

DM EXTRA!

August 12, 2005

Board Lessons Learned from the Disney Decision

“For the reasons set forth in the Court’s Opinion of this date, judgment is hereby entered in the above captioned action against plaintiffs and in favor of the defendants on all counts.”

With these concluding words, **Chancellor William B. Chandler III**, in the Delaware Court of Chancery, handed down a decision *In Re the Walt Disney Company Derivative Litigation* on August 9, 2005, in a case awaited for nearly a decade.* The Chandler decision favored defendants who had awarded outgoing CEO **Michael Ovitz** a severance package worth \$140 million, even though Mr. Ovitz had undistinguished performance.

Mr. Ovitz’s pay may have been wrong, but the process that led to it was partly right, said the court. The Chandler decision confirms the importance of some very basic steps that every board must take to receive the protections of the business judgment rule. At the same time, continuing controversy also suggests additional steps boards can take to ensure good governance.

This *DMX* highlights the practices in compensation that the Chandler decision cited in delivering his positive verdict, and suggests additional best processes any board can take to

ensure optimum governance - and even surer legal protection. Best practices are quoted from NACD’s two most recent Blue Ribbon Commission reports - [Report of the NACD Blue Ribbon Commission on Executive Compensation](#) and [Report of the NACD Blue Ribbon Commission on Board Leadership](#).

Disney’s Practices for Compliance in Compensation

- 1. The board made the decision to hire Michael Ovitz on its own; directors were not unduly influenced by management.** “I do not believe that the evidence, considered fairly, demonstrates that Eisner actively took up steps to defeat or short-circuit a decision making process that otherwise would have occurred.” (Disney 136)
- 2. The compensation committee hired a qualified independent consultant.** “[The compensation consultant] appears to have been selected with reasonable care, especially in light of his previous engagements with the Company and in connection with past executive compensation contracts that were, structurally at least, similar to the [Ovitz] agreement.” (Disney 157)

Director > Summary

About NACD

National Association of Corporate Directors (NACD), an independent not-for-profit organization founded in 1977, is the country’s only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, private, and closely held firms. NACD lists all interested members on The Director’s Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.



Two Lafayette Centre
1133 21st St. NW, Suite 700
Washington, D.C. 20036

202-775-0509
www.nacdonline.org

3. The compensation committee made its decision following arms-length negotiation and consideration of qualifications.

“Viewed objectively, the compensation committee was asked to make a decision knowing that 1) Ovitz was a third party with whom [its agent] negotiated at arm’s length; 2) Ovitz was a highly regarded industry figure; 3) Ovitz was widely believed to possess skills and experience that would be very valuable to the Company., especially in light of the CapCities/ABC acquisition...; 4) in order to accept the Company’s presidency, Ovitz was leaving and giving up his very successful business...; 5) the CEO and others in senior management were supporting the hiring; and 6) the potential compensation was not economically material to the company.” (Disney 158)

Related Best Practices for Going Beyond Compliance in Compensation

1. Separate the roles of the board and CEO in decision making and in general. “The CEO and the leader of the independent directors need to be actively involved in defining their respective roles and boundaries so that they are agreed upon.” (NACD *Blue Ribbon Commission on Board Leadership*, p. 11)

2. Consider supplementing the work of an independent compensation consultant with the work of other professional advisors. In addition to retaining an independent compensation consultant, “retain other professional advisors, including legal, accounting, and tax experts, and a skilled negotiator, if necessary.” (NACD *Blue Ribbon Commission on Executive Compensation*, p. 19)

3. Go beyond market considerations to consider business goals and internal equity. “Instead of compensation based on an alleged ‘market’ for CEO talent, strive for compensation decisions based on a strong business rationale - as well as on fairness in relation to both external and internal benchmarks.” (NACD *Blue Ribbon Commission on Executive Compensation*, p. 13)

Closing Thoughts

While the entire Disney case was compensation based, some of the observations Chancellor Chandler made were less about the rules themselves and more about the expectations of the board and how they have changed. What do we - directors, shareholders, and, yes, the courts - expect of boards today?

We now expect boards to be independent-minded as well as independent. We expect that boards will demand more information, and call on independent experts when needed. We expect that there will be a process, and that process will take into account internal equity, performance goals, and other important values.

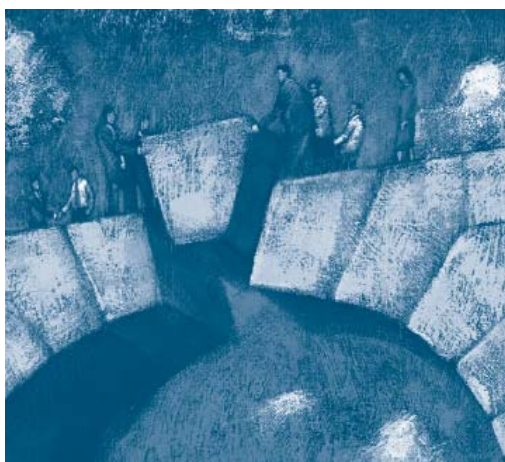
“These expectations are no longer optional. There is an urgency here,” says **Roger W. Raber**, CEO and President of NACD. “Best practices may not be legally required, but the entire tone of the Disney decision shows that they need to be embraced and implemented.”

Chancellor Chandler chided the intrusiveness of Disney’s management as “infecting” the decision making. Those are strong words. They highlight the importance of defined roles, open communication, challenging board members, healthy debate, rigorous analysis, and thoughtful decision making. The Chancellor’s stern comments imply that Disney directors played by the rules – but just barely. They did enough to keep themselves out of legal trouble, but not enough to avoid the embarrassment of the law suits, the time and energy of defending themselves, and the reputational damage done.

By focusing on what the Disney board did that was right, and by going beyond compliance, directors can increase the odds that their boardroom decisions, if ever challenged, will lead to the same positive verdict. “Disney directors were skating on thin ice and were lucky to get to the other side,” says Raber. “Directors should not tempt fate by trying to do the same. They should embrace best practices in every area, and they should do it now.” ■

* *In Re the Walt Disney Company Derivative Litigation, Consolidated C.A. No. 15452, Delaware Chancery Court, August 9, 2005.* Previous cases in the Chancery Court (Del. Ch.) and Delaware Supreme Court (Del.) included *Walt Disney Co. Derivative Litigation (Del. Ch. 1998)*, *Brehm v. Eisner (Del. 2000)*, and *Walt Disney Co. Derivative Litigation (Del. Ch. 2003)*.

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