Governance Lessons from the Disney Litigation

By H. Stephen Grace Jr. and John E. Haupert

The smoke has cleared and the dust has settled on 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. After lengthy and costly litigation, both the Chancery Court and Delaware’s Supreme Court found in favor of the defendant directors. However, the insightful comments of the court’s chancellor and the complex issues raised during the litigation keep the focus on this governance case of the century. Corporate governance seminars will continue to examine aspects of the case for years to come.

H.S. Grace & Company, Inc., in its role as the consultant to the primary D&O carrier and its counsel, had the opportunity to examine Disney’s corporate governance structure and its workings in connection with the hiring and termination of Ovitz, and we believe there are many valuable insights and lessons to be learned from Disney. This current article builds on and extends our findings in two prior articles, and sets forth our belief that Disney offers practical insights to boards, senior management, and their counsel regarding compensation cultures, board minutes, and ongoing vigilance by corporate boards. In the first of those articles (Directors Monthly, August 2008, “An Insider Revisits the ‘Disney Case’” http://hsgraceco.com/images/stories/articles/Article1.pdf), we discussed the practices and processes Disney had actually employed, pointed out what we perceived as the flaws in the Disney plaintiffs’ allegations, and noted that “The ongoing criticisms [of the Delaware courts’ decisions] basically represent a continued acceptance of the plaintiffs’ charges, with the critics failing to recognize the serious flaws in these allegations, which became clear during the trial.”

In our second article (the New York State Bar Association Journal, July/August 2009, “Plaintiff Expert Reports: An Insider Revisits Disney” http://hsgraceco.com/images/stories/articles/Article1.pdf), we asked the question “. . . whether an examination of the report of the plaintiffs’ compensation expert offers insights that actually support the courts’ decisions for the defendants. Do the issues the expert chose to examine and those he chose not to examine speak to the factual issues of interest to the courts? Do the analyses undertaken reflect on the strengths and weaknesses of the plaintiffs’ allegations?” In other words, did the plaintiffs’ expert avoid performing certain analyses which would have confirmed the acceptability of Disney actions?

Based on our examination of Disney’s compensation culture, which formed the framework for Disney’s negotiations with, hiring of, and termination of Ovitz, we believe its compensation culture and its governance practices and processes offer valuable insights to boards and their compensation committees. Further, we believe that the Disney litigation offers interesting insights into the challenging issue of the determination of what and how much to include in corporate board and board committee meeting minutes. A third lesson the Disney matter confirms is the importance of ongoing vigilance on the part of both boards and senior management. We address each of the areas in the following sections.

The Disney Compensation Culture

The plaintiffs’ allegations regarding Disney’s compensation culture were very provocative. The plaintiffs’ Second Amended Consolidated Derivative Complaint (Complaint) allegations included these charges:

• Michael Eisner, the CEO of Disney, recruited Ovitz as a result of their personal friendship;
• The hiring of Ovitz was facilitated by Irwin Russell in his role as chair of the compensation committee;
• The compensation committee “inadequately investigated the proposed terms of the Ovitz employment agreement (OEA),” and the compensation committee and the old Board paid insufficient attention to the terms of the OEA; and
• At the September 1995 compensation committee meeting, more time was spent on Russell’s additional compensation for handling the negotiations than on the terms of the OEA.

Additional allegations regarding Disney’s compensation culture and the actions of Eisner and the Disney Board are seen throughout the Complaint. At first blush, these allegations paint a picture of ineptitude and conflicts of interest by the CEO and board. However, Chancellor Chandler’s opinion, various trial-related information, and public documents point out the serious issues in the plaintiffs’ allegations. These
findings properly take into account the well-recognized risks associated with business investment decisions, including the hiring or promotion of senior executives; the factors at work that may have influenced Disney’s decision to seek the services of Ovitz; the company’s hiring process; the terms of the OEA; the performance of Ovitz; the termination process; and the termination agreement. Disney’s compensation culture formed the framework within which the business investment decision of seeking to hire Ovitz was conducted.

It is well understood that sign-on bonuses, stock, restricted stock grants, stock options, periodic bonuses, and lucrative back-end payments are often components of the contracts entered into by firms seeking the services of capable CEOs, COOs, and other executives who possess special talents. Table I compares key compensation components for five well-known senior executives (Five Executives) with those received by Ovitz: Michael Armstrong on his joining AT&T, Carly Fiorina on her joining Hewlett-Packard, Gary Wendt on his joining Conso, Robert Nardelli on his joining Home Depot, and Larry Johnston on his joining Albertson’s. Section 2 of Table I reflects the various forms of front-end compensation paid to the Five Executives and that paid to Ovitz. The Five Executives all received various forms of front-end compensation. Ovitz received no front-end consideration in spite of the high level of compensation he was foregoing by departing from Creative Artist Agency (CAA), along with the power and perks associated with his ownership position at CAA. Other than salary and the potential for a shareholder oriented performance based bonus, Ovitz received a single stock option grant for the five-year-employment term from which he would benefit only if the shareholders benefitted. Disney did not pay any other forms of front-end compensation. It is remarkable that, even though Ovitz’s prior compensation package at CAA far exceeded that of the Five Executives and there was pressure at Disney to find a replacement for Frank Wells who had died, Disney stayed with its compensation culture. Certain proxy comments regarding executive compensation forfeited at prior companies for the Five Executives and Ovitz are shown in Table II. The distinctiveness of Disney’s culture is evidenced by these proxy comments.

Each of the Five Executives received stock options which vested over time. Ovitz also received stock options which vested over time. However, unlike the Five Executives who were guaranteed annual bonuses or grants of stock options or restricted stock within their compensation agreements, the OEA did not guarantee such annual grants.

The employment agreement of each of the Five Executives incorporated termination provisions, which included cash compensation, removal of restrictions on restricted stock, the vesting of part or all of stock options or other equity based awards and other considerations. Ovitz’s termination provisions included only cash compensation and the vesting of his initial stock option grant of 3 million shares. The cash compensation and the vesting and/or removal of restrictions on restricted stock assured the Five Executives of financial consideration should they be terminated, along with other consideration such as immediate forgiveness of any outstanding loan principal. Ovitz’s only assured consideration at termination was the cash component, which declined over time to a minimum of $10 million by the end of his five-year term.

In summary, the Five Executives received a number of forms of compensation, many of which insured the Five Executives of benefits regardless of whether there were concomitant benefits to shareholders. Disney’s employment agreement with Ovitz stands in sharp contrast to those of the Five Executives. The fact that his back-end package was largely influenced by the value of his stock options insured that Ovitz would benefit only if the Disney shareholders likewise benefited. This was the case, as Disney’s share price rose from approximately $57.00 per share to $71.00 per share during Ovitz’s tenure.

Disney’s conservative compensation culture is further reflected by the fact the Ovitz’s compensation was not excessive when compared with other Disney executives. Option grants were provided to Eisner under his 1989 contract for 2 million shares (which subsequently became 8 million shares in 1995 as a result of the four-for-one stock split declared in April 1992). So, by the time of Ovitz’s hiring in October 1995, the decision by the board to grant Ovitz 3 million shares does not appear to be out of line with Eisner’s 8 million shares. Similar to Eisner, Frank Wells (Wells) whom Ovitz succeeded, under his 1989 contract was granted 750,000 shares and, as a result of the four-for-one stock split, these options were equivalent to 3 million shares, equaling the grant of shares to Ovitz. The second option grant to Ovitz did not occur until Ovitz had been at Disney for five years, and was cancelled in the case of a non-fault termination. These actions support the fact that Ovitz’s compensation was not unusual nor overly generous within the Disney business parameters.

The hiring process itself was well structured with an important role being played by the compensation committee. Initial discussions with Ovitz involved Russell, Disney’s compensation committee chair, Eisner and, later, Raymond Watson, the former Disney chairman and a member of the compensation committee. Having the chair of the compensation committee and a long-term board member head the negotiations insured both compensation committee awareness and board awareness of the flow of these negotiations. Watson had been the chairman of Disney at the time Eisner and Wells joined. A highly creditable consultant, Graef Crystal, was quickly involved in assisting Russell and Watson. The negotiations were lengthy and required tough bargaining. Ovitz’s contract terms changed considerably during the course of these negotiations and the changes 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.

An examination of what occurred among and between the parties negates the plaintiffs’ allegations. Disney’s compensation culture framed the negotiations with Ovitz, which was quite remarkable given the extent of Ovitz’s earning power in his previous employment, but Disney did not bend from its
compensation culture. The compensation committee not only adequately investigated the terms of the OEA, but was deeply involved in the Ovitz negotiations as a result of Russell’s and Watson’s leadership of the negotiations.

We believe that Disney’s compensation culture and the role it played in the negotiations with Ovitz may offer useful lessons today. Disney put a compensation culture in place that took into account the interests of their shareholders. They stuck with it notwithstanding their need for a senior executive and notwithstanding Ovitz’s significant earning power at CAA. Their use of the compensation culture in the Ovitz negotiations was a sound move, as was the power given to the compensation committee that was enhanced by a compensation expert.

**Board and Board Committee Meeting Minutes**

The challenge of recording board and board committee minutes is well understood. There is always a struggle to determine what and how much to include. The Disney case shows the complexity of recording board and board committee minutes and offers some insight into how to deal with it.

There has been, and continues to be an evolution of thought regarding the composition of board and board committee meeting minutes. In the past the thinking might have been summarized as “less is better.” However, in light of the tidal wave of litigation, much of which attacks CEO’s and boards, a school of thought has developed advocating more comprehensive minutes, providing more detail about what actually occurred at the meetings. The interesting dilemma is “how much is enough?”

The Disney case hits this issue head on. The plaintiffs alleged that the compensation committee “...inadequately investigated the proposed term of the OEA...” and pointed to the fact that at the September 26, 1995, compensation committee meeting, more time was spent on discussing additional compensation for Russell’s handling the negotiations than was spent on the terms of the OEA, which was recommended to the board for approval. The plaintiffs used the brief minutes of the committee meeting as a platform for attacking Disney’s actions.

The information developed during discovery and the information presented at trial reveal a much different picture than the allegations. Compensation committee members Russell and Watson, both of whom understood the Disney compensation culture, actually led the negotiations with Ovitz and his advisors. Furthermore, Russell and Watson wisely employed a compensation expert, Crystal, to assist in the negotiations with Ovitz and his team which were lengthy and contentious.

The September 26, 1995, meeting of the compensation committee did not need to address the terms and provisions and the remaining open items to be resolved in the negotiations, as Russell and Watson had been directing the negotiations. Since Russell and Watson were satisfied with the state of the negotiations, the package was ready to present to the entire board for its review and approval. The only remaining issue to discuss was Russell’s compensation.

The interesting question here, and a question that has no clear answer, is whether it would have been appropriate to include in the compensation committee meeting minutes a detailed description of what had gone on regarding the origins and the conduct of the negotiations with Ovitz. Had the involvement of Russell and Watson and their familiarity with and understanding of these negotiations and the OEA been detailed in the minutes, would this information have seriously, if not fatally, damaged the plaintiffs’ allegations regarding the alleged inadequacies of the Disney Board’s actions? We believe it would have but others take the position that confidentiality, competition and privacy discourage including too much. Whatever position is taken it would benefit both sides to have discussions about how to properly convey the work that has been done leading up to board or board committee recommendation or decision.

**Vigilance**

Nations have recognized that “The price of peace is ongoing vigilance.” These words may be paraphrased for consideration by boards as follows, “The price of good governance is ongoing vigilance.” The facts in the Disney case speak directly to the challenge of boards exercising proper diligence. Chancellor Chandler’s opinion and the documents from the case speak not only to Disney’s decision to seek the services of Ovitz, but also to the manner in which Disney sought these services and, in particular, the roles of Eisner and of board members serving on the compensation committee.

Despite Chancellor Chandler’s positive finding for the defendants, his observations regarding weaknesses in the process are insightful and suggest that the lack of board vigilance could have resulted in a different outcome. Regarding the termination of Ovitz, Chancellor Chandler again points to the importance of not only the authority to undertake an action, but the process by which an action is undertaken.

Chancellor Chandler’s thoughtful insights point to the need for “ongoing vigilance” on the part of boards. Given that opportunities may arise for a firm which must be addressed in a brief window of time, given the sensitivity of employment at senior levels and the fact that boardroom discussion of feelings regarding the CEO or other senior management may not be workable given the difference in feelings of various board members, and given numerous other issues, boards must not only insure that there are proper assignments/delegations of authority, but also must insure that the associated processes are supportable.

Interestingly, Disney’s circumstances offered an additional challenge to board vigilance. Disney’s success under Eisner and Wells in the period 1984–1995 was spectacular. Ten thousand dollars invested in Disney stock in September 1984 was worth approximately $160,000 by July 1994, while $10,000 invested in the S&P index over this period would have an approximate value of $56,000. Given Eisner and Wells dedication and success, it could be expected that the Disney board’s respect and trust for the two of them grew over that period. Given significant levels of confidence and comfort in the firm’s management team, it can certainly be understood that a board could perhaps become slightly more relaxed in the way they were addressing their responsibilities. Notwithstanding what may have actually happened
at Disney regarding the relationship between the board and Eisner, Chancellor Chandler’s comments point to the risk of a board perhaps relaxing in the addressing of their responsibilities. It may be that, regardless of the extent of a relationship or the depth of trust and respect that is developed over the course of that relationship, a board, and senior management, must continue to be vigilant in addressing their respective responsibilities.

Disney had a well thought out shareholder orientated compensation culture and negotiated the Ovitz arrangement within the framework of its compensation culture and in a form that was consistent with the compensation of other members of Disney senior management. Yet these positives were weakened by the court’s views of Eisner and the board as set out in Chancellor Chandler’s opinion. The Chancellor’s insights point to the need for continual consideration and observation of board and management practices and processes.

The authors agree, not only based on their own executive experience and that of their colleagues, but also based on their involvement in numerous complex commercial litigation matters covering a broad range of industries and business organization structures. Again and again, as in Disney, the Delaware courts, and others, have focused on board and management roles, responsibilities, practices and processes, and whether these have been addressed in an acceptable manner.

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The authors benefited from the comments of Sheryl Hopkins, also a member of the Grace & Co. Board of Advisors.

TABLE I
Comparison of High-Profile Non-Disney Executives to Michael Ovitz - Key Compensation Components

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<tbody>
<tr>
<td><strong>1. Key compensation components at date of hire:</strong></td>
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<tr>
<td>Signing bonus</td>
<td>$2,050,000</td>
<td>$3,000,000</td>
<td>$45,000,000</td>
<td>$0</td>
<td>$1,230,000</td>
<td>$0</td>
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<tr>
<td>Restricted stock or stock options - which vests upon hire or which cannot be forfeited even on a termination for cause (value of restricted stock based on stock price at date of hire and value of stock options based on Black-Scholes)</td>
<td>$0</td>
<td>$22,260,000 (7)</td>
<td>$34,052,000</td>
<td>$3,546,000</td>
<td>$0</td>
<td></td>
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<tr>
<td>Restricted stock - vests over time (valued at date of grant)</td>
<td>$14,900,000 (8)</td>
<td>$65,600,000</td>
<td>$0</td>
<td>$24,450,000</td>
<td>$17,439,000</td>
<td>$0</td>
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<tr>
<td>Stock options - vests over time (valued at date of grant based on Black-Scholes)</td>
<td>$9,000,000</td>
<td>$24,400,000</td>
<td>$13,840,000</td>
<td>$63,920,000</td>
<td>$3,858,000</td>
<td>$110,000,000</td>
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<tr>
<td>Guaranteed bonuses, stock or restricted stock over life of employment contract</td>
<td>Est. $4,200,000</td>
<td>$1,616,000</td>
<td>$8,000,000 to $50,000,000 (9)</td>
<td>$72,500,000 (10)</td>
<td>Est. $87,050,000</td>
<td>$0</td>
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<tr>
<td>Other key components</td>
<td>$704,000 (11)</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$10,000,000 (12)</td>
<td>$0</td>
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<tr>
<td><strong>Total</strong></td>
<td>$30,854,000</td>
<td>$94,616,000</td>
<td>$89,100,000 to $131,100,000</td>
<td>$224,922,000</td>
<td>Est. $113,123,000</td>
<td>$110,000,000</td>
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2. Non-Fault Termination Provisions:

- Cash compensation, full vesting of stock options, removal of restrictions on restricted stock and supplemental pension benefits shall fully vest.
- Cash compensation, full vesting of restricted stock and restricted stock units and 50% vesting of unvested stock options.
- Cash compensation, vesting of 4 million options (out of 10 million grant) and full vesting of restricted stock.
- Cash compensation, immediate vesting of unvested equity-based awards, granting of additional stock option awards, if applicable and immediate forgiveness of outstanding loan principal.
- Cash compensation and full vesting of all outstanding stock options and deferrable restricted stock awards.
- Cash compensation and vesting of 60% of his stock options.

Notes:

(1) AT&T Proxies filed 3/26/98 and 3/19/99. Part of his restricted stock (224,561 units), which vest on 10/1/03 have a floor of $10 million. (Proxy filed 3/26/98, p. 39.)

(2) Hewlett Packard Proxy filed 1/14/00.

(3) Conseco Proxies filed 4/30/2001, 4/30/2002 and 10-Q 6/30/00. Wendt employment agreement dated 6/28/00. In addition to the compensation of Mr. Wendt, Conseco issued a warrant to GE to purchase 10,500,000 shares of Conseco common stock at a purchase price of $5.75 per share (estimated value - $21.0 million). (Source 10-Q 6/30/00).

(4) Hewlett Packard Proxy filed 1/14/00. Method of valuing warrant not disclosed.

(5) Albertson’s Proxy filed 5/2/2002.

(6) Proxy filed 2/25/97 and Graef Crystal letter to Irwin Russell dated 8/12/95.

(7) Amount for Mr. Wendt includes $18.8 million of restricted stock which cannot be forfeited upon termination for “just cause” prior to June 30, 2002. The remaining amount includes the value (using Black-Scholes) of stock options that vested immediately on the grant date.

(8) Under certain time based circumstances, Mr. Armstrong’s agreement provided a floor of $10 million on his restricted stock units (Proxy filed 3/26/98, p. 39.)

(9) Represents the range of additional compensation for Mr. Wendt based on stock price two years after hiring date. (Proxy filed 4/30/01, p. 6.)

(10) For Nardelli, represents guaranteed annual bonuses of $15.0 million and estimated present value of annual stock options of $37.5 million.

(11) Estimated value by AT&T of Mr. Armstrong’s supplemental pension was $704,000 (Proxy filed 3/19/99, p. 62.)

(12) Represents a loan to Mr. Nardelli made at the date of grant, which was to be forgiven ratably over 5 years. (Proxy filed 4/18/02, p. 18.)

(13) In the various employment agreements, non-fault termination provisions may have also been referred to as company-initiated terminations for other than cause, involuntary termination other than for cause, and termination without just cause, and similar language.
<table>
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<th>Company</th>
<th>Person</th>
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| AT&T         | Mr. Armstrong | “To address certain forfeitures experienced when Mr. Armstrong left his previous employer, the Company paid a premium of $2,050,000 to purchase a split-dollar survivorship insurance policy insuring Mr. Armstrong and his spouse.” (AT&T Proxy, filed 3/19/99, p. 50.)  
|              |        | “Mr. Armstrong was also granted AT&T Restricted Stock, AT&T Restricted Stock Units and AT&T Stock Options under the 1997 LTIP to replace similar grants forfeited from his prior employer and to provide strong incentives to create shareholder value for AT&T shareowners.” (AT&T Proxy, filed 3/19/99, p. 51.) |
| Hewlett Packard | Ms. Fiorina | “The Board of Directors approved Ms. Fiorina’s employment agreement after an extensive search had been conducted by the Board, the Organization Review and Nominating Committee and an Ad Hoc Committee established in connection with the CEO search, with the assistance of an executive search firm. In determining the final compensation amounts, we focused on the importance of hiring a president and chief executive officer with an outstanding business and leadership record. We also reviewed Ms. Fiorina’s compensation package in comparison with the compensation packages of CEOs of selected large industrial companies, with particular emphasis on CEOs who had been hired externally and received packages intended to compensate them partially for amounts forfeited from their former employers. In setting total CEO compensation, we believe that it is especially relevant to review companies that are not a part of the S&P High Tech Index because of the possibility that a company outside of one industry may recruit a CEO from another industry. We also considered the fact that HP does not have a Chief Operating Officer and therefore Ms. Fiorina would assume the additional responsibilities usually associated with that position. Finally, we recognized the need to consider Ms. Fiorina’s compensation at her previous employer, as well as the value of benefits under various plans of her employer that would be forfeited upon her resignation.” (Hewlett Packard Proxy, filed 1/14/00, p. 42.) |
| Conseco      | Mr. Wendt | “Pursuant to the [employment] agreement Mr. Wendt received a cash payment of $45,000,000 at signing, which amount was partial compensation for benefits he was forfeiting from a prior employer.” (Conseco Proxy, filed 4/30/01, p. 6.) |
| Home Depot   | Mr. Nardelli | “The Company believes it is essential that a large portion of our executive officers’ total compensation is tied to stock performance, which more closely aligns their interests with the long-term interests of stockholders. To reflect this belief and in recognition that Mr. Nardelli forfeited substantial equity ownership rights provided by his former employer, Mr. Nardelli received two stock option awards.” (Home Depot Proxy, filed 4/23/01, p. 16.) |
| Albertson’s  | Mr. Johnston | “In negotiating the terms of Mr. Johnston's employment agreement, the Board sought advice from outside legal counsel and independent compensation consultants, and considered such factors as the competitive levels of Chief Executive Officer compensation at other companies of comparable industry and size, the Company’s internal executive compensation practices, and the level of compensation deemed necessary to induce Mr. Johnston to accept the Company’s offer of employment and restore amounts forfeited by him upon leaving his former employer.” (Albertson’s Proxy, filed 5/2/02, p. 24.) |
| Disney       | Mr. Ovitz | “Prior to entering into the agreement, the Company negotiated with Mr. Ovitz extensively regarding its terms, with particular emphasis on establishing a total compensation package which would, within the framework of the established policies of the Company, induce Mr. Ovitz to relinquish his significant earning power and the substantial value of his ownership interest in CAA. In those negotiations, the Company declined to pay Mr. Ovitz any signing bonus or to grant him any restricted stock or other form of compensation not dependent solely upon future growth of the Company. Instead, in order to induce Mr. Ovitz to relinquish his ownership position at CAA, the agreement included a number of provisions (described further below) concerning compensation payable to Mr. Ovitz in the event of certain types of early termination of his employment by Company.” (Disney Proxy, filed 1/9/97, p. 14.) |