employed a Gross Negligence Standard in a Case of Director Inaction and Held That the Directions of the Walt Disney Company Did Not Breach Their Fiduciary Duty of Due Care*, 59 SMU L. Rev. 405 (2006)

<https://scholar.smu.edu/smulr/vol59/iss1/11>

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CORPORATE LAW—FIDUCIARY
BREACH—THE DELAWARE COURT OF
CHANCERY EMPLOYED A GROSS
NEGLIGENCE STANDARD IN A CASE OF
DIRECTOR INACTION AND HELD THAT
THE DIRECTORS OF THE WALT DISNEY
COMPANY DID NOT BREACH THEIR
FIDUCIARY DUTY OF DUE CARE

*Leslie Mattingly**

AFTER the high-profile hiring and firing of Michael Ovitz by The Walt Disney Company (“Disney”), the corporation’s shareholders brought a derivative suit against the company’s board of directors in the case of *In re The Walt Disney Co. Derivative Litigation*.¹ The shareholders alleged that the board members had “consciously and intentionally disregarded their responsibilities” with respect to their decisions to hire and fire Ovitz; thereby, breaching their fiduciary duties to the corporation.² The Chancery Court of Delaware disagreed and held in favor of the defendants.³ In the context of director inaction, the court should employ an ordinary negligence standard, because directors who ignore their responsibilities should not benefit from the presumption of the business judgment rule. Further, even with the protection of the business judgment rule, the facts of the case do not support the court’s conclusion that Disney Chairman and CEO, Michael Eisner, availed himself of all reasonable information available in making his decisions to hire and fire Ovitz, because the process he employed in making that decision completely denied involvement to the rest of the board of directors.

The saga began with the sudden death of Disney’s president, when the company was faced with finding a replacement.⁴ Eisner took complete

* B.A., Texas Christian University; J.D. Candidate, SMU Dedman School of Law (May 2007). Special thanks to Will, for putting up with me—I know it’s not easy.

1. *In re The Walt Disney Co. Derivative Lit’g*, No. Civ. A. 15452, 2005 WL 2056651, at *1 (Del. Ch. Aug. 9, 2005).

2. *Id.* at *1, *35.

3. *Id.* at *1.

4. *Id.* at *3.

control of the process and actively pursued his friend of almost twenty-five years, Ovitz.⁵ Ovitz was a co-founder of Creative Artist Agency (CAA), a preeminent talent agency.⁶ Eisner enlisted Irwin Russell, the chairman of Disney's compensation committee, to negotiate the financial terms of the deal.⁷ Relying on nothing more than the approximated representations of Ovitz's attorney, Russell assumed that Ovitz was earning roughly \$20 to \$25 million a year at CAA.⁸ After developing a proposed employment agreement, Russell prepared a study of the agreement for Eisner which reported that Ovitz's salary would be much greater than the Disney CEO's and that the number of stock options provided for in the agreement far exceeded not only Disney standards, but those of corporate America.⁹ Financial analysis revealed that Ovitz's proposed employment agreement was worth somewhere between \$23 and \$24 million per year once Ovitz's salary and stock options were taken into consideration.¹⁰ The agreement also contained a non-fault termination provision which would be triggered if Disney fired Ovitz for any reason other than gross negligence, malfeasance, or if Ovitz walked away for a reason not permitted by the agreement.¹¹ During these negotiations, Eisner called a board meeting, before which only three board members knew about the negotiations with Ovitz or the terms of the employment agreement.¹²

Eisner informed Disney's general counsel and chief financial officer that Ovitz had accepted the offer, and both men were unhappy with the decision.¹³ The next day, however, Ovitz and Eisner signed the agreement, which outlined Ovitz's employment terms.¹⁴ The agreement was subject to the compensation committee's and board of director's approval; however, Eisner never provided a copy of the analysis or the actual terms of the agreement to the committee.¹⁵ When the committee met, they discussed the terms of Ovitz's agreement for merely an hour, and never examined an actual draft of the agreement.¹⁶ Afterward, the full board unanimously elected Ovitz Disney's president.¹⁷ It was apparent early on, however, that Ovitz was failing to integrate into the corporate culture at Disney and had little, if any, success with the projects to which he was assigned.¹⁸ The plaintiffs alleged grounds for a fault-based termination existed, because Ovitz was a habitual liar and he failed to

5. *Id.*

6. *Id.* at *3-4.

7. *Id.* at *5.

8. *Id.*

9. *Id.* at *6.

10. *Id.* at *7.

11. *Id.* at *6.

12. *Id.* at *7.

13. *Id.* at *8.

14. *Id.*

15. *Id.*

16. *Id.* at *9.

17. *Id.* at *10.

18. *Id.* at *11-14.

comply with the company's expense policy.¹⁹ The court, however, did not believe there was sufficient evidence of this.²⁰ In the end, Eisner concluded that his only alternative was to terminate Ovitz in a non-fault manner, thus triggering his extremely generous severance package.²¹ Again, no one sat down to a full board meeting and no outside consultation occurred before making the decision.²²

The plaintiff-stockholders brought this suit in the Court of Chancery of Delaware.²³ After surviving the defendants' motions for summary judgment, the plaintiffs were left with the burden of proving that the directors did one of the following things: breached their fiduciary duties, acted in bad faith, or exercised unadvised judgment when they hired and subsequently fired Ovitz.²⁴

The Delaware court ultimately held that the defendants did not breach their fiduciary duties or commit waste. In so deciding, the court employed a standard of gross negligence to determine whether a breach of the duty of care occurred²⁵ and measured good faith against "the concept of intentional dereliction of duty" and "conscious disregard for one's responsibilities."²⁶ Under these standards, the court reasoned the defendants "were at most ordinarily negligent" and, therefore, did not breach their fiduciary duty of care.²⁷ Further, through the use of a subjective standard, the court found that the directors acted in good faith.²⁸ The court determined that the duty of loyalty was only at issue in analyzing Ovitz's behavior surrounding his termination.²⁹ On this issue, however, the court found that because Ovitz did not play a part in the decision to terminate himself without cause, he did not breach his fiduciary duty of loyalty.³⁰

The court reasoned that, in order for the plaintiffs to prevail on all claims, they must rebut the presumption imposed by the business judgment rule—that decisions of the board are informed, in good faith, and made in the best interest of the company.³¹ Alternatively, the plaintiff must show that the challenged transaction constituted waste,³² meaning

19. *See id.* at *16.

20. *Id.* at *14-16.

21. *Id.* at *20. Regarding the decision to fire Ovitz, the court came to the correct conclusion that according to the bylaws, the board did not have a duty to act, therefore they did not breach their fiduciary duties or act in bad faith by failing to take action. The court found that Eisner exercised proper business judgment in determining that a non-fault termination was his only option. *Id.* at *51. The severance package's value was estimated to be worth between \$70 and 140 million. *Id.* at *25.

22. *Id.* at *18, 20.

23. *Id.* at *1.

24. *Id.* at *36.

25. *Id.* at *32.

26. *Id.* at *36.

27. *Id.* at *39.

28. *Id.* at *41-43, 46-47.

29. *Id.* at *31.

30. *Id.* at *37.

31. *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

32. *The Walt Disney Co. Derivative Lit'g*, 2005 WL 2056651, at *31.

no reasonable business person could find that the corporation received adequate compensation for the transaction.³³ In order to rebut the presumption imposed by the business judgment rule, the plaintiffs must show that the defendant directors breached their fiduciary duties of due care or loyalty.³⁴ If plaintiffs proved that the directors committed waste, this would equate to an act of bad faith on their part.³⁵

To determine whether the Disney directors violated their fiduciary duty of care, the court relied on the Supreme Court of Delaware's summary statement in *Brehm v. Eisner* that directors must consider all material information that is reasonably available when making a business decision.³⁶ To determine whether there was a violation when the directors failed to act, the court used the standard set forth by *In re Caremark International Inc. Derivative Litigation*,³⁷ in which the court held that the board's consistent and continuous failure to engage in oversight will condition liability.³⁸ For purposes of good faith, the court stated that directors must act with "honesty of purpose and in the best interests and welfare of the corporation,"³⁹ basing this conclusion on examples of bad faith given in *Gagliardi v. Trifoods International, Inc.*⁴⁰

Applying these standards to the facts of this case, the court reached the conclusion that the defendants had not breached their fiduciary duties to the shareholders of the corporation. Concerning the issue of waste, surrounding the firing of Ovitz, which triggered his non-fault severance package, the court found that there was no way that the company could have avoided this result, because there were no grounds for a fault-based termination and the company was better off without Ovitz.⁴¹ As to the decision by the board to hire Ovitz in the first place, despite the lack of board meetings to discuss the issue, Eisner's failure to inform the board of the negotiations until they were essentially complete, and the failure to provide the compensation committee with a draft of the proposed employment agreement; the court found that the directors satisfied the standard required of them—to consider all material information that is reasonably available in making their decision.⁴² The court repeatedly emphasized that the standard in making these determinations is gross negligence and that, while the actions of the board fell far short of what shareholders should expect of their fiduciaries, the actions did not rise to the level required for gross negligence.⁴³

33. See *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000).

34. *Cede & Co.*, 634 A.2d at 361.

35. *The Walt Disney Co. Derivative Lit'g*, 2005 WL 2056651 at *32.

36. 746 A.2d at 259.

37. 698 A.2d 959 (Del. 1996).

38. *Id.* at 971.

39. *The Walt Disney Co. Derivative Lit'g*, 2005 WL 2056651, at *36.

40. 683 A.2d 1049 (Del. Ch. 1996).

41. *The Walt Disney Co. Derivative Lit'g*, 2005 WL 2056651, at *39.

42. *Id.* at *39-47.

43. See *id.* at *41.

The standards employed by the court for establishing a breach of the fiduciary duty of care, while certainly based on precedent, present a contradiction in terms that has persisted in duty of care jurisprudence. The court first cites *Graham v. Allis-Chalmers Manufacturing Co.* for the proposition that due care requires a fiduciary to act with the “amount of care which ordinarily careful and prudent men would use in similar circumstances.”⁴⁴ This standard appears to be an ordinary negligence standard of liability. The court then relies on seemingly contradicting precedent that actions taken by directors must be grossly negligent in order to give rise to an actionable claim.⁴⁵ Ultimately, the court adopted a gross negligence standard for determining liability.⁴⁶ Unfortunately, the apparent consequence of adopting this standard is to allow a director to escape liability despite a failure to act as a reasonably prudent man. In this case, the Chancery Court should have followed the line of cases which have held that ordinary negligence is the standard for determining liability when the claim alleged is director neglect, or inaction,⁴⁷ as was the case with the board in Disney, with the exception of Eisner and Russell. That line of case law reasoned, correctly, that the gross negligence standard was the proper corollary to the business judgment rule. In cases of director inaction, however, where the business judgment rule is inapplicable, the court held that the standard should be one of ordinary negligence, as the deference given to directors performing their duties to the best of their abilities should be greater than the deference awarded to a director who has completely abandoned his responsibility.⁴⁸ This rationale properly advances the policies underlying the business judgment rule, and the decision is in line with the decision in *Allis-Chalmers*.⁴⁹ The court concedes that the actions of the board were negligent with respect to their duties surrounding the decision to hire Michael Ovitz; therefore, those directors who were accused of inaction should be held liable under the ordinary negligence standard.

Concerning Eisner’s liability, the court improperly declined to consider the unilateral process Eisner employed in deciding to hire Ovitz, establishing the terms of his employment agreement and compensation package, and determining whether he complied with his fiduciary duty of care. Being the “mastermind” behind these decisions, Eisner should properly enjoy the benefit of the business judgment rule. Despite this benefit, one could argue that Eisner’s behavior rose to a level which constitutes a breach of his fiduciary duties. The court states that he “failed to keep the board as informed as he should have,” “stretched the outer boundaries of his authority as CEO by acting without specific board direction or in-

44. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

45. *See Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000).

46. *The Walt Disney Co. Derivative Lit’g*, 2005 WL 2056651, at *32.

47. *See, e.g., Rabkin v. Philip A. Hunt Chem. Corp.*, 1987 WL 28436, at *1, *3 (Del. Ch. Dec. 17, 1987).

48. *Id.* at *3.

49. *Graham*, 188 A.2d at 130.

volvement,” and “issued a press release that placed significant pressure on the board to accept Ovitz and approve the compensation package.”⁵⁰ However, the court finds that this is irrelevant for determining whether Eisner failed to inform himself of all material information that was reasonably available, so as to breach his fiduciary duty.⁵¹ The fact that Eisner never involved the board during the negotiation or decision-making process should be considered evidence that he failed to inform himself of all material information that was reasonably available. Given that the purpose of board meetings is to foster the exchange of various viewpoints and ideas, there should be a presumption that material information could result from conducting such a meeting, especially because certain officers were opposed to hiring Ovitz from the beginning. Consequently, a board meeting should have been held to allow discussion of the reasons for their discontent with the decision. Eisner’s failure to involve the board, therefore, should be a source of potential liability because it deprived him of what could have been material information surrounding the hiring decision.

Two members of the compensation committee, Sidney Poitier and Ignacio Lozano, were extremely uninvolved in the process of approving Ovitz’s employment agreement, and clear grounds existed to hold them liable for their inaction.⁵² The extent of their involvement with the hiring process consisted of one phone conversation each, during which terms were discussed for the proposed agreement.⁵³ Their next involvement came when it was time to approve the agreement in a committee meeting (which lasted less than one hour). At the meeting they approved the agreement based on their examination of a summary term sheet, without ever reviewing the actual agreement, the correspondence which criticized the terms of the agreement, or any of the financial calculations concerning the value of the agreement.⁵⁴ The court held, however, that these men were informed of all material information, and as a result, did not breach their fiduciary duties.⁵⁵ This is an arguable conclusion. One could easily imagine that had they considered the financial analysis that revealed the true value of the employment agreement and then considered an analyst’s views on the implications of that compensation level, they might have made a different decision about the agreement and its terms.

By allowing this case to proceed to trial, the court seemed to imply that it would take a harder look at the actions of directors and possibly hold them to a stricter standard in evaluating their behavior. This assumption proved to be incorrect, as the court relied on the self-serving testimony of the very directors who had come under fire and interpreted those facts and testimony in such a way as to preclude liability at all costs. The argu-

50. *The Walt Disney Co. Derivative Lit’g*, 2005 WL 2056651, at *43.

51. *Id.* at *41.

52. *See id.* at *43.

53. *Id.* at *44.

54. *Id.*

55. *Id.* at *46.

ment for an ordinary negligence standard for directors who have neglected their responsibilities is a strong one, and the court should have considered that line of authority. Further, because the business judgment rule emphasizes the process over the substance of business decisions, it would not be difficult to conclude that Eisner's unilateral actions were inappropriate and constituted a breach of his fiduciary duty. Directors should be required to dedicate a certain amount of time and energy to their position in deciding what would be in the best interest of the shareholders. Imposing a greater risk of liability on directors of companies would not deter qualified individuals from serving in that capacity, as the courts fear, but would deter *unqualified* individuals from serving in that capacity. Given the facts of this case, combined with the decision the court reached, one can conclude that the duty of care is nothing more than a farce, and that directors are free to completely ignore their responsibilities to the company while still escaping liability.

