STIKEMAN ELLIOTT

OCTOBER 2006

The Business Judgment Rule After *Disney*

by D'Arcy Nordick

This article outlines the current state of the business judgment rule in the U.S. and Canada, with particular attention to the recent Walt Disney litigation in Delaware over the large termination package – by some accounts as high as $140 million – paid to Michael Ovitz after his 14-month stint as company president.

The Business Judgment Rule after *Disney*

by D'Arcy Nordick

THIS ARTICLE OUTLINES THE CURRENT STATE OF THE BUSINESS JUDGMENT RULE in the U.S. and Canada, with particular attention to the recent Walt Disney litigation in Delaware over the large termination package – by some accounts as high as $140 million – paid to Michael Ovitz after his 14 months as company president.[1] In affirming the Chancery Court's decision that the Disney directors did not breach their fiduciary duties in relation to Ovitz' hiring and severance package, the Delaware Supreme Court reaffirmed its deferential stance in analyzing directors' business decisions – even in the face of conduct falling well short of corporate best practices. As discussed below, because Canadian courts have been receptive to corporate law principles emanating from Delaware, the reaffirmation of the traditional business judgment rule in Disney is an encouraging development for Canadian directors.

The Business Judgment Rule in the U.S.

The details of the business judgment rule have developed in a series of Delaware decisions extending over more than twenty years. In its 1985 ruling in *Smith v. Van Gorkom*, the Delaware Supreme Court described the business judgment rule as a product of the fundamental principle that a corporation is managed by its board of directors.[2] The same court had stated in *Aronson v. Lewis* that the rule creates a rebuttable presumption that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[3] This policy of judicial deference puts the onus on plaintiffs to produce evidence of fraud, bad faith, or self-dealing on the part of the directors. Without such evidence, courts will refrain from second-guessing the directors.

In the Delaware jurisprudence, this deference is qualified in certain situations, with two levels of heightened review: "enhanced scrutiny" and "entire fairness". The first of these applies most notably in the following situations:

- where a board **adopts defensive measures** in response to an alleged threat to corporate control or policy; and
- where a board **approves a transaction involving a sale of control and/or break-up** of the company.

1 *In re The Walt Disney Company Derivative Litigation*, No. 411, 2005 (Del. June 8, 2006).
2 *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).
3 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

In such cases, the board must meet a higher **"enhanced scrutiny"** standard – referred to in the first case as the "*Unocal* Standard"[4] and in the second as the "*Revlon* Duty".[5] The decision process, including information relied on, must satisfy this standard. In addition, under the enhanced scrutiny test, in contrast with the business judgment rule, the court will examine the reasonableness of the directors' decision.

A still more exacting standard of review – the **"entire fairness"** test – is applied where an actual conflict of interest exists among directors, including in the case of a going private transaction involving a controlling stockholder. In such circumstances, an entire fairness review will be used to determine whether the transaction is entirely fair to the corporation's shareholders from a procedural and substantive point of view.

The Business Judgment Rule in Canada

Under Canadian corporate law, the business judgment rule is also an extension of enabling corporate statutes. Under the *Canada Business Corporations Act* (CBCA), the duty to manage, or supervise the management of, the business and affairs of a corporation is vested in the board of directors.[6] The discharge of this duty is guided by the directors' fundamental duties, set out in s. 122(1) of the CBCA, to act honestly and in good faith with a view the best interests of the corporation (the "fiduciary duty") and to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances (the "duty of care").

As interpreted in Canada, the business judgment "rule" is not so much a stand-alone rule as a description of how the directors' duty of care is construed, namely so as to require reasonable and considered decisions but not perfect ones. Although imported from U.S. jurisprudence fairly recently, it is now firmly established, having been recognized in 1991 by the Ontario Court of Appeal in *Brant Investments Ltd. v. Keep Rite Inc.*[7] and applied in several subsequent Ontario decisions.[8] The Supreme Court of Canada endorsed it in its 2004 ruling in *Peoples Department Stores,* in the course of a thorough review of the statutory duty of care.[9] The Court stated:

> Directors and officers will not be held to be in breach of the duty of care…if they act prudently and on a reasonably informed basis. The decisions they make must be reasonable decisions in light of all the circumstances about which the directors or officers knew or ought to have known. In determining whether directors have acted in a manner that breached the duty of care, it is worth repeating that perfection is not demanded. Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making, but they are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made.[10]

This reiterates and cements the proposition that good faith business decisions made by directors will be afforded substantial deference by the courts in Canada.

It is important to recognize, however, that the business judgment rule does not give directors *carte blanche* to make careless decisions. In its 2006 decision in *Ford Motor Co. of Canada, Ltd. v. OMERS*, the Ontario Court of Appeal refused to defer to a board that appeared to rubber-stamp

4 *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).
5 *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985).
6 CBCA, s. 122(1). We will restrict our discussion here mainly to the relevant CBCA provisions. The corresponding provisions of most other Canadian corporations statutes, however, are generally similar.
7 *Brant Investments Ltd. v. Keep Rite Inc.* (1991), 3 O.R. (3d) 289 (C.A.).
8 *Maple Leaf Foods Inc. v. Schneider Corp.* (1998), 42 O.R. (3d) 177 (C.A.); *Kerr et al. v. Danier Leather Inc. et al.* (2005), 77 O.R. (3d) 321 (C.A.).
9 *Peoples Department Stores Inc.* (*Trustee of*) *v. Wise,* [2004] 3 S.C.R. 461.
10 *Ibid* at para. 67.

decisions made by the company's majority owner.[11] To take advantage of the business judgment rule, there must first have been a genuine exercise of judgment.[12] The courts may also require that the decision have manifested at least a minimal degree of reasonableness. *Peoples* adopted a passage from *Maple Leaf Foods Inc. v. Schneider Corp*.[13] where it was held that "provided the decision taken is within a range of reasonableness, the court ought not to substitute its opinion for that of the board," and "as long as the directors have selected one of several reasonable alternatives, deference is accorded to the board's decision." By including this passage, and by referring to a "reasonable business decision" in the paragraph quoted above, the Court suggests that although the majority of the analysis under the business judgment rule is concerned with the process used by directors in coming to a decision, courts in Canada will also analyze the reasonableness of the directors' decision from the point of view of the directors at the time the decision was made. This emphasis on reasonableness (as opposed to a focus on process) may, at least theoretically, be one of the more important differences between the way that the rule is applied in Canada and Delaware.

The Disney Litigation

The Delaware Court of Chancery's August 2005 decision in *Disney*, upheld in all respects by the Delaware Supreme Court in June 2006, suggests that, even in an age of tightened corporate governance regulation, the Delaware courts will for the most part continue to take a hands-off attitude when legitimate, good faith business judgments are at issue. Chancellor Chandler left little doubt about this when he wrote that "this [business judgment] presumption applies when there is no evidence of fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment on the part of the directors" and that "in the absence of this evidence the board's decision will be upheld unless it cannot be 'attributed to any rational business purpose.'"

The result in *Disney* was remarkable because, as suggested earlier, the Delaware courts agreed that the conduct of Disney, Ovitz, CEO Michael Eisner and other officers and board members fell far short of "best practices". In the post-Enron era, when "corporate governance" has become a household word, one might easily have imagined a harsher reaction to some of the deficiencies that the evidence revealed. For example, it appeared that neither the full Disney board nor the compensation committee had demanded or received a clear explanation of the precise size of the company's potential severance liability to Ovitz. Nor had the company adequately documented the board members' discussions of this very significant issue. Nevertheless, Chancellor Chandler was satisfied by the testimony he heard that the magnitude of Ovitz's package was easily inferable from information in the board's possession.

Another controversial issue was the power wielded by Eisner, and in particular the fact that Ovitz was terminated by him without formal board approval. The company's charter gave only ambiguous support to the assertion that the CEO had the authority to dismiss corporate officers. However, Chancellor Chandler accepted the testimony of various board members that Eisner was generally understood to have this power as sufficient to resolve the ambiguity in his favour. Finally, neither the Chancery nor the Supreme Court found any bad faith in the reliance of Eisner and others on rather perfunctory advice from in-house legal counsel that Ovitz could not have been terminated for cause – a crucial issue since the massive termination payment was not required in the case of for-cause dismissal.

11 *Ford Motor Co. of Canada, Ltd. v. OMERS* (2006), 79 O.R. (3d) 81 (C.A.); leave to appeal to the S.C.C. refused August 24, 2006 (2006 CanLII 29064).

12 See also the unreported Ontario Superior Court decision in *Itak International Corp. v. CPI Plastics Group Ltd.*, June 21, 2006 (2006 CanLII 22117).

13 *Maple Leaf Foods Inc. v. Schneider Corp.* (1998), 42 O.R. (3d) 177 (C.A.).

These findings were based on an interpretation of "bad faith" – which generally must be shown to rebut the business judgment presumption – that specifically excludes merely negligent (and even grossly negligent) conduct. The Delaware Supreme Court approved the Court of Chancery's statement that there must be either outright malevolence or, at least, an intentional dereliction of duty or disregard for duty. Simple inattention or carelessness, even to the extent of negligently failing to inform oneself of available material facts, does not on its own constitute bad faith. Both courts also rejected the argument that Disney's conduct amounted to "waste" of the corporation's assets (another exception to the business judgment presumption), holding that waste will be found only rarely, where a corporation's acts are unconscionable and irrational.

The most significant aspect of the *Disney* case is the degree of deference afforded to the Disney directors given the court's dissatisfaction with their conduct. Thus, while the Chancery stated that "there are many aspects of the defendants' conduct that fell significantly short of the best practices of ideal corporate governance" it went on to say that "the common law cannot hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices." In the current environment of highly publicized corporate scandals, the court's insistence that "times may change, but fiduciary duties do not" and that "fiduciaries who act faithfully and honestly… are indeed granted wide latitude in their efforts to maximize shareholders' investments" may be the most important legacy of this case – at least in the U.S. context. Whether Canadian courts follow Delaware's lead will only become evident with the passage of time.[14] ■

14 The author would like to thank Michael Devereux, a 2006 summer student at Stikeman Elliott LLP, for his valuable contributions to this article.