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LANDMARK "DISNEY" DECISION PROVIDES GUIDANCE FOR COMPENSATION GOVERNANCE

The June 2006 landmark decision by the Delaware Supreme Court over the $130 million severance payout by The Walt Disney Company to Michael Ovitz provides guidance on possible legal protection for compensation committees that use termination tally sheets when approving employment agreements for senior executives. The decision describes a tally sheet showing payments in the event of a termination of employment under various scenarios as a best practice that would provide conclusive evidence that the compensation committee was adequately informed in satisfying its duty to exercise due care. Other aspects of the business judgment rule were also clarified by the ruling.

The Delaware Supreme Court in its June 8, 2006 decision affirmed the Court of Chancery's dismissal of all claims brought by shareholders of The Walt Disney Company (Disney) in a derivative action against Disney directors for breaches of fiduciary duty in connection with the $130 million severance payout made to Michael Ovitz in connection with the termination of his employment. Amid the growing public concern regarding executive compensation and severance payments, the Disney decision was closely watched by the legal and business communities for possible changes or exceptions to the business judgment rule governing directors' fiduciary duties.

This alert letter discusses a significant compensation aspect of the decision: legal protection for compensation committee members is enhanced if they use so-called termination "tally sheets" in connection with their evaluation of proposed employment agreements for senior executives. Broader implications of the decision for the business judgment rule generally are also briefly discussed given the growing importance of using appropriate processes and procedures in the governance of executive compensation.

BACKGROUND AND SUMMARY OF DECISION

Michael Ovitz was hired by Disney in August 1995 as President under a five-year employment agreement that was approved by Disney's Compensation Committee and finalized in December 1995. His employment was terminated without cause in December 1996, only fourteen months after he officially became President of Disney in October 1995, and he received a severance

payout consisting of cash severance and accelerated vesting of stock options that was valued at a total of approximately $130 million.

Lawsuits were brought shortly thereafter by Disney shareholders, in January 1997 in the Delaware Court of Chancery claiming that the severance payout was the result of fiduciary duty breaches by the Disney directors under Delaware law. The plaintiffs made multiple claims including: (1) breach of fiduciary duties by the Disney directors, including both a lack of "due care" and "good faith", (2) waste of corporate assets, and (3) breach of fiduciary duty by Ovitz himself. After numerous proceedings, the case was finally decided by the Chancery Court in August 2005 in favor of the defendants on all claims. Upon appeal, the Delaware Supreme Court on June 8, 2006 affirmed the Chancery Court decision.

TALLY SHEET AS BEST PRACTICE

One of the principal issues addressed in the Supreme Court's decision is whether the Disney compensation committee exercised due care under Delaware law in initially approving Ovitz' employment agreement and the severance payout provisions. The decision describes this issue as whether the Chancery Court correctly found that the compensation committee was adequately informed of the full magnitude of the payout or whether, as the plaintiffs asserted, the compensation committee members were "grossly negligent" as they did not "properly inform themselves of the material facts." In concluding that the finding was supported by the evidence, the Supreme Court agreed "… that although the committee's process did not fall below the level required for a proper exercise of due care, it did fall short of what best practices would have counseled."

From the perspective of compensation practitioners, it is very significant that the Supreme Court described a process that it considered to be a "best practice" scenario; i.e., the use of a tally sheet (referred to as a "spreadsheet" in the decision) that was:

- prepared by or with the assistance of a compensation expert that would disclose the amounts payable to Ovitz under the employment agreement under various likely circumstances;
- explained to the members of the compensation committee by the compensation expert, or by a committee member who was knowledgeable about the agreement and the tally sheet;
- attached as an exhibit to the minutes of the meeting of the compensation committee at which it was discussed; and
- the basis for the deliberations and decision of the compensation committee.

Other Reasons for Tally Sheets

The latest proxy voting policies announced by Institutional Shareholder Services (ISS) in November 2005 with respect to its recommendation on voting for directors who serve on a company's compensation committee provide that in 2007 ISS will consider recommending the

withholding of votes from committee members and potentially recommending votes against new or amended equity plans if proxy disclosure does not include sufficient tally sheet disclosure related to CEO pay.

The final rules approved by the SEC on July 26, 2006 that make significant revisions to the proxy disclosure of executive compensation require narrative disclosure of each contract, plan or arrangement providing for payment to a named executive officer upon termination of employment under various circumstances, including quantification of the amount of estimated annual payments and benefits. The requirement is similar to what would be included in a termination tally sheet.

BROADER IMPLICATIONS FOR THE BUSINESS JUDGMENT RULE

Under Delaware corporate law, directors owe shareholders the duty of loyalty and due care, and must act in good faith. Under the business judgment rule, corporate directors are presumed to have met these duties and are protected from liability except where it is proven otherwise. If the presumption of the business judgment rule is not rebutted, no damages will be awarded unless it is determined that the transaction was so unreasonable it constituted a waste of assets.

Among other aspects, the Disney decision provides additional context on the duty to act in good faith which, as stated in the decision, is "not a well-developed area of our corporate fiduciary law." Specifically the decision makes clear that gross negligence, including the failure to inform oneself of material facts, cannot constitute bad faith that comes only from either "actual intent to do harm" or "intentional dereliction of duty, a conscious disregard for one's responsibilities."

In regard to the plaintiff's claim that the severance provisions of the agreement constituted waste as they incentivized Ovitz to perform poorly, the decision reiterates the extremely high legal standard needed to prove waste as the "unconscionable case where directors irrationally squander or give away corporate assets."

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This letter is intended to alert compensation professionals about developments that may affect their companies, and should not be considered or relied upon as legal advice. Specific questions about the Delaware Supreme Court decision in the Disney case and the use of tally sheets as evidence of the exercise of due care by directors should be discussed with appropriate counsel. General questions applicable to the use of tally sheets or other compensation governance issues may be directed to Richard Alpern in our New York office at 212-299-3599 or by email at rlalpern@fwcook.com, or to Edward Graskamp in our Chicago office at 312-894-0031 or by email at edgraskamp@fwcook.com. This letter and other published materials are available on our website, www.fwcook.com.