The Disney Verdict and the Protection of Investors
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The Delaware Chancery Court issued its long-awaited and important opinion in the Disney litigation earlier this week, absolving the defendant directors of any liability. The decision makes it clear that investors cannot look to judicially imposed liability for protection from disastrous compensation decisions and other governance failures. What the decision leaves unclear, however, is where shareholders can look to for such protection under existing corporate arrangements.

Chancellor William Chandler's opinion vividly describes the governance failures at Disney: an imperial chief executive with “many lapses” and a board too willing to follow his whims, a critical report by a compensation consultant that is not circulated to all members of the compensation committee, directors that spend 25 minutes reviewing a compensation package whose problematic structure is now famous, and so forth. Throughout, Chancellor Chandler stresses that his decision should not be viewed as condoning what happened at Disney. Rather, it results from the long-standing deference that Delaware courts have accorded to directors' decisions.

Under the business judgment rule, directors' decisions deserve complete deference unless the process of reaching them is egregiously flawed. The last time the Delaware courts lifted this presumption was 20 years ago in the Van Gorkom case, in which directors approved the sale of the company after discussing it for two hours and without seeing a draft of the agreement or a fairness opinion on the sale price.

Because the special circumstances of the Disney case suggested a clearly flawed process, the shareholders' complaint was not dismissed at the outset and some observers thought it might produce another Van Gorkom. Nonetheless, even these circumstances proved insufficient for overcoming the presumption in favor of deference to directors' judgment, because the court concluded that the Disney directors were, at most, ordinarily negligent. While ordinary negligence is sufficient for imposing liability on many professionals, it is not sufficient in respect of directors enjoying the protection of the business judgment rule. Directors are shielded from liability as long as their negligence did not rise to the level of gross negligence and they believed they were acting in the company's interests (even if there was little objective basis for this belief).

The court's opinion sends a reassuring message to directors, at least as far as cases litigated in Delaware and other state courts are concerned: directors have little to fear from liability. It also signals to investors that they should not look to the courts for protection from governance failures. Indeed, articulating the philosophy underlying the Delaware courts' reluctance to find directors liable, the opinion relies on the existence of other mechanisms for protecting investor interests. The redress for management failures, the court stresses, “must come from the markets, through the action of shareholders and the free flow of capital, and not from this court”

However, existing legal arrangements make it difficult for investors to use the other mechanisms suggested for redressing governance failures. To begin with, legal arrangements block electoral challenges to incumbent directors, and shareholders' power to replace directors is now largely a myth. Shareholders cannot even place director candidates on the corporate ballot and a modest reform to allow some shareholder nominations in special circumstances has been deadlocked at the Securities and Exchange Commission.

Legal arrangements also make it difficult for shareholders to initiate and adopt governance arrangements for their companies. Shareholders lack the power to initiate changes in corporate charters. And SEC rules, state law and charter provisions limit shareholders' power to amend corporate by-laws. Shareholders may pass advisory resolutions but boards often ignore them.

As to protection by the capital markets and the free flow of capital, management's power to block takeover bids weakens the discipline that the market for corporate control could provide. Shareholders can sell their own shares but cannot escape the costs of governance failures: the price at which they sell will reflect these failures.

Thus, the mechanisms on which Chancellor Chandler and the Delaware courts rely for protecting investors will not be effective without legal reforms. Shareholder power to replace directors should be turned into a reality. Shareholders should be able to initiate and approve changes in firms' governance arrangements. Management's power to block takeovers and changes in governance arrangements should be curtailed. Courts, legislators and SEC regulators should co-operate in providing the infrastructure for shareholder actions and market forces to provide constraints on governance failures.

By making it clear that courts will not hold directors liable for governance failure, the Disney opinion highlights the need for reforms that will make directors otherwise accountable. Decisions such as this are acceptable only within a system that provides other mechanisms for protecting the interests of investors.

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