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EXECUTIVE SUMMARY

SARBANES-OXLEY ACT TASK FORCE

DISNEY'S MESSAGE TO HEALTHCARE GOVERNANCE: PROCESS COUNTS!

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Executive Summary

The August 9 decision of the Delaware Chancery Court in the highly publicized *Walt Disney Co.* shareholder derivative litigation has important implications for the standard of conduct to be applied to healthcare corporate directors in the exercise of their oversight function.[1]

The decision represents a strong affirmation of the traditional business judgment rule[2] and of the importance of "process" and "good faith" in decision-making. As such, it reflects a more moderate approach than evidenced in other recent decisions perceived as more easily allowing challenges to director conduct. It should not, however, be

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[1] *In Re The Walt Disney Company Derivative Litigation,* Del. Ch., C.A. No. 15452; 2005 Del. Ch. LEXIS 113 (Aug. 9, 2005) (henceforth, *Disney*).

[2] The business judgment rule is a common-law presumption that, absent evidence of fraud, bad faith or self-dealing, corporate directors will be presumed to have obtained relevant information about a matter under consideration and acted on such matter in the best interests of the corporation. Essentially, it provides that so long as directors have not violated their fiduciary duties to the corporation and have engaged in an appropriate deliberative process, a court will not second-guess their decisions even if those decisions ultimately prove to have been unwise.

interpreted as a basis for relaxing levels of director attentiveness, and may have particularly limited application in the nonprofit context. This article will briefly review the underlying facts, analyze the court's decision, and offer a series of possible responses to be considered by healthcare boards.

I. CASE "SNAPSHOT"

The *Disney* litigation focused on matters of "good faith," loyalty, waste of assets, and the exercise of business judgment by individual corporate directors. The fundamental question was whether the terms of the hiring (and subsequent termination without cause) of Michael Ovitz as Disney chief operating officer amounted to (as the plaintiffs alleged) a breach of the directors' duty of due care with respect to their oversight responsibilities. The shareholders had alleged, in essence, that the conduct of the individual Disney directors demonstrated a conscious disregard of their fiduciary duties to the corporation and, as a result, the directors' decisions were not entitled to the protection of the business judgment rule.[3]

II. SUMMARY

In a 175-page decision, the Chancery Court ruled for the Disney board, concluding that the board's conduct had been in "good faith" and with "honesty of purpose" , and thus that any shortcomings in the process constituted ordinary negligence at most and, therefore, fell within the protections of the business judgment rule. While the court was highly critical of several aspects of the board's decision-making process, it was unwilling to impose personal liability where the evidence

[3] The claims alleged in *Disney* and several 2004 Delaware cases reflected a pleading strategy (*i.e.,* "bad faith"), designed to avoid application both of the business judgment rule defense and of director indemnification and insurance protections, which may exclude coverage for bad faith and duty of loyalty violations.

demonstrated an absence of conflicts of interest or personal enrichment; an intention to act in the best interests of the corporation; and a delegation to the compensation committee, which considered the facts and made an affirmative decision.

III. GENERAL RELEVANCE OF DELAWARE DECISIONS

Delaware cases are worthy of note by nonprofit corporations because of the number of businesses incorporated in Delaware, the volume of business controversies litigated in Delaware courts, the strength of its judiciary (including a specialized court, the Chancery Court, that has jurisdiction over cases arising under its corporate laws), and the fact that it has a unified corporation code, for both for-profit and nonprofit corporations. Furthermore, Delaware decisions often address alleged violations of fiduciary duty that closely resemble those duties owed by directors of nonprofit corporations. Accordingly, rulings of Delaware courts on issues of director conduct can be particularly informative to nonprofit organizations—and those who regulate them.

IV. OVERVIEW OF THE FACTS

The shareholder-plaintiffs' complaint was directly related to the circumstances involved in the employment and subsequent termination of Michael Ovitz as Chief Operating Officer. At the time of his employment, Mr. Ovitz was a close personal friend of Disney CEO Michael Eisner, and was the highly compensated president of a large and successful Hollywood talent agency. Specifically, the plaintiffs charged that certain Disney directors breached their duties of loyalty, good faith, and care owed to Disney in two respects: first by causing Disney to enter into an employment agreement with Mr. Ovitz, which they alleged provided for "onerous and unconscionable" compensation and severance benefits; and second, by causing Disney to fulfill the terms of the

employment agreement, without taking any steps to minimize or eliminate Disney's exposure relating to Mr. Ovitz's rights thereunder relating to termination.

The causes of action were based in part on allegations that the named directors ratified the employment agreement despite: (1) the alleged excessive compensation and severance benefits, (2) Mr. Ovitz's alleged lack of qualifications for the position, and the likelihood (given Disney executive management history) of early termination; (3) a failure to investigate adequately the impact on the company of an Ovitz resignation prior to the natural conclusion of the employment agreement; and (4) a failure to make a "serious exploration of Disney's legal alternatives" upon Mr. Ovitz's termination (*e.g.,* whether the circumstances constituted or warranted a "for cause" termination, with a corresponding reduction in Mr. Ovitz's termination benefits).

The causes of action were also based in part on allegations that the named directors subordinated the best interests of Disney to their allegiance to the CEO by agreeing to support, and subsequently abide by the terms of, the Ovitz employment agreement as proposed by Mr. Eisner. In the complaint, the plaintiffs identified a series of business and employment relationships with Disney and Mr. Eisner they alleged gave rise to conflicts for those directors and rendered them unable to render independent business judgment with respect to Mr. Eisner's proposals (*e.g.,* that they were Disney employees beholden to Mr. Eisner for substantial discretionary compensation, or professionals who received substantial compensation from Disney).

V. ANALYSIS: OVERVIEW

Disney reflects a vigorous confirmation of the vitality of the business judgment rule as applied to good faith decisions of a governing board—even when those

decisions have disastrous results. The decision confirms the long-standing reluctance of Delaware courts to engage in *post-hoc* substantive reviews of such decisions, particularly when market forces are available to provide ultimate redress. Thus, the essence of the decision appears to be that, in the context of the duty of care, "good faith" and "honesty of purpose" will overcome a multitude of governance failings. Under this approach, a plaintiff alleging breach of the duty of care bears a significant evidentiary burden of proof.

VI. THE STANDARD OF CARE

At its core, *Disney* revolves around the exercise of the duty of care by individual directors and the question of whether those directors were acting in "good faith" with respect to the corporation.[4] With respect to the duty of care, the court was explicit in emphasizing the importance of "process." In this regard, the court noted that:

> . . . (C)ompliance with a director's duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact believes a decision substantively wrong, or degree of wrong extending through "stupid" to "egregious" or "irrational," provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in *a good faith* effort to advance corporate interests. Thus, the

[4] The Chancellor commented favorably on the wisdom of rendering liability determinations on a director-by-director basis, rather than on a "board as a whole" basis. *Id.,* p. 109. This has particular significance where personal liability is sought to be imposed on directors, since it suggests that individual directors may avoid liability even where the process followed by the board as a whole is flawed.

> business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions.[5]

In order to overcome the business judgment rule in the context of the duty of care—where an affirmative decision has been made by the board—the court reaffirmed the need for plaintiffs to demonstrate gross negligence.[6] In this regard. the court defined gross negligence as:

> . . . a reckless indifference to or deliberate disregard of the whole body of stockholders or actions which are "without the bounds of reason."[7]

With regard to the issue of "good faith," the court concluded that the concept of "intentional dereliction of duty, a conscious disregard for one's responsibilities," was an appropriate (although not the only) standard for determining whether the Disney directors acted in good faith. To act in good faith requires that a director act at all times with an honesty of purpose and in the best interests and welfare of the corporation. The business judgment rule creates a presumption that a director acted in good faith. Bad faith, in contrast, is present where (among other situations) a fiduciary: (a) intentionally acts with a purpose other than that of advancing the best interests of the corporation; (b) acts with the intent to violate applicable positive law; or (c) intentionally fails to act in the face of a known duty to act. In "shorthand," then, bad faith is present when it can be demonstrated that the directors' acts were contrary to their legal obligations and were

[5] *Disney,* supra at p. 113.
[6] The *Disney* opinion also includes a useful discussion of application of the business judgment rule in matters of director inaction. *Id.,* p. 113-114.
[7] *Disney,* supra at p. 114.

intentional and/or represented a conscious disregard for those obligations—and were not merely negligent.

VII. APPLICATION OF STANDARD

It is in the application of this "good faith" standard that the decision has proven most noteworthy, if also most controversial. This is particularly the case given the court's earlier (2003) decision to deny the directors' motion to dismiss the original complaint, where the allegations could be held to state a breach of fiduciary duty claim insofar as the complaint alleged that the directors consciously and intentionally disregarded their responsibilities.[8]

With respect to the conduct of most of the defendant-directors/officers, the court was highly critical. "For the future, many lessons of what not to do can be learned from the defendants' conduct here."[9] The conduct criticized included (a) the Chair/CEO's limiting information provided to the board; (b) "stacking" the board of directors with friends and acquaintances of the Chair/CEO; (c) the Chair/CEO's "stretching the outer limits" of his authority; (d) a board culture of passivity; (e) limited scrutiny by board and committee members of compensation-related information and representations; (f) limited director involvement in the review of the underlying employment agreement; (g) failure to obtain an opinion from outside counsel on the employment agreement; and (h) failure of one director (also, as it happens, a lawyer who had served as Disney's general counsel) to correct the presentation of another director despite knowing it to be incorrect.

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[8] *In re Walt Disney Co. Derivative Litigation,* 825 A.2d 275 (Del. Ch. 2003).
[9] *Disney,* supra at p. 134.

Despite this surfeit of failures, the court concluded that no director acted in bad faith and each was, at most, ordinarily negligent, a finding which is insufficient to overcome the protections of the business judgment rule under Delaware law. Indeed, the court found that the conduct of each of the individual directors was taken with a subjective belief that the actions were in the best interests of the company, *i.e.,* that in each case the directors made an affirmative decision subjectively believing that they knew what they needed to know, for the most part knew what they were required to do, and thought they were doing the best they could to support the company by facilitating a transaction they thought had merit.

VIII. LIMITED APPLICATION TO NONPROFITS

Many states acknowledge application of the business judgment rule to nonprofit corporations.[10] Nevertheless, the underlying premise of the court's decision may not readily translate to nonprofit governance. It should be clearly noted that the court repeatedly stressed the role of the capital markets as offering the ultimate form of redress for failures of management and governance. The court concluded that the capital markets—and not the judiciary—was the more appropriate "party" to apportion liability/accountability based upon the ultimate outcome of decisions made by the Disney fiduciaries made in good faith. To hold otherwise would, the court observed, encourage decisions that minimize corporate risk and not increase corporate value.[11]

Such a "market remedy" is not directly available in the nonprofit context, where the Attorney General, rather than shareholders, is the principal agent of redress. In the

[10] *See, for example,* Sec. 8.30(d), Revised Model Nonprofit Corporation Act; "Fiduciary Duties of Directors of a charitable corporation," Floyd Perkins, Bureau Chief, Charitable Trusts Bureau, Illinois Attorney General's Office.

[11] *Disney,* supra at p. 4.

nonprofit model, the board of directors is perceived as the "first line of defense" of charitable interests. Membership rights and derivative powers may not be deemed to provide an oversight function equivalent to the power of the markets. Accordingly, attorneys general and other state charity officials may be less willing to interpret Disney-type fiduciary lapses as protected under the business judgment rule, particularly where they conclude that the level of inquiry conducted in advance of a decision did not constitute "reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."[12] In such cases, state charity officials may feel more compelled to intervene.

An additional nonprofit distinction may exist in regard to the conduct of the compensation committee. Some "activist" attorneys general have taken the position (albeit without any legal precedent and in clear contravention of the standards established by the Internal Revenue Service in interpreting its own regulations) that nonprofit directors are obligated to satisfy the provisions of the "rebuttable presumption of reasonableness" tax safe harbor in connection with executive compensation decisions.[13] The *Disney* court concluded that members of the compensation committee had acted in good faith even though their actions in that capacity fell short of "ideal corporate governance." A state charity official may be more inclined to scrutinize such conduct when (although their actions were taken in good faith) the directors failed to satisfy the requirements of the "rebuttable presumption."

[12] This is the standard under many nonprofit corporation code provisions in order to come within the business judgment rule. (See, for example, Cal. Corporation Code § 5231).
[13] See Compliance Review of HealthPartners, http://www.ag.state.mn.us/consumer/health/law%5Flegis.htm (at p. 45).

Accordingly, nonprofit healthcare boards should not interpret *Disney* as providing *carte-blanche* protection for poor decisions that were nonetheless made in good faith. Experience suggests that state charity officials and other nonprofit regulators may be less willing to accept evidence of good faith as justification for acts they interpret as failing to meet the basic reasonable inquiry test.

IX. "BEST PRACTICES"

In deference to the current "corporate responsibility" environment, the court drew a significant distinction between "best practices" as an aspirational goal, and fiduciary duty as a legal obligation. The court observed that while governance best practices include compliance with fiduciary duties, compliance with fiduciary duties may not always be enough to satisfy governance best practices. In other words, failure to comply with best practices does not, in and of itself, constitute a violation of fiduciary duty. Unlike corporate governance standards, fiduciary duties do not change over time. For that reason, the court declined to apply "21st century notions of best practices" in analyzing whether decisions of the Disney board, which occurred ten years ago, were misplaced.[14]

Nevertheless, the court strongly encouraged directors and officers to employ best practices, as those practices are understood at the time a corporate decision is taken. Furthermore, it should be noted that, in the recent view of a former Chief Justice of Delaware, the thoughtful and attentive pursuit of governance best practices can serve as an affirmative demonstration of good faith:

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[14] *Disney,* supra at p. 2.

"The movement in corporate America to achieve best practices is key. Good corporate practices, when genuinely used . . . would perforce and simultaneously lead directors to act in good faith . . . *the conscientious pursuit by directors of principles of best practices is the best prophylactic against liability."* [Emphasis added.][15]

X. A RECOMMENDED RESPONSE

In advising healthcare boards post-*Disney* on the exercise of the duty of care, we recommend that governing boards take the following steps to support "good faith" decision-making:

1. Confirming the applicability of the business judgment rule in the relevant jurisdiction.
2. Adopting and maintaining recognized governance "best practices."
3. Exercising active engagement in board discussions and emphasizing "process" protections as a key element in board decision-making.
4. Maintaining an awareness of the financial posture and related competitive strategy of the enterprise.
5. Confirming board access to information and advisors necessary to making an informed decision.
6. Monitoring the board agenda and reviewing all board and committee meeting minutes.

[15] E. Norman Veasey, "Counseling Directors in the New Corporate Culture," THE BUSINESS LAWYER, Vol. 59, August 2004 at 1456-1457.

7. Assuring a functioning and effective conflicts of interest disclosure and review process.

8. Having a coherent understanding of any business transactions brought to the board for approval, and the relationship of the transaction to the mission of the organization.

These recommendations are designed to emphasize "good faith" and position the board's action for the protection of the business judgment rule.

An expanded version of this article will be published soon as a Health Lawyers Expert Series monograph.

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