Executive Risks

Willis

December 2004

Update Disney: The Case that Means Worries Aplenty for the Kings and Princes of the Magic Kingdom

Eyes on the Trial

A rare, high-profile court case in Delaware is already changing the climate in which boards conduct business and has the potential to raise the legal standard to which directors must adhere to avoid personal liability.

The case is a shareholders' derivative suit against the Walt Disney Company's board of directors (including the independent directors who sit on the compensation committee) and concerns the propriety of the board's actions in reviewing and approving an employment agreement and non-cause termination clause negotiated by Chief Executive Officer Michael Eisner for then-Disney president and good friend Michael Ovitz. Pursuant to this agreement, Ovitz received a $140 million severance payment after just one year of service.

Having survived the defendants' earlier motion to dismiss, the case is now proceeding to trial. The event is being closely watched by those in corporate boardrooms, legal and insurance circles, and by the general public – as much for its celebrity witnesses and the exposition of business friendships "Hollywood-style" as for its potential impact on corporate governance, individual liability and D&O insurance.

The Shareholder Claims

Disney shareholders allege that directors (1) blindly approved the employment agreement without conducting any due diligence, (2) ignored Eisner's dealings with Ovitz regarding the latter's non-fault termination without any review or deliberation, and (3) rubber-stamped the CEO's decisions without any meaningful review and without hiring an outside compensation expert. Shareholders further claim that the directors should be held personally liable to the corporation for damages (presumably in the amount of the severance package) for knowingly or intentionally failing to exercise due care regarding Ovitz's employment and compensation.

Essentially, shareholders contend that the board could have obviated the problem if it had fully informed itself rather than abdicating its fiduciary responsibilities and relying on the CEO. The shareholders seek the return to the company of the allegedly excessive compensation.

Business Judgment Rule Under Attack

This case is significant for two reasons. First, courts usually refrain from ruling on corporate compensation. Second, the case has the potential to alter the standard to which directors are held when courts evaluate whether they have met the fiduciary duty owed to the corporation and if, in turn, directors are entitled to protection from personal liability. The standard at issue is the revered "business judgment rule." This rule has long been cited by directors responding to charges of breach of fiduciary duty. Simply put, the rule creates a presumption that directors making business decisions act on an informed basis, in good faith and in the honest belief that the action is in the best interests of the company.

The business judgment rule protects directors as they exercise their discretion in pursuing business opportunities for the corporation and limits second-guessing by shareholders (and the courts) if a decision has detrimental financial consequences to the corporation. Delaware and other states have enacted statutes exculpating directors from liability except where the director acted in bad faith or engaged in intentional misconduct or a knowing violation of the law; and the by-laws or charters of most corporations contain indemnification provisions requiring the corporation to indemnify its directors and officers for actions taken in good faith. The Disney case is causing alarm because the trial's outcome could set a new standard for stringent and diligent review that a board must undertake in approving financial transactions in order to invoke the business judgment rule.

Earlier Decision Denied Defendants' Motion to Dismiss

The court denied the defendants' earlier motion to dismiss, stating that the board failed to exercise any business judgment or make any good faith attempt to fulfill its fiduciary duties when it approved an employment agreement and enormous compensation package that included questionable options and termination provisions more favorable to Ovitz than to Disney. The shareholders allege that the directors knew they were making decisions without the proper information and merely passed off the details to Ovitz and his good friend, Eisner. At trial, they must prove that the directors committed an egregious breach of duty, and therefore are not entitled to protection under the business judgment rule.

The Disney case is causing alarm because the trial's outcome could set a new standard for stringent and diligent review that a board must undertake in approving financial transactions in order to invoke the business judgment rule.

Potential New Legal Standard

If the trial results in a plaintiffs' verdict, then a new, broader legal standard could emerge in Delaware, a prominent corporate jurisdiction. The court may rule that a "knowing or intentional lack of due care in the directors' decision-making process" constitutes an egregious breach of fiduciary duty resulting in denial of the protection of the business judgment rule. This may be an easier standard for prosecutors to satisfy than a "bad faith" or "intentional misconduct" standard. A plaintiffs' verdict, therefore, could simply mean that boards should be extremely careful about their diligence and approval processes regarding executive compensation.

Insurance Ramifications of a Plaintiffs' Verdict

What are the potential obligations of Disney's D&O insurance carriers in the event the trial results in a plaintiffs' verdict? Based on the terms and conditions of a current, standard D&O policy, a claim alleging breach of fiduciary duties by the directors or officers is precisely the type of alleged wrongful act that would trigger coverage. Moreover, the type of conduct that is alleged in the Disney case (failure to act, failure to investigate and conduct due diligence, and abdication of responsibility) does not appear to trigger any typical exclusions in a D&O policy such as the fraud or personal profit exclusions. Arguably, none of the exclusions contained in a typical D&O policy seem to be squarely on point for this case. However, if the court orders ex-President Ovitz to return any or all of his compensation, D&O carriers are likely to balk at paying what they may label as disgorgement of illegal profit or gain (even though there is no claim that the individuals who are seeking coverage under the policy received any illegal profit or gain). The question of if and how their D&O policy responds is of paramount importance to Disney directors facing potential personal liability, particularly in light of the earlier court decision denying them corporate indemnification.

Executive Risks Regional Contacts

For further information, please contact any of the following:

Tom Ciano
Three Copley Place
Suite 300
Boston, MA 02116
P- 617 351 7517
F- 617 351 7430
ciano_to@willis.com

Brian Gauen
10 South LaSalle Street
Suite 3000
Chicago, IL 60603
P- 312 621 4855
F- 312 621 6870
brian.gauen@willis.com

Jim Iacino
1400 16th Street
Suite 400
Denver, CO 80202
P- 720 932 8203
F- 720 932 8138
jim.iacino@willis.com

Todd Jones
5 Corporate Center
100 Matsonford Road
Radnor, PA 19087
P- 610 254 7284
F- 610 254 5600
todd.jones@willis.com

Steve Pincus
7 Hanover Square
7th Floor
New York, NY 10004
P- 212 837 0734
F- 212 509 4912
pincus_st@willis.com

Brenda Shelly
One Bush Street
San Francisco, CA 94104
P- 415 291 1520
F- 415 398 4986
brenda.shelly@willis.com

Dan Vecchio
10 South LaSalle Street
Suite 3000
Chicago, IL 60603
P- 312 621 4799
F- 312 621 6870
dan.vecchio@willis.com