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An Insider Revisits the "Disney Case"

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According to the author, who was there in the thick of it, the Disney court got it right. Get over it.

The smoke has cleared and the dust has settled. The corporate governance "case of the century," the shareholder derivative litigation in connection with Walt Disney Company's hiring and subsequent termination of Michael Ovitz has concluded. Both the Chancery Court and Delaware's Supreme Court found in favor of the defendant directors.

The conclusion of the "Disney case" has one exception—the continuing criticism of the Delaware courts' decisions. Immediately following the Chancery Court verdict and to the present day, these criticisms have continued. Critics charge that the courts failed to see important, highly visible facts, and that the "pro-business" inclinations of the Delaware courts drove their decisions, despite all the evidence to the contrary.

The Delaware courts have been unfairly maligned, and the inaccuracies of the criticisms should be addressed. The work of the Delaware courts as exemplified in these cases sends an important two-fold message: (1) plaintiffs' allegations must be supported by the facts; and (2) directors and officers must properly discharge

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their responsibilities.

My familiarity with the Disney case—having served as a consultant to the primary D&O carrier and its counsel—aids my understanding of the courts' opinions. The ongoing criticisms basically represent a continued acceptance of the plaintiffs' charges (led by Milberg Weiss, LLP), with the critics failing to recognize the serious flaws in these allegations, which became clear during the trial.

The Milberg Weiss Complaint

The plaintiffs' allegations were incendiary. The Plaintiffs' Second Amended Consolidated Derivative Complaint allegations included these charges:

- Paragraph 3 – Eisner recruited Ovitz as a result of their personal friendship.
- Paragraph 3 – The hiring of Ovitz was facilitated by Irwin Russell in his role as chair of the compensation committee.
- Paragraph 4 – The compensation committee "inadequately investigated the proposed terms of the Ovitz Employment Agreement (OEA)…" The compensation committee and the old board paid insufficient attention to the terms of the OEA.
- At the September 1995 meeting, more time was spent on Russell's additional compensation for handling the negotiations than on the terms of the OEA.
- Paragraph 5 – The compensation committee and the old board "indifferently and recklessly, failed to obtain and consider all material information reasonably available to them and evaluate whether the OEA was desirable from a corporate standpoint…"

The allegations continued throughout the complaint, all highly critical of the actions of Eisner and the Disney board.

The Continuing Criticisms

The criticisms that followed the courts' opinions parallel the Milberg Weiss allegations. Examples of these criticisms are provided in an article written by Professor Lucian Bebchuk, director of the Program on Corporate Governance at Harvard Law School, and in a recent book by Professor Zabihollah Rezaee. The Bebchuk article appeared immediately after the Chancery Court decision in August 2005 ("The Disney Verdict and the Protection of Investors," *Financial Times,* August 12, 2005) and opens as follows:

> The Delaware Chancery Court issued its long-awaited and important opinion in the Disney litigation earlier this week, absolving the defendant directors of any liability. The decision makes it clear that investors cannot look to judicially imposed liability for protection from disastrous compensation decisions and other governance failures. What the decision leaves unclear, however, is where shareholders can look to for such protection under existing corporate arrangements.
>
> Chancellor William Chandler's opinion vividly describes the governance failures at Disney: an imperial chief executive with "many lapses" and a board too willing to follow his whims; a critical report by a compensation consultant that is not circulated to all members of the compensation committee; directors that spend 25 minutes reviewing a compensation package whose problematic structure is now famous; and so forth.

Critics charge that the courts failed to see important, highly visible facts, and that the "pro-business" inclinations of the Delaware courts drove their decisions, despite all the evidence to the contrary.

Professor Bebchuk concludes his article:

> By making it clear that courts will not hold directors liable for governance failure, the Disney opinion highlights the need for reforms that will make directors otherwise accountable. Decisions such as this are acceptable only within a system that provides other mechanisms for protecting the interests of investors.

Professor Rezaee, in his book *Corporate Governance Post Sarbanes-Oxley: Regulations, Requirements, and*

Director Summary: A consultant for the defense in the well-known "Disney case," litigated in the Delaware Court of Chancery and the Delaware Supreme Court, shares his perspective on why the courts' decisions were the right ones. Both courts found that the termination package awarded by Disney's board to ousted CEO Michael Ovitz was within the bounds of the business judgement rule.

Business investment decisions involve risk, whether the decisions involve mergers or acquisitions, systems development, sports and entertainment undertakings, or the hiring or termination of senior executives.

Integrated Processes (John Wiley & Sons, 2007), follows Bebchuk with his statement, "This court opinion of not holding directors liable for governance failure definitely underscores the need for reforms, such as majority shareholder voting, to enable shareholders to hold directors accountable."

The Hiring and Termination of Michael Ovitz

Chancellor William B. Chandler's opinion, other trial-related information, and public documents point out the serious flaws in the Milberg Weiss allegations. These documents address the well-understood risks associated with business investment decisions, including the hiring of senior executives; the factors at work which may have influenced Disney's decision to seek the services of Michael Ovitz; the hiring process; the terms of the hiring; the performance of Ovitz; the termination process; and the terms of the termination.

Business investment decisions involve risk. Mergers or acquisitions, systems development, sports and entertainment undertakings, or the hiring or termination of senior executives all involve some degree of risk. Over the years, publicly available data has made clear the risks associated with these business investment decisions. Firms seek the services of capable CEOs, COOs, and other executives who often possess special talents. Large front-end, sign-on bonuses, stock and stock options, periodic bonuses, lucrative back-end payments, and other provisions are often components of the contracts entered into with these individuals. Both the hiring of a new executive and the promotion of a proven executive are fraught with risk.

For an example, one has only to examine the details of the hiring of Gary Wendt to lead Conseco Inc., where Wendt was paid a sign-on bonus of $45 million and received various other forms of compensation, including a back-end annual pension when he turned 65 years old. Conseco and Wendt separated only a few years after Wendt took over the leadership of Conseco.

In the case of terminations, even when a formal contract may not be in place, a company may elect to make a significant payment to a departing executive. The payout that Doug Ivestor, CEO of Coca Cola, received upon his severance from the company, is one example. When Coca Cola's board determined that Ivestor needed to step aside, Ivestor did not actually have an employment agreement that spoke to such an occurrence. Further, Ivestor was not seen as contributing in any significant ways to Coca Cola going forward. Despite that, the severance he received was estimated to be worth $166 million.

The Decision to Hire Michael Ovitz

Chandler's opinion and the documents from the case speak to Disney's decision to seek the services of Michael Ovitz. The growth in the Disney share price from the time that Eisner and Frank Wells joined Disney in 1984 until the mid-1990s was outstanding. Ten thousand dollars invested in Disney stock in September 1984 was worth approximately $160,000 by July 1994. In an April 1995 *Fortune* article, John Huey said, "Disney has consistently reported annual increases in profits and return on equity of more than 20 percent, and Wall Street has rewarded it by driving its market value up from less than $2 billion in 1994 to more than $28 billion today—bigger than Ford, for example."

In 1994, Disney was hit with multiple significant personnel issues. Frank Wells's death in April 1994 in a helicopter accident was followed four months later by Eisner's quadruple bypass surgery. At nearly the same time, Jeff Katzenberg, who headed Walt Disney Studios, departed. There had been three capable executives who had worked together for a considerable period of time; now there was only one, and that one was in the process of recovering from surgery.

Further complications developed at this time with Disney's agreement to acquire CapCities, which would add 60 percent to Disney's size. Disney's decision to seek the services of Michael Ovitz was sound. Ovitz was widely recognized as the most powerful player in the content area.

Further, Ovitz was "in play." Edgar Bronfman, chairman of Seagram's—which had acquired 80 percent of MCA from Matsushita—was estimated by *The Economist* to have placed an employment package of between $250 million and $300 million on the table to persuade Ovitz to become the entertainment group's new chairman. The MCA offer recognized both the power of Ovitz's position in running Creative Artists Agency (CAA) as well as his estimated income of $20-25 million earned annually in that position. When Ovitz declined the MCA offer, *The Economist* speculated that "it is only a matter of time before he (Ovitz) is offered yet another, more tempting media giant to run—without a young proprietor to second-guess him all the time. One would be Time Warner… another could be Viacom…"

The Hiring Process

The hiring process was well structured. An important element in Disney's search was Disney's "pay-for-performance" culture. The employment agreements of Eisner, Wells, Katzenberg, and others, all reflected a careful adherence to this culture of rewarding business success, which had been in place since Eisner and Wells arrived in the mid-1980s. There were no upfront signing bonuses, awards of stock, restricted stock, or guaranteed annual bonuses. Base salary compensation was seen as being reasonable; one stock option was awarded per multi-year employment contract and annual bonuses depended upon the achievement of defined performance criteria.

Marketplace acceptance of Disney's pay-for-performance culture is well established. Corporate governance observer Nell Minow, in a December 23, 2001, *Fortune* article on Eisner, said that prior to 1996 she "applauded Eisner not just for reviving Disney, but for taking a modest base salary of $750,000" in what she called a "truly credible pay plan based on escalated options." The compensation structure was recognized as creative, forward-thinking, and beneficial to shareholders.

Initial discussions with Ovitz involved Irwin Russell, Disney's compensation committee chair, Eisner, and later on, Raymond Watson, former Disney chairman and a member of the compensation committee. Having the chair of the compensation committee and another long-term board member head the negotiations ensured both compensation committee awareness and board awareness of the flow of these negotiations. Raymond Watson had been the chairman of Disney at the time Eisner and Wells joined.

A highly credible consultant, Graef Crystal, was quickly involved in assisting Russell and Watson. The negotiations were lengthy and contentious. Ovitz's contract terms changed during the course of these negotiations. The evidence indicates that these changes in the compensation terms favored Disney.

The Ovitz deal was arm's length. Ovitz's advisors were capable and independent of Disney, while the individuals leading the negotiations for Disney were "informed buyers of talent" who had a clear understanding of the compensation parameters within which a compensation package with Ovitz had to be structured.

The Terms of Hiring

The investment community and the press both responded in a strong, positive manner when the negotiations between Disney and Ovitz were revealed. The commentary was highly favorable, pointing out what many believed to be enormous synergies that could be achieved as a result of Ovitz joining Disney. While Eisner and Ovitz were friends, they had not been able to come to terms on any business arrangement over the many years during which both stood as powerhouses in the industry. Eisner was simply not willing to pay the prices Ovitz demanded.

In the case of terminations, even when a formal contract may not be in place a company may elect to make a significant payment to a departing executive.

Ovitz's compensation conformed to Disney's compensation structure. Ovitz received no front-end bonus, no stock awards, and no restricted stock awards. He received a stock-option grant basically equivalent to that held by Frank Wells, his COO predecessor. The no-fault termination provision was necessary to induce Ovitz to join Disney. Crystal stated that, without this provision, Ovitz almost certainly would have refused Disney's offer, and the board might have had to entice him by offering a "huge and very likely more costly front-end bonus."

Non-monetary considerations appear to have been a part of Disney's negotiations with Ovitz. In Ovitz's testimony at trial he said he found interesting the opportunity to participate on the "buy side" after having been on the "sell side" for many years. The terms and conditions of Ovitz's compensation structure were logical and consistent with those of Eisner, Wells, and Katzenberg, as well as his past position as CEO of CAA and the compensation offer by Seagrams.

Ovitz was strongly motivated to succeed. His employment agreement, as detailed above, was pay-for-performance. With no signing bonus, or similar guarantees, compensation was mostly option-based, and thus the contract created an incentive for Ovitz to succeed. Further, Ovitz had no incentive to fail, even though there was the cash-termination benefit and the fact that his options would vest in the case of a no-fault termination. In leaving CAA and declining the MCA offer, Ovitz left cash flows far larger than the Disney cash-termination benefit. Also, there was no assurance the vested options would have any value. Furthermore, Ovitz already had sub-

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stantial wealth.

In comparison with other high-profile, non-Disney executives, Ovitz's compensation could not be considered excessive. Proxy data for Michael Armstrong, CEO of AT&T; Carly Fiorina, CEO of Hewlett Packard; Gary Wendt, CEO of Conseco; Robert Nardelli, CEO of Home Depot; and Larry Johnston, CEO of Albertson's, demonstrate that Ovitz's termination payments were not excessive when compared with those referred to as "the Five Executives." Assuming all the executives were terminated within 15 months after hire and their respective share prices increased 25 percent, Michael Ovitz finished fourth in terms of total compensation received over the 15-month period.

The Performance of Ovitz

Talent-driven businesses are often characterized by high personnel turnover. In many respects, the story of Ovitz at Disney is the story of a clash of operating styles. Much has been written about Ovitz's operating style; it simply did not fit with Disney's culture. Certainly, Ovitz was highly motivated to succeed. He had the opportunity to exercise potentially significant influence at Disney and personal failure was not, in his view, an option. Once the organizational problems at Disney were set out for Ovitz, he only doubled his resolve to be successful in his role, but the culture clash was too great.

The Termination Process

Amongst the top leadership and the board, a broad-based awareness developed that Ovitz did not fit within the Disney operating structure. Yet, Ovitz appears to have been largely unaware of these fractures. He continued to be committed to succeeding in his role even after Eisner discussed with him the problems that were developing. His termination was apparently based on business considerations and contract driven. Disney made an effort to determine whether to effect a "for cause" termination and concluded that its only business option was to proceed along the lines set out in Ovitz's employment contract for a no-fault termination.

Eisner headed the separation negotiations. Such an arrangement is not unusual. Given that Ovitz was on the board, it was not possible to hold any discussions regarding his performance or his pending termination at a board meeting.

The Terms of the Termination

The monetary terms of Ovitz's no-fault termination were set out in his employment contract. Ovitz was to receive, and did receive, a cash termination payment of $38.9 million. Ovitz's 3 million shares vested, and at the time of the vesting, Disney's price had risen to $71 a share (the strike price was $57 a share). At the $71 share price, Ovitz's 3 million shares had a value of $42 million (3 million shares times $14 per share). This total is consistent with Ovitz's statement to the press regarding his termination compensation, and contrasts with reported allegations that the termination compensation paid Ovitz was $140 million.

Conclusion

Criticism of the Disney decision continues to this day, decrying the Delaware courts as excessively pro-business and the decision an affirmation of that culture. But those who would criticize the decision would do well to examine the evidence. The opinions of the Delaware courts point out the serious flaws in the Milberg Weiss allegations. Yet these same flawed allegations continue to be relied upon by the critics of the courts. A dose of reality is in order. ■

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