Lessons From The Not-So-Wonderful World Of Disney

By Harvey L. Pitt, Compliance Week Columnist—September 27, 2005

The Walt Disney Company has transformed many engaging fairy tales and stories into fantastic animated and live-action movies. Unfortunately, over the last decade, the most intriguing Disney productions have emanated from its corporate executive suite. From the highly-publicized trial in Delaware Chancery Court regarding Michael Ovitz’s compensation and termination packages, to James Stewart’s gripping and revealing recent book, DisneyWar, the public has watched a number of board-level dramas unfold at the Not-Always-So-Wonderful World of Disney.

In Chancellor Chandler’s 174-page opinion disposing of claims about the hiring and firing of former Disney president Michael Ovitz, there are many lessons to be learned (or unlearned, depending on your perspective). Some of the best lessons must be gleaned by reading between the lines; the record is replete with examples of the contrast between “ideal corporate governance practices and the unwholesome boardroom culture at Disney.” Those who look for silver linings may take comfort from the Chancellor’s oft-repeated mantra that the law does not require companies to implement best practices; they can, if they choose, merely scrape by. But a careful reading of the decision reveals why that course of action is short-sighted and destined to produce bad results.

• **Scraping by comes with significant costs.**

There’s an interesting recitation at the beginning of the decision that might be overlooked by those who like to get right to the “meat” of things. At the outset, Chancellor Chandler notes that the “trial consumed thirty-seven days and generated 9,360 pages of transcript from twenty-four witnesses. The Court also reviewed thousands of pages of deposition transcripts and 1,033 trial exhibits that filled more than twenty-two 3½-inch binders.” This recitation demonstrates one irrefutable fact of life—if you merely scrape by, expect to spend hundreds of millions of dollars on legal expenses and lost executive time that could otherwise have been avoided.

• **When you wish upon a star, your dreams don’t always come true.**

Foremost among the corporate problems reflected in Disney are the problems that can arise if directors abdicate their fiduciary obligation to help management set priorities. No matter how carefully outside directors review management action plans, they also need to consider and develop their own oversight initiatives. This is especially true when it comes to choosing and compensating corporate executives, and succession planning. These are simply not areas that can, or should, be delegated to senior managers. Michael Ovitz had a stellar reputation. In other circumstances, he might have prospered as Disney’s president. But no single individual can ever be any major public
company’s sole hope for success, and placing reliance on an “imperial CEO” like Eisner, no matter how successful he may have been in the past, is a surefire prescription for failure, as the hiring of Ovitz amply demonstrates.

- **Let your conscience be your guide.**

  In the hiring and firing of Michael Ovitz, the Court found that Disney’s outside directors were “taken for a wild ride, and most of it was in the dark.” This was due in large part to the directors’ lack of practical as opposed to legally-sufficient independence. Disney’s compensation committee was chaired by Michael Eisner’s personal attorney, Irwin Russell, and also included the past chairman of the company’s board, Raymond Watson, who had hired Eisner. Eisner, Russell and Watson were the most involved in hiring Ovitz, and, “Russell, per Eisner’s direction, assumed the lead role in negotiating the financial terms of the contract.” This is significant because Russell was also negotiating Eisner’s compensation with Disney at the same time, and the proposed deal he worked out with Ovitz provided “Ovitz’s total compensation could not exceed 75% of Eisner’s.” So the more money Ovitz was paid, the more Eisner would have to be paid. Russell also received separate compensation for his role in negotiating the deal with Ovitz. Both Russell and Eisner had conflicts of interest.

- **A chain is only as strong as its weakest link.**

  The two most independent members of the committee, Sidney Poitier and Ignacio Lozano, were the least involved in the process—receiving telephone updates and attending compensation committee meetings. Compensation committee members should not be close friends of the CEO, nor have affiliations, business relations, or interlocking relationships with senior management. At Disney, however, “Eisner stacked his board of directors with friends and other acquaintances who, though not necessarily beholden to him in a legal sense, were certainly more willing to accede to his wishes and support him unconditionally than truly independent directors.” Thus, Disney provides a clear example of “how ornamental, passive directors contribute to sycophantic tendencies among directors and how imperial CEOs can exploit this condition for their own benefit, especially in the executive compensation and severance area.”

- **Don’t put Dopey, Sleepy and Bashful on the compensation committee.**

  Compensation committees should be small (three to five members), and each member should be independent of management, not only as a “legal” matter, but also as a “pragmatic” one. Committee members should be selected by the independent members of the board, not the CEO. The full board should ratify the selection of all committee members and designate the chairman of the committee.

- **Don’t rely on Grumpy for legal advice.**

  It’s important not to rely on those who may be disgruntled by the proposed hiring of a senior executive. Equally bad is relying on the legal advice of those who are ecstatic about assisting you in getting rid of your mistakes (and unblocking their career paths). It takes someone with no vested interest in a prior decision, and no economic stake in the pending decision, to evaluate the
appropriate methodology of unraveling it. Similarly, when outside advice is solicited, it’s critical that it be shared with all directors, whether the advice was what was hoped for, or not. There is also no justification for depriving relevant committees, or the board as a whole, to access to experts that have, in fact, been hired.

**While “trust and a little bit of pixie dust” may work in Never-Never Land, good compensation committees should follow and document meticulous procedures.**

It turns out that due diligence, hard work and meticulous planning and documentation are also needed in addition to “trust and a little bit of pixie dust.” The first question a committee and board should address in determining compensation is what does the board want the executive to achieve? If the board cannot articulate this, then it cannot set compensation. As with any job, whether it’s flipping hamburgers or running a Fortune 500® company, a clear delineation of goals and responsibilities is necessary. Once it’s decided for what compensation is being awarded, the next critical decision is how much each person deserves to make. Thereafter, the question is what form the compensation should take? Factors giving rise to bonus payments should be clearly delineated and understood. And, careful notes should be kept of all committee deliberations. [I covered this topic extensively in my July 2004 column for Compliance Week, “Ensuring Your CEOs Are Worth Their ‘Salt’.” My previous columns are available from the box above, right.]

**Make sure Pinocchio’s discussions don’t cause his nose to grow.**

Michael Eisner was very adept at talking to individual directors one-on-one, which—as one expert testified—resulted in the directors being “unequally or unevenly informed with regard to significant matters,” and had “the effect of vitiating, sapping the board’s ability as an institution to function together collectively and collegially and deliberatively.” The economic term for this is information asymmetry. Great care should be taken to make sure directors are fully and evenly informed. Often the best way to do this is in writing, with each director given ample time to review and digest the information. A package of materials furnished to directors in advance of meetings at which executive compensation arrangements will be discussed is most helpful. Among other things, the package should contain a complete draft of the proposed agreement, a summary of its key provisions, an analysis of the costs of the proposed compensation over the life of the agreement, information about similar arrangements at comparable companies, details concerning the standards for unraveling the employment agreement, and similar information. Relying upon one-on-one discussions, even if everyone’s told the same story (and even if they’re told the truth) deprives committees and boards of the synergy that collegial discussions produce. There’s no substitute for an actual meeting.

**Creating self-fulfilling prophecies is always a worthwhile endeavor.**

One of the factors that helped Disney’s directors was the fact that Disney’s stock price increased by 4.4 percent, and its market capitalization by more than $1 billion, in a single day, after the announcement of Ovitz’s hiring. These things may seem like pure serendipity, but the fact is that if a corporate action is worth taking, it is worth ensuring that the media understand how valuable the course of action could prove to be.
• **Breaking compensation packages into individual components, rather than consider them as a unified whole, can lead to “Goofy” decisions.**

Boards must pay heed to the fact that breaking compensation decisions up into separate pieces may allow individual pieces to seem rational, while the aggregate package is anything but. Situations can and do arise in which the total may be greater than the sum of the parts. That’s why it’s important for compensation committee members to step back and look at the entire picture. Failing that, they should ask themselves how the compensation package would look, or reflect on the company, if it were the subject of a lawsuit or newspaper story.

• **In a “Mickey Mouse” world, hope for the best, but assume the worst.**

Anyone can take credit for a decision that works out perfectly. No one wants responsibility for a decision that craters. The best way to avoid being left holding the bag is to develop scenarios of what might and could go wrong, and decide whether the proposed agreement raises problems in that light.

• **Don’t lull your shareholders into Sleeping Beauties—a lucid and complete description of compensation, and all relevant details, should be included in company filings.**

Make sure anyone can understand the disclosure, calculate the compensation, and figure out what the cost will be if the contract is performed to the end of the term, or if it is terminated without fault. In this context, it is critical for companies to go beyond boilerplate justifications for compensation decisions, such as the need for the company to pay a higher level of compensation in order to “remain competitive.” Compensation committees should be more specific in their disclosures, explaining the strategic rationales that underlie their decisions, the data they examined, and the methodology used to arrive at their conclusions. The SEC is currently considering ways to improve disclosure concerning executive compensation so that it’s clearer for investors and easier to locate and understand. Amounts are relevant, but perhaps more important is how those amounts are tied to performance. Investors need to know what the executive’s goals are and how his or her compensation is related to those goals. What are the financial consequences to the executive of not attaining those goals?

• **In every corporation’s “Circle of Life,” directors will be judged collectively and individually.**

One of the fascinating elements of the Disney decision is that it appears to view the conduct of Disney’s directors in three specific ways—as a unified whole, as subgroups (the compensation committee members) and as individuals. When boards are assessed collectively, the failure of an entire board to meet the standards imposed by their corporate fiduciary duties of loyalty, care and good faith will not permit an individual director to claim he or she didn’t know or wasn’t assigned that function. Similarly, the Disney decision makes it clear that subsets of directors—the compensation committee and the two truly independent members of that committee—may also rise or fall collectively. But perhaps of greatest interest is the Chancellor’s decision that each director should also be evaluated individually. In the Emerging Communications decision, Supreme Court
Judge Jacobs—sitting as a Chancellor—held an individual with greater substantive knowledge than his colleagues to a higher standard of care. In Disney, the opposite result obtained, but the two independent members of the compensation committee—Messrs. Poitier and Lozano—were assessed individually.

It’s a sad truism that only litigators gain from litigation; clients rarely, if ever, do. For most corporations, the goal should be to avoid litigation, or to ensure its early dismissal. Learning Disney’s lessons can provide a solid basis for doing so.

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