PERSONAL LIABILITY FOR DIRECTORS AND OFFICERS
UNDER ERISA FIDUCIARY THEORIES

Section of Business Law
Program: Officer and Director Liability Under ERISA Employee Benefits and Executive Compensation

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By

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I. The Risks

A. Personal Liability

1. ERISA imposes personal liability on fiduciaries to make good any loss or to restore any profits resulting from fiduciary breach. ERISA § 409, 29 U.S.C. § 1109.

B. Co-Fiduciary Liability

1. Directors & Officers can be held liable for breach of co-fiduciary (e.g. the company). ERISA § 405, 29 U.S.C. § 1105.

C. No Insurance

1. Directors & Officers policies typically exclude fiduciary conduct related to ERISA.

D. No Indemnity

1. The company may not be in position to indemnify or defend because of its financial condition.

E. Deep Pockets

1. Directors & Officers may be only remaining deep pockets.

F. Criminal Prosecution


2. See also United States v. Phillips, 19 F.3d 1565 (11th Cir. 1994). (Employer paid kickbacks, in form of illegal pension payments, to union officials and failed to inform other beneficiaries of change in plan).

II. Liability Under ERISA

A. ERISA Fiduciary Duty

1. Corporate form does not insulate Directors & Officers from liability for actions taken as an ERISA fiduciary. Directors & Officers are ERISA fiduciaries “to the extent” they exercise:
a) Discretionary control or authority over plan management;

b) Discretionary authority or responsibility over plan administration;

c) Any authority or control over management or disposition of plan assets.

d) Authority to select and retain plan fiduciaries.


2. Fiduciary Duties:


B. Fiduciary Duty Case Law Impacting Directors & Officers

1. Eaves v. Penn, 587 F.2d 453 (10th Cir. 1978).

a) Officer and director of company acted as fiduciary in recommending, designing and implementing amendment of original profit sharing plan to ESOP.


a) Involved a defined benefit plan investment in qualified employer securities during a hostile take-over fight. The plan trustees were the CEO/Chairman of the Board, the CFO, and the Treasurer. The defined benefit plan held company stock as 4% of its assets. The company was in the midst of hostile take-over fight and the Directors & Officers had promptly rejected offers to tender stock. The plan trustees met for a half hour and decided (i) not to tender and (ii) to use plan assets to purchase company stock up to the 10% limit imposed on defined benefit plans.
b) The purchases were made at the high prices resulting from the tender offer. The day after the plan purchased stock, the district court entered a preliminary injunction enjoining the take over and the price of the shares plummeted.

c) The court held that trustees had duty to avoid placing themselves in position where acts as officers or directors of the corporation prevented functioning with complete loyalty to plan participants: “Although officers of a corporation who are trustees of its pension plan do not violate their duties as trustees by taking action which, after careful and impartial investigation, they reasonably conclude best to promote the interests of participants and beneficiaries simply because it incidentally benefits the corporation or, indeed, themselves, their decisions must be made with an eye single to the interests of the participants and beneficiaries.” 680 F.2d at 271.


   a) The company used profit-sharing trust assets to purchase stock in other companies that certain board members and officers sought to obtain corporate control over or a control premium.

   b) The fact that trust earned 72% return on investments did not bar disgorgement of profit remedy and the fiduciaries were liable for profits earned from use of trust assets. The court placed the burden on the fiduciaries to show which profits were attributable to their own investments and efforts versus those attributable to use of plan assets. 727 F.2d at 122-23, 137-39.

   c) The court held that the duty of loyalty included avoiding situations where acts as Directors & Officers prevented complete loyalty to the plan participants. The court declined to adopt a *per se* rule requiring appointment of an independent fiduciary but strongly recommended it and subjected conflicted fiduciary acts to strict scrutiny. 727 F.2d at 125-26, 132.

   d) The court also held that Directors & Officers are fiduciaries “to the extent” they exercise discretionary authority over selection and retention of plan fiduciaries, including the duty to monitor activities and to act when they knew of conflict caused by plan investments in corporate control contests. 727 F.2d at 133-36.

   a) The district court held the president of a small company, who also served as the plan’s administrator, was personally liable for using corporate funds to pay business expenses rather than health insurance premiums.

   b) The Eleventh Circuit reversed and held the president was acting in corporate capacity, not as a plan fiduciary.


   a) ESOP corporate-control case where the ESOP committee did not solicit proxy votes of retirees. Although the power to appoint and remove fiduciaries includes the duty to monitor, the court held that Board members had no “notice of misadventure” from their appointees to trigger a fiduciary duty. The plan documents provided that proxy votes did not need to be solicited from retired employees.


   a) The officers caused a corporate fiduciary to wrongfully deny claims and the company backdated a plan amendment to deny a benefit claim. An individual then sued the employer and officers involved in backdating the amendment. The Employer was the named plan fiduciary.

   b) The court applied a traditional “corporate form” analysis to hold that the officers were not liable because when exercising discretionary authority they were acting on behalf of the corporation, not as individuals. The court also held that when an ERISA plan names the corporation as the fiduciary, the officers who exercise discretion on behalf of that corporation are not fiduciaries unless they have individual discretionary roles as to plan administration. 952 F. 2d at 36-38.

a) The plan sold its interests in company stores to company, who then resold those interests for higher amounts in a sale-leaseback transaction to a third party. The price at which the plan sold its interests to the company was based on a disputed real estate appraisal. The plan trustees included the founder and vice-chairmen of company and the president of the company. 884 F. Supp. at 351-52.

b) The court applied agency theory to conclude that the company may have been a fiduciary in relation to the sale because the trustees may have been acting on the company's, not the plan's, behalf in approving the sale. Id. at 352-53. However, Circle K’s CEO was not a fiduciary because there was no evidence he controlled or influenced plan trustees.


   a) Corporate directors who were trustees of ESOP, committed “flagrant breach of their fiduciary duties” by soliciting votes and campaigning on behalf of incumbent management rather than providing a neutral explanation of pass through voting.


   a) One of the lead Executive Life cases where a defined benefit plan is terminated and insurance annuities are purchased from Executive Life in conjunction with the termination of the plan, with the surplus assets reverting to the employer.

   b) The company was the named fiduciary and stated that the Directors & Officers were acting “on behalf of” the company, not as individuals, in carrying out their duties. The court held the Directors & Officers individually liable as fiduciaries, even when acting in their corporate form carrying out delegated duties.

   c) The court applied the functional test of ERISA § 3(21) to determine fiduciary status. The court also held that ERISA § 409 does not draw any distinction between “named fiduciaries” and fiduciaries generally. The court also held ERISA § 410 prohibits the plan or other agreements from relieving a fiduciary from fiduciary responsibility or liability.
d) Finally, the court deferred to the DOL’s interpretation of the fiduciary duty provisions imposing personal liability so that the acts of Directors and Officers are not immunized by their administrative status. *Id.* at 1458-61.


   a) In the context of a bitter dispute over pension plan proceeds from a marital separation dissolution order, the court held that when a committee is the named plan fiduciary, those corporate officers who carry out fiduciary functions are themselves fiduciaries who cannot be shielded from liability by their corporate functions. The court also held that the Committee need not officially delegate fiduciary duties to the officers for them to be personally liable as fiduciaries.


   a) In the context of deciding a motion to dismiss, the determination of whether the Directors & Officers are fiduciaries is fact intensive and turns on the extent of responsibility and control exercised by the individual with respect to the plan. Thus, court will not dismiss fiduciary claims against Directors & Officers at this stage of proceedings, as there may be facts that develop demonstrating fiduciary status.

C. Duty to Appoint and Monitor ERISA Fiduciaries

1. Liability may also arise from the Directors and Officers duty to appoint and monitor ERISA fiduciaries.


   a) Company used defined benefit plan assets to purchase stock in companies in which certain board members and officers were seeking to get corporate control or a control premium.

   b) Applying *Leigh v. Engle*, the court held corporate directors breached their fiduciary duty in selecting, monitoring, and overseeing plan administrator's actions; 622 F. Supp. at 1211.
c) The directors knew of the conflicting loyalties of the plan administrator, were aware of these investments, and themselves had an interest in the transaction;

d) Court applied co-fiduciary liability under ERISA § 405 because the director's failure to monitor and investigate enabled breach; and

e) The fact that transaction was profitable for plan did not bar liability and defendants were still forced to disgorge profits. 622 F. Supp. at 1216.


   a) Claim made that directors of the bank breached their fiduciary duties by continuing to invest in employer stock. At motion to dismiss stage, court applies a broad definition of fiduciary conduct to include control over plans, including selection of plan committee members, precluding dismissal of officers and directors. 698 F. Supp. at 860.


   a) Director of company breached fiduciary duties by negotiating a $100,000 pay out to himself on his ESOP account when company and ESOP were in financial distress.

   b) As a director, defendant had a duty to monitor plan administrator who approved the payment to him.


   a) An ESOP case where court held that corporate director's power to appoint plan trustees includes duty to monitor appointed trustees and may impose a duty to prevent wrongful conduct. The Eighth Circuit remanded for further findings.


   a) Here the company established a 401(k) and ESOP plan. A corporate division was spun off in an asset sale. The sales agreement contemplated a trust-to-trust transfer of all securities for employees transferred to new company.
b) After the transaction, the trust assets were frozen for 18 months to finalize sale and transfer, from March 31, 1989 to November 1, 1990. During this period the predecessor company stock declined almost 80%, from $49 to $10 per share.

c) The predecessor employer, Quantum Chemical Corp., was the plan sponsor, but not the plan administrator or named fiduciary. Quantum's Board of Directors appointed the plan’s administrative committee and its ESOP plan's trustees.

d) The court granted summary judgment dismissing company and board members. The court held that fiduciary duties of the board of directors were limited to its “appoint and remove” powers. The court also held that the discretion to manage the plan and invest assets was vested in administrative committee. There was no showing that the directors influenced decisions of administrative committee. Finally, there was no specific evidence the board knew of any wrongdoing by the committee appointees. 838 F. Supp. at 347-48.

D. Co-Fiduciary Liability

1. Under ERISA, a co-fiduciary may be liable for breaches by other fiduciaries if s/he:

   a) Knowingly participated in or concealed breach;

   b) Failed to exercise fiduciary duty enabled breach; or

   c) Knew of the breach and failed to take steps to cure that breach. ERISA § 405(a), 29 U.S.C. §1105(a).

2. In Sandoval v. Simmons, 622 F. Supp. 1174 (C.D. Ill. 1985), the company used defined benefit pension plan assets to purchase stock in companies in which certain board members and officers were seeking to obtain corporate control or a control premium. The directors knew of the conflicting loyalties of the plan administrator, were aware of these investments, and themselves had an interest in the transaction. Co-fiduciary liability attached under § 405 because of the director's failure to monitor and investigate enabled breach. 622 F. Supp. at 1211.

3. Free v. Briody, 732 F.2d 1331, 1335-37 (7th Cir. 1984). The Trustee/CEO invested plan assets with a financial advisor who embezzled
them those assets. The co-trustee breached fiduciary duties to use reasonable care to prevent the CEO from committing this breach and to jointly manage and control assets of the plan. The court held that the co-trustee simply cannot do nothing while another trustee depletes the plan’s assets.

E. Investment in Company Stock


2. Investment in company stock is presumed prudent for Employee Stock Ownership Plans (“ESOP”).

3. When a company’s financial situation worsens, Directors & Officers claims may be asserted on the basis that they:
   a) Knew or should have known that company stock was not a prudent investment option for the plan;
   b) Made misrepresentations about and/or failed to disclose adverse information about company stock; or
   c) There is a causal link between a failure to investigate and harm suffered by plan.

   a) Bloomingdales, a division of Federated, had a DC plan that allowed investment in company stock and that company matched in company stock. The DC plan allowed for a “pre-retirement transfer option” in which if a participant met certain age and service requirements, he could transfer company contributions into low risk funds. The stock market crash in October 1987 sent the stock down. The plan administrators then sent a reminder notice of the transfer option, which included the ability to value company stock over a 90 day average for transfer purposes ($50 at that time versus $33 market price). Three months after transfer, another company announced an unsolicited hostile tender offer of $47 a share that ultimately resulted in a merger price of $73 a share. Plaintiffs who used the pre-retirement transfer option before the hostile takeover, sued the company, the plan, and the members of
the company's board and the plan's administrative committee, claiming a breach of fiduciary duties because they failed to disclose: (i) existence of takeover offers or negotiations and (ii) that stock analysts assigned a break-up value to the company stock of $65 to $90 a share. *Id.* at *1 to *4. The court granted summary judgment to defendants because there was no connection between the plan administrators and the hostile takeover company. Defendants did not gain from the employees tendering their shares.

b) On the duty to disclose claim, the court adopted 10b-5 materiality standards and rules:

1. An objective standard that takes into account information in the public domain, such as that company was a takeover candidate;

2. No duty as to insiders to speculate or opine on the value of company stock, because such speculation and opinions carries with it liability if speculation and opinion proves inaccurate.


a) The district court earlier granted summary judgment dismissing the company and its board members. The court next held the defendants were not acting in a fiduciary capacity. Plaintiffs alleged that during the transfer period, the ESOP fiduciaries knew:

1. The employer’s re-capitalization increased financial risk;

2. The employer had decreased operational diversity and declines in sales and revenue and;

3. A major fire occurred at one of employer's plants.

b) Plaintiff appealed summary judgment granted to remaining ESOP plan trustees. With respect to the claim for breach of duties to diversify ESOP assets during the transfer period, the court reviewed the ESOP fiduciary’s decision to continue investing in employer securities for an abuse of discretion. A fiduciary’s decision to remain invested in employer securities is presumed reasonable. A fiduciary’s failure to investigate an investment
decision alone is not sufficient to show that the decision was not reasonable. Instead, the court held plaintiff must show that an adequate investigation would have revealed that the investment was improvident. The fiduciary’s inside knowledge of the company's financial woes did not override this ESOP presumption. During the transfer period the stock price was fluctuating and several investment advisors were advising in favor of investment in employer stock. 66 F.3d at 1459-60.


   a) A bank set up an ESOP that invested primarily in the bank’s stock. During a year-long period, the bank’s stock value fell to almost zero. Despite the rapid decline, the investment committee for the bank, who were the directors of the bank, did not divest and acquired on behalf of the ESOP additional stock. At the same time, defendants were selling their own personal holdings in bank stock.

   b) The court concluded that an ESOP fiduciary is entitled to a presumption that it acted consistently with ERISA by investing in employer stock. This presumption can be overcome by showing an abuse of discretion by the fiduciary. An abuse of discretion can be shown if the plan continues to invest when the financial status of the company shows a precipitous decline. As the financial situation deteriorates, loyalties are divided and discretion thus diminishes. Loyalties are further divided by the tension between serving the corporation in the corporate director role versus the plan and its participants in the plan fiduciary role. In these circumstances, the fiduciaries must be able to show that they impartially investigated options. 66 F.3d at 572.


   a) At issue was a stock bonus plan where the company matched employee contributions in company stock. Plaintiffs claimed the individual defendants should have diversified out of company stock because the ongoing government investigation of the company during the 1997-98 period negatively impacted the value of the stock, which dropped by about 50% and because of the company’s poor financial performance. The court held that even though the retirement committee’s procedure to review the
prudence of investment in company stock was deficient, its purchases of company stock were prudent. *Id.* at 6. There was public knowledge of corporate malfeasance. The court held that had the committee fully investigated, it would have continued to invest in company stock because:

1. The company was sound financially measuring its net assets, cash flows, and income increased during this period;
2. Independent financial analysts supported retaining company stock;
3. Investment managers and insiders continued to invest in stock; and
4. The demographics of the workforce suggested should follow a long-term investment strategy.


   a) Decided at the motion to dismiss stage. The court held that it would not dismiss the fiduciary allegations against the directors at this stage of the litigation but warned that plaintiffs would have to meet a “very high burden” to hold the directors liable for making impudent investments by following plan terms that all employer matches must be in employer stock.


   a) The case involved a 401(k) plan where the participants controlled their individual account investments. However, the employer matched employee contributions with company stock. Negative information about the company was disclosed, leading to a sharp drop in the price of the company’s stock and a securities fraud class action. Plaintiff brought a class action under ERISA against the company, its CEO/director, and against the Investment Committee members. *Id.* at *2.

   b) The court held that the company and CEO had only limited fiduciary duties and that the authority to make investment decisions as to employer-matching contributions rested with the
investment committee. The court also held that the CEO or company did not assume any duties beyond those owed to the market in general, a subject to be addressed in the securities law case. *Id.* at *2 to *3.

c) “If the allegations of wrongdoing, including allegations of providing misinformation and failing to provide accurate information, ultimately prove true, the Plan's remedy will be the same as for the plaintiff class in the related securities action. This result is not at all unreasonable as the duties of disclosure owed to the Plan by the corporate defendants are not based on the duties owed by an ERISA fiduciary to a Plan and its participants, but the general duties of disclosure owed by a corporation and its officers to the corporation's shareholders.” *Id.* at *8.

d) Regarding allegations that Investment Committee members breached fiduciary duties by investing employer match contributions in company stock, the court dismissed the claim because there were no allegations that committee knew of or disseminated false information. The court also held there were no allegations the committee was pressured to invest in company stock and ERISA does not impose a different standard of care regarding investments in company stock as opposed to other stock.


a) In this case, the court applied the ESOP presumption to an individual account stock bonus plan and relieved the fiduciaries from their diversification obligations. The court adopted the conclusions of the Third Circuit (*Moench*) and the Sixth Circuit (*Kuper*) and held an ESOP fiduciary is entitled to a presumption that its decision to remain invested in employer securities was reasonable.


a) An ESOP case where the company directors & officers also acted as the trustees and fiduciaries of the plan. The major plan asset was an insurance company. Plaintiff alleged the directors & officers provided false or misleading financial statements and depleted the insurance company’s assets. 782 F. Supp. at 965-67.
b) The court held that plaintiff failed to state a claim under ERISA by alleging nothing more than mismanagement of the corporate entity on which fiduciaries served as directors & officers. 782 F. Supp. at 963.

c) However the court held plaintiff did state a claim for breach of duty to diversify because investments in company stock were made in a fiduciary capacity and there was knowledge in their capacity as officers and directors concerning the subsidiaries’ deteriorating financial state and of fraudulent acts to conceal. The court noted this meant the fiduciaries knew they needed to take steps to prevent dissipation of plan assets and to consider suing themselves in a stockholders’ derivative action. 782 F. Supp. at 967-69.

F. Communications

1. In Varity Corp. v. Howe, 116 S. Ct. 1065 (1996), company communications about the transfer of employees from their incumbent employer to a successor employer became fiduciary communications because the communications were made at a meeting on employee benefits, conducted by senior management with authority over benefits, and senior management intentionally and fraudulently linked statements regarding business conditions to benefits to present the message that employees’ benefits would be secure at the successor employer.

   a) Other employment decisions may impact an employee’s benefits under the terms of the Retirement Plan – e.g., an employee does not qualify for benefits until hired; he or she only accrues service while employed; the amount of pay raises will increase the amount of his benefit. Communications on these and myriad other employment issues are not transformed into ERISA “fiduciary communications” simply because these issues may affect benefits.


   a) Plan administrators are not required to inform all participants of every corporate event, especially contingent events, that might impact company’s stock value.

a) Stock appraisal reports were not required to be disclosed. Company has no general duty to disclose financial information simply because it offers ESOP.

III. Strategies and Defenses

A. Insider Information


2. A fiduciary has no obligation to provide investment advice to plan participants. 29 C.F.R. 2550.404c-1(c)(4).

   a) Directors & Officers are not liable as ESOP trustees despite 80% decline in stock price during transfer period because inside knowledge of company’s financial woes does not override the presumption of prudent investment. During transfer period, the stock price fluctuated and several investment advisors were positive about employer’s stock.

   a) Acting on inside information about company stock would violate the spirit of securities laws and regulations prohibiting insider trading. ERISA does not impose a different standard of care regarding investments in company stock as opposed to other stock.

   a) Plan administrators did not breach fiduciary duty in notifying employees of transfer option shortly before stock price soared. Several newspaper articles had speculated that company stock was undervalued.

   a) The bank was a trustee for a small company ESOP. The plaintiff claimed the bank trustee knew or should have known of
mismanagement at company because the bank was also the commercial lender to company. The personnel at the bank who had knowledge of the performance of the company loans followed the law in not communicating information about those loans and the company’s finances to personnel at bank acting as trustees of ESOP. Additionally, the bank was also acting as a directed trustee with respect to its role here.

   
a) Directors & Officers who were also trustees and fiduciaries of plan breached a duty to diversify when they knew of dissipation of plan assets and fraudulent acts.

   
a) An ESOP may pursue minority stockholder claims. The decision not to assert such claim is one of plan administration. As plan fiduciaries, the corporate officers had a duty to bring derivative suit if they knew there was a breach of corporate fiduciary duties to shareholders. 965 F.2d at 667.

   
a) In this ESOP case, management bought out a subsidiary in a spin-off through an ESOP. Defendant was the CEO, Chairman of the Board, and an ESOP trustee. Unilaterally he paid himself excessive compensation and was sued by the Corporation and the ESOP plan after he retired. On the ERISA claims, court held he breached fiduciary duties as trustee.

   b) As a trustee, defendant was charged with knowledge of improper actions he took as officer or director. He placed himself in a position where his acts as an officer or a director prevented him from functioning with complete loyalty to the ESOP participants. As a trustee, he should have brought a derivative action challenging his improper actions as officer and director. He breached his duties by concealing material information (*i.e.*, his compensation and bonuses) from his co-trustees. 76 F. Supp. at 636-38.

a) A bank was alleged to breach its fiduciary duty as a trustee by resigning as trustee and turning plan assets over to company president. The bank allegedly knew the company had financial difficulties and the company president had not complied with his fiduciary duties. The court held that a reasonably prudent trustee would have not have sent plan assets to the company president and would have informed beneficiaries of circumstances.

B. Independent Control

1. ERISA relieves fiduciaries of liability for breaches resulting from a participant’s independent exercise of control over an individual account plan. § 404(c), 29 U.S.C. § 1104(c). The participant must have a broad range of investment choices. The participant will not be deemed to have exercised independent control if subjected to improper influence by plan sponsor or fiduciary or if plan fiduciary concealed material non-public information, unless disclosure would violate federal law.

   a) See also 29 C.F.R. 2550.404c-1(c)(2).

2. In re Unisys Savings Plan Litigation, 74 F.3d 420 (3rd Cir. 1996).

   a) Unisys’ DC plan included as guaranteed investment options funds comprised mainly of Executive Life junk bonds. Responding to the defendant’s reliance on an ERISA §404(c) defense, the court noted that the statute insulates the fiduciary from responsibility for participant investment decisions. However, the § 404(c) defense is not applicable if there were breaches of duties to inform regarding the investments. 74 F.3d at 445, n.22. The court also held that the plan must offer acceptable comparable alternative investments. 74 F.3d at 447. The plan must also provide information sufficient for the average participant to understand and assess:

   b) the control the participant has and the financial consequences of exercising that control;

   c) the alternative funds offered;

   d) the investments in which fund assets were placed;

   a) In this case, the bank was the trustee of plan. When the bank's investment manager resigned, the bank told the plan it would continue as trustee only if the plan was amended to become a participant-directed investment plan. The participants eventually directed 100% of their investments into an offered hedge fund, that declared bankruptcy because of mismanagement and securities fraud. 289 F.3d at 1230-31. Because the bank did not comply with the appropriate plan amendment procedure, conversion to 404(c) plan was ineffective and the bank was liable for plan investments. 289 F.3d at 1233-38.

C. Steps To Consider To Protect Directors & Officers

1. Specifically delegate fiduciary duties in the plan documents.

2. Remove Directors & Officers from plan administrative or investment committees.

3. Obtain ERISA fiduciary insurance policies.


5. **Beddall v. State Street Bank**, 137 F.3d 12 (1st Cir. 1998). Directed Trustee case where defendant was not liable for incorrect valuation of plan’s assets because plan documents and trust agreement divested trustee of any and all management authority or discretionary control over assets. Awareness of problem did not create fiduciary duty.
D. Steps To Consider To Limit Exposure

1. Appoint an independent fiduciary to evaluate company stock as investment during volatility.

2. Use the SPD to authorize spokesperson for plan.

3. Avoid commingling communications regarding company’s financial condition with information on plan.

4. Avoid recommending plan investments in company stock.

IV. Final Thought

A. Fiduciary Status

1. As the Supreme Court clarified in *Pegram v. Herdrich*, 120 S. Ct. 2143, 2153 (2000), the threshold question is not whether a Director or Officer’s action in connection with a plan adversely affects a participant’s interest, but whether the person was acting as a fiduciary when taking the action subject to complaint. The performance of ministerial functions with respect to a plan does not make one a fiduciary.
What Directors and Officers Need to Know About Personal Liability for Employee Benefits & Executive Compensation under ERISA & Corporate Law

August 7, 2004
ERISA’s Fiduciary Duties Apply to Plan Investments in Company Stock

- ERISA requires all assets to be prudently managed
  - no exception for company stock
    - See e.g., Kmart, Williams, WorldCom ERISA Decisions
  - Directors and Officers must be on alert for conflicts due to dual loyalties
“Even in the context of an ESOP, which is designed to offer employees the opportunity solely to invest in the employer’s stock, a fiduciary may be liable for continuing to offer an investment in the employer’s securities, at least where the plaintiff can show that circumstances arose which were not known or anticipated by the settlor of the trust that made a continued investment in the company’s stock imprudent, and in effect, impaired the purpose for which the trust was established.”

Bottom Line

- Fiduciary duties apply to company stock
- Must investigate merits of investments in company stock
- Must discontinue investment and take action to protect the Plan by divesting, if the stock has become too risky
How Do Company Officers & Directors Become ERISA Fiduciaries?

- Being named as a Plan fiduciary in Plan documents
- Performing Plan administrative functions
  - Misleading Plan participants regarding merits of investment in company stock
- Appointing/removing, thus, monitoring other Plan fiduciaries
Duty to Disclose Material Information

- Cannot mislead other fiduciaries or participants
- Must disclose information that they know or should know will have an extreme impact on the Plan
  - *Enron, WorldCom* cases make these duties clear in context of corporate fraud and wrongdoing
“[W]hen they spoke about plan investments, [Defendants] had a fiduciary obligation not to materially mislead plan participants…about the risk involved in investing their assets in and retaining its stock….Defendants allegedly breached their fiduciary duty to protect the plan participants and beneficiaries through failure to disclose to them and to other Committee Members that what they knew or should have known, through prudent investigation, was a threat to the pension plans or to correct any material misinformation.”

*Enron ERISA Decision*, 2003 WL 22245394, at *103.
Interaction of ERISA & Securities Laws

- Fiduciaries must make public disclosures, if necessary, to satisfy duties
- Insider trading defense rejected in, e.g. WorldCom, Kmart, Enron ERISA decisions
- McKesson, Hull discredited

Securities Laws Are No Defense
“Second, and more significant, the Court finds that the McKesson court’s rationale is misguided for the following reasons…Defendants’ argument that despite the duty of loyalty, a fiduciary should make no disclosure to the plan participants, because under the securities laws he cannot selectively disclose nonpublic information, translates in essence into an argument that the fiduciary should both breach his duty under ERISA and, in violation of the securities laws, become part of the alleged fraudulent scheme to conceal Enron’s financial condition to the continuing detriment of current and prospective Enron shareholders, which include his plan’s participants. This Court does not believe that Congress, ERISA or the federal securities statutes sanction such conduct or such a solution, i.e., violating all the statutes and conning the public.”

“Defendants had a duty under securities laws not to make any material misrepresentations; they also had a duty to disseminate truthful information to plan participants, including the information contained in SEC filings. Contrary to Conaway and the Outside Directors’ argument, their duties under ERISA and securities law co-exist.”

Duty to Monitor

- Persons who appoint fiduciaries must monitor their appointees

- Scope of monitoring duties settled in recent cases
  - must supervise/evaluate performance
  - provide material information
  - remove incompetent fiduciaries
“[T]hese Defendants allegedly exercised, but in specified cases not well, their explicit duty to select and appoint fiduciaries, but…failed to provide material information or correct misleading information essential to prudent administration of the plans…and failed to monitor or remove their appointees for incompetence.”

Thank you, John [Beystehner, COO, United Parcel Service].

Thank you, Dr. [Jeff] Sonnenfeld [Associate Dean, Yale School of Management], for the invitation to be here. I also want to introduce Ann Combs, the Assistant Secretary for Employment Benefits Security at the Department of Labor who is doing a terrific job.

Every year, this Forum offers an interesting and thought-provoking gathering of community and corporate executives to discuss significant issues facing our economy and our society. Chief among these issues have been corporate governance and highlighting the importance of public trust to a free enterprise economy that has brought about so many benefits for our people.

Today is the one-year anniversary of the President’s Jobs and Growth Act of 2003. Three Fridays ago, I announced the national unemployment number for the month of April at 5.6 percent.

Our economy has come a long way. As you may recall, the stock market peaked in March 2000. In August 2000, manufacturing hit the doldrums. By the time this Administration came into office, the nation was already in a recession though it was not widely reported at the time.

The economy was responding to the President’s first round of tax cuts when the attacks of September 11, 2001, occurred. 1.5 million jobs were lost in the aftermath. The President’s two subsequent tax reduction programs helped to make the recession one of the shortest and shallowest in recent history.
First quarter GDP growth for 2004 of 4.4 percent illustrates that the economy is growing robustly. When combined with the last half of 2003, that represents the **strongest** four-quarter growth rate in **almost 20 years**. Real after-tax incomes are up 10 percent since the fourth quarter of 2000, substantially above the levels of the last recession. Inflation and interest rates are near 40-year lows, pushing homeownership to all-time highs.

The forward momentum of the American economy is also reflected in the strengthening labor market. Last month was the 8th straight month of job growth, with 1.1 million new jobs created since last August. And, these are good jobs—real average hourly wages that rose 2.2 percent over the past 12 months. First-time jobless claims continued to fall—decreasing by 3,000 to 344,000—for the week ending May 22. Nationally, the unemployment rate of 5.6 percent is lower than the average unemployment rate in the decade of the 1970s, 1980s and 1990s.

The smooth functioning of the free enterprise system and our markets and the benefits they bring are built upon public trust, accurate and reliable information and overall transparency. When institutions violate the public trust, our economy and workers suffer.

The last couple of years have seen the very public and visible collapse of several major Fortune 500 companies with grievous consequences for workers’ pension plans. Strong fiduciary oversight and protecting workers’ benefits are the Department’s highest priorities. We take great pride at the Department of Labor in our enforcement record and results. In 2003 alone, we recovered $1.4 billion for workers pension and health benefits programs.

In the course of recovering workers’ pension assets, we have seen a clear lack of understanding or appreciation of the fiduciary’s responsibilities under ERISA. Today, a CEO is much more than the manager of an organization. He or she is a steward of the vitality of our economy and the public trust. Executive decisions need to be made not only in the short-term interest of the organization, but with an eye to the long-term interest of the economy and the preserving the benefits of the free enterprise system.

That’s why I am here today to discuss the need for corporate and organizational CEOs to be more aware and vigilant about the responsibilities of being pension fiduciaries and to review the steps that should be taken to ensure that retirement promises made to workers are kept.

The total value of our nation’s retirement investments—including 401(k)s and IRAs—has been estimated at a staggering $12 trillion. About $4.3 trillion reside in private-sector, employer-provided retirement plans. These plans are regulated by the U.S. Department of Labor under ERISA, the Employee Retirement Income Security Act. So the Department has a keen interest in protecting retirement security and has been in the forefront of crafting the President’s retirement
We strongly believe that when the future of individual retirees is secure, our nation is more secure.

With trillions of dollars in assets, our nation’s retirement plans are major players in the economy. Pension plans are significant institutional investors in the Fortune 500. Out of the $15.5 trillion in corporate stock currently outstanding, ERISA regulated pension plans hold $1.9 trillion or about 12 percent. State and local pension plans hold another $1.3 trillion. This means about 20 percent of all corporate stock is held by pension plans. The health of our nation’s pension assets and our nation’s private economy, therefore, is deeply intertwined.

The fiduciary provisions of ERISA protect workers’ pension plans from mismanagement and misuse of assets. These provisions hold fiduciaries to a very high standard of care. Under ERISA, retirement plans are not extensions of the corporation. They are entirely separate entities, holding assets in trust. And they must be managed solely in the interest of the plan, its participants and beneficiaries. No other agendas are appropriate. Fiduciaries are required to avoid conflicts of interest, to pay only reasonable fees and to diversify the plan’s investments in order to minimize the risk of large losses.

ERISA is a roadmap for reasonable, prudent and thoughtful decision making as a pension fiduciary. It is a process-driven regimen. So it is helpful to document all decisions related to pension plan governance and oversight in writing.

To begin with, it is important for CEOs to be aware of who are the fiduciaries of their employees’ pension plans. Under ERISA, each plan must have a named fiduciary, designated in the plan documents. In many cases, the named fiduciary is the CEO or the Board of Directors. But it is permissible, in fact common, for the CEO or Board to designate someone else. Often, an administrative committee serves as the fiduciary and manages the operation of the plan.

It is important to note, however, that designating another person or entity to manage a plan does not relieve the CEO—or other named fiduciary—of responsibility or liability. The CEO or designating official has a responsibility to monitor the performance of the fiduciary of the plan. That means reading their reports, holding regular meetings regarding the performance of the plan, and providing the designated plan managers with necessary information. It also means updating plan documents and taking action if the designated fiduciary makes imprudent decisions.

Updating plan documents may sound pretty obvious. But you would be surprised how many times the Department has audited plans and found inconsistent provisions or the failure to make amendments that reflect corporate changes. This is not just a clerical problem. Under the law, the plan must be administered in accordance with its terms. If its terms are inconsistent or unclear, a whole host of legal problems can occur.
In addition, individuals can become fiduciaries by virtue of the actions they take. Under ERISA, anyone who manages or has control over plan assets is a fiduciary. You may not be the fiduciary named in plan documents. But if you function in a manner that gives you control over the plan’s assets, you become a fiduciary. And you will be held to the same standard of acting prudently and solely in the interest of the workers and retirees in the plan.

Fiduciaries who do not live up to their responsibilities may be personally liable to restore the plans’ losses.

These requirements can be especially challenging for the CEOs of small and medium-sized organizations. Typically, they do not have large human resource staffs to whom they can designate these responsibilities and ERISA is a very complex statute. That’s why the Department launched a new fiduciary education campaign called, “Getting It Right.” It’s part of this Administration’s compliance assistance efforts. The goal is to reach out to the regulated community, educate them to what the law requires, and help prevent problems from occurring in the first place. The campaign’s written materials provide detailed guidance on how pension plan fiduciaries can fulfill their responsibilities under ERISA. They are written in clear prose that even non-lawyers can understand.

As part of this effort, we are also launching a series of fiduciary training seminars around the country. They are especially designed to help small and medium-sized organizations. That’s why in addition to the Society of Human Resource Managers, the U.S. Chamber of Commerce, and the Association of Independent Certified Public Accountants, the Department enlisted the National Federation of Independent Businesses and the Small Business administration as partners. They are helping to get the word out.

When it comes to fiduciary responsibility, ERISA is a model. It provides us with tools to strengthen the governance of private defined benefit plans and to recover losses. Much has been written recently about the under funding of some private-sector pension plans, especially in older industries undergoing transition. As Chairperson of the Board of Directors of the PBGC, Pension Benefits Guaranty Corporation, the federal insurance program for traditional defined benefit pension plans, I am deeply concerned about these problems. That’s why the Department is a key player on a White House task force that is working on this issue.

We are closing in on a comprehensive strategy to deal with these shortfalls. Our goal is to improve the measurement of pension liabilities and to strengthen the funding rules so that promises made are promises kept. In addition, we hope to reduce volatility in funding contributions and strengthen transparency through enhanced disclosure to workers, regulators and the financial markets.

For all these reasons, it is more important than ever for CEOs to be aware of and pay attention to pension plan governance. The time has come to move the focus...
of pension plan governance out of the human resources department and beyond compliance with tax laws. The executive level suite needs to focus on pension plan governance itself, especially the responsibility and liability of pension plan fiduciaries.

Offering a retirement plan can be one of the most challenging, yet rewarding, decisions an employer can make. When it comes to fiduciary responsibility, let ERISA be the guide to thoughtful, reasonable and prudent decision-making. The nation’s workers deserve nothing less than this high standard of care. By putting the principles of ERISA into practice, we can ensure that the retirement promises made to our nation’s workers are kept. And we can be confident that a majority of retirees will continue to experience the comfortable retirement that was once available only to a few.

More information and guidance is available by accessing the Department’s Web site: www.dol.gov. You will be grateful you did so and so will your employees.

Thank you.

# # #
IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

IN RE THE WALT DISNEY COMPANY ) CONSOLIDATED
DERIVATIVE LITIGATION ) C.A. No. 15452

MEMORANDUM OPINION

Date Submitted: March 6, 2003
Date Decided: May 28, 2003


David C. McBride and Christian Douglas Wright, of YOUNG CONAWAY STARGATT & TAYLOR, LLP, Wilmington, Delaware; OF COUNSEL: Ronald L. Olson, George M. Garvey, Mark H. Epstein and Jason L. Haas, of MUNGER, TOLLES & OLSON LLP, Los Angeles, California, Attorneys for Defendant Michael S. Ovitz.

Joel Friedlander, of BOUCHARD, MARGULES & FRIEDLANDER, Wilmington, Delaware, Attorney for The Walt Disney Company.

R. Franklin Balotti and Anne C. Foster, of RICHARDS, LAYTON & FINGER, Wilmington, Delaware, Attorneys for Director Defendants.

CHANDLER, Chancellor
In this derivative action filed on behalf of nominal defendant Walt Disney Company, plaintiffs allege that the defendant directors breached their fiduciary duties when they blindly approved an employment agreement with defendant Michael Ovitz and then, again without any review or deliberation, ignored defendant Michael Eisner's dealings with Ovitz regarding his non-fault termination. Plaintiffs seek rescission and/or money damages from defendants and Ovitz, or compensation for damages allegedly sustained by Disney and disgorgement of Ovitz's unjust enrichment.

The matter is now before the Court in a somewhat unusual posture. Defendants moved to dismiss plaintiffs' second amended derivative complaint (hereinafter the "new complaint") pursuant to Court of Chancery Rules 12(b)(6) and 23.1. Because defendants relied on certain documents (not incorporated by reference in plaintiffs' new complaint) in seeking dismissal of the new complaint, the Court converted the motions into summary judgment motions and afforded plaintiffs an opportunity to undertake discovery. Defendants promptly moved to reargue the Court's decision to convert the motions into summary judgment motions, offering to excise from the briefs all references to the disputed documents. I denied defendants' request for reargument.' Although the motions

1 In re The Walt Disney Co. Derivative Litig., Del. Ch., C.A. No. 15452-NC, Chandler, C., bench ruling (March 6, 2003).
before me now have technically been converted to summary judgment motions, out of an abundance of caution the Court nevertheless will treat them as motions to dismiss, and address their merits without considering references to, or the contents of, the disputed documents.

As will be explained in greater detail below, I conclude that plaintiffs' new complaint sufficiently pleads a breach of fiduciary duty by the Old and the New Disney Board of Directors* so as to withstand a motion to dismiss under Chancery Rules 23.1 and 12(b)(6). Stated briefly, plaintiffs' new allegations give rise to a cognizable question whether the defendant directors of the Walt Disney Company should be held personally liable to the corporation for a knowing or intentional lack of due care in the directors' decision-making process regarding Ovitz's employment and termination. It is rare when a court imposes liability on directors of a corporation for breach of the duty of care, and this Court is hesitant to second-guess the business judgment of a disinterested and independent board of directors. But the facts alleged in the new complaint do not implicate merely negligent or grossly negligent decision making by corporate directors. Quite the contrary; plaintiffs' new complaint suggests that the Disney directors failed to exercise any business judgment and failed to make any good faith attempt to fulfill their

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2 The Disney Board of Directors changed from the time Ovitz was hired to the time of his non-fault termination. Therefore, the board at the time Ovitz was hired is referred to as the “Old Board,” and the board at the time of the non-fault termination is the “New Board.”
fiduciary duties to Disney and its stockholders. Allegations that Disney's directors abdicated all responsibility to consider appropriately an action of material importance to the corporation puts directly in question whether the board's decision-making processes were employed in a good faith effort to advance corporate interests. In short, the new complaint alleges facts implying that the Disney directors failed to "act in good faith and meet minimal proceduralist standards of attention."3 Based on the facts asserted in the new complaint, therefore, I believe plaintiffs have stated cognizable claims for which demand is excused and on which a more complete factual record is necessary.

I. PROCEDURAL AND FACTUAL BACKGROUND

As mentioned, this case involves an attack on decisions of the Walt Disney Company's board of directors, approving an executive compensation contract for Michael Ovitz, as well as impliedly approving a non-fault termination that resulted in an award to Ovitz (allegedly exceeding $140,000,000) after barely one year of employment. After the Supreme Court's remand regarding plaintiffs' first amended complaint,4 plaintiffs used the "tools at hand," a request for books and records as authorized under 8 Del. C. § 220, to obtain information about the nature

4 Brehm v. Eisner, 746 A.2d 244,249 (Del. 2000).
of the Disney Board’s involvement in the decision to hire and, eventually, to terminate Ovitz. Using the information gained from that request, plaintiffs drafted and filed the new complaint, which is the subject of the pending motions. The facts, as alleged in the new complaint, portray a markedly different picture of the corporate processes that resulted in the Ovitz employment agreement than that portrayed in the first amended complaint? For that reason, it is necessary to set forth the repleaded facts in some detail. The facts set forth hereafter are taken directly from the new complaint and, for purposes of the present motions, are accepted as true. Of course, I hold no opinion as to the actual truth of any of the allegations set forth in the new complaint; nor do I hold any view as to the likely ultimate outcome on the merits of claims based on these asserted facts. I determine here only that the facts, if true, arguably support all three of plaintiffs’ claims for relief, as asserted in the new complaint, and are sufficient to excuse demand and to state claims that warrant development of a full record.

A. The Decision to Hire Ovitz

Michael Eisner is the chief executive officer (“CEO”) of the Walt Disney Company. In 1994, Eisner’s second-in-command, Frank Wells, died in a

5 This case is yet another example where a books and records request in the first instance might have prevented expensive and time-consuming procedural machinations that too often occur in derivative litigation. The Supreme Court and this Court have repeatedly urged derivative plaintiffs to seek books and records before filing a complaint. See, e.g., Gutman v. Nvidia Corp., Del. Ch., C.A. No. 19571-NC, at l-2, Strine, V.C. (May 5, 2003). The amended pleading in this case is a perfect illustration of the benefit of such an approach.
Two other key executives—Jeffrey Katzenberg and Richard Frank—left Disney shortly thereafter, allegedly because of Eisner's management style. Eisner began looking for a new president for Disney and chose Michael Ovitz. Ovitz was founder and head of CAA, a talent agency; he had never been an executive for a publicly owned entertainment company. He had, however, been Eisner's close friend for over twenty-five years.

Eisner decided unilaterally to hire Ovitz. On August 13, 1995, he informed three Old Board members—Stephen Bollenbach, Sanford Litvack, and Irwin Russell (Eisner's personal attorney)—of that fact. All three protested Eisner's decision to hire Ovitz. Nevertheless, Eisner persisted, sending Ovitz a letter on August 14, 1995, that set forth certain material terms of his prospective employment. Before this, neither the Old Board nor the compensation committee had ever discussed hiring Ovitz as president of Disney. No discussions or presentations were made to the compensation committee or to the Old Board regarding Ovitz's hiring as president of Walt Disney until September 26, 1995.

Before informing Bollenbach, Litvack, and Russell on August 13, 1995, Eisner collected information on his own, through his position as the Disney CEO, on the potential hiring of Ovitz. In an internal document created around July 7, 1995, concerns were raised about the number of stock options to be granted to Ovitz. The document warned that the number was far beyond the normal standards.
of both Disney and corporate America and would receive significant public criticism. Additionally, Graef Crystal, an executive compensation expert, informed board member Russell, via a letter dated August 12, 1995, that, generally speaking, a large signing bonus is hazardous because the full cost is borne immediately and completely even if the executive fails to serve the full term of employment.6 Neither of these documents, however, were submitted to either the compensation committee or the Old Board before hiring Ovitz. Disney prepared a draft employment agreement on September 23, 1995. A copy of the draft was sent to Ovitz’s lawyers, but was not provided to members of the compensation committee.

The compensation committee, consisting of defendants Ignacio Lozano, Jr., Sidney Poitier, Russell, and Raymond Watson, met on September 26, 1995, for just under an hour. Three subjects were discussed at the meeting, one of which was Ovitz’s employment. According to the minutes, the committee spent the least amount of time during the meeting discussing Ovitz’s hiring. In fact, it appears that more time was spent on discussions of paying $250,000 to Russell for his role in securing Ovitz’s employment than was actually spent on discussions of Ovitz’s employment. The minutes show that several issues were raised and discussed by

6 Graef Crystal had been retained to advise Disney on Eisner’s employment contract. Although not absolutely clear in the new complaint, it was apparently in this context that Crystal advised Russell of the dangers of a large signing bonus.
the committee members concerning Russell’s fee. All that occurred during the meeting regarding Ovitz’s employment was that Russell reviewed the employment terms with the committee and answered a few questions. Immediately thereafter, the committee adopted a resolution of approval.

No copy of the September 23, 1995 draft employment agreement was actually given to the committee. Instead, the committee members received, at the meeting itself, a rough summary of the agreement. The summary, however, was incomplete. It stated that Ovitz was to receive options to purchase five million shares of stock, but did not state the exercise price. The committee also did not receive any of the materials already produced by Disney regarding Ovitz’s possible employment. No spreadsheet or similar type of analytical document showing the potential payout to Ovitz throughout the contract, or the possible cost of his severance package upon a non-fault termination, was created or presented. Nor did the committee request or receive any information as to how the draft agreement compared with similar agreements throughout the entertainment industry, or information regarding other similarly situated executives in the same industry.

The committee also lacked the benefit of an expert to guide them through the process. Graef Crystal, an executive compensation expert, had been hired to provide advice to Disney on Eisner’s new employment contract. Even though he had earlier told Russell that large signing bonuses, generally speaking, can be
hazardous, neither he nor any other expert had been retained to assist Disney regarding Ovitz's hiring. Thus, no presentations, spreadsheets, written analyses, or opinions were given by any expert for the compensation committee to rely upon in reaching its decision. Although Crystal was not retained as a compensation consultant on the Ovitz contract, he later lamented his failure to intervene and produce a spreadsheet showing the potential costs of the employment agreement.

The compensation committee was informed that further negotiations would occur and that the stock option grant would be delayed until the final contract was worked out. The committee approved the general terms and conditions of the employment agreement, but did not condition their approval on being able to review the final agreement. Instead, the committee granted Eisner the authority to approve the final terms and conditions of the contract as long as they were within the framework of the draft agreement.

Immediately after the compensation committee met on September 26, the Old Board met. Again, no expert was present to advise the board. Nor were any documents produced to the board for it to review before the meeting regarding the Ovitz contract. The board did not ask for additional information to be collected or presented regarding Ovitz's hiring. According to the minutes, the compensation committee did not make any recommendation or report to the board concerning its resolution to hire Ovitz. Nor did Russell, who allegedly secured Ovitz's
employment, make a presentation to the board. The minutes of the meeting were fifteen pages long, but only a page and a half covered Ovitz's possible employment. A portion of that page and a half was spent discussing the $250,000 fee paid to Russell for obtaining Ovitz. According to the minutes, the Old Board did not ask any questions about the details of Ovitz's salary, stock options, or possible termination. The Old Board also did not consider the consequences of a termination, or the various payout scenarios that existed. Nevertheless, at that same meeting, the Old Board decided to appoint Ovitz president of Disney. Final negotiation of the employment agreement was left to Eisner, Ovitz's close friend for over twenty-five years.

B. Negotiation of the Employment Agreement

Ovitz was officially hired on October 1, 1995, and began serving as Disney's president, although he did not yet have an executed employment agreement with Disney. On October 16, 1995, the compensation committee was informed, via a brief oral report, that negotiations were ongoing with Ovitz. The committee was not given a draft of the employment agreement either before or during the meeting. A summary similar to the one given on September 26, 1995, was presented. The committee did not seek any further information about the negotiations or about the terms and conditions of Ovitz's agreement, nor was any information proffered regarding the scope of the non-fault termination provision.
And, as before, no expert was available to advise the committee as to the employment agreement.

Negotiations continued among Ovitz, Eisner, and their attorneys. The lawyers circulated drafts on October 3, October 10, October 16, October 20, October 23, and December 12, 1995. The employment agreement was physically executed between Michael Ovitz and the Walt Disney Company on December 12, 1995. The employment agreement, however, was backdated to October 1, 1995, the day Ovitz began working as Disney's president. Additionally, the stock option agreement associated with the employment agreement was executed by Eisner (for Disney) on April 2, 1996. Ovitz did not countersign the stock option agreement until November 15, 1996, when he was already discussing his plans to leave Disney’s employ. Neither the Old Board nor the compensation committee reviewed or approved the final employment agreement before it was executed and made binding upon Disney.

c. The Final Version of Ovitz’s Employment Agreement

The final version of Ovitz’s employment agreement differed significantly from the drafts summarized to the compensation committee on September 26, 1995, and October 16, 1995. First, the final version caused Ovitz’s stock options to be “in the money” when granted. The September 23rd draft agreement set the exercise price at the stock price on October 2, 1995, the day after Ovitz began as
president. On October 16, 1995, the compensation committee agreed to change the exercise price to the price on that date (October 16, 1995), a price similar to that on October 2nd. The agreement was not signed until December 12, 1995, however, at which point the value of Disney stock had increased by eight percent—from $56.875 per share on October 16th to $61.50 per share on December 12th. The overall stock market, according to the Dow Jones Industrial Average, had also increased by about eight percent at the same time. By waiting to sign the agreement until December, but not changing the date of the exercise price, Ovitz had stock options that instantly were “in the money.” This allowed Ovitz to play a “win-win” game at Disney’s expense—if the market price of Disney stock had fallen between October 16 and December 12, Ovitz could have demanded a downward adjustment to the option exercise price; if the price had risen (as in fact it had) Ovitz would receive “in the money” options.

Another difference in the final version of Ovitz’s employment agreement concerned the circumstances surrounding a non-fault termination. The September 23rd draft agreement stated that non-fault termination benefits would only be provided if Disney wrongfully terminated Ovitz, or Ovitz died or became disabled. The October 16th draft contained a very similar definition. These were the only

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7 The options were apparently granted to Ovitz when the employment agreement was signed on December 12, 1995. Ovitz did not countersign the accompanying stock option agreement until November 15, 1996.
two drafts of which the compensation committee was made aware. The final version of the agreement, however, offered Ovitz a non-fault termination as long as Ovitz did not act with gross negligence or malfeasance. Therefore, instead of protecting Ovitz from a wrongful termination by Disney, Ovitz was able to receive the full benefits of a non-fault termination, even if he acted negligently or was unable to perform his duties, as long as his behavior did not reach the level of gross negligence or malfeasance. Additionally, a non-compete clause was not included within the agreement should Ovitz leave Disney’s employ.

The employment agreement had a term of five years. Ovitz was to receive a salary of $1 million per year, a potential bonus each year from $0 to $10 million, and a series of stock options (the “A” options) that enabled Ovitz to purchase three million shares of Disney stock at the October 16, 1995 exercise price. The options were to vest at one million per year for three years beginning September 30, 1998. At the end of the contract term, if Disney entered into a new contract with Ovitz, he was entitled to the “B” options, an additional two million shares. There was no requirement, however, that Disney enter into a new contract with Ovitz.

Should a non-fault termination occur, however, the terms of the final version of the employment agreement appeared to be even more generous. Under a non-fault termination, Ovitz was to receive his salary for the remainder of the contract, discounted at a risk-free rate keyed to Disney’s borrowing costs. He was also to
receive a $7.5 million bonus for each year remaining on his contract, discounted at the same risk-free rate, even though no set bonus amount was guaranteed in the contract. Additionally, all of his “A” stock options were to vest immediately, instead of waiting for the final three years of his contract for them to vest. The final benefit of the non-fault termination was a lump sum “termination payment” of $10 million. The termination payment was equal to the payment Ovitz would receive should he complete his full five-year term with Disney, but not receive an offer for a new contract. Graef Crystal opined in the January 13, 1997, edition of California Law Business that “the contract was most valuable to Ovitz the sooner he left Disney.”

D. Ovitz’s Performance as Disney’s President

Ovitz began serving as president of Disney on October 1, 1995, and became a Disney director in January 1996. Ovitz’s tenure as Disney’s president proved unsuccessful. Ovitz was not a good second-in-command, and he and Eisner were both aware of that fact. Eisner told defendant Watson, via memorandum, that he (Eisner) “had made an error in judgment in who I brought into the company.”** Other company executives were reported in the December 14, 1996 edition of the New York Times as saying that Ovitz had an excessively lavish office, an imperious management style, and had started a feud with NBC during his tenure.

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8 Pls.' Second Am. Compl. ¶ 70.
Even Ovitz admitted, during a September 30, 1996 interview on “Larry King Live,” that he knew “about 1% of what I need to know.”

Even though admitting that he did not know his job, Ovitz studiously avoided attempts to be educated. Eisner instructed Ovitz to meet weekly with Disney’s chief financial officer, defendant Bollenbach. The meetings were scheduled to occur each Monday at 2 p.m., but every week Ovitz cancelled at the last minute. Bollenbach was quoted in a December 1996 issue of Vanity Fair as saying that Ovitz failed to meet with him at all, “didn’t understand the duties of an executive at a public company[,] and he didn’t want to learn.”

Instead of working to learn his duties as Disney’s president, Ovitz began seeking alternative employment. He consulted Eisner to ensure that no action would be taken against him by Disney if he sought employment elsewhere. Eisner agreed that the best thing for Disney, Eisner, and Ovitz was for Ovitz to gain employment elsewhere. Eisner wrote to the chairman of Sony Japan that Ovitz could negotiate with Sony without any repercussions from Disney. Ovitz and Sony began negotiations for Ovitz to become head of Sony’s entertainment business, but the negotiations ultimately failed. With the possibility of having another company

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9 PIs.’ Second Am. Compl. ¶ 74.
10 PIs.’ Second Am. Compl. ¶ 73.
absorb the cost of Ovitz's departure now gone, Eisner and Ovitz began in earnest to discuss a non-fault termination.

E. The Non-Fault Termination

Ovitz wanted to leave Disney, but could only terminate his employment if one of three events occurred: (1) he was not elected or retained as president and a director of Disney; (2) he was assigned duties materially inconsistent with his role as president; or (3) Disney reduced his annual salary or failed to grant his stock options, pay him discretionary bonuses, or make any required compensation payment. None of these three events occurred. If Ovitz resigned outright, he might have been liable to Disney for damages and would not have received the benefits of the non-fault termination. He also desired to protect his reputation when exiting from his position with Disney. Eisner agreed to help Ovitz depart Disney without sacrificing any of his benefits. Eisner and Ovitz worked together as close personal friends to have Ovitz receive a non-fault termination. Eisner stated in a letter to Ovitz that: "I agree with you that we must work together to assure a smooth transition and deal with the public relations brilliantly. I am committed to make this a win-win situation, to keep our friendship intact, to be positive, to say and write only glowing things . . . . Nobody ever needs to know anything other than positive things from either of us. This can all work out!"
Eisner, Litvack, and Ovitz met at Eisner's apartment on December 11, 1996, to finalize Ovitz's non-fault termination. The new complaint alleges that the New Board was aware that Eisner was negotiating with Ovitz the terms of his separation. Litvack sent a letter to Ovitz on December 12, 1996, stating that, by "mutual agreement," (1) Ovitz's term of employment would end on January 31, 1997; and (2) "this letter will for all purposes of the Employment Agreement be given the same effect as though there had been a 'Non-Fault Termination,' and the Company will pay you, on or before February 5, 1997, all amounts due you under the Employment Agreement, including those under Section 11(c) thereof. In addition, the stock options granted pursuant to Option A, will vest as of January 31, 1997 and will expire in accordance with their terms on September 30, 2002." On December 12, 1996, Ovitz's departure from Disney became public. Neither the New Board of Directors nor the compensation committee had been consulted or given their approval for a non-fault termination. In addition, no record exists of any action by the New Board once the non-fault termination became public on December 12, 1996.

On December 27, 1996, Litvack sent Ovitz a new letter superseding the December 12th letter. The December 27th letter stated that Ovitz's termination

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12 PIs.' Second Am. Compl. ¶ 85.
would “be treated as a ‘Non-Fault Termination.’” 13 This differed from the December 12th letter, which treated Ovitz’s termination “as though there had been a ‘Non-Fault Termination.’” 14 It also made the termination of Ovitz’s employment and his resignation as a Disney director effective as of the close of business on December 27th, instead of on January 3 1, 1997, as in the December 12th letter. Additionally, it listed the amount payable to Ovitz as $38,888,230.77, and stated that the “A” options to purchase three million shares of Disney vested on December 27th, instead of January 3 1, 1997, as in the December 12th letter. Both Eisner and Litvack signed the letter. Again, however, neither the New Board nor the compensation committee reviewed or approved the December 27th letter. No record exists of any New Board action after the December 27th letter became public, nor had any board member raised any questions or concerns since the original December 12th letter became public.

According to the new complaint, Disney’s bylaws required board approval for Ovitz’s non-fault termination. Eisner and Litvack allegedly did not have the authority to provide for a non-fault termination without board consent. No documents or board minutes currently exist showing an affirmative decision by the

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13 PIs.’ Second Am. Compl. ¶ 87.
14 PIs.’ Second Am. Compl. ¶ 85.
New Board or any of its committees to grant Ovitz a non-fault termination. The New Board was already aware that Eisner was granting the non-fault termination as of December 12, 1996, the day it became public. No record of any action by the New Board affirming or questioning that decision by Eisner either before or after that date has been produced. There are also no records showing that alternatives to a non-fault termination were ever evaluated by the New Board or by any of its committees.

II. STANDARD OF REVIEW

A. Rule 23.1 Motion to Dismiss

When the plaintiff alleges a derivative claim, demand must be made on the board or excused based upon futility. To determine whether demand would be futile, the Court must determine whether the particular facts, as alleged, create a reason to doubt that: “(1) the directors are disinterested and independent” or “(2) the challenged transaction was otherwise the product of a valid exercise of business judgment.”

The complaint must plead with sufficient particularity the facts to support demand futility. This is more than the notice pleading requirement under Court

15 See Court of Chancery Rule 23.1.
17 Brehm, 746 A.2d at 245.
of Chancery Rule 8(a), but is not to the level of evidence.” The complaint must set forth “particularized factual statements that are essential to the claim.” Mere speculation or opinion is not enough.\footnote{Id.}

B. Rule 12(b)(6) Motion to Dismiss

The standard governing a motion to dismiss is well established. A party is entitled to dismissal of the complaint only where it is clear from its allegations that the plaintiff would not be entitled to relief under any set of facts that could be proven to support the claim.\footnote{Rabkin v. Philip A. Hunt Chemical Corp., 498 A.2d 1099, 1104 (Del. 1985).} Moreover, the Court is required to accept all of plaintiffs well-pleaded factual allegations as true and give plaintiff the benefit of all inferences that may be drawn from the facts.\footnote{Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988).} Conclusory statements, without specific allegations of facts to support them, will not suffice.\footnote{In re Tri-Star Pictures, Inc., 634 A.2d 3 19,326 (Del. 1993).} Since the standard under Rule 12(b)(6) is less stringent than the standard under Rule 23.1, a complaint that survives a Rule 23.1 motion to dismiss generally will also survive a Rule 12(b)(6) motion to dismiss, assuming that it otherwise contains sufficient facts to state a cognizable claim.\footnote{See Solomon v. Pathe Communications Corp., 672 A.2d 35, 39 (Del. 1996).}
III. ANALYSIS

The primary issue before the Court is whether plaintiffs’ new complaint survives the Rule 23.1 motion to dismiss under the second prong of *Aronson v. Lewis*. In order for demand to be excused under the second prong of *Aronson*, plaintiffs must allege particularized facts that raise doubt about whether the challenged transaction is entitled to the protection of the business judgment rule. Plaintiffs may rebut the presumption that the board’s decision is entitled to deference by raising a reason to doubt whether the board’s action was taken on an informed basis or whether the directors honestly and in good faith believed that the action was in the best interests of the corporation. Thus, plaintiffs must plead particularized facts sufficient to raise (1) a reason to doubt that the action was taken honestly and in good faith or (2) a reason to doubt that the board was adequately informed in making the decision.

Defendants contend that the new complaint cannot be read reasonably to allege any fiduciary duty violation other than, at most, a breach of the directors’

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25 *Aronson*, 473 A.2d at 814. The Supreme Court affirmed the dismissal of plaintiffs’ previous complaint under the first prong of *Aronson* and prohibited that issue from being relitigated. *Brehm*, 746 A.2d at 258 & n. 42. As discussed earlier, the new complaint must survive a Rule 23.1 motion to dismiss because it is a derivative action. The facts alleged here are the same for both the 23.1 motions and the 12(b)(6) motions. Thus, since the standard for a Rule 23.1 dismissal is more stringent than that under Rule 12(b)(6), should the new complaint survive under the second prong of *Aronson*, it will survive under Rule 12(b)(6) if its facts otherwise state a cognizable claim.

26 *Id.* at 812.
duty of due care. They further assert that even if the complaint states a breach of the directors’ duty of care, Disney’s charter provision, based on 8 Del. C. § 102(b)(7), would apply and the individual directors would be protected from personal damages liability for any breach of their duty of care. A § 102(b)(7) provision in a corporation’s charter does not “eliminate or limit the liability of a director: (i) for any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.” A fair reading of the new complaint, in my opinion, gives rise to a reason to doubt whether the board’s actions were taken honestly and in good faith, as required under the second prong of Aronson. Since acts or omissions not undertaken honestly and in good faith, or which involve intentional misconduct, do not fall within the protective ambit of § 102(b)(7), I cannot dismiss the complaint based on the exculpatory Disney charter provision.

Defendants also argue that Ovitz’s employment agreement was a reasonable exercise of business judgment. They argue that Ovitz’s previous position as head

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28 8 Del. C. § 102(b)(7). As to (iii), § 174 deals with a director’s liability for unlawful payment of dividends or unlawful stock purchase or redemption.

29 See Malpiede v. Townson, 780 A.2d 1075, 1094 (Del. 2001) (holding that, as a matter of law, § 102(b)(7) bars a claim only if there is an unambiguous, residual due care claim and nothing else).
of CAA required a large compensation package to entice him to become Disney’s president. As to the non-fault termination, defendants contend that that decision was reasonable in that the board wished to avoid protracted litigation with Ovitz. The Court is appropriately hesitant to second-guess the business judgment of a disinterested and independent board of directors. As alleged in the new complaint, however, the facts belie any assertion that the New or Old Boards exercised any business judgment or made any good faith attempt to fulfill the fiduciary duties they owed to Disney and its shareholders.

A. The Old and New Boards

According to the new complaint, Eisner unilaterally made the decision to hire Ovitz, even in the face of internal documents warning of potential adverse publicity and with three members of the board of directors initially objecting to the hiring when Eisner first broached the idea in August 1995. No draft employment agreements were presented to the compensation committee or to the Disney board for review before the September 26, 1995 meetings. The compensation committee met for less than an hour on September 26, 1995, and spent most of its time on two other topics, including the compensation of director Russell for helping secure Ovitz’s employment. With respect to the employment agreement itself, the committee received only a summary of its terms and conditions. No questions were asked about the employment agreement. No time was taken to review the
documents for approval. Instead, the committee approved the hiring of Ovitz and directed Eisner, Ovitz's close friend, to carry out the negotiations with regard to certain still unresolved and significant details.30

The Old Board met immediately after the committee did. Less than one and one-half pages of the fifteen pages of Old Board minutes were devoted to discussions of Ovitz's hiring as Disney's new president. Actually, most of that time appears to have been spent discussing compensation for director Russell. No presentations were made to the Old Board regarding the terms of the draft agreement. No questions were raised, at least so far as the minutes reflect. At the end of the meeting, the Old Board authorized Ovitz's hiring as Disney's president. No further review or approval of the employment agreement occurred. Throughout both meetings, no expert consultant was present to advise the compensation committee or the Old Board. Notably, the Old Board approved Ovitz's hiring even though the employment agreement was still a "work in progress." The Old Board simply passed off the details to Ovitz and his good friend, Eisner.

30 The allegation that Eisner and Ovitz had been close friends for over twenty-five years is not mentioned to show self-interest or domination. Instead, the allegation is mentioned because it casts doubt on the good faith and judgment behind the Old and New Boards' decisions to allow two close personal friends to control the payment of shareholders' money to Ovitz.
Negotiation over the remaining terms took place solely between Eisner, Ovitz, and attorneys representing Disney and Ovitz. The compensation committee met briefly in October to review the negotiations, but failed again to actually consider a draft of the agreement or to establish any guidelines to be used in the negotiations. The committee was apparently not otherwise involved in the negotiations. Negotiations with Eisner continued until mid-December, but Ovitz had already started serving as Disney’s president as of October 1, 1995.

Eisner and Ovitz reached a final agreement on December 12, 1995. They agreed to backdate the agreement, however, to October 1, 1995. The final employment agreement also differed substantially from the original draft, but evidently no further committee or board review of it ever occurred. The final version of Ovitz’s employment agreement was signed (according to the new complaint) without any board input beyond the limited discussion on September 26, 1995.

From the outset, Ovitz performed poorly as Disney’s president. In short order, Ovitz wanted out, and, once again, his good friend Eisner came to the rescue, agreeing to Ovitz’s request for a non-fault termination. Disney’s board, however, was allegedly never consulted in this process. No board committee was ever consulted, nor were any experts consulted. Eisner and Litvack alone granted Ovitz’s non-fault termination, which became public on December 12, 1996.
Again, Disney's board did not appear to question this action, although affirmative board action seemed to be required. On December 27, 1996, Eisner and Litvack, without explanation, accelerated the effective date of the non-fault termination, from January 31, 1997, to December 27, 1996. Again, the board apparently took no action; no questions were asked as to why this was done.

Disney had lost several key executives in the months before Ovitz was hired. Moreover, the position of president is obviously important in a publicly owned corporation. But the Old Board and the compensation committee (it is alleged) each spent less than an hour reviewing Ovitz's possible hiring. According to the new complaint, neither the Old Board nor the compensation committee reviewed the actual draft employment agreement. Nor did they evaluate the details of Ovitz's salary or his severance provisions. No expert presented the board with details of the agreement, outlined the pros and cons of either the salary or non-fault termination provisions, or analyzed comparable industry standards for such agreements.31 Notwithstanding this alleged information vacuum, the Old Board and the compensation committee approved Ovitz's hiring, appointed Eisner to

31 In the earlier proceedings in this case, defendants represented that Graef Crystal served as the expert with regard to Ovitz's employment, arguably providing the board with the statutory safe harbor under 8 Del. C. § 141(e). The new complaint, however, alleges that Graef Crystal was hired as the expert with regard to Eisner's new employment agreement, not Ovitz's agreement. Accepting this change in facts as true for purposes of this motion, Disney's board is not entitled to invoke §141(e)'s protection based on a board's reliance upon a qualified expert selected with reasonable care.
negotiate with Ovitz directly in drafting the unresolved terms of his employment, never asked to review the final terms, and were never voluntarily provided those terms.

During the negotiation over the unresolved terms, the compensation committee was involved only once, at the very early stages in October 1995. The final agreement varied significantly from the draft agreement in the areas of both stock options and the terms of the non-fault termination. Neither the compensation committee nor the Old Board sought to review, nor did they review, the final agreement. In addition, both the Old Board and the committee failed to meet in order to evaluate the final agreement before it became binding on Disney. To repeat, no expert was retained to advise the Old Board, the committee, or Eisner during the negotiation process.

The new complaint, fairly read, also charges the New Board with a similar ostrich-like approach regarding Ovitz’s non-fault termination. Eisner and Litvack granted Ovitz a non-fault termination on December 12, 1996, and the news became public that day. Although formal board approval appeared necessary for a non-fault termination, the new complaint alleges that no New Board member even asked for a meeting to discuss Eisner’s and Litvack’s decision. On December 27, 1996, when Eisner and Litvack accelerated Ovitz’s non-fault termination by over a month, with a payout of more than $38 million in cash, together with the three
million "A" stock options, the board again failed to do anything. Instead, it appears from the new complaint that the New Board played no role in Eisner’s agreement to award Ovitz more than $38 million in cash and the three million "A" stock options, all for leaving a job that Ovitz had allegedly proven incapable of performing.

The New Board apparently never sought to negotiate with Ovitz regarding his departure. Nor, apparently, did it consider whether to seek a termination based on fault. During the fifteen-day period between announcement of Ovitz’s termination and its effective date, the New Board allegedly chose to remain invisible in the process. The new complaint alleges that the New Board: (1) failed to ask why it had not been informed; (2) failed to inquire about the conditions and terms of the agreement; and (3) failed even to attempt to stop or delay the termination until more information could be collected. If the board had taken the time or effort to review these or other options, perhaps with the assistance of expert legal advisors, the business judgment rule might well protect its decision. In this case, however, the new complaint asserts that the New Board directors refused to explore any alternatives, and refused to even attempt to evaluate the implications of the non-fault termination-blindly allowing Eisner to hand over to his personal
friend, Ovitz, more than $38 million in cash and the three million “A” stock options.\textsuperscript{32}

These facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation. Instead, the facts alleged in the new complaint suggest that the defendant directors \textit{consciously and intentionally disregarded their responsibilities}, adopting a “we don’t care about the risks” attitude concerning a material corporate decision. Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct, in my opinion, that may not have been taken honestly and in good faith to advance the best interests of the company. Put differently, all of the alleged facts, if true, imply that the defendant directors knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss. Viewed in this light, plaintiffs’ new complaint sufficiently alleges a breach of the directors’ obligation to act honestly and in good faith in the corporation’s best interests for a Court to

\textsuperscript{32} Plaintiffs allege that the present value of the cash and the value of the stock options totaled over $140 million to Ovitz as severance. At this time I need not determine whether plaintiffs’ allegations as to the value of the payout are correct or incorrect.
conclude, if the facts are true, that the defendant directors’ conduct fell outside the protection of the business judgment rule.\(^{33}\)

Of course, the alleged facts need only give rise to a reason to doubt business judgment protection, not “a judicial finding that the directors’ actions are not protected by the business judgment rule.”\(^{34}\) For this reason, I conclude that plaintiffs have satisfied the second prong of *Aronson*, and that demand is excused.

I also conclude that plaintiffs’ pleading is sufficient to withstand a motion to dismiss under Rule 12(b)(6). Specifically, plaintiffs’ claims are based on an alleged knowing and deliberate indifference to a potential risk of harm to the corporation. Where a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director’s actions are either “not in good faith” or “involve intentional misconduct.”\(^{35}\) Thus, plaintiffs’ allegations support claims that fall outside the liability waiver provided under Disney’s certificate of incorporation.

**B. Ovitz**

Defendant Ovitz contends that the action against him should be dismissed because he owed no fiduciary duty not to seek the best possible employment agreement for himself. Ovitz did have the right to seek the best employment agreement for himself. Ovitz did have the right to seek the best employment agreement for himself.

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\(^{33}\) *Aronson*, 473 A.2d at 812.

\(^{34}\) *Grobow*, 539 A.2d at 186.

\(^{35}\) 8 Del. C. § 102(b)(7)(ii).
agreement possible for himself. Nevertheless, once Ovitz became a fiduciary of Disney on October 1, 1995, according to the new complaint, he also had a duty to negotiate honestly and in good faith so as not to advantage himself at the expense of the Disney shareholders. He arguably failed to fulfill that duty, according to the facts alleged in the new complaint.

Ovitz and Eisner had been close friends for over twenty-five years. Ovitz knew when he became president of Disney on October 1, 1995, that his unexecuted contract was still under negotiation. Instead of negotiating with an impartial entity, such as the compensation committee, Ovitz and his attorneys negotiated directly with Eisner, his close personal friend. Perhaps not surprisingly, the final version of the employment agreement differed significantly from the draft version summarized to the board and to the compensation committee on September 26, 1995. Had those changes been the result of arms-length bargaining, Ovitz’s motion to dismiss might have merit. At this stage, however, the alleged facts (which I must accept as true) suggest that Ovitz and Eisner had almost absolute control over the terms of Ovitz’s contract.

The new complaint arguably charges that Ovitz engaged in a carefully orchestrated, self-serving process controlled directly by his close friend Eisner, all designed to provide Ovitz with enormous financial benefits. The case law cited by Ovitz in support of his position suggests that an officer may negotiate his or her
own employment agreement as long as the process involves negotiations performed in an adversarial and arms-length manner.36 The facts, as alleged in the new complaint, belie an adversarial, arms-length negotiation process between Ovitz and the Walt Disney Company. Instead, the alleged facts, if true, would support an inference that Ovitz may have breached his fiduciary duties by engaging in a self-interested transaction in negotiating his employment agreement directly with his personal friend Eisner.

The same is true regarding the non-fault termination. In that instance, Ovitz was also serving as a member of the Disney board of directors. The Supreme Court recently held in *Telxon Corp. v. Meyerson* that "directoral self-compensation decisions lie outside the business judgment rule's presumptive protection, so that, where properly challenged, the receipt of self-determined benefits is subject to an affirmative showing that the compensation arrangements are fair to the corporation." 37 According to the facts alleged in the new complaint, Ovitz did not advise the Disney board of his decision to seek a departure that would be fair and equitable to all parties. Instead, he went to his close friend, Eisner, and, working

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36 Ovitz cites *Stifel Fin. Corp. v. Cochran*, 2002 WL 13 16240 (Del. Supr.), as well as certain other non-precedential cases, to support his position. All cases, as pointed out directly by Ovitz in his reply brief, base the holding upon an adversarial, arms-length transaction.

37 802 A.2d 257,265 (Del. 2002).
together, they developed a secret strategy that would enable Ovitz to extract the maximum benefit from his contract, all without board approval.

Although the strategy was economically injurious and a public relations disaster for Disney, the Ovitz/Eisner exit strategy allegedly was designed principally to protect their personal reputations, while assuring Ovitz a huge personal payoff after barely a year of mediocre to poor job performance. These allegations, if ultimately found to be true, would suggest a faithless fiduciary who obtained extraordinary personal financial benefits at the expense of the constituency for whom he was obliged to act honestly and in good faith. Because Ovitz was a fiduciary during both the negotiation of his employment agreement and the non-fault termination, he had an obligation to ensure the process of his contract negotiation and termination was both impartial and fair. The facts, as plead, give rise to a reasonable inference that, assisted by Eisner, he ignored that obligation.

IV. CONCLUSION

It is of course true that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions, as the limits of human competence necessarily impede judicial review. But our corporation law's theoretical justification for disregarding honest errors simply does not apply to intentional misconduct or to egregious process failures that implicate the foundational
directorial obligation to act honestly and in good faith to advance corporate interests. Because the facts alleged here, if true, portray directors consciously indifferent to a material issue facing the corporation, the law must be strong enough to intervene against abuse of trust. Accordingly, all three of plaintiffs' claims for relief concerning fiduciary duty breaches and waste survive defendants' motions to dismiss.

The practical effect of this ruling is that defendants must answer the new complaint and plaintiffs may proceed to take appropriate discovery on the merits of their claims. To that end, a case scheduling order has been entered that will promptly bring this matter before the Court on a fully developed factual record.

IT IS SO ORDERED.