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The Discretion of Judges and Corporate Executives: An Insider's View of the Disney Case

JOHN J. DONOHUE III

The widely publicized Disney case is perhaps the most important corporate law litigation in many decades. The case illustrates the immense discretion in the hands of trial judges in Delaware Chancery Court to let their passive corporate law ideology determine the outcome even in cases of egregious management neglect. Unfortunately, as managers, not shareholders, are the ones who decide where to incorporate and Delaware—the state of choice—depends on incorporation revenues to feed its coffers, too often this discretion is exercised to protect management at shareholder expense.

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DID DISNEY MANAGEMENT WASTE \$200 MILLION DOLLARS?

The seeds of the litigation were sown over a decade ago when the Walt Disney Company energized the movie industry with the spectacular hiring of super-agent Michael S. Ovitz as the company's president. Despite the early enthusiasm, fourteen months later, Ovitz was fired by his longtime friend, Disney's chief executive, Michael D. Eisner.

Prior to the termination, Disney had to decide whether to let Ovitz go and pay a nonfault termination payment of roughly \$200 million (in today's dollars) or exercise its rights under the contract and terminate him for cause if Ovitz had acted with "gross negligence or malfeasance." Disney chose to pay, sending Ovitz on his way with a kingly ransom. If this had been

an informed business decision made after an evaluation of the legal rights of the company and the costs and benefits of proceeding under the two options, the case would have been an easy one. Judges shouldn't second-guess legitimate business decisions on substantive grounds.

What made the case so troubling was that documentary evidence in the form of numerous writings by Eisner—coupled with confirmation under oath by the then owner of 25 percent of the shares of Disney stock, Sid Bass—showed that Eisner believed that Ovitz was repeatedly lying to other Disney executives in the course of his business dealings at Disney. Eisner wrote in an unsent letter to Ovitz: "I did not know when you were telling the truth about big things, about small things. And while you were telling me that those dishonest days were over, you were

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deceiving me on a specific matter.” Eisner went on to mention General Counsel Sandy Litvack’s recitation of “example after example of your not telling the truth.”

Eisner and the board members, who received his written statements repeatedly indicting Ovitz for lying, were clearly on notice that a termination for cause was at least arguably permissible. Eisner’s memo to another Disney executive at the time of Ovitz’s discharge clearly summarized his view of Ovitz: “He is a psychopath (doesn’t know right from wrong), cannot tell the truth. Basically has a character problem, too devious, too untrustworthy to everybody, and only out for himself....”

Yet, neither Eisner nor any of the board members who received his written statements or even the General Counsel ever called for a factual investigation of the questions of dishonest behavior. Moreover, no one asked for a written legal opinion about either the standards for discharge or whether the company’s interests would best be served by dismissing Ovitz for cause and saving the roughly \$200 million.

Eisner did hire Price Waterhouse to document every dollar of the millions in expenditures that Ovitz ran up during his brief tenure, but

“Project Ovitz” was terminated when shareholders filed suit in the wake of the massive Ovitz severance. While Price Waterhouse’s initial report was replete with evidence of possibly unjustified expenditures, Judge William Chandler refused even to consider the evidence on the grounds of hearsay, even though the document clearly put Disney executives on notice of potential violations of company expenditure policies.

Chandler engaged in even greater contortions to find as a matter of fact that all the contemporaneous written and oral statements by Eisner and others about Ovitz being a liar were inaccurate. The Judge claimed he rested his opinion on seeing the witnesses testify at trial, which served to insulate his holdings from reversal. However, his tortured findings were also irrelevant—it was the job of the Disney directors to investigate in 1996 whether the allegations of Eisner and others about Ovitz’s malfeasance were true, not the job of a rubber-stamping Judge ten years after the fact. By 2005 all the evidence of misconduct that was repeatedly referred to by Eisner was either stale or “forgotten” by the board members who stood to lose millions by remembering (or ruled inadmissible by Judge Chandler). Chandler’s job was to see

that the directors had investigated the facts and the law relevant to Ovitz’s dismissal so that *they* could make an informed business decision. The judge misunderstood not only the board’s role, but his own.

Managers are shielded from shareholder actions when they exercise informed and legitimate business judgment—this is the so-called “business judgment” rule. What the Disney case shows is that a judge who is bent on dispensation can almost always fit management decisions within the business judgment rule by after the fact “findings” of fact.

WILL DELAWARE COURTS PROTECT SHAREHOLDERS?

The Disney case shows the immense power that judges have to insulate flawed corporate processes by crediting self-serving testimony at trial over directly conflicting contemporaneous written statements by the same witnesses. If I am right, what does that imply for shareholder protection?

Managers, not shareholders, choose the state of incorporation, and that state then becomes the forum for many corporate disputes such as Disney’s. Is it good to convey the message that CEOs can hand out hundreds of millions in corporate

assets like candy to corporate executives (to lure them or get rid of them) without following strict procedures? It is certainly good for CEOs, and this laissez faire attitude makes it good for the coffers of the state of Delaware, which benefits from the franchise fees paid by 300,000 companies (including almost 60 percent of the Fortune 500 companies) who choose to incorporate there. Query, though, whether the disrespect for corporate procedures that the Disney case engenders is good for shareholders or ultimately for America. There has been enormous effort in the last few years, following Enron and other scandals, to limit fraud. Should Delaware be doing more about managerial neglect?

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REFERENCES AND FURTHER READING

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