

## **A Whole New World: What D&Os should know about their fiduciary duties after Disney**

By Catherine A. Asaro

On the surface, the August 9<sup>th</sup> decision of Delaware Chancery Chancellor William Chandler, III in *Disney*<sup>1</sup>, arguably the highest profile corporate case in the state's history, appears to be a victory for the defendant directors. However, scratching just beneath the surface reveals that the decision is really sending a warning to directors as to the future criteria Courts will look to in holding directors liable for breaches of their fiduciary duties in derivative actions. With the appeal<sup>2</sup> pending as to whether the Board of Directors breached their fiduciary duties by paying former President Michael Ovitz a compensation/severance package estimated at \$140 million for his controversial termination *without cause*, directors would be wise to pay close attention to the Delaware Supreme Court's interpretation of best corporate governance practices.

Although the Court of Chancery gave due deference to the decisions of Disney's Board of Directors reaffirming the vitality of the business judgment rule, in his

lengthy decision Chancellor Chandler also chastised them for not doing more to comply with best corporate governance practices. In unequivocal language, the Court drew a distinction between the liability standards governing a director's conduct and the aspirational ideal of best practices. That dividing line is starting to get a little blurred. From what can be gleaned from Chancellor Chandler's decision, Disney's Board seemed to teeter right on the edge of what the Court deemed acceptable practices.

Since the concept of best corporate governance is an evolving standard, Disney's Board greatly benefited from the fact that their decision to hire and subsequently fire Michael Ovitz pre-dated the current wave of corporate scandals by 10 years. Disasters such as Enron and WorldCom have since reshaped the Court's expectations of best corporate governance practices. Taking the timeframe into consideration, the Court of Chancery found that "applying 21<sup>st</sup> century notions of best practices in analyzing whether those decisions were actionable would be misplaced."

In light of a pending appeal, the question now becomes will the Delaware Supreme Court concur

---

<sup>1</sup> In re Walt Disney Company Derivative Litigation, C.A. No. 15452 (Del. Ch. Aug. 9, 2005).

<sup>2</sup> In mid-September, Milberg Weiss Bershad & Schulman filed a notice of appeal with the Delaware Supreme Court.

with the Chancery Court's reasoning and affirm its decision or will it find that the Board breached its fiduciary duties? Taking an affirmative response to the latter question one step further raises the question of what effect a breach will have on a corporation's traditional D&O policy? Bearing that in mind, directors may want to review their D&O policy exclusions, severability provisions, and assess the possibility of rescission. These are all valid concerns for board members to think about and seek answers to long before they find themselves named in and forced to defend against a derivative action.

### **I. Fiduciary Duties of the Board**

Recognizing that the essence of business is risk-taking, the Disney decision shows us that the Court has drawn a line in the sand when it comes to respecting decisions of well-informed directors acting in good faith. In a nutshell, the Court defined "acting in good faith" as imposing an obligation on a director to, at all times, act with an honesty of purpose and in the best interests and welfare of the corporation.<sup>3</sup> So, even in hindsight, if a decision turns out badly as long as it was made on an informed basis and in the honest belief that the action taken was in the company's best interest, the Courts will not second-guess the board's sound business judgment.

However, reading between the lines of the text creates some intrigue as to

an important question left unanswered by this decision. That question is: *DO INDEPENDENT DIRECTORS HAVE A SEPARATE FIDUCIARY DUTY OF GOOD FAITH?* In light of the heightened scrutiny of the acts and, more importantly, omissions of the board, the Court's failure to affirmatively rule on this question opens somewhat of a Pandora's Box for directors in future derivative actions. By commenting that issues of good faith are "inseparably and necessarily intertwined with the duties of care and loyalty," the Court sidestepped the issue at hand. However, avoiding the issue does not mean it will go away. In fact, one can rest assured that the plaintiff's bar is regrouping to prepare its second wave of arguments on this issue. With that in mind, directors would be remiss to hold stock in the Court's answer to such a seminal and heavily litigated issue standing the test of time.

### **II. Pointers on Good Governance**

Directors have an obligation to take an active interest in the management of the business. Silently acceding to decisions advocated by a CEO whose actions could be interpreted as trying to usurp the Board's authority will not be sanctioned by the Court, particularly, with regard to hot button issues such as executive compensation and severance packages. In his inaugural speech this past August, SEC Chairman Christopher Cox commented that he wants companies to do a better job of disclosing executive compensation packages to their investors. A

---

<sup>3</sup> In re Walt Disney Co., at 107; see also, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

priority on his corporate reform agenda, Chairman Cox is developing an executive-compensation disclosure requirement that will provide shareholders with an aggregate number for various kinds of executive compensation. To that end, he has put together a team of SEC investigators to uncover how companies disguise executive pay or special bonuses.

In this post-Enron era, directors guiding companies not only must be prepared to explain but must also adequately document the basis for their decisions particularly on highly controversial issues. The days of collectively looking at boards in deciding fiduciary claims are over. Conduct is being examined on a director-by-director basis. The Courts and shareholders alike have zero tolerance for boards stacked with hand-picked yes men. Every director should be vigilant on significant issues affecting management, actively engage in discussions, think objectively and act independently. Individual directors are subject to heightened scrutiny by the Courts forcing them to step up and take responsibility for becoming fully informed on matters passed during a board meeting or be prepared to deal with the consequences.

Given the trend to individually scrutinize directors in the aftermath of such outrageous corporate abuses, the plaintiff's bar may believe that the time has come to invoke a separate fiduciary duty of good faith further broadening the scope of liability of individual directors. If

that is the case, it is sure to give way to an emerging area of law that will require exacting judicial guidance in establishing the boundaries of this new fiduciary obligation.

### **III. Costs of Derivative Actions**

Although few derivative actions result in monetary damages, they hold potential for very large losses taking for example the \$54 million settlement in Cendant. Shareholders bring these types of actions against directors and officers on behalf of and for the benefit of the company with the proceeds going back into the company. The intended objective of a derivative action is to effectuate a change in corporate governance and management to protect the long-term interests of the company. A derivative action can be triggered by a violation of a fiduciary duty owed to shareholders. In recent years there has been a marked increase in the number of derivative action rulings. It is not uncommon for a derivative action to be filed along with a securities class action.

With the plaintiff's bar actively recruiting institutional investors as lead plaintiffs in securities class actions coupled with the fact that such actions tend to settle faster and for significantly higher amounts, it is entirely possible that a settlement in a securities class action could exhaust insurance from a traditional D&O policy leaving directors without coverage. Defense costs and awards for plaintiff's attorney fees are major financial exposures in derivative lawsuits. Directors should also be aware that there is a serious

risk that defense costs alone could exhaust the policy before trial. In fact, litigation costs in Disney thus far on both sides are estimated to have exceeded millions of dollars.

Aside from being very expensive to defend, by their nature, derivative lawsuits are highly disruptive to daily business operations. Typically, derivative lawsuits assert allegations of corporate waste, mismanagement, or breaches of fiduciary duties of care and loyalty owed to shareholders through negligence, mismanagement or self-dealing. Liability will be imposed if a director's conduct exhibits "reckless indifference to or deliberate disregard of whole body of stockholders' interest or that are without bounds of reason." Although the Court implied he may have pushed the outer limits of his authority by hiring Michael Ovitz without specifically involving the board, the Court did not find that CEO Eisner acted in bad faith nor did the Court find the board to have been grossly negligent in ratifying his decision.

#### **IV. D&O coverage**

With the appeal looming large in Disney, considering the impact of a reversal should cause directors and officers to re-examine the scope of their D&O coverage. Will a traditional D&O policy cover the board if a director is found to have breached his or her fiduciary duty? In that case, it is possible that their liability insurance will not cover them if fraud or some other uncovered act or element of loss is

involved which would put their own personal assets at risk. The ramifications of such a finding could be devastating. Both the corporation and individual directors have a joint interest in addressing the consequences of fiduciary breaches long before they find themselves embroiled in expensive litigation. From a corporation's perspective in order to continue to attract and maintain the talent that drives their business, it is important to ensure that their D&O policies provide adequate protection.

When contemplating the need for additional coverage, issues such as policy exclusions, severability, and rescission should take precedence. Some policies contain exclusions for claims related to securities law, financial restatements, or financial impairment of the company. Directors need to be aware of the wording of the policy's severability clauses as restrictive clauses may leave an innocent director without coverage despite their lack of knowledge of any wrongdoing. Along those same lines, there is the possibility that an insurer may attempt to rescind a policy for an inadvertent material misrepresentation or omission retroactive to the date that the application was submitted.

These days insurers are answering the demands of the market by providing D&O products that enable directors to focus their time and efforts on fulfilling their duties to the shareholders. When companies are unable to indemnify directors and officers in their business capacity

and they are forced to put their personal assets on the line, an additional layer of protection may be the answer. From separate Side A only policy, to a Side A Difference in Condition (DIC) policy, there are a number of options available in the market to explore.

One way to ensure that you are covered under circumstances where traditional D&O policies are unavailable is by purchasing a separate Side A only policy that provides additional dedicated coverage to individual directors. Under a separate Side A only policy, individual directors obtain the direct benefit of coverage for losses that can not financially or legally be indemnified by the company. A derivative lawsuit can be one example of a situation where a company may be legally prohibited from indemnifying a director or officer. This additional layer of coverage is triggered when a director's primary sources of financial protection, indemnification and traditional D&O insurance, are unavailable. Since the company is not insured under this policy it will not be frozen in the event of a bankruptcy.

Further additional coverage to consider is a Side A difference in condition (DIC) policy. It has gained interest in that it offers fewer exclusions, more favorable severability language, and is non-rescindable. These policies offer extremely broad coverage and are written in favor of the buyer. Another critical feature of Side A DIC coverage is the policy's drop

down component enabling it to act as your primary coverage in the event your company can not cover or it is excluded from your policy.

For directors and officers to stay in the game, knowing what the Courts consider good corporate governance is critical. The times have forced a change in the criteria for complying with the best corporate governance practices as well as the roles of directors and officers today. Corporate boards should view Disney as a wake-up call. The decision has opened the door for another Court to answer the question of whether directors have a separate fiduciary duty of good faith which will expose directors to a whole host of challenging issues. Given the notoriety of recent corporate debacles reaching billions of dollars, the increase in the filing of derivative actions, and the tireless efforts of the plaintiff's bar to break new ground, an answer to that question may not be far off. Directors need to educate themselves about their exposure and take proactive steps to reduce the likelihood of personal liability. There is no down side to exploring your options, in fact, taking the time to learn about your corporation's D&O policy and about additional coverages to protect yourself is time well spent.

### **Revolutionary.**

Beecher Carlson is revolutionary. We're an integrated commercial insurance and risk management brokerage that leverages a unique combination of advanced analytics, technology tools and years of

industry expertise to assess and model risks in a way that provides clients the right solution, every time. For more information about the services we provide, call 800-657-0243 or visit [www.beechercarlson.com](http://www.beechercarlson.com).

Catherine A. Asaro is an Assistant Vice President at Beecher Carlson's Executive Liability Practice in New York. Catherine holds a B.S. degree in Business Management from St. John's University and a J.D. from New York Law School. Catherine is admitted to practice before the New York State and Federal Bar. She can

be reached at [casaro@bechercarlson.com](mailto:casaro@bechercarlson.com)

#### Disclaimer

This publication is for informational purposes only. It is not a guarantee of coverage and should not be used as a substitute for an individualized assessment of one's need for insurance or alternative risk services. Nor should it be relied upon as legal advice, which should only be rendered by a competent attorney familiar with the facts and circumstances of a particular matter.

© 2005 Beecher Carlson Holdings, Inc.  
All Rights Reserved.