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A swarm of activist shareholders challenge corporate governance, with surprising results

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STOCK RESPONSES

Shareholders Ask for Changes in Corporate Governance, and the Courts Are Starting to See It Their Way

JOHN GIBEAUT

THE RESULT WAS PREDICTABLE enough in 1998 when shareholders of Walt Disney Co. went to Delaware Chancery Court to challenge a $140 million severance package handed to company president Michael S. Ovitz.

Chancellor William B. Chandler III blew off the shareholders with the business judgment rule, that venerable bludgeon that has whacked countless other derivative lawsuits. The rule states that judges may defer to corporate directors' decisions, provided they don't involve fraud or other horrendous conduct.

Sure, the severance agreement was a whopper. And the complaint painted an ugly picture of Ovitz's 14-month stint at Disney that began in 1995 with his recruitment by chairman and CEO Michael D. Eisner, Ovitz's friend of 25 years.

But scale and relationships didn't matter to Chandler. The law was the law. Besides, the complaint was a mess, relying heavily on conclusory statements from newspaper editorials about Ovitz's highly publicized exit.

"Nature does not sink a ship merely because of its size, and neither do courts overrule a board's decision to approve and later honor a severance package, merely because of its size," the chancellor wrote in dismissing the case. *In re Walt Disney Co.*, 731 A.2d 342.

The old shareholder brush-off was no surprise in a state known as hospitable to corporate defendants. The Delaware Supreme Court wasn't impressed with the complaint, either,

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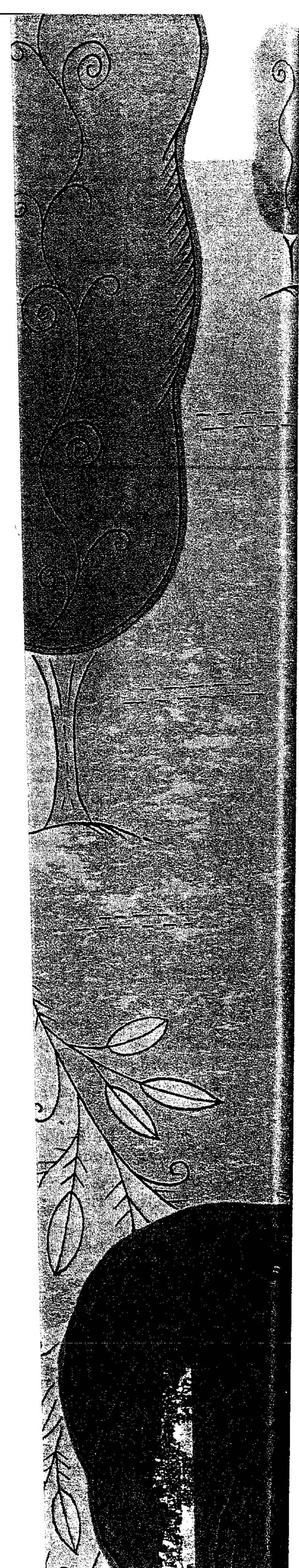

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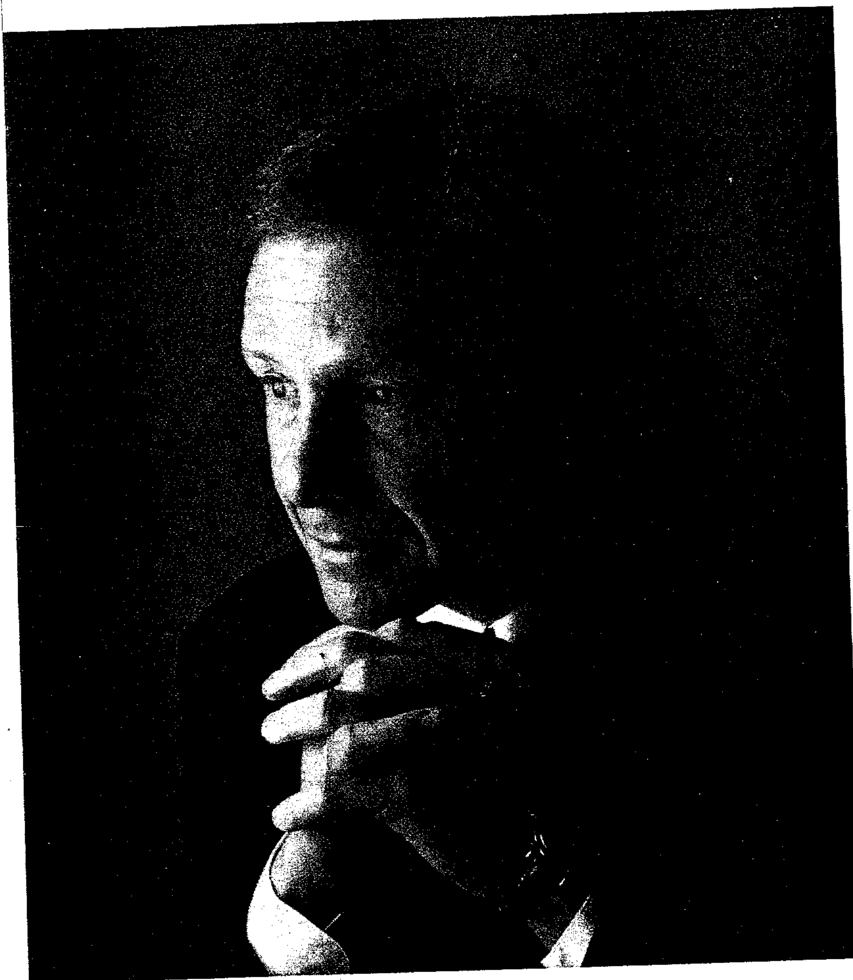

Michael Ovitz

shareholders another shot.

Indeed, with the *Disney* denial and a series of other recent decisions leaning toward stockholders, some directors and officers are wondering whether Delaware has yanked the rug from under them. Yes and no, says Chief Justice E. Norman Veasey, who cites *Disney* as an example of the new scrutiny his court is applying to defendants in derivative actions.

"It's the same chancellor; it's the same law," Veasey says. "But we use the common law. The common law is always evolving. As so, the expectations of directors are evolving."

New pressure on directors isn't coming just from the Delaware courts, whose influence on corporate law reaches far beyond the state's borders. Large institutional shareholders and a few wealthy individuals also have turned up the heat on other fronts.

This year's annual meeting season generated a record 324 shareholder proposals related to executive compensation, triple the 106 filed in 2002, according to Investor Responsibility Research Center, an independent tracker of proxy voting and corporate governance issues. Because shareholder proposals usually must be filed in the early fall for the following year's meeting, it was the first chance for investors to voice their opinions on corporate governance since Enron Corp. filed for bankruptcy in December 2001.

And because of the Delaware decisions and other developments, shareholder class actions, once considered nuisances, have assumed prominence.

calling it "a pastiche of prolix invective." Still, the amount of Ovitz's severance and the "casual, if not sloppy and perfunctory" way the board handled his employment troubled the justices. So, while agreeing that the chancellor had properly dismissed the action, they gave the plaintiffs a chance to file it again. 746 A.2d 244 (2000).

The resurrected complaint came before Chandler this spring, again on the directors' motion to dismiss. This time, the motion was denied.

Unlike the first complaint, this was no Mickey Mouse job. The Disney directors were swept into a vortex of shareholder activism that has engulfed hundreds of other public companies. This time the courts are willing to listen.

"The facts alleged in the new complaint do not implicate merely negligent or grossly negligent decision-making by corporate directors," Chandler wrote on May 28. 825 A.2d 275. "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 fiduciary duties to Disney and its stockholders."

The case is expected to go to trial early next year.

Delaware is nicknamed the First State because it was the earliest of the 13 colonies to ratify the U.S. Constitution. But the state's justices may have sown the seeds for another revolution when they gave the Disney

REFORM ACT SPURS ACTIVISM

WHILE ENRON AND THE STRING OF SCANDALS THAT FOLlowed generally are regarded as watersheds, the wave of shareholder activism actually began to build in 1995 with passage of the Private Securities Litigation Reform Act. The act largely weeded out groundless suits by professional plaintiffs egged on by a small cadre of lawyers.

In the old days the first person inside the courthouse door became the lead plaintiff, even though his or her interests may have been minuscule. Under the statute, however, judges select lead plaintiffs with sufficient financial interest in the outcome to supervise both the litigation and counsel. That cleared the way for institutional investors with trillions of dollars at stake and made litigation a major part of shareholder activism.

"In the past, it was almost a side game," says Patrick S. McGurn, counsel for Institutional Shareholder Services, which provides proxy and governance assistance to nearly 1,000 corporate and institutional clients. "There were professional plaintiffs and a plaintiffs bar, but it was pretty much a closed circuit. Under the old system, the plaintiffs and the companies would settle for the limits of the [directors and officers' insurance] policy."

No more. Now, McGurn says, the name of the game is

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"good governance at gunpoint."

To that end, shareholders reached an unprecedented settlement in May that included major corporate governance reforms in a federal insider-trading suit against Houston-based Hanover Compressor Co. Besides getting $80 million, the shareholders won the right to nominate two directors, and the company agreed to rotate its outside auditor.

Those and other aspects of the deal exceed requirements of the 2002 Sarbanes-Oxley Act, which is supposed to clean up corporate conduct by making directors and management more accountable to the investing public.

Observers say it's just a matter of time before awards reach the billion-dollar mark. They also see demands for changes in governance as the rule rather than the exception in derivative actions.

"It's actually become part of the plaintiffs attorneys' marketing," McGurn says.

The federal government also is exerting pressure. Until Sarbanes-Oxley, the feds had focused on regulating the stock markets and left policing company behavior to the states. At the urging of large shareholders, the Securities and Exchange Commission is working on new regulations that would give major shareholders a greater say in director selection. Commissioners hope to issue a draft by September that would become final in time for 2004 annual meetings.

REVERSAL OF FORTUNES

THE DELAWARE COURTS HAVEN'T WASTED TIME CARVING out their niche in an anticipated new order that could ram federal securities law straight into state laws controlling corporate governance. In a string of opinions dating to June 2002, the Delaware Supreme Court has reversed a half dozen chancery court decisions that favored directors. Among the rulings that were shot down was one that locked in shareholder votes in favor of one merger, even though a better offer had come along. Another case involved limits on a shareholder's efforts to obtain documents supporting allegations of accounting irregularities that forced a company to reduce its revenue statement by $327.4 million.

As a regular on the rubber chicken circuit, Veasey often comes across directors who wonder whether Delaware has abandoned the old rules.

"They're asking if the business judgment rule is still alive," Veasey says. "I say, 'Yes, it is. We will not second-guess your business judgment, but we are going to look at your process.' "

If there ever was a case about process—or the lack of it—*Disney* may be it. By all rights, the supreme court could have let the case lie in the same ground where the chancellor had buried it. But with a strong hint from the justices to use a state statute to obtain Disney's records, the shareholders exhumed the complaint.

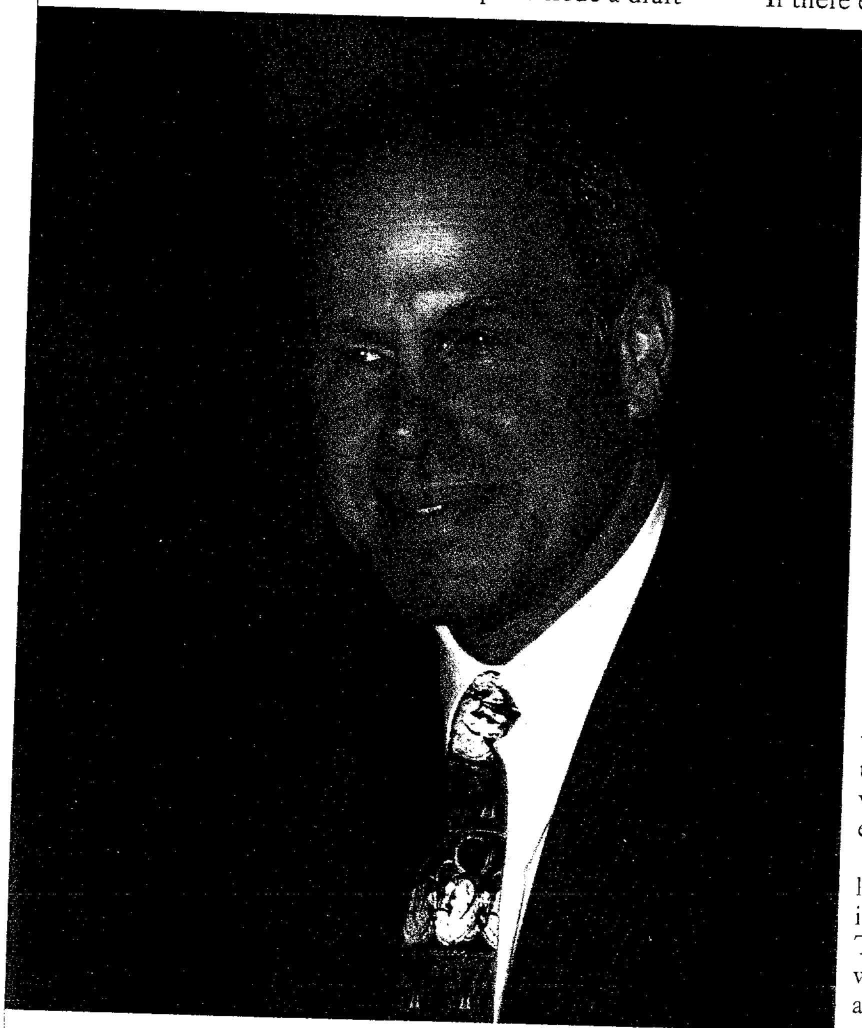
In denying the second motion to dismiss, Chandler recited the allegations in excruciating detail:

Ovitz, founder of a talent agency, had never worked as an executive for a publicly held entertainment company. Still, Eisner unilaterally decided to hire him over the protests of at least three board members. Though lawyers for Eisner and Ovitz summarized initial drafts of employment contracts, neither the board nor the compensation committee saw the final version, reached in December 1995.

The five-year deal gave Ovitz a $1 million salary, annual bonuses up to $10 million and options to purchase 3 million shares of Disney stock "in the money." That meant in exercising the options, Ovitz would at most pay the price at the time specified in the contract, regardless of what the stock did afterward. The initial summaries didn't state the exercise price.

More significantly, the final agreement allowed Ovitz to collect severance pay even if it turned out he wasn't qualified for the job. The drafts granted severance only in cases of wrongful termination, death or physical disability.

It wasn't long before Eisner and Ovitz both decided that bringing Ovitz to Disney was a mistake. In a September 1996 interview



Michael Eisner

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with Larry King, Ovitz admitted knowing "about 1 percent of what I need to know." He began looking for another job while on Disney's payroll. Eisner tried to make things easy on his friend.

"I agree with you that we must work together to assure a smooth transition and deal with the public relations brilliantly," Eisner told Ovitz in a memorandum. "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."

The SEC could tip the balance between federal and state law.

The two friends quietly worked out a pact in December 1996. Ovitz would receive $38.9 million in cash and another $100 million in stock. Disney's bylaws required board approval, but the complaint cited no participation by the directors or the compensation committee, though members knew Ovitz was on his way out.

"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," Chandler wrote. "Instead the facts alleged in the new complaint suggest that the defendant directors consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude."

Though Eisner's words may return to haunt Disney, a company spokesman expresses confidence that the entertainment giant will prevail at trial.

"This procedural decision simply says the plaintiffs get a chance to prove what they asserted," says John W. Spelich, Disney vice president for corporate communications.

The state supreme court's decision to send *Disney* back for repleading should sound alarms in other boardrooms, says lead plaintiffs lawyer Steven G. Schulman of New York City.

"In this case, had the facts not come to light, it would have just gone by the boards, as I'm sure has happened in other cases," Schulman says. "In most cases, the facts aren't going to be that bad, but it's a wake-up call. You can't abdicate your responsibility, and you just can't go through the motions."

Delaware judges also haven't shied from discussing expectations directors face today that a few years ago concerned neither the directors nor the courts.

"Directors need to do their homework and realize that they're the boss," says Veasey, Delaware's chief justice.

In published comments and in interviews, the state's judges predict that plaintiffs lawyers will attempt to hold directors to a higher standard of independence from the companies they guide. While courts closely scrutinize mergers for self-dealing, they typically accord directors presumptions of independence and impartiality in more routine matters.

Writing for the ABA's *Business Lawyer* in August 2002, Vice Chancellor Leo E. Strine Jr. says he expects the plaintiffs bar to press the courts to reverse presumptions of independence. Instead, courts will likely be asked to assume, for purposes of motions to dismiss, that directors have suspect connections to management, according to the article. Plaintiffs lawyers are likely to urge courts to consider everything from management domination in board member selection to directors' service fees, which can reach six figures in large companies.

The state high court soon may explore the limits of Strine's view. In June he denied a motion to dismiss a shareholder action that alleges insider trading by officers and directors of software maker Oracle Corp.

Strine said the defendants were too closely tied to a special litigation committee appointed to investigate the matter. The committee cleared the defendants, who included: chairman and CEO Lawrence Ellison, Oracle's largest shareholder; board member Michael Boskin, a Stanford University economics professor and chairman of the first President Bush's Council of Economic Advisers; board member Donald Lucas, a Stanford graduate and a generous contributor to the university; and chief financial officer Michael Henley.

The special committee consisted of Stanford law professor Joseph Grundfest, a former SEC commissioner and head of the university's highly regarded directors college; and Stanford professor Hector Garcia-Molina, chairman of the computer sciences department.

Though both investigators also were board members, Strine pushed the conflicts envelope further than ever. He cited sometimes tenuous personal and philanthropic ties among the defendants, the investigators and Stanford, including millions of dollars in donations to the school by Oracle, Ellison and Lucas.

"Rather than form [a special litigation committee] whose membership was free from bias-creating relationships, Oracle formed a committee fraught with them," Strine wrote. *In re Oracle Corp.*, 824 A.2d 917 (June 13).

Still, Strine acknowledged in a footnote that his conclusion was out of step with Delaware case law—at least, as it stood at the time. "I readily concede that the result I reach is in tension with the specific outcomes of certain other decisions."

COMPRESSOR COMPANY CLUES IN

MEANWHILE, IN HOUSTON FEDERAL COURT, HANOVER Compressor wasn't about to wait around for a crippling judgment in its insider trading case. With Enron crumbling right across town, it just didn't look good for Hanover, which in 2002 had to chop $83 million from its financial statement to atone for improperly reported revenue. So the company started to deal for more than money and in mid-May reached a landmark governance agreement with the plaintiff stockholders.

"The new wave for the plaintiffs bar is to seek reform

all the way up to the board," says lead defense lawyer Kevin T. Abikoff of Washington, D.C. "Hanover looked at this, looked at the environment and took what I call a mature and disciplined approach."

In addition to paying the $80 million to cover investor losses, Hanover agreed to allow holders of greater than 1 percent of its outstanding shares to nominate two candidates for board seats. Though the settlement requires court approval, the company agreed to begin work immediately on filling the director slots to ease fears the plaintiffs raised about getting stonewalled later in the game.

"I said if we do it before we go in front of the judge, you know we're going to do it right," says Abikoff, recalling the negotiations with the shareholders.

Hanover also will rotate its entire audit firm every five years. Sarbanes-Oxley requires only a five-year rotation of the partner in charge of the audit.

Also under the settlement, two-thirds of Hanover's board, including the chairman, must consist of independent directors, using a strict definition of independence designed to eliminate financial and personal ties to the com- pany. All members of the audit, compensation and nominating committees must be independent. Sarbanes-Oxley requires only independent audit committee members.

While the New York Stock Exchange and Nasdaq have gone further than Sarbanes-Oxley and proposed independent compensation and nomination processes, both would require only a majority of independent board directors.

In other significant reforms, Hanover executives will be prohibited from selling personal stock when the company is using its money to buy back stock in the market. Also, shareholders must approve new executive stock option plans and the repricing of existing options. The settlement also restricts accelerated vesting of directors and officers' options. In June, the SEC approved similar limits proposed by the stock exchanges.

"The wisdom of the defendants to do this has been borne out in the price of the stock," says lead plaintiffs lawyer Darren J. Robbins of San Diego. "It basically doubled."

But the Hanover deal and others sure to come could look like kids' stuff depending on the outcome of the debate before the SEC over increased shareholder participation in corporate affairs.

The SEC staff recommended in July that the commission open up director elections in limited circumstances and give large, long-term shareholders the right to nominate candidates on company ballots distributed with proxy materials. The staff recommendation would require "triggering events," such as a company ignoring shareholder proposals that receive majority votes.

The request came after the commission rejected an appeal from the American Federation of State, County and Municipal Employees Pension Plan to force Citigroup Inc. to allow use of its company materials in its director elections. The SEC received nearly 700 comments from the public as the staff studied the idea.

Though almost anyone can nominate a candidate, companies don't have to permit use of their proxy materials, which are distributed to all shareholders and typically carry only ballots with management-supported slates. Independent candidates do surface in hostile takeover attempts. But any SEC changes to the selection process likely would exclude corporate raiders and force them to go it alone through traditional proxy fights that they must finance. Instead, the commission is focusing on institutional stockholders who are not interested in such conquests but who complain that it's too expensive for them to wage campaigns to address governance concerns without access to the company ballot.

"Sarbanes-Oxley was only half a solution," says Richard C. Ferlauto, AFSCME director for pension investment policy. "It created procedural reforms, but it really didn't affect the relationship or the balance of power between boards and shareholders."

Advocates say the SEC can protect a system from abuse and keep it from becoming unwieldy by limiting participation to owners of threshold amounts of stock—say anywhere from 3 percent to 10 percent of outstanding shares—that they must hold for a substantial time period, possibly several years. In addition, shareholders probably wouldn't be able to nominate enough directors to gain a majority on a board.

"I think our proposals have taken all of those concerns into account," says Robert D. Lenhard, a lawyer for AFSCME. "We've tried to ensure that this is a mechanism for long-term shareholders."

But by changing the election process, the SEC also risks tipping the delicate balance between federal and state law, already somewhat disrupted by Sarbanes-Oxley. That could prove tricky.

DELVING INTO STATE LAW

FEDERAL LAW HISTORICALLY HAS REGULATED THE SECURITIES markets primarily by requiring specified financial disclosures from public companies to maintain investor confidence. On the other hand, control of corporate structure, transactions and conduct historically has fallen to the states, as has the law governing fiduciary duties directors owe to shareholders.

Still, Sarbanes-Oxley noticeably intruded into state territory by dabbling with audit committee composition, definitions of director independence, lawyer regulation and more. The more detailed stock exchange proposals on structure and conduct need SEC approval and would march even deeper into state law.

Practically speaking, neither Sarbanes-Oxley nor the exchange proposals create new causes of action for stockholders. Violations of Sarbanes-Oxley in all likelihood entail only criminal prosecutions or government civil actions, and not private litigation. The most the stock exchanges can do is revoke a corporation's listing, which could spell disaster for the company and shareholders alike, making litigation on that front like shooting oneself in the foot.

Judging from their reactions to the SEC study of director selection, corporations and related professional associations appear willing to live with Sarbanes-Oxley and the exchange proposals. But by and large, they see nothing but trouble ahead if the SEC throws the boardroom doors wide open to shareholders. Corporate voices say Sarbanes-Oxley and new exchange rules need time to

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