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Authors
Cox, James D.
Talley, Eric

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Hope and Despair in the Magic Kingdom: *In Re Walt Disney Company Derivative Litigation*

by

James D. Cox
Duke University

Eric Talley
University of California at Berkeley

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Depending on one's perspective, executive compensation represents either agency cost's most grotesque symptom or the key to its spiritual salvation. The divide between those who own a firm and those who manage it – and the costs associated with remedying that gulf – are by now well understood: Simply put, managers and owner/shareholders concur that profit maximization is the appropriate aspiration for corporate endeavors, but their non-symmetric economic stakes cause them to disagree as to both the means for doing so, and the just whose profits are to count in that maximization process.

The task of aligning interests of managers and owners is therefore a vital one for organizational and legal design. In concept (if not practice), the burden has historically been shouldered by a quasi-

"portfolio" of legal proscriptions, corporate governance structures, and executive pay arrangements, all working simultaneously. Under this view, a well crafted pay package, governance device, or fiduciary obligation would preferably work to complement other components of the portfolio, augmenting their benefits and/or dampening their shortcomings. Consequentially, then, our collective optimism about conquering agency cost problems transcends compensation packages alone, embracing instead a belief that courts are keenly able to mediate the mutual interaction of these incentive devices, whether shareholders attempt to do so explicitly or not.

The recent Delaware Supreme Court case of *In re Walt Disney Company Derivative Litigation*[1] presented a prime – and somewhat historic – opportunity for corporate law to embrace its idyllic role as an incentives mediator, and to do so in an explicit way. As we shall illustrate in the pages below, the opinion at the very least casts a dark shadow over such functional romanticism, and more likely pushes the conversation regarding enforcement of executive compensation in another (possibly unexpected) direction. Despite this ill foreboding, *Disney* nonetheless deserves its iconic moniker, for at least two reasons. First, as developed below, *Disney* minimally documents the virtually insurmountable challenge that courts face in addressing intractable agency costs issues through their executive compensation jurisprudence.[2] Perhaps more constructively, however, *Disney* might be understood as an early harbinger of a new template (still embryonic)

[1] 906 A.2d 27 (2006).

[2] Executive compensation is by no means the only area of the courts' difficulties in dealing with agency costs. Courts have not earned high marks in their treatments of management-

for understanding and applying fiduciary obligations for directors and officers. If the latter proves to be the case (and mitosis is still underway), it would most definitely push *Disney* into the realm of corporate law stardom.

I. The Paycheck in the Courtroom

Lawyers, young and old, are well-advised not to base their livelihoods exclusively on fees from challenging executive compensation in public companies. To do so is a recipe for ignominious starvation. Despite the abundance of seemingly worthy targets for such challenges, the pre-*Disney* jurisprudence around compensation had grown steadily and consistently deferential towards executive pay. Descriptively, at least, one can trace this evolution across three dimensions.

A. The Slow Defeat of Substance by Process

Perhaps more than anything else, Delaware courts lost their appetite for reining in executive compensation because they failed to develop a durable template for benchmarking and judging the appropriateness of specific compensation packages. If anything, while navigating their wayward tact, courts have likely contributed to the overall insularity of the compensation setting process, possibly even making the problem worse, not better. A review of the history of the

owner conflicts in several other areas, such as going private transactions and defensive maneuvers.

courts' interface with executive compensation reveals that exorbitant pay levels have long been fodder for public debate, but one that increasingly played out beyond the courtroom walls.

That hasn't always been the case. During the Great Depression there were numerous legal attacks on executive compensation -- many of them successful – focusing on bonus and incentive compensation arrangements. The policy import of these suits and compensation-related abuses was ably captured in both press accounts and in extensive congressional hearings leading up the enactment of the federal securities laws. In fact, prior to *Disney*, the most famous well known attack on executive compensation came precisely from that era. *Rogers v. Hill*[3] involved a shareholder suit surrounding bonuses awarded to executives and directors of the American Tobacco Company between 1929 and 1931. The CEO of American Tobacco, who already earned an annual salary in excess of $1 million (around $14 million in today's dollars), was granted the option to purchase immediately shares for an amount $1,169,000 below their current market value (approximately $16 million in current dollars). As part of their approval of the option arrangement, the directors awarded themselves handsome options as well. The case ended triumphantly for the plaintiff in the U.S. Supreme Court. The Court concluded that even though the arrangement had been approved by the stockholders and was therefore "supported by the presumption of regularity" that presumption nevertheless would not justify payments of sums as salaries so large as in substance and effect to amount to spoliation or waste of corporate property.

> . . . *If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of the minority.* . . . The facts alleged by the plaintiff are sufficient to require the District Court, upon consideration of all the relevant facts brought forward by the parties, determine whether and to what extent payments to individual defendants under the by-laws constitute misuse and waste of the money of the corporation.[4]

The substantive reasonableness inquiry reflected in *Rogers* would undoubtedly strike today's corporate law practitioners and scholars as both quaint and anachronistic; for it has been steadily abandoned over the last half century, displaced entirely (or nearly so) by a gradual elevation of process over substance. Signs of the sea change were first manifest in the context of the Delaware Supreme Court's treatment of executive stock options some 30 years later. Given the dominance that Delaware by then enjoyed in incorporations, it is not surprising that the state took the lead in defining the first governing standards for evaluating bonus and profit-sharing (e.g., stock option) arrangements for executives. It did so, evidently, in an admirably self aware fashion, first feigning allegiance to substantive standards that would putatively guide its review. In the leading case, *Beard v. Elster,*[5] the Court set forth the following litmus test for evaluating stock options:

> All stock option plans must be tested against the requirements that they contain conditions, or that surrounding circumstances are such, that the corporation may reasonably expect to receive the contemplated benefit from the grant of the options. Furthermore, there must be a reasonable relationship between the value of the benefits passing to the corporation and the value of the options granted.[6]

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[3] 289 U.S. 582 (1933).

[4] Rogers v. Hill, 289 U.S. 582, 591-92 (1933)(quoting in part J. Swan's dissenting opinion in the Second Circuit's decision dismissing the suit)(emphasis added).

[5] 160 A. 2d 731 (Del. 1960).

[6] Id at 737.

This language tended to echo prior precedents, in which the Court had (*inter alia*) struck down stock options granted to executives because the options could be exercised up to six months *after* their holder had resigned.[7] In contrast, *Beard* upheld an option grant that required executives to be employees when they exercised their options. Although the Court noted this factual distinction to justify its holding, it also emphasized another important (though unrelated) observation: that the option plan had been expressly approved by independent directors – a theme that would begin to take a more prominent position on stage in future cases.

Curiously, the *Beard* opinion spends little time exploring its articulated substantive standard: that there must exist a reasonable relationship between the gains the employee reaps by exercising the option and the value the corporation receives from the executive's continued service. Perhaps one reason for this neglect is the fundamental indeterminacy and, hence, non-administrability of such a standard in practice. As is well understood, an option's ultimate payoff is the difference between its strike price and the underlying security's market value at the time of exercise, a gap that reflects (or at least supposed to reflect) the change in the security's value since the date the option was granted the executive. The realized profit could be due to multiple factors, many of which, if not most, defy easy attribution either directly or indirectly to the option holder's contribution. Yet a substantive reasonability test requires a court to make just such an attribution. In the shadow of this indeterminacy, it is perhaps

[7] *See* Kerbs v. California Eastern Airways, 90 A.2d 652, 656 (Del. 1952); Gottlieb v. Heyden Chemical Corp., 90 A.2d 660, 664 (Del. 1952).

understandable why the *Beard* Court ultimately placed great faith on a more familiar and accessible indicator: the conceptualization of outside directors as unbiased monitors, exercising their business judgment within the protective shell of organizational independence.[8] Notwithstanding whether this account is more myth than description in practice,[9] judicial comfort with the concept of the independent director (or shareholder) approval steadily began to displace the substantive judicial scrutiny of executive compensation that had theretofore been the norm.[10]

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[8] Another and more important consequence of the courts' emphasis on process is that there is no legal standard by which compensation decisions might be judged. To be sure, compensation is to be "fair" and not "wasteful." But these are merely code words for "deliberate," "thoughtful," and "reasonably examined." These are expressions of process devoid of substance. In analogous areas where the courts are called on to assess the fairness of transactions because they involve obvious self dealing on the part of officers or even directors, their inquiry is more substantive. Thus, whether a building rented from a company controlled by the lessee's CEO is fair to the lessee is determined by comparing the lease's terms with leases of comparable properties. See e.g., Lewis . S.L. & E., Inc., 629 F.2d 764 (2d Cir. 1980)(fairness of related-party transaction judged by whether rents were substantially below prevailing market rents). This approach works poorly for CEO compensation. It entails the risk of the same mischief presented by the compensation committee's encounter with their consultants. And compensation practices within an industry or across many referent industries may be so out of line that the resulting reference is untrustworthy. But the greatest concern simply is that CEOs are not like apples or even prime real estate among which crisp comparisons can be made. When challenging an executive's compensation the issue is confused by the unique endowments of the executive as well as the equally unique challenges that confront the firm. Third party reference points may prove helpful, but only as a starting point. In the end, the courts are likely to defer to the compensation committee's judgment regarding just how a host of intangible variables are to be weighed in setting executive compensation.

[9] Although many of the reforms promulgated by the Sarbanes Oxley Act place great emphasis on board and committee independence, the evidence is relatively weak that such independence infatuations have a significant effect on the advent or severity of corporate scandals. Stephen P. Ferris, and Xuemin (Sterling) Yana, "Do independent directors and chairmen matter? The role of boards of directors in mutual fund governance," Journal of Corporate Finance Volume 13, Issues 2-3, June 2007, Pages 392-420.

[10] 160 A.2d at 737. The result of the shift from substance to process is that suits against executive compensation have their highest chance for success in close corporations and much lower level of success in public corporations. This is because process is more likely overlooked in close corporations whereas process is most always present in public corporations due to their ability to retain talented and compulsive counsel. Consider that, in their study of all litigated compensation disputes between 1912 and 2000, Professors

B. Demand Requirements and the Alchemy of Layered Process

Not only have process concerns provided ballast to the tenets of corporate law as applied in the boardroom, but such focal concerns were soon to colonize courtroom procedure as well. Today, the single greatest barrier that a shareholder-plaintiff faces in challenging executive compensation claims is a thoroughgoing procedural hurdle: satisfying the so-called "demand requirement." A suit challenging executive compensation is almost certain to be classified as a derivative suit: the shareholder sues in equity to force the corporation to assert its rights against another (often a corporate fiduciary). Under Delaware law, a shareholder may not commence most derivative suits before first making a demand on the board, which can refer the matter to a committee of disinterested and independent directors that is empowered to dismiss the suit as harmful to the corporation's best interests. The demand requirement is excused, however, if the shareholder can allege facts establishing a reasonable doubt either that the directors were disinterested and independent or that the action challenged was facially harmful to the corporation.

Thomas and Martin report that plaintiffs' success is about fifty percent greater in close corporations than it is in public corporation when the complaint is not process but substantively based and twice as high when the complaint focuses on process. Because the Thomas and Martin study does not reveal the 124 cases captured in their study it is likely that the public company cases are skewed toward the earlier time period of their study and do not therefore reflect the more contemporary emphasis on process over substance. If their data is so skewed, which this author believes is highly likely, then, even though their data reflect slim odds of successes enjoyed by plaintiffs attacking compensation decisions in public companies, even those slim odds are even slimmer today when the emphasis on process produces even greater insularity for compensation decision making. See Randall S. Thomas & Kenneth J. Martin, Litigating Challenges To Executive Pay: An Exercise In Futility, 79 Wash.U.L. Q. 569, Tbls. 4 & 8 at 608 & 610 (2001).

A leading Delaware case*, Aronson v. Lewis*,[11] reflects how high a hurdle the demand requirement places in the path of the derivative suit plaintiff when the focus is executive compensation. *Aronson* involved a challenge to the employment contract awarded to Leo Fink, the owner of 47 percent of the firm's voting stock. When Fink was 75 years old, the firm granted him an employment contract that would pay him $150,000 a year (plus 5 percent of the firm's pre-tax profits above $2.4 million). Fink could terminate the contract at any time and would receive a six figure consulting payment for the remainder of his life; the payments would be made even if he became incapacitated. The board also approved interest free loans to Fink that totaled $225,000. Announcing that the suit could proceed without the approval by Fink's hand-picked board only if the plaintiff's complaint alleged facts that created "reasonable doubt" regarding either the board's independence or that the compensation arrangement was excessive, the Delaware Supreme Court dismissed the action. Neither Fink's dominant ownership stake nor a facially one-sided employment/loan agreement was deemed sufficient to raise a reasonable doubt as to either the compensation package's reasonability or that it was the product of an independent judgment by the directors approving the compensation.[12]

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[11] 473 A.2d 805 (Del. 1984).

[12] Lewis was allowed to amend his complaint and as amended withstood the defendants' motion to dismiss. *See* Lewis v. Aronson, 1985 WL 11553, 11 Del. J. Corp. L. 243 (Del. Ch. May 1, 1985). However, even this subsequent opinion held that demand was not excused by allegation that Fink controlled a *majority* of the shares, that the board nominees were his nominees, or that a majority of the directors served in subservient officer positions that could be terminated as a result of Fink's financial interests in various firms. What permitted the complaint to withstand a motion to dismiss was the allegation that the compensation arrangement was a means of addressing Fink's concern

Post *Aronson* decisions largely confirm the view that the decision was not aberrational.[13] One observable impact of *Aronson* is the greater prominence that the demand requirement plays in Delaware after *Aronson*. Prior to *Aronson*, defendants made motions to dismiss the derivative suit challenging executive compensation for failure to make a demand on the board in roughly the same percentage of cases in Delaware (14 percent) as outside of Delaware (18 percent); after *Aronson*, however, such motions in executive compensation decisions proliferated, and are now made in seventy-five percent of Delaware cases compared with only fourteen percent for non-Delaware cases during the same post-*Aronson* period.[14]

And, if the demand requirement is insufficiently imposing in its own right for plaintiffs, lurking in the shadows is the reality of its stubborn persistence and reappearance at later procedural junctures.

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that, in a multifaceted stock sale and purchase arrangement involving companies that seven of the Meyer's directors were themselves officers or directors, that Fink had received too low a price for the shares he sold. Thus, the complaint alleged the consulting contract with Fink was a ruse, being merely a means to use the assets of Meyers to compensate Fink for his sale of shares to companies in which seven of the Meyers directors were officers or directors. So alleged, the court believed that a demand on the board could be excused since a majority of the Meyers directors were interested in the outcome of the suit. The court also believed reasonable doubt was raised in the amended complaint whether the contract with Fink was the product of a reasonable business judgment. The amended complaint alleged that Fink lived in Florida but Meyers' operations were in New York and states other than Florida. Moreover, the amended complaint also alleged that through a contract Meyers had with a second corporation and that corporation's contract with Fink that Fink was already bound to provide managerial services to Myers. The court said this additional fact raised a reasonable doubt whether the services Fink would provide are so grossly inadequate that no sound business judgment would deem it worth what the Meyers was called upon to pay for those services.

[13] *See e.g.,* Levine v. Smith, 591 A.2d 194 (Del. 1991)(requiring demand because at least 12 of 21 directors of General Motors were believed to be independent). Beam v. Stewart, 845 A. 2nd 1040 (demand not excused despite significant personal and professional ties by majority of directors to defendant).

[14] Randall S. Thomas & Kenneth J. Martin, Litigating Challenges to Executive Pay: An Exercise in Futility?, 79 Wash. U.L.Q. 569, 579 (2001).

Thus, when the directors of Zapata Corporation agreed in 1977 to accelerate the exercise date for stock options for senior officers to just before the company announced a self-tender for its shares at substantial premium over the market price,[15] the plaintiff, eyeing a clear case for excusing the demand, filed suit on behalf of Zapata. However, four years later, the corporation creatively resurrected the demand requirement by appointing two new directors to its board of directors, assigning them to a newly created special litigation committee, and charging the committee with the responsibility for assessing whether the suit was in the corporation's best interest. The Delaware Supreme Court's landmark decision, *Maldonado v. Zapata Corporation,*[16] specifically approved the use of such a committee to insulate a company from what would otherwise be a demand-excused shareholder suit, essentially reintroducing judicial deference to "independent" directors at yet another juncture (with some caveats).[17] By so doing, the case cast additional doubt on the efficacy of derivative litigation for policing compensation practices.

C. The State Competition Dimension

A third dimension of the judiciary's apparent reluctance to scrutinize executive compensation decisions can also be understood in

[15] The apparent rationale for this move was to permit executives to avoid serious tax consequences, though so doing caused the corporation to lose the concomitant tax deduction.
[16] 430 A.2d 779 (Del. 1981).
[17] In particular, the *Zapata* court held that in addition to requiring that the special committee be independent and fully informed, the court would exercise its own business judgment in deciding whether the suit should go forward. *Id.*

the context of state competition for the provision of corporate law. Under most such accounts, states seek to project themselves as attractive jurisdictions for incorporation, offering (depending on whose account one believes) either the most "efficient" combination of statutes and corporate jurisprudence, or the most protective havens for managers to wallow in perquisites, value extraction and private benefits of control. Regardless of which interpretation one ultimately subscribes to, it has become clear in recent years that significant network effects have enabled Delaware to enjoy a secure (and likely unerodable) advantage over other states in attracting and retaining public incorporations. Within such a protected market environment, Delaware's jurisprudence and statutory structure is unlikely to be "penalized" even if it were to take on an excessively lax and permissive posture, minimizing the airing of dirty corporate laundry, emphasizing process over substance, and generally going along to get along. Although it is extremely challenging to test whether Delaware has drifted into such a territory,[18] the notable lack of substantive skepticism that Delaware has traditionally accorded executive compensation and the corresponding procedural hurdles to those challenging executive pay is at the very least highly suggestive.

More recently, it has been posited that if Delaware remains wary of any competing jurisdiction, it is not sister states but rather federal jurisprudence that represents the greatest threat. For example, Mark Roe has examined interesting correlations between Delaware decisions and poaching on Delaware's turf by federal regulatory

[18] Some, however, have certainly tried. See, e.g., Guhan Subramanian, The Disappearing Delaware Effect, 20 J. L. Econ. & Org. 32-59 (2004).

developments.[19] The thesis is that the Delaware judiciary finds its spine to resist managerial appropriation of shareholder wealth only in instances when needed to moderate or deflect entirely further federal incursions on state corporate law. Thus, judicial laxity toward managerial excesses, particularly in Delaware, may occasionally be accompanied by outlier decisions, instrumentally calculated to stave off subsequent federal regulatory intrusions.

II. *Disney* as a Culminating Event

The *Disney* case embodied each of the above maladies associated with corporate law's treatment of executive pay. Initially, many observers marked the litigation as signaling an important move towards closer judicial scrutiny of executive compensation decisions. Its ultimate resolution, however, along with events since, suggest that its effects have likely been smaller than (or at least very different from) those a *priori* expectations.

The case initially arose from the Disney board's approval of an executive compensation contract with Michael Ovitz and its implied approval of a no-fault termination of Ovitz resulting in his receipt of a sum in excess of $140 million after barely one year of employment. The Chancery Court held, based on facts set forth in a complaint that could not be more egregious, that the plaintiff's complaint withstood the defendant's motion to dismiss. Among the facts alleged was that Ovitz was hired pursuant to pressure from Disney's CEO, Michael

[19] *See* Marc J. Roe, Delaware's Competition, 117 Harv. L. Rev. 588 (2003); Marc J. Roe, Delaware's Politics, 118 Harv. L. Rev. 2491 (2005).

Eisner; that Eisner and Ovitz had been close friends for 25 years; that Ovitz had never been an executive for a publicly owned entertainment company; and that internal documents had warned that Ovitz was unqualified. In addition, a member of the compensation committee received a $250,000 fee to secure Ovitz's employment with Disney, and neither the compensation committee nor the board had received, or had an opportunity to review, either the draft or final employment contract with Ovitz. Indeed, the compensation committee and the board had devoted hardly any time at their meetings to reviewing and approving the employment of Ovitz, since the compensation committee and the board had delegated the details of the transaction to Eisner. Moreover, the board did not condition the effectiveness of the contract on their final review or approval, which is particularly notable in light of the fact that the final version of the employment contract varied significantly from the drafts earlier summarized for the compensation committee.[20] Other pertinent factors included the fact that from the outset of his employment, Ovitz evidently performed poorly; that no experts were consulted at any time in either the employment or termination of Ovitz; that the terms for Ovitz's departure were entered into without express committee or board approval; and, finally, that the severance agreement entered into by Eisner, acting for Disney, awarded Ovitz $140 million for being fired, and did so far more quickly than if he had worked through the entire term of his contract for Disney.

[20] For example, the drafts summarized for the compensation committee provided that Ovitz could invoke the non-fault termination clause (that resulted in substantial financial awards) if he was *wrongfully* terminated, died or became disabled. The final version allowed any departure to trigger the clause unless he was terminated for gross negligence or malfeasance.

A. The Judicial Windup

These are, no doubt, provocative facts in their own right. But what made the Disney litigation even more interesting was the recidivist relationship it had cultivated over time with the Delaware judiciary. In 2000, the Delaware Supreme Court took a first pass at the Ovitz compensation dispute, in *Brehm v. Eisner,*[21] affirming a prior dismissal by the Chancery Court for failure to state a claim. In so doing, however, the *Brehm* left the courtroom door partly ajar, allowing the plaintiffs the opportunity to re-plead their case. In fact, the Court provided a veritable "how-to" manual on demonstrating that the board, notwithstanding its disinterestedness and reliance on outside experts and subcommittees (both facially permitted under DGCL 141(e)),[22] might have breached its duties approving the original contract and the non-fault termination:

> To survive a Rule 23.1 motion to dismiss in a due care case where an expert has advised the board in its decisionmaking process, the complaint must allege particularized facts (not conclusions) that, if proved, would show, for example, that: (a) the directors did not in fact rely on the expert; (b) their reliance was not in good faith; (c) they did not reasonably believe that the expert's advice was within the expert's professional competence; (d) the expert was not selected with reasonable care by or on behalf of the

[21] 746 A.2d 244 (Del. Sup. Ct. 2000) (en banc).

[22] Section 141(e) reads:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation. 8 Del. C. § 141(e).

> corporation, and the faulty selection process was attributable to the directors; (e) the subject matter (in this case the cost calculation) that was material and reasonably available was so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice; or (f) that the decision of the Board was so unconscionable as to constitute waste or fraud.[23]

The second significant intersection that Delaware courts had with the *Disney* litigation came in 2003, when the plaintiffs re-pled their complaint, this time following – almost to the letter – the recipe provided three years before in *Brehm.*[24] Once again, Disney moved to dismiss the complaint, this time arguing that the complaint dealt solely with duty of care issues, and that Disney had an "exculpatory" provision in its charter, authorized under Section 102(b)(7) of the Delaware Code, allowing it to shield directors from all monetary liability associated with a breached duty of care.

Chancellor Chandler, however, refused to grant the motion, noting that by its text, § 102(b)(7) provisions do not "eliminate or limit the liability of a director: (i) [f]or any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law … or (iv) for any transaction from which the director derived an improper personal benefit."[25]

Focusing on the second exclusion above, Chandler ruled that since the plaintiff had alleged that the Disney board acted without taking into account the welfare of the company, they were essentially making a pleading that fell within one of the exceptions to § 102(b)(7).

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[23] Brehm, at 261.
[24] In re Disney SH Litigation, 825 A.2d 275 (Del. Ch. 2003).
[25] *Id.*

In denying Disney's demurer and excusing demand, the Chancellor observed:

> These facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation. Instead, the facts . . . suggest that the defendant directors consciously and intentionally disregarded their responsibilities, adopting a "we don't care about the risks" attitude concerning a material corporate decision. Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct, in my opinion, that may not have been taken honestly and in good faith to advance the best interests of the company. Put differently, all of the alleged facts, if true, 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. Viewed in this light . . . [the] complaint alleges a breach of the directors' obligation to act honestly and in good faith in the corporation's best interests for a Court to conclude, if the facts are true, that the defendant directors' conduct fell outside the protection of the business judgment rule.[26]

To be sure, the underlying complaint had remained faithful to its evolved Delaware rhetorical heritage, focusing on process rather than the substantive reasonability of compensation itself. However, Chandler's assessment of possible procedural inadequacies hinted strongly that the need for attentiveness among outside directors could critically hinge – at least in part – on the magnitude of Ovitz' compensation package.

But perhaps more compelling, this linkage bore directly on another important consideration posed to the Delaware courts in *Disney*, namely the existence and content of a theretofore unexplored third rail in fiduciary duty law: the duty to act in good faith. Then-

[26] *Id.* at 289.

Chancellor William Allen's 1991 *Caremark* opinion[27] had laid some of the initial groundwork for good faith jurisprudence, holding that a board (and/or individual members) did not act in good faith if there was a "sustained and systematic" failure of director oversight. That opinion pushed an already well established linkage between the monitoring role of directors and good faith, suggesting the possibility that woefully bad governance constituted bad faith, and was therefore actionable.

Allen's *Caremark* opinion, however, left two important questions largely unresolved. The first was whether a "sustained and systematic failure of oversight" was anything more than a simple duty of care violation by means of nonfeasance rather than misfeasance – a question that Chandler's 2003 opinion had provisionally (but not conclusively) answered in the affirmative. Second, just how extreme a departure from "good governance" would such a failure of oversight have to be in order to be actionable? For this answer, we had to wait (and in many ways we are still waiting).

After a protracted trial, Chancellor Chandler released his opinion in *Disney* in the late summer of 2005.[28] Perhaps most notably, Chandler largely reaffirmed his earlier sentiment (albeit hedging his bets all the while) that a failure to act in good faith was, in principal, an alternative means for breaching one's fiduciary duties:

> 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

[27] Caremark Int'l Derivative Litig., 698 A.2d 959 (Del.Ch.1996).
[28] In re Walt Disney Co. Derivative Litigation, 907 A.2d 693 (Del.Ch. 2005).

> 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.

In applying this standard, Chancellor Chandler did something that many observers had found surprising (at least in light of his prior holdings in the case): he held that the Disney defendants would still receive protection from the Business Judgment Rule – that is, they would enjoy a strong presumption that they acted with appropriate care and good faith when acting for the corporation. In applying this standard, Chandler found that while Disney's senior executives, board and compensation committee were far from exemplar paragons of corporate governance best practices, the plaintiffs had not overcome the business judgment rule and demonstrated a dereliction of duties meeting the "deliberate indifference and inaction" standard. In fact, in at least some specific aspects of the case (such as the allegation involving the board's decision to grant Ovitz a non-fault termination), Chandler held that any alternative decision by the board was legally unsupportable and would have been subject to a legitimate legal claim by Ovitz for damages.

B. The Supreme Court Bunts

Almost a year after the Chancery Court issued its decision on the merits, a unanimous Supreme Court of Delaware affirmed.[29]

[29] In re Walt Disney Co. Derivative Litigation, 906 A.2d 27 (Del. 2006).

Compared to Chandler's 84 page tome,[30] the Supreme Court's analysis appears veritably svelte at 47 pages. Its looks are deceiving, however; for much of the opinion incorporated the Chancery Court opinion either by reference or verbatim.

In addressing the issue of good faith, the Court found (as did Chandler) that such a doctrine was independently actionable and distinct from the duty of care. Specifically approving the lower court's formulation of bad faith as stemming from "intentional indifference and inaction" in the face of a duty to act, the Supreme Court added a visual metaphor of a *spectrum of scienter* to animate its conception of bad faith. On one extreme end of this spectrum resides deliberate and subjective motivation to do harm to the corporation and its shareholders. The opinion does not delve far into this matter, and indeed the pled facts did not allege subjective bad faith; but it would seem self evident that such conduct both should be actionable and would be on many grounds outside good faith (e.g., waste and *ultra vires*).

On the other end of the spectrum, the Court explored grossly negligent conduct, which historically would have triggered duty of care liability. Although Chandler had not definitively answered whether such conduct would also trigger good faith liability, the Supreme Court answered this with an unambiguous "no." In order to violate one's duty to act in good faith, the majority held, one had to do more than breach a duty of care. Much (though not all) of the Court's reasoning was through statutory construction: significant portions of

[30] , 907 A.2d 693 (Del.Ch. 2005).

Delaware's statutory scheme (such as §§ 102(b)(7) and 145) single out good faith distinctly, differentiating it explicitly from due care.

This left a final, Goldiloxian category, involving interstitial motivations along the lines of the Chancery Court's formulation of bad faith. Here, the Court found numerous grounds for supporting Chandler's formulation; not only would many hypothetical situations involving subjective intent to harm shareholders fall into this category, but (as noted above) notable portions of Delaware's statutory canvas were already painted with the colors of good faith. In a very real sense, possibly motivated good faith's longstanding but largely uninterrogated statutory presence, the Court seemed compelled to find that good faith should mean *something*, and here was an appropriate way to fill in the gap. After its discussion of good faith as a general matter, Justice Jacobs specifically approved of Chandler's "deliberate indifference and inaction" metric for bad faith; and moreover, the Court concluded that such a formulation was possibly under-inclusive still:

> [W]e uphold the Court of Chancery's definition as a legally appropriate, although not the exclusive, definition of fiduciary bad faith. We need go no further. To engage in an effort to craft (in the Court's words) "a definitive and categorical definition of the universe of acts that would constitute bad faith" would be unwise and is unnecessary to dispose of the issues presented on this appeal.[31]

Significantly, the Court also upheld Chandler's utilization of the business judgment rule presumption when scrutinizing defendants' alleged bad faith. Although we can surely speculate as to whether the

[31] *Id.* at 67.

case would have come out differently in the absence of such deference, the applicability of the business judgment rule within good faith cases may suggest something even more: it may imply, for example, that prospective defendants can attempt to address liability risk under the good faith doctrine by papering their decisions with additional layers of process.

C. Extra Innings

Relative to many of the other cases discussed in this volume, the *Disney* case is of a very young and still-ripening vintage. Its text, subtext, and reach are likely to be debated and remain unsettled for some time to come. However, since *Disney*, the Supreme Court has had at least one occasion to revisit the good faith doctrine, issuing an opinion that warrants mention here.

In November 2006, the Court decided *Stone v. Ritter,*[32] a case in which shareholders had brought suit against AmSouth bank in connection with a $40 million deferred prosecution settlement it reached with federal banking authorities, settling charges that it had failed to take appropriate investigative/reporting steps upon receiving credible evidence of material wrongdoing involving a money laundering and Ponzi scheme conducted by one of its account holders.

In *Ritter,* the Chancery Court had dismissed the shareholder action, holding that the plaintiffs had not adequately plead pursuant to *Caremark* that the fine was a result of a "systematic and sustained

failure of director oversight." In its opinion, the Supreme Court affirmed, and in so doing specifically linked the *Caremark* doctrine to the good faith doctrine established in *Disney*. More significantly, the Court proceeded also to render an opinion once again on whether a "Bad Faith" action constitutes a separately actionable claim from other claims involving breached fiduciary duties:

> It is important, in this context, to clarify a doctrinal issue that is critical to understanding fiduciary liability under *Caremark* as we construe that case. The phraseology used in *Caremark* and that we employ here – describing the lack of good faith as a "necessary condition to liability" – is deliberate. The purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, *ipso facto,* in the direct imposition of fiduciary liability. The failure to act in good faith may result in liability because the requirement to act in good faith "is a subsidiary element[,]" i.e., a condition, "of the fundamental duty of loyalty." [citing *Guttman v. Huang*, 823 A.2d 492, 506 n. 34 (Del.Ch.2003).] It follows that because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.[33]

This is somewhat of a curious place to end up, particularly in light of the fact that (a) none of the Disney cases had explicitly identified good faith with loyalty; and (b) Chancellor Allen in his *Caremark* opinion specifically noted that the case was one he identified as a duty of care case, and not a duty of loyalty case.[34] Be that as it may, the immediate post-Disney interpretation of the good faith doctrine – for both executive compensation and other arenas of corporate behavior – is that the doctrine of good faith resides as a wholly owned subsidiary of the duty of loyalty.

[32] Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006).
[33] Id. at 369-70.
[34] *In re* Caremark, 698 A.2d at 967.

III. Does *Disney* Mark a Sea Change for Fiduciary Law?

The *Disney* opinion and its immediate progeny have placed the debate around executive compensation, as well as the emerging doctrine of good faith, in an especially murky territory. Although it now seems possible to challenge executive pay decisions on the grounds that they were made in bad faith, the task of doing so is complicated in at least three ways. First, defendants retain the protection of the business judgment rule, which effectively precludes all but the strongest cases from going forward. Second, because of the business judgment rule's focus on process, it is likely that corporate defendants may feel invited to erect additional procedural measures to insulate them from future liability claims. And finally, at least recent interpretations of Disney have characterized the good faith doctrine, somewhat curiously, as a flavor of the duty of loyalty.

In varying degrees, each of these aspects of *Disney* supports our earlier concern: that there is no *there* with respect to substantive standards by which courts can mediate claims of excessive executive compensation. Moreover, as a matter of doctrine, *Disney* seems to provide a type of mixed message. It embraces a fiduciary obligation to act in good faith, but moves it more toward the intentional spectrum of misconduct than many before *Disney* believed was its rightful location. Given this mixed message, it is not entirely clear whether *Disney* will ultimately be seen to mark a sea change for the historical

judicial deference accorded executive pay decisions (at least within Delaware).

To be sure, the *Disney* plaintiffs got their day in court, so the demand requirement did not prove insuperable. But even here, *Disney* permits larger themes to be considered. Thus, taking the cynical view, we might cast the earlier Delaware *Disney* decisions grappling with the demand requirement as analogous to the cat playing with a mouse (no allusions to Mickey here intended) before swallowing it whole. *Brehm* provided a path for the plaintiff to escape the talons of the demand requirement and following the prescribed template the amended complaint ultimately survived a motion. This provided just enough hope that Delaware can clean the corporate stables so that federal encroachment was not necessary. Indeed, the Disney wars took place soon after Congress had already done some significant poaching on state law terrain by enacting the Sarbanes-Oxley Act of 2002. In hindsight, the Delaware Supreme Court may have merely been involved in an elaborate doctrinal gesticulation which did enough --- but only enough --- to keep Washington regulators and lawmakers convinced that Delaware's courts remain vigilant about compensation-borne agency costs.

Viewed in this light, the Delaware Supreme Court may have squandered an opportunity to be creative and innovative in fields of governance, compensation, and managerial accountability. Whether they did so rightly or wrongly is subject to considerable argument; but regardless of one's side in this debate, the sound and fury of the good faith rhetoric that ultimately produces meandering and flaccid

substantive intervention is at the very least annoying to many commentators.

Nevertheless, our opinion is that it is still too early to write off *Disney's* possible wake in at least two respects. First, the opinion still has a number of loose ends that have yet to be tied up. It is clear that the doctrine of good faith – while showing few signs of kinetic energy – has considerable potential force. It is incompletely theorized, and subject to additional refinement, alteration, and growth. It is quite possible that the Delaware courts will utilize this largely blank canvass to craft an image of the good faith duty that is rigorous and coherent.

Second, and more abstractly, the current disorganized state of fiduciary law after the *Disney* and *Ritter* decisions may provide an interesting opportunity for the emergence of a transcendental "über-duty" that envelops and swallows the other conventional duties more holistically and parsimoniously. Indeed, the traditional substantive and doctrinal distinctions between the duties of care and loyalty have always seemed a bit artificial and difficult to defend – at least to us. To be sure, the standard distinction between them is well-worn territory: the duty of care focuses on acts of managerial negligence or shirking, while the duty of loyalty focuses on conflicts of interest or stealing. Nevertheless, at their economic core, both duties are essentially legal constructs that endeavor to achieve the same result: minimizing the incidence and effects of managerial "moral hazard." It is difficult – and in many ways troubling – to understand why two legal duties with largely coterminous goals tend to go about

effectuating those goals in such distinct ways.[35] Although some legal scholars have argued that perhaps care and loyalty are regulated differently because they involve different stakes or different psychological frames for the participants,[36] the evidence for such clams seems to be somewhat unimpressive.[37]

The addition of the duty to act in good faith (with its contorted doctrinal contours) may, much like chemical clarification, cleanse these doctrinal waters by muddying them even further. Indeed, the sorts of facts that would typically establish such an allegation tend to reflect extreme managerial inattentiveness, very much akin to that described by William Allen in the *Caremark* case, and which was, until very recently, perceived as a flavor of the duty of care (pertaining to nonfeasance). Nevertheless, as *Ritter* apparently concludes, such violations are now to be categorized (curiously) as breached duties of loyalty. At the same time, while conventional duty of loyalty cases involving uncleansed conflicts of interest do not invoke the business judgment rule, the duty to act in good faith apparently does receive the rule's presumptive protection. Future decisions inevitably must grapple with locating actionable neglectfulness within this new – and confusing – terrain. Nevertheless, the end result of this doctrinal maelstrom is that the boundaries between care, loyalty, and good faith are likely to become irretrievably intertwined. And that ultimately may be a good thing, if what emerges is a more holistic fiduciary duty that

[35] For example, the business judgment rule historically does not apply to "uncleansed" duty of loyalty cases, while it provides strong protection to any duty of care case.

[36] Robert Cooter & Bradley Friedman, "The Fiduciary Relationship: Its Economic Character and Legal Consequences," 66 N.Y.U. L. Rev. 1045 (1991)

[37] Jennifer Arlen, Matthew Spitzer & Eric Talley, Endowment Effects Within Corporate Agency Relationships, 31 J. Legal. Stud. 1 (2002).

blends elements of care, loyalty and good faith, into an all things considered standard for managerial comportment. Rather than cubby holing behavior into one category or another, courts may develop a jurisprudential standard whose commands can be summarized simply: Do not engage in unreasonable amounts of moral hazard.

At minimum, the *Disney* opinion has placed a new bottle on the scales of justice; it is a bottle that is still sufficiently empty that subsequent judicial applications may fill it not with the stale bromides of the past, but rather a rich blend of substantive reference points that will guide future mediations of disputes regarding executive compensation. We believe this is possible by wisely addressing -- on a case-by-case basis -- the issues inherent in executive pay, which include the relative independence of the compensation process, demanding strong links between pay and performance, and evidence that the corporate and not the executive's interest pervades the compensation package. If appropriately developed, such a doctrine may well plant the seeds for what could become, perhaps ironically, a less deferential, less procedurally fixated, more finely tailored, more efficient, and ultimately more sensible legal landscape, to the benefit of shareholders and managers alike.