

Good Faith, Poor Practices: The Disney Ruling From A Credit Perspective

“Unlike ideals of corporate governance, a fiduciary’s duties do not change over time. How we understand those duties may evolve and become refined, but the duties themselves have not changed... Delaware law does not—indeed, the common law cannot—hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices...”—*Chancellor William B Chandler III, In re The Walt Disney Company Derivative Litigation, No. 15452 (Del. Ch. Aug. 9, 2005)*

With these words, Chancellor Chandler upheld the actions of the Walt Disney Co. board of directors, but raised serious questions for those serving as directors all the same. Shareholders had sued the board, asking that it reimburse the company for the \$140 million severance package that former Disney President Michael Ovitz was awarded when CEO Michael Eisner and the board fired him after only 14 months on the job.

In his decision, Chancellor Chandler found that the board had acted in good faith in fulfilling its fiduciary duties in dismissing Ovitz and granting him his package. In that sense, the Delaware decision may help insulate corporate boards from future litigation in this area. Yet the revelations about how Disney’s management made key decisions—particularly relating to executive pay—may ultimately have more serious consequences than are apparent at the moment. For example, the focus on the way boards make decisions could intensify and, in extreme cases, the credit ratings on companies with boards that take their responsibilities too cavalierly could be affected.

In recent years, Standard & Poor’s Rating Services has begun to examine such issues more closely in evaluating creditworthiness. On Oct. 28, 2004, we published “Corporate Ratings Criteria—The Evolving Role of Corporate Governance in Credit Rating Analysis.” This article made clear that companies with high credit ratings could potentially have governance standards that are problematic—and that, conversely, strong corporate governance does not, by itself, indicate strong creditworthiness. Nonetheless, the article also stated that weak corporate governance can undermine a company’s credit standing, and uncontrolled executive compensation was cited as an example. That said, it is worth noting that Standard & Poor’s raised its long-term corporate credit rating on The Walt Disney Co. to ‘A-’ from ‘BBB+’ on May 24, 2005, while the highly publicized litigation was in progress.

Governance Analysts

Dan Konigsburg
New York
(1) 212-438-3046
dan_konigsburg@
standardandpoors.com

Laurence Hazell
New York
(1) 212-438-1864
laurence_hazell@
standardandpoors.com

Publication Date

August 26, 2005

Even if the plaintiffs had succeeded in the Disney case, it is unlikely that there would have been any credit issues for the company, as the sum involved is immaterial to Standard & Poor's current view of Disney's creditworthiness. The personal liability of directors could have had a bearing on our assessment of board effectiveness, given the impact on the directors as individuals. However, only four board members remain from the time of the payment to Mr. Ovitz.

The issues underlying executive payment decisions remain relevant to any assessment of board quality and, in turn, credit quality. In our view, a board's compensation philosophy is a window into the directors' effective oversight of management. In making decisions on executive compensation (and succession planning), boards exercise their own *managerial*, as opposed to *management oversight*, function. In other words, the actions of a board's compensation committee provide critical insight into the ability of directors to make rational, proportionate, and defensible decisions. For market observers, including Standard & Poor's, such decisions can provide one of the litmus tests of board effectiveness, as they test a board's independent qualitative decision making directly and visibly, and help indicate how directors make evaluations across the gamut of corporate actions they decide as fiduciaries.

Poor or deficient pay practices can thus be an indication of an ineffective board. Best practices dictate that executive pay should be set independently of management (particularly the CEO, who, in the U.S., generally sits on and chairs the board). They also require that executive compensation be strongly connected to the company's performance. This means that executive pay should go down (if the business suffers), as well as go up (as the business prospers). Of course, the relationship need not be purely mechanical: Any capable compensation committee should be able to make a persuasive case why pay, in certain circumstances, should advance even when a company's performance is declining (links to longer-term goals would be one such example).

The central lesson of the Disney opinion is that boards may hew to fiduciary duties, but still fail significant corporate governance tests. The case has thus put a spotlight on executive pay at all companies, irrespective of the outcome for Disney's board. Chancellor Chandler's comments also serve as a reminder that Disney approved Ovitz's golden parachute 10 years ago—and that “applying 21st-century notions of best practices in analyzing whether those decisions were actionable would be misplaced.” This speaks directly to the evolving nature and standards of fiduciary duties. Future court decisions will determine how new notions of good corporate governance will refine the scope of directors' fiduciary duties—even if those duties themselves do not change. In the meantime, as Chancellor Chandler observes, redress for poor decisions—if those are deemed by the courts to have been made in good faith—must come from the markets through the actions of shareholders and the free flow of capital in order for the essential element of risk taking in pursuit of maximizing value to occur.

In the 10 years since Mr. Ovitz was awarded his “breathtaking” (as described by Chancellor Chandler) severance package—and notwithstanding the intervening corporate debacles referred to by the judge (including Enron and WorldCom)—outsized payments to executives with short tenures are still granted (executive compensation decisions at Morgan Stanley being one recent example). These massive severance packages suggest that, in these cases, boards have done a poor job of negotiating executive contracts—presumably because they do not have the power, or perhaps the skills, to do better. Severance packages are usually put in place when bringing in a new CEO, and overly generous departure terms can give an executive excessive leverage, thus spelling trouble for the quality of the relationship between the CEO and board.

As the issues regarding compensation surfaced by the Disney ruling continue to play out in Corporate America, Standard & Poor's will monitor how boards deal with the complex concerns that accompany the principle of ‘pay for performance’. Again, while the sums involved in excessive pay packages may at times seem staggering, they themselves are not capable of affecting credit ratings. Compensation issues do, however, exhibit a crucial element of board decision making that can potentially influence Standard & Poor's evaluation of a company's creditworthiness.

Published by Standard & Poor's, a Division of The McGraw-Hill Companies, Inc. Executive offices: 1221 Avenue of the Americas, New York, NY 10020. Editorial offices: 55 Water Street, New York, NY 10041. Subscriber services: (1) 212-438-7280. Copyright 2005 by The McGraw-Hill Companies, Inc. Reproduction in whole or in part prohibited except by permission. All rights reserved. Information has been obtained by Standard & Poor's from sources believed to be reliable. However, because of the possibility of human or mechanical error by our sources, Standard & Poor's or others, Standard & Poor's does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions or the result obtained from the use of such information. Ratings are statements of opinion, not statements of fact or recommendations to buy, hold, or sell any securities.

Standard & Poor's uses billing and contact data collected from subscribers for billing and order fulfillment purposes, and occasionally to inform subscribers about products or services from Standard & Poor's and our parent, The McGraw-Hill Companies, that may be of interest to them. All subscriber billing and contact data collected is processed in the U.S. If you would prefer not to have your information used as outlined in this notice, or if you wish to review your information for accuracy, or for more information on our privacy practices, please call us at (1) 212-438-7280. For more information about The McGraw-Hill Companies Privacy Policy please visit www.mcgraw-hill.com/privacy.html.

Standard & Poor's receives compensation for rating obligations and other analytic activities. The fees generally vary from US \$5,000 to over US\$1,500,000. While Standard & Poor's reserves the right to disseminate the rating it receives no payment for doing so, except for subscriptions to its publications. The Standard & Poor's ratings and other analytic services are performed as entirely separate activities in order to preserve the independence and objectivity of each analytic process. Each analytic service, including ratings, may be based on information that is not available to other analytic areas.