

Client Alert

A report
for clients
and friends
of the firm July 2003

The Delaware Chancery Court Offers Guidance on Executive Employment Arrangements

The Delaware Court of Chancery (the "Court") in late May issued its decision *In re The Walt Disney Company Derivative Litigation*, which allowed a suit brought by shareholders to proceed against directors of the Walt Disney Company ("Disney") regarding the approval of an employment agreement for Michael Ovitz ("Ovitz"), former president of Disney, and the compensation and severance paid pursuant to that agreement (allegedly exceeding \$140 million). Although largely procedural in nature, the case serves as a reminder to compensation committees, senior executives and boards of the importance of appropriate process in approving compensation arrangements. It will likely heighten the level of scrutiny given to such arrangements by compensation committees.

The case involved the hiring of Ovitz as president and his subsequent termination within an approximately one-year period. The plaintiffs alleged, among other assertions, that the directors failed to review Ovitz's final employment contract (which differed substantially from the version reviewed), failed to consider the potential costs of the arrangement and to obtain a market comparison of the contract provisions, and permitted the negotiations of the final contract and termination to be done by the chief executive officer of Disney, who was a close personal friend of Ovitz. The Court ruled on a procedural motion and assumed the truth of the far-reaching allegations of the plaintiffs. Future litigation will determine the outcome of the case, but the Court's decision underscores the importance of good corporate governance in the executive compensation arena.

The directors asserted the business judgment rule as a defense to plaintiffs' broad allegations. The business judgment rule is a judicial presumption that in

making a decision, directors were informed, acted in good faith and honestly believed that their decision was in the best interests of the corporation. This presumption ordinarily protects directors from liability in carrying out their responsibilities. However, the business judgment rule can be overturned if directors fail to act in a manner consistent with the presumption.

In *Disney*, the Court held that the plaintiffs' complaint alleged "a breach of the directors' obligation to act honestly and in good faith in the corporation's best interests" sufficient for a court to conclude, if it found the allegations to be true, that the directors' conduct fell outside the protections of the business judgment rule. The Court also found that if plaintiffs' allegations were true, Ovitz may have breached his fiduciary duties in negotiating his employment and severance arrangements by not ensuring that the negotiations were "adversarial and arm's length" and "impartial and fair." The Court noted that because Ovitz was an officer when his contract was completed, and an officer and director when his termination arrangements were completed, he owed a fiduciary duty to the company at such times.

The case underscores the "good faith" element of the business judgment rule and notes that a corporate charter provision limiting liability for breach of fiduciary duty based on Section 102(b)(7) of the Delaware General Corporation Law does not shield a director from personal liability for "acts or omissions not in good faith" or for "intentional misconduct." The Court stated in its decision, "our corporation law's theoretical justification for disregarding honest errors simply does not apply to intentional misconduct or to egregious process failures that implicate the foundational directorial obligation to act honestly and in good faith to advance corporate interests."

Disney enumerated what the Court perceived to be potential procedural defects in the manner in which the board and compensation committee approved Ovitz's employment and severance arrangements. The case indicates that in connection with the approval of compensation arrangements for senior officers, good corporate governance practices include the following:

- **Documents Reviewed Should Reflect Material Terms.** The material terms of a proposed compensation agreement, and eventually a substantially final form of the contract, along with relevant supporting materials, should be given to the compensation committee for review, discussion and analysis. If term sheets are used, they should be detailed and updated as changes occur. The final contract should be circulated for final review, discussion and approval. The compensation committee should be provided with adequate time to review the applicable materials and accumulate relevant information.
- **Consideration Should be Given to Retention of a Compensation Expert.** Projected costs of the various items of compensation provided by the contract, including severance, should be provided to the compensation committee at the time members are asked to approve the arrangement. The compensation committee should have the authority to retain and should consider retaining a compensation consultant to inform it of prevailing norms and practices and the advisability of various elements of a proposed compensation agreement. In certain cases the compensation committee may also find it advisable to retain special counsel to assist in the negotiation of significant contracts rather than leave that to the general counsel, head of human resources or usual outside counsel.
- **The Compensation Committee Should Play an Active Role.** Ideally, the compensation committee (which is typically made up of independent directors) should negotiate the terms of the compensation agreement with the executive, especially if other officers of the corporation who would otherwise do the negotiating are close to the executive or will be reporting to the executive upon commencement of employment. Because it is sometimes difficult to act and negotiate by committee, it may be more practical to have the chairman of the compensation committee or another designated member of the committee take the lead in negotiating the contract and report back to the full compensation committee. The Court explained that it is not sufficient for the compensation committee to "review the employment terms" and ask "a few questions." Instead, the "pros and cons" of various provisions and comparability to industry standards should be considered by the compensation committee.
- **Minutes Should Reflect Deliberations.** Minutes should be written to accurately reflect directors' detailed and good faith consideration of the material terms of a proposed compensation arrangement, including the devotion of substantial time to such matters.
- **Negotiations Should be Arm's Length.** An employee director should recuse himself or herself from negotiations regarding his or her compensation arrangements or be prepared to make an affirmative showing that "the

compensation arrangements are fair to the corporation." Officers (including those involved in renewal or severance discussions) need to be mindful that they have a duty to negotiate their own compensation arrangements honestly and in good faith, in a manner that is arm's length.

- **Officers Should Execute Contracts Before Commencing Work.** Ideally, newly hired officers should complete negotiation of their employment contracts prior to starting work and gaining a fiduciary obligation to their employer. Such timing enhances the arm's-length nature of the negotiation. For similar reasons (as well as to maintain relationships), whether negotiation of an executive's employment contract or severance is done before, during or after the employment period, it may also be helpful for the executive to have his or her own counsel handle the negotiations instead of negotiating personally with the compensation committee.

While the *Disney* ruling was procedural and simply allows plaintiffs the opportunity to prove the veracity of their allegations in court, it sets forth the basis on which Delaware courts will likely review the actions of compensation committees and in-place officers and directors with respect to consideration of significant compensation arrangements. In light of the changing legal and economic climate, compensation committees should look at the Court's decision as useful guidance regarding their responsibilities in reviewing and approving these arrangements.

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Client Alert

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