DIRECTORS BEHAVING BADLY: 21ST CENTURY CORPORATE GOVERNANCE STANDARDS

by

Robert Sprague*

Introduction

Corporate governance in the 21st century has so far been recovering from major financial scandals emanating from former industry titans such as Enron, WorldCom, and Tyco International.[1] As a result of those and other financial scandals, Congress passed sweeping legislation to make corporate decisions more open and transparent. For example, section 302 of the Sarbanes-Oxley Act of 2002 requires chief executive officers and chief financial officers of publicly traded corporations to personally attest to the accuracy of financial statements;[2] section 402 severely restricts the ability of publicly traded corporations to make loans to officers and directors;[3] section 404 requires publicly traded corporations to adopt effective internal control procedures;[4] and section 409 requires nearly real-time disclosures of information concerning material changes in a publicly traded corporation's financial condition or operations.[5]

Despite these legislative efforts, corporate scandals continue. As of May 11, 2007, over 80 publicly traded corporations were forced to restate earnings as a result of backdating options awarded to executive officers.[6] This latest corporate scandal involves stock option grants awarded to executives being retroactively priced on a date when the company's stock hit a low price, allowing the executives to realize a larger gain on their options.[7] Nearly 100 publicly traded companies are being investigated by the SEC for backdating options, leading to 19 chief executive officers (along with dozens of additional executives and directors) of those companies either resigning or being terminated.[8] But not all corporate scandals are purely financial in nature.

In 2006, the Hewlett-Packard Company, one of the venerable companies in the high-tech industry,[9] became embroiled in a corporate scandal—accused of spying on its own directors (as well as reporters). Similarly, the Walt Disney Company—again, a venerable company, this time in the entertainment industry—was embroiled in the past ten years in derivative litigation focused on the adequacy of oversight exercised by its board of directors. While the focus of corporate governance in recent years has been on financial improprieties,[10] the subject of this paper exemplifies how other improprieties continue in corporate boardrooms. This paper examines in detail the so called "Hewlett-Packard scandal," including the specific laws that were allegedly broken by its chairman of the board (as well as the company's legal counsel). This paper also examines an allegedly exorbitant severance package awarded to a Disney executive and director, and the degree of involvement (or lack thereof) of Disney's board in the matter. Stated another way: What are the corporate governance standards when directors behave badly, but without a motive for personal remuneration? The Hewlett-Packard and Disney corporate scandals are used as a platform to examine the current fiduciary standards applied to corporate boards in alleged wrongdoing that does not specifically involve fraud or personal financial gain. This paper concludes that where personal financial gain is not involved, directors are given wide latitude to behave badly.

The Hewlett-Packard Scandal

One of the first priorities in 2005 for Hewlett-Packard's newly appointed Non-Executive Chairman of the Board, Patricia C. Dunn, was to identify and stop the source of leaks to the press of confidential, non-public information known only to members of the Hewlett-Packard board of directors.[11] As a result, Dunn began an investigation, titled "Kona,"[12] into the leaks, using an outside investigative services company, Security Outsourcing Solutions, Inc., that had worked exclusively for Hewlett-Packard for the previous eight years.[13] The proposed investigative activity was to include electronic surveillance of e-mail and other communications accounts, and Dunn allegedly turned over to Security Outsourcing Solutions, Inc.'s Managing Director, Ron DeLia, contact information of Hewlett-Packard board members, including telephone numbers.[14]

DeLia, in turn, contracted with Action Research Group (ARG) to obtain telephone subscriber records, with the knowledge that ARG used a method known as "pretexting" to obtain the information.[15] In June 2005, DeLia reportedly explained pretexting to Dunn and Ann Baskins (then General Counsel for Hewlett-Packard) when reporting the results of his investigations, describing pretexting as requesting account information from telephone companies by pretending to be the account holder.[16] By August 2005, the Kona investigation was ended, as the source of the leaks had not been identified, and by then there had been no leaks from the boardroom for several months.[17]

In January 2006, however, there was another leak of confidential, non-public information apparently from the board of directors.[18] A second investigation, titled "Kona II," was initiated, this time supervised by Kevin Hunsaker, a member of Hewlett-Packard's legal department who reported directly to Baskins.[19] Again, DeLia was retained to lead the investigation, and DeLia, again, contracted with ARG to obtain telephone records of members of the Hewlett-Packard board of directors and of certain reporters.[20]

During this second investigation, Hunsaker requested more detailed information as to how the investigative team was obtaining cellular and home telephone records, to which a member of the investigative team responded:

> The methodology utilized is social engineering, [DeLia] has investigators call operators under some ruse, to obtain the call record over the phone, its [*sic*] verbally communicated to the investigator, who has to write it down. In essence the Operator shouldn't give it out, and that person is liable in some sense. [DeLia] can describe the operation better, as well as the fact that this technique since he, and others, have been using it, has not been challenged. I think it is on the edge, but above board.[21]

Hunsaker's response (via e-mail): "I shouldn't have asked …."[22]

Despite Hunsaker's trepidations, the Kona II investigation continued into Spring 2006, with the investigators obtaining subscriber information for nearly 600 telephone numbers.[23] Hewlett-Packard admitted to obtaining telephone records for board members and reporters, all without the subscribers' permission.[24] Throughout the Kona II investigation, Hunsaker regularly updated Dunn.[25]

The Kona II investigation did, however, bear fruit—identifying board member George Keyworth as the likely source of the latest leak.[26] This matter may have remained private but for the reaction of another Hewlett-Packard board member and friend of Keyworth, Tom Perkins. When the results of the investigation were presented to the full board, Perkins became upset, supposedly at the prospect that the board was going to ask for Keyworth's resignation.[27] Perkins then resigned from the Hewlett-Packard board.[28]

Subsequently, Perkins requested that Hewlett-Packard investigate the manner in which the investigation was conducted, "asserting that phone and e-mail communications had been improperly recorded as part of the investigation…."[29] At this point, the Hewlett-Packard board was compelled to file a revised Form 8-K with the Securities and Exchange Commission to explain in more detail the reasons for Perkins' resignation. In its Form 8-K, Hewlett-Packard admitted to using "pretexting" in the investigation, and that in a review of the methods used in the investigation, outside counsel to the board's Nominating and Governance Committee had advised the Committee "that the use of pretexting at the time of the investigation was not generally unlawful …, but … counsel could not confirm that the techniques employed … complied in all respects with applicable law."[30] Hewlett-Packard also disclosed in its Form 8-K that the California Attorney General was "requesting information concerning the process employed in the investigations into the leaks."[31]

On September 22, 2006, Dunn resigned as the Non-Executive Chairman of the Hewlett-Packard Board of Directors.[32] Both Hunsaker and Baskins also left Hewlett-Packard.[33] On October 4, 2006, the California Attorney General filed criminal charges against Dunn, Hunsaker, DeLia, and two employees of ARG based on the pretexting activities.[34] On December 7, 2006, Hewlett-Packard agreed to pay $14.5 million to the California Attorney General's office to settle civil charges, again stemming from the pretexting activities.[35]

What Is Pretexting?

The California Attorney General's office describes pretexting as "third parties falsely representing themselves as [telephone] customers in order to obtain account access and/or information relating to legitimate customers without the customers['] consent or knowledge."[36] The California Attorney General's office also describes three methods of pretexting: first, a pretexter changes the caller I.D. on his/her telephone to that of a legitimate customer, thereby "spoofing" the telephone company into believing that the legitimate customer's telephone was being used to open an account; second, creating an online account using a legitimate customer's telephone number and some or all of the customer's social security number; and third, obtaining a multi-digit account code from a legitimate customer's billing statement and using the code to pretend to be the customer when contacting the telephone company's customer service.[37]

As implied in the correspondence with Hewlett-Packard's Hunsaker by an investigator, pretexting is a fairly common practice.[38] For example, AT&T's own internal investigation revealed that as many as 2,500 of its customer accounts may have been compromised during 2006.[39] Since the summer of 2005, the Federal Communications Commission (FCC) has been investigating the activities of data brokers who advertise the sale of personal telephone records for a price.[40] Although the data brokers "almost universally" denied using pretexting to obtain their information, the FCC's investigation revealed "that data brokers routinely engaged in this practice—often by impersonating the account holder or another company employee.[41] The Federal Trade Commission (FTC) has also been actively investigating data brokers and their use of pretexting.[42]

As the FTC has noted, although "the acquisition of telephone records does not present the same risk of immediate financial harm as the acquisition of financial records does, it nonetheless is a serious intrusion into consumers' privacy and could result in stalking, harassment, and embarrassment."[43] It is believed most pretexters are private investigators, seeking information for clients involved in divorces or other civil disputes.[44] For the most part, however, data brokers provide the information to their clients "with no concern for how the information will be used."[45]

As discussed below, until 2007, there was no law directly outlawing pretexting for the purpose of obtaining phone records.[46] However, the FTC believes it has authority to file lawsuits against individuals engaged in pretexting for telephone records. Section 5 of the FTC Act authorizes the FTC to prevent persons from "using unfair methods of competition in or affecting commerce and unfair or deceptive acts or practices in or affecting commerce."[47] The FTC has brought lawsuits

alleging that companies sold confidential consumer call records obtained through fraud or other illegal means, and "that this practice was both deceptive and unfair under Section 5 of the FTC Act."[48]

It is reported that the Hewlett-Packard pretexting scandal brought new momentum for Congress to enact the Law Enforcement and Privacy Protection Act of 2006,[49] which was signed into law by President Bush on January 12, 2007.[50] Section 3 of the Act amends Title 18 of the U.S. Code by adding a new section "that provides explicit criminal penalties for fraudulently obtaining or providing confidential phone records information of a consumer held by a telephone company or IP-enabled voice service."[51] In particular, the new law prohibits acquiring confidential phone records by making false or fraudulent statements or representation to a telecommunications employee or a customer, or by accessing customer accounts via the Internet without authorization.[52] The Act also prohibits the sale or purchase of such confidential records.[53] Penalties include a fine (up to $250,000 for an individual and up to $500,000 for an organization)[54] and/or imprisonment for up to 10 years.[55]

On September 29, 2006, California Governor Arnold Schwarzenegger signed into law California's pretexting law, which went into effect January 1, 2007. As with the federal pretexting law, the Hewlett-Packard scandal also apparently influenced the passage of California's legislation, as a similar bill (though with reportedly tougher provisions) was voted down just days before the Hewlett-Packard scandal became public.[56] California's pretexting law adds a new section (638) to the state's penal code which prohibits anyone from obtaining calling record information without consent or through fraud.[57]

The New HP Way: Legal, But Still Embarrassing

Of course, neither the federal Law Enforcement and Privacy Protection Act of 2006 nor California's pretexting law had yet been enacted when the Hewlett-Packard pretexting took place.[58] This does not mean, however, that, as noted above, charges were not filed. In particular, the principal investigators, Ron DeLia, Matthew DePante, and Bryan Wagner, were charged with violating California's laws against unlawfully obtaining customer records,[59] identity theft,[60] and unauthorized access to computer data.[61] Dunn and Hunsaker were charged with conspiracy to commit those crimes.[62] In addition, Wagner, who worked for ARG and allegedly engaged in most of the pretexting, was charged by the U.S. Attorney's General San Francisco office with aggravated identity theft.[63] Wagner agreed to plead guilty to the federal charges in exchange for testimony.[64]

The California charges were dropped against Dunn in March 2007.[65] Charges against Hunsaker, DeLia, and DePante will be dropped in September 2007 if they each perform 96 hours of community service.[66] It is currently questionable whether the federal government is continuing an investigation into the matter.[67]

Though the conduct by Hewlett-Packard's board may not have been illegal in the strictest sense, its pretexting scandal has additional consequences. As noted by one commentator:

> The HP case demonstrates one method by which a corporation can thwart journalists' efforts to gather information. The effect of such an action is twofold. Not only might such espionage be effective in ending a particular investigation, but it might also have a chilling effect on journalists who are concerned about the invasion of privacy wrought by techniques such as those practiced by HP.[68]

A *San Francisco Chronicle* editorial expresses the concern that the "tepid" conclusion to California's criminal case against Hewlett-Packard "leaves the door open for other companies to behave badly. Which they will."[69] A similar sentiment was echoed by a lawyer for the *New York Times*, who stated, "H.P. can and should do more to acknowledge the harm that was done and to demonstrate to other companies that may be tempted to engage in similar conduct that this is not an offense that carries no consequences."[70] Indeed, a number of news reporters who were allegedly targets of Hewlett-Packard's investigations are considering suing Hewlett-Packard for invasion of privacy.[71] Of still greater potential consequence to the participants is a derivative lawsuit which has been filed against them by a number of shareholders directly arising from conduct surrounding the pretexting scandal.[72]

Corporate internal investigations have become more common in the past twenty years. "In light of the vast and complicated array of regulatory legislation confronting the modern corporation, corporations, unlike most individuals, 'constantly go to lawyers to find out how to obey the law,' particularly since compliance with the law in this area is hardly an instinctive matter"[73] "As a consequence, more and more corporations in one form or another are utilizing internal investigations to investigate potential wrongdoing by employees, including, in some instances, senior management."[74]

"Internal corporate investigations have become an established response to allegations of improprieties on the part of the corporation, its officers, or its employees."[75] However, whether the internal investigation is initiated as a result of an impending investigation by a regulatory body or as a result of an internal complaint or grievance, the principal concern is to maintain confidentiality so that "the results of an investigation conducted as part of a good faith effort to respond to, investigate, and resolve an internal company problem [don't] provide a road map for an adversary to establish civil or criminal liability of the corporation, its officers, or its directors."[76] In other words, the concern is that damaging information may be unearthed that may later be discoverable in litigation against the corporation.[77] Ultimately, the corporation wants to maintain the attorney-client privilege throughout the investigation.[78]

Hewlett-Packard's investigations into the leaks of confidential, non-public information were not, however, motivated by possible regulatory actions or employee complaints. Perhaps this was why those in charge of the investigations

were not necessarily concerned with following established protocols. Former Non-Executive Chairman of the Board Dunn cites the violation of a particular section of the company's Standards of Business Conduct as the reason for the leak investigations:

> You may not grant interviews or provide comments to the press without prior approval from HP Corporate Communications. Unless you receive other guidance from HP Corporate Communications, you are expected to decline the opportunity to respond to any inquiries for news or information about HP and refer the request to the appropriate HP spokesperson.[79]

It is clearly arguable that a director of Hewlett-Packard could find the surreptitious access of his personal phone records by outside investigators to be a highly offensive invasion of privacy, particularly when such conduct violates, at a minimum, the Standards of Business Conduct, to which all Hewlett-Packard directors, officers, and employees attest compliance annually.[80]

The founders of Hewlett-Packard established at the outset that one of the objectives of the company would be good corporate citizenship.[81] Indeed, Hewlett-Packard has been so admired in corporate circles that its methods of operation have been referred to as "the HP way."[82] Hewlett-Packard's board of directors appears to have failed to uphold some of the basic tenants of corporate governance. In essence, corporate governance represents the classic agency problem: how can "corporate managers, as agents of the shareholders, be induced to manage corporate assets in the best interests of their principals?"[83]

> The perspective of the corporate law traditionalist is one that recognizes there is great value to the American … approach to corporation law. This approach invests corporate managers with a great deal of authority to pursue business strategies through diverse means, subject to a few important constraints. These constraints—that stockholders approve certain important transactions such as mergers, vote for directors annually, and have access to books and records; that stockholders can hold managers accountable for failing to fulfill their fiduciary duties; and that state and federal policies give independent directors the clout and duty to police corporate insiders—are vital. They provide assurance that managers will not abuse the powers granted them, thereby instilling confidence in investors that capital may be safely entrusted to corporations run by centralized management.[84]

The directors of Hewlett-Packard

> stand in a fiduciary relationship not only to the stockholders but also to the corporation[] upon whose board[] they serve. The director's fiduciary duty to both the corporation and its shareholders has been characterized … as a triad: due care, good faith, and loyalty. That triparte fiduciary duty does not operate intermittently but is the constant compass by which all director actions for the corporation and interactions with its shareholders must be guided.[85]

So, how did Hewlett-Packard lose its way in 2005 and particularly 2006?

As a member of Hewlett-Packard's legal department, Hunsaker should have known that the pretexting activities were, at a minimum, unethical, let alone possibly illegal. In fact, he expressed his concern with pretexting early in 2006 and, yet, he allowed it to continue.[86] And since Hunsaker regularly reported the details of the 2006 investigation to Dunn,[87] she, despite her protestations,[88] is equally culpable. The ends of the investigation—identifying the source of the leak—appear to have outweighed the means—pretexting.

In Hunsaker's (and Dunn's) defense, pretexting does not appear to be an uncommon corporate investigative method. Other large corporations have been found to be clients of firms implicated in investigations of pretexting.[89] Nor was Hewlett-Packard the first corporation to hire corporate spies.[90] There is often a tendency for corporations to provide little oversight of the methods used by outside investigators.[91] However, as Hunsaker and Dunn have discovered, "don't ask, don't tell" is not (at least in terms of keeping their jobs) a "robust defense."[92] And, as Hewlett-Packard has discovered, "no amount of distancing can isolate companies when the media, alleged illegal activity, or a juicy story is involved."[93]

One commentator has asserted that in fast-changing corporate environments, "people tend to make up their own rules."[94] In effect, they create their own rationale for what is acceptable and, within this rationale, their actions make perfect sense at the time.[95] Still, it seems so unseemly to learn that, beyond surreptitiously spying on its own directors, Hewlett-Packard's investigators also searched through the trash of a reporter, videotaped her, and conducted surveillance of her to see if she met with a Hewlett-Packard director.[96]

Others, as expressed by Dunn herself, may also believe that tighter financial regulations, represented through Sarbanes-Oxley,[97] divert too much attention from day-to-day governance.[98] Dunn asserts that in the Silicon Valley's

> culture of innovation, [where] freedom of maneuver and creativity are seen as essential to value creation[,] [t]he machinery required to implement [Sarbanes-Oxley] in the boardroom can be seen as cumbersome, time-wasting and a drag on directors' desires to focus on the truly interesting and valuable parts of their roles—for example, business and product strategy.[99]

It also must not be forgotten that the events that gave rise to the Hewlett-Packard investigations were the leaking to the press of confidential, non-public information by, it turns out, one of the members of the company's board of directors. One of the fundamental fiduciary duties of corporate directors is to not disclose confidential information.[100] Further, once the director was confronted with the evidence from the investigation and admitted culpability, he refused to resign from the board.[101]

Tellingly, Dunn also believes that "[t]he fact that the rules applied to everyone was not accepted by everyone on the HP Board."[102] Yet, Hewlett-Packard's own corporate governance objectives state that "HP is committed to maintaining the highest standards of business conduct and corporate governance, which we believe are essential to running our business efficiently, serving our stockholders well and maintaining HP's integrity in the marketplace."[103]

Primarily as a result of the pretexting scandal, it has become painfully, and publicly, obvious that there is a substantial disconnect between what Hewlett-Packard says and the actions of its board. Dunn supposedly never particularly wanted to be Hewlett-Packard's chairman, and was asked to assume the role because the board was so badly divided.[104] Board members Keyworth and Perkins allegedly criticized Dunn and sought her ouster as chairman,[105] as well as allegedly colluded to oust former CEO Carly Fiorina.[106] Perkins, more than once, was reported to have poked Dunn in the clavicle with his finger to emphasize his point at the time, leading another board member to refer to Perkins' conduct as "chairman abuse."[107]

After their resignations from the Hewlett-Packard board, both Dunn and Perkins engaged in a public debate, criticizing each other's conduct on the board. Dunn, through her lawyer, accused Perkins of making false accusations against her—of "'rewriting history ….'"[108] Perkins wrote an op-ed piece for the *Wall Street Journal*, lamenting the "compliance" board represented by the likes of Dunn.[109] Dunn and Perkins disagreed on the fundamental roles of members of the board—and did so publicly. Perkins was the chair of the Nominating and Governance Committee, yet when Dunn would try to raise governance issues (such as inconsistencies between the company's by-laws and the directors' handbook), Perkins would become frustrated, emphasizing that time should be spent on strategy.[110] Dunn is quoted as saying, "All you need to do is say the words, 'corporate governance' and Tom [Perkins] sees red."[111] Perkins has stated that, in his opinion, the pretexting scandal was "a red herring. I see this embarrassing public mess as actually the culmination of a war for control of the board …" of Hewlett-Packard.[112] Perkins describes the attempted combination of a "Guidance board, with its focus on technical strategy, marketing, and so forth [represented by Perkins], and the Compliance board, with its focus on legal issues [represented by Dunn] …" as a failed experiment at Hewlett-Packard.[113] Perkins appears to believe that a "compliance" board is necessary (primarily because of Sarbanes-Oxley), but that ultimately, the board must be more concerned with business strategy than legal compliance. "[W]hen the going gets tough—and it always does at some point—the CEO will wish that he had a board in place to help guide the company and the CEO over the rough patches."[114]

The Hewlett-Packard scandal raises three issues associated with board conduct: leaking confidential information to help shape corporate strategy;[115] spying on board members; and emphasizing performance over compliance. None of these activities involved personal gain on the part of any of the participants. Therefore, what legal standards apply? Tangentially, the answer comes from the Delaware Supreme Court (since Hewlett-Packard is a Delaware corporation),[116] primarily from recent Walt Disney Company derivative litigation.

The Walt Disney Company and Executive Compensation

The Walt Disney Company is a venerable icon in American culture. Beginning with Walt Disney's Mickey Mouse cartoons and full-length animated movies such as *Snow White and the Seven Dwarfs*, the Walt Disney Company grew into an entertainment conglomerate, including a movie studio, broadcast and cable television stations, retail stores, and vacation resorts and theme parks around the world.[117]

From 1984 to 2004, Disney was run by Michael Eisner, its CEO and Chairman of the Board of Directors. (Eisner resigned as Chairman in 2004 and resigned as CEO in 2005.) In the first ten years of his reign, Eisner's "right hand man" was Disney's President, Frank Wells. Unfortunately, Wells died in a helicopter crash in 1994. Three months after Wells' untimely death, Eisner underwent triple bypass surgery. By the close of 1994, Eisner and Disney's Board of Directors knew they needed to bring in someone who could not only assist Eisner in running Disney, but who also could someday succeed Eisner as CEO.

Eisner believed Michael Ovitz was that person. Ovitz was a co-founder of Creative Artist Agency, the premier talent agency in Hollywood at that time. CAA represented Hollywood's top actors, directors, and screenwriters.[118] In 1995, Michael Ovitz was considered the most powerful person in Hollywood. And Ovitz was beginning to believe that his next best career move would be to run a movie studio. Eisner, who had known Ovitz socially and professionally for over 25 years, was concerned with the possibility of having Ovitz as a competitor: "I couldn't do business with him. He was too tough, so I thought he would be better on our side."

Eisner was successful in recruiting Ovitz to leave CAA and join Disney. But Ovitz would be giving up a lot. CAA was generating about $150 million per year in revenues and Ovitz himself was earning $20 - $25 million per year. Ovitz wanted "upside participation" – to be compensated for leaving a lucrative business he controlled – and he wanted "downside protection" – in case things did not work out at Disney.

Initially, Ovitz wanted a $50 million signing bonus for joining Disney, but this was refused based on Disney's long-standing policy of not paying signing bonuses. Ultimately, Ovitz negotiated a five year employment agreement with Eisner and two members of Disney's Board of Directors' Compensation Committee that contained the following basic terms: $1 million annual salary; potential for a $7.5 million annual performance bonus; 3 million Disney share options (vesting in years 3, 4, and 5);[119] the option to renew the contract for an additional two years, which would include an additional 2 million

(immediately vesting) Disney share options; and if Ovitz quit during the first five years, he would forfeit any stock options not yet vested and he would not work for a competing movie studio.

A compensation expert estimated the total value of Ovitz's original 5-year contract to be $115 million. If Ovitz renewed the contract for the additional two years, the total value for the seven years was estimated at $168 million. That was the "upside participation" Ovitz negotiated.

The "downside protection" Ovitz negotiated was a "no fault termination" (NFT) clause in the contract. If, during the initial 5-year contract, Ovitz was fired for any reason other than gross negligence or malfeasance, he would receive: his remaining salary under the 5-year contract; $7.5 million per year for unaccrued bonuses under the 5-year contact; immediate vesting of all of the 3 million share options under the original 5-year contract; and $10 million cash in lieu of the share options under the 2-year renewal option.

Eisner and Ovitz began their initial negotiations in July, 1995 and had orally reached a deal by August 12, 1995. On August 14, 1995, Eisner and Ovitz signed a letter agreement outlining the basic terms of Ovitz's employment contract with Disney. Eisner then contacted each member of Disney's board to inform them of the deal, which was announced to the public later that same day—and Disney's stock rose 4.4%, adding $1 billion to the company's capitalization.

On September 26, 1995, the Disney's Board of Directors' Compensation Committee met for one hour to discuss five issues, one of which was Ovitz's contract. The Compensation Committee reviewed the letter agreement Eisner and Ovitz had signed, not Ovitz's final contract. The Committee unanimously approved the terms described in the letter agreement "subject to further reasonable negotiations." Immediately thereafter, Disney's full board met. Eisner explained what Ovitz's role would be with Disney and the board unanimously elected Ovitz as President of Disney and nominated him to the Disney board.

On October 1, 1995, Ovitz assumed his role as Disney's President. On October 16, 1995, the Compensation Committee approved Ovitz's employment agreement. The Committee also priced Ovitz's stock options at that day's stock price.

At the end of 1995, Eisner was optimistic: "1996 is going to be a great year. We are going to be a great team. We will be strong, smart, and unstoppable!!!"

However, even before Ovitz joined Disney, there were ominous warning signs of trouble to come:

- Initially Eisner and Ovitz discussed Ovitz's role at Disney as co-CEO with Eisner, but the final offer made to Ovitz reduced his role to President.
- Before the final contract was signed, two executives (Disney's CFO and its General Counsel) refused to report to Ovitz instead of Eisner—diminishing Ovitz's authority within Disney. Indeed, these executives were described as being overtly hostile to Ovitz.[120]
- The head of the Compensation Committee believed Ovitz's compensation was "extraordinary."
- Disney's outside compensation expert believed Ovitz's contract gave him the best of both worlds—low risk and high return. This opinion was not shared with the rest of Disney's board.
- Upon Ovitz accepting Eisner's offer to join Disney's, Eisner is reported to have stated, "I think I just made the biggest mistake of my career. Can I take it back?"[121]
- Shortly thereafter, Ovitz came to a similar conclusion, reportedly telling his wife, "I just made the biggest mistake of my career."[122]

By January, 1996, Eisner was beginning to have more serious second thoughts. Ovitz was considered to have acted "elitist" at an executive retreat—insisting on taking a limousine while the rest of the executives traveled together in shuttle buses. Ovitz quickly upset a number of Disney executives by appearing to pursue projects within their purview without their knowledge, consent, or participation.[123] Part of the problem seemed to be that Ovitz was trying to do too much, too soon, without recognizing formal corporate structures.[124] By the summer of 1996, Eisner decided Ovitz was a bad fit for Disney and was performing poorly, and Eisner was speaking to several Disney directors about Ovitz's failure to adapt to the Disney culture.

During the summer of 1996, Eisner tried to find a way to get rid of Ovitz. First, he tried to get Ovitz to resign, but Ovitz refused. Eisner then tried to "trade" Ovitz to Sony—having Sony buy out Ovitz's Disney contract as part of a larger deal Disney and Sony were trying to negotiate. Eisner also tried to find any reason to fire Ovitz based on gross negligence or malfeasance, but was unable to do so.

According to Eisner and Disney board members, Ovitz's specific failures included: failure to follow Eisner's directives and generally doing very little work; failing to transition from a smaller private company to a large public company—he could not adapt to the corporate culture; not being trusted—he was always "agenting" (putting a spin on the facts); and having trouble complying with Disney's policies relating to gifts and expenses.[125] In his defense, Ovitz claimed that any failures were due to Eisner's micromanaging and not being given enough time for his (Ovitz's) efforts to bear fruit.

In September, 1996, Eisner sent a letter to two of Disney's board members, stating, in part:

> If I should be hit by a truck, the company simply cannot make Ovitz CEO or leave him as president with a figurehead CEO. It would be catastrophic. I hate saying it, but his strength of personality together with his erratic behavior and pathological problems, and I hate saying that, is a mixture leading to disaster for this company.

By the fall of 1996, the Disney directors were convinced Ovitz would have to be terminated. Yet, at a November 25, 1996 board of directors meeting, the only mention of Ovitz in the official minutes of the meeting was the board's unanimous renomination of Ovitz to a new 3-year term on the board. And on December 10, 1996, the Disney Board of Directors' Executive Performance Plan Committee met to consider annual bonuses for Disney's top executives—voting to award Ovitz his $7.5 million bonus.

Two days later, Eisner publicly announced Ovitz would be leaving Disney "by mutual agreement." On December 20, 1996, the Executive Performance Plan Committee met again, this time to rescind Ovitz's bonus. On December 27, 1996, Eisner officially dismissed Ovitz as of January 31, 1997. By dismissing Ovitz without cause, Eisner approved the NFT severance provided in Ovitz's employment agreement: $38 million in cash and the immediate vesting of 3 million Disney share options (valued at approximately $91.5 million). As a result, Ovitz received a severance valued at $129.5 million for his 16 months a Disney—during which time he was reportedly a "disaster" as a corporate executive. At this point, the Disney board had never formally met to discuss Ovitz's termination, though the termination was explained to the board by Eisner at a January 27, 1997 board meeting.

A number of Disney shareholders later filed a derivative lawsuit, accusing the Disney board of directors of breach of their fiduciary duties and violation of the business judgment rule for: approving Ovitz's employment agreement, particularly with the NFT provisions; and approving the NFT severance payment upon Ovitz's termination.

Duty of Care in Delaware

After a trial lasting thirty-seven days over nearly three months, the Delaware Court of Chancery determined that "'the director defendants did not breach their fiduciary duties or commit waste[,]'" and entered judgment in favor of all the defendants on all the claims.[126] In upholding the Court of Chancery's ruling, the Delaware Supreme Court held that the "Chancellor's factual findings and legal rulings were correct and not erroneous in any respect."[127]

As explained by the Delaware Supreme Court, the plaintiff-appellants' claims against the Disney directors were based on breaches of the fiduciary duties to act with due care and in good faith—depriving the Disney defendants of the protection of the business judgment rule. Alternatively, the appellants asserted that if the business judgment rule did protect the Disney defendants they nonetheless were liable for committing corporate waste.[128]

In Delaware, the business judgment rule is a 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.'"[129] The presumption can be rebutted by a showing that the directors breached their fiduciary duty of care, or of loyalty, or acted in bad faith (at which point the burden shifts to the defendants to demonstrate that the challenged act was entirely fair to the corporation and its shareholders).[130] The Delaware Supreme Court noted that while Disney's corporate charter made the board responsible for selecting the corporation's officers, it also properly delegated responsibility to the compensation committee to establish and approve "the salaries, together with benefits and stock options, of the Company's CEO and President."[131] The court noted that this was exactly what happened: "The full board ultimately selected Ovitz as President, and the compensation committee considered and ultimately approved the OEA [Ovitz's employment agreement], which embodied the terms of Ovitz's employment, including his compensation."[132]

The plaintiff-appellants then claimed that the compensation committee had failed to exercise proper care in approving Ovitz's employment agreement, which contained the NFT. Specifically, "that the compensation committee approved the OEA with NFT provisions that could potentially result in an enormous payout, without informing themselves of what the full magnitude of that payout could be."[133] The Delaware Supreme Court agreed with the Court of Chancery that the compensation committee failed follow a best practices scenario, but that it had sufficiently informed itself of the potential magnitude of NFT payout.[134]

The Delaware Supreme Court then addressed the concept of good faith, a duty that is "relatively unchartered."[135] The court identified three categories of fiduciary conduct, all of which involve some form of bad faith conduct. The first category, "subjective bad faith" (fiduciary conduct motivated by an actual intent to do harm), is, the court believed, clearly a violation of the duty of good faith.[136]

The second category identified by the court involves lack of due care—"fiduciary action taken solely by reason of gross negligence and without any malevolent intent."[137] While the Delaware Supreme Court acknowledged that the duties of care and loyalty are closely intertwined and occasionally overlap, it nevertheless concluded that "grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith."[138] In other words, a violation of the duty of care is not automatically an act or omission "not in good faith."

The third category involves intentional dereliction of duty, a conscious disregard for one's responsibilities.[139] This involves cases where

> corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty … but is qualitatively more culpable than gross negligence, should be proscribed.[140]

The Delaware Supreme Court declined to articulate a definitive definition of this category of bad faith,[141] and, instead, upheld the Court of Chancery's definition:

> Upon long and careful consideration, I am of the opinion that the concept of *intentional dereliction of duty*, a *conscious disregard for one's responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction *in the face of a duty to act* is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.[142]

Once the court had dealt with the issue of the potential for the board's liability in allowing Ovitz to be hired under the provisions of his employment agreement, the court next turned to whether the board was liable due to the NFT severance payment paid to Ovitz upon his termination. Here, the Delaware Supreme Court agreed with the Court of Chancery that Disney's charter properly gave Eisner the authority of terminate Ovitz—without the board's prior approval.[143] In addition, the Delaware Supreme Court agreed with the Court of Chancery that the evidence supported Eisner's decision that, once it was determined Ovitz must be terminated, the termination would be without cause.[144] In summary, the Delaware Supreme Court ruled "the Court of Chancery correctly determined that the decisions of the Disney defendants to approve the OEA, to hire Ovitz as President, and then to terminate him on an NFT basis, were protected business judgments, made without any violations of fiduciary duty."[145]

The plaintiff-appellants' final claim was that even if the approval of the OEA was protected by the business judgment rule, the payment of the NFT severance amount to Ovitz constituted corporate waste.[146] The standards to recover under a theory of corporate waste are very high. The plaintiffs must prove that the exchange giving rise to the waste is "'so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.'"[147] "A claim of waste will arise only in the *rare*, 'unconscionable case where directors irrationally squander or give away corporate assets.'"[148] The court rejected the corporate waste claim, noting that "the NFT provisions in the OEA had a rational business purpose: to induce Ovitz to leave CAA, at what would otherwise be a considerable cost to him, in order to join Disney."[149]

Conclusion

Based on the Delaware Supreme Court's ruling in the *Walt Disney Derivative Litigation*, where there is no direct financial gain, board members will not be legally culpable for bad behavior unless that behavior: is motivated by an actual intent to do harm; is grossly negligent; or involves a conscious disregard for one's responsibility (which is beyond simple inattention or failure to be informed of all material facts). One can see that under such strict measures, board members will probably not be considered to have breached their fiduciary duties to shareholders, even when they have invaded the privacy of other directors by spying on them, or have allowed a severance package paying a failed executive nearly $130 million for 16 months of sub-par performance.

Within the board of directors of Hewlett-Packard, there was obviously a disconnect between adoption and implementation of corporate governance standards. The Hewlett-Packard scandal may come to represent a striking example of a board of directors that only gives lip service to corporate governance and its fiduciary duties. At the same time, its board may also represent a struggle for control of the corporation's soul, between "guidance" directors (focused on strategy) and "compliance" directors (focused on rules of conduct). As for Disney, its "Ovitz" episode represents a compliant board,[150] generally approving—after the fact—decisions made solely by its CEO, regardless of how costly to the corporation.

The fundamental issue is what degree of bad behavior will be permitted from a board of directors? The answer appears to simply be as much as shareholders are willing to tolerate. As the Delaware Supreme Court pointed out (agreeing with the Delaware Court of Chancery), Disney's board's conduct was well short of "best practices." But that is not the standard required: "Delaware law does not—indeed, the common law cannot—hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices."[151] When bad decisions are made but the directors' conduct falls short of the bad faith standards expressed by the Delaware courts, redress "must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court."[152]

Footnotes

---

* J.D., MBA, Assistant Professor, Department of Management & Marketing, University of Wyoming College of Business. The author wishes to thank Stephen P. Smith, J.D., University of Wyoming College of Law, 2008, for his excellent assistance in performing research for this paper. Portions of this paper relating to Hewlett-Packard's pretexting scandal are published in the 2007 MBAA/MALSB conference proceedings.

[1] *See, e.g.*, Floyd Norris, *Tyco to Pay $3 Billion in Settlement*, N.Y. TIMES, May 16, 2007, at C1.

[2] Pub.L. 107-204, Title III, § 302, July 30, 2002, 116 Stat. 777, codified at 15 U.S.C. § 7241 (2007).

[3] Pub.L. 107-204, Title IV, § 402(a), July 30, 2002, 116 Stat. 771, codified at 15 U.S.C. § 78m(k) (2007).

[4] Pub.L. 107-204, Title IV, § 404, July 30, 2002, 116 Stat. 789, codified at 15 U.S.C. § 7262 (2007).

[5] Pub.L. 107-204, Title IV, § 409, July 30, 2002, 116 Stat. 771, codified at 15 U.S.C. § 78m(l) (2007). *See infra*, notes 29-31 and accompanying text for an example of the application of this particular provision.

[6] *See Options Scorecard*, WALL ST. J. ONLINE, *at* http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html.

[7] *See* Charles Forelle & James Bandler, *The Perfect Payday: Some CEOs Reap Millions by Landing Stock Options When They are Most Valuable. Luck—or Something Else?*, WALL ST. J. ONLINE, Mar. 18, 2006, *at* http://online.wsj.com/article/SB114265075068802118.html?mod=2_1227_2.

[8] *See Options Scorecard*, *supra* note 6.

[9] William Hewlett and David Packard began working together in a small garage in Palo Alto, California in 1939. DAVID PACKARD, THE HP WAY: HOW BILL HEWLETT AND I BUILT OUR COMPANY 35 (David Kirby & Karen Lewis eds., HarperBusiness 1995). In 1989, the State of California designated the garage as a California Historical Landmark and "the birthplace of Silicon Valley." *Id*. Hewlett-Packard may be also be referred to as "HP" or "H-P" by various sources cited herein.

[10] *See, e.g.*, Michael A. Perino, *Enron's Legislative Aftermath: Some Reflections On the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 ST. JOHN'S L. REV. 671, 672 (2002) (noting that the primary focus of the Sarbanes-Oxley Act is to deter securities fraud).

[11] *See Hewlett-Packard's Pretexting Scandal: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce*, 109th Cong. 1-2 (2006) (submission of Patricia C. Dunn) *at* http://energycommerce.house.gov/reparchives/108/Hearings/09282006hearing2042/Dunn.pdf.

[12] So named supposedly because Dunn was vacationing in her home in Kona, Hawaii, when the investigation was initiated. *See* ALAN MURRAY, REVOLT IN THE BOARDROOM 141 (2007).

[13] *See* Declaration in Support of Felony Complaint and Arrest Warrant, People of the State of California v. Patricia C. Dunn, et al., Cal. Sup. Ct., Oct. 4, 2006, at 3-4, and n.2, *at* http://ag.ca.gov/newsalerts/cms06/06-087_0b.pdf.

[14] *See id*. Dunn was made aware of DeLia and his company through a Hewlett-Packard employee responsible for the company's global security. *See* Submission of Patricia C. Dunn, *supra* note 11, at 8-9.

[15] *See* Declaration in Support of Felony Complaint and Arrest Warrant, *supra* note 13, at 4.

[16] *See id.* at 4. Pretexting involves gaining access to customer records—in the case of telephone records, the telephone numbers of calls made to and from the account, along with date, time, and duration of the calls (not the content of the calls themselves). *See infra*, text accompanying notes 36-57 for a more detailed discussion of pretexting.

[17] *See* Submission of Patricia C. Dunn, *supra* note 11, at 15.

[18] *See id*. at 16-17 *See also* Declaration in Support of Felony Complaint and Arrest Warrant, *supra* note 13, at 4.

[19] *See* Submission of Patricia C. Dunn, *supra* note 11, at 17-18. Ironically, Hunsaker has also been identified as Hewlett-Packard's ethics director. *See, e.g.*, Charles Babington, *Charges Dropped Against HP's Dunn*, WASH. POST, March 15, 2007, at D1.

[20] *See* Declaration in Support of Felony Complaint and Arrest Warrant, *supra* note 13, at 5.

[21] *Id*.

[22] *Id*.

[23] *See id*. at 6.

[24] *See id*. at 5. For example, board member Tom Perkins, upon his inquiry to AT&T, received confirmation that someone, using Perkins' telephone number and the last four digits of his social security number, had opened online accounts and reviewed his billing records for December 2005 and January 2006. *See* Murray, *supra* note 12, at 151-52.

[25] *See* Declaration in Support of Felony Complaint and Arrest Warrant, *supra* note 13, at 6.

[26] *See* Submission of Patricia C. Dunn, *supra* note 11, at 19. The pretexting revealed that Keyworth had had contact with the reporter who published the leaked information. *See id*. at 20.

[27] *See id*. at 24. Perkins was allegedly upset that Dunn planned to reveal the results of the investigation to the entire board rather than handle the matter in confidence with the Nominating and Governance Committee, of which Perkins was the chair. *See* Murray, *supra* note 12, at 145. Perkins is quoted as saying, "'Pattie, you betrayed me. You and I had an agreement we would handle this offline without disclosing the name of the leaker.'" *Id*. at 146.

[28] *See* Submission of Patricia C. Dunn, *supra* note 11, at 26.

[29] Form 8-K (Report of unscheduled material events or corporate changes), Hewlett Packard Co., Sept. 6, 2006, 2, *at* http://ccbn.10kwizard.com/xml/download.php?repo=tenk&ipage=4372176&format=PDF.

[30] *Id*. at 3.

[31] *Id*. Hewlett-Packard also disclosed in its Form 8-K filing that the board would not be nominating Keyworth for another term on the board. *Id*. The SEC subsequently found that Hewlett-Packard did not disclose the reasons for Perkins' resignation through a Form 8-K in a timely manner, entering a settlement agreement with Hewlett-Packard to "cease and desist from committing or causing any violations and any future violations" of the Form 8-K requirements. In the Matter of Hewlett-Packard Company, Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-

Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934, Securities and Exchange Commission, Administrative Proceeding File No. 3-12643, May 23, 2007, *at* http://www.sec.gov/litigation/admin/2007/34-55801.pdf.

[32] *See* Submission of Patricia C. Dunn, *supra* note 11, at 28. *See also Who's Who in the H-P Controversy*, WALL ST. J. ONLINE, *at* http://online.wsj.com/public/resources/documents/info-hpboard0609-08.html.

[33] *See id*.

[34] People of the State of California v. Patria C. Dunn, et al., Cal. Sup. Ct., Oct. 4, 2006, *at* http://ag.ca.gov/newsalerts/cms06/06-087_0a.pdf.

[35] Christopher Lawton, *H-P Settles Civil Charges in "Pretexting" Scandal*, WALL ST. J., Dec. 8, 2006, at A3. Final Judgment and Permanent Injunction *at* http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/hp/cahp120706civjdgmnt.pdf.

[36] Declaration in Support of Felony Complaint and Arrest Warrant, *supra* note 13, at 2-3.

[37] *See id*. at 3. Another method is known as "dialing for dummies"

> and basically amounts to a kind of craps shoot in which the pretexter phones up Customer Service "800 numbers" of telephone companies over and over again, trying one ruse after the next until he or she finally connects with a service rep gullible enough to swallow the bait and provide the information being sought.

Internet Data Brokers and Pretexting: Who Has Access to Your Private Records?: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce, 109th Cong. (2006) (testimony of Christopher Byron) *at* http://energycommerce.house.gov/reparchives/108/Hearings/09292006hearing2047/Byron.pdf (reporter recounting his experience as the victim of pretexting, though not related to the Hewlett-Packard investigations). For a reporter's perspective as a target of Hewlett-Packard's investigation, *see* Pui-Wing Tam, *A Reporter's Story: How H-P Kept Tabs on Me for a Year*, WALL ST. J., Oct. 19, 2006, at A1.

[38] *See supra*, text accompanying note 21.

[39] *See* Matt Richtel, *With a Little Stealth, Just About Anyone Can Get Phone Records*, N.Y. TIMES, Sept. 7, 2006, at C9 (describing pretexting as a commonly used privacy hole; not specifically related to the Hewlett-Packard scandal).

[40] *See Internet Data Brokers and Pretexting: Who Has Access to Your Private Records?: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce*, 109th Cong. (2006) (written statement of Kris Anne Monteith, Chief, Enforcement Bureau, Federal Communications Commission) *at* http://energycommerce.house.gov/reparchives/108/Hearings/09292006hearing2047/Monteith.pdf.

[41] *Id*. (noting also the FCC had "seen some limited instance of employee misconduct—that is, employees of telecommunications carriers who illegally share this information with data brokers in exchange for a fee.").

[42] *See Internet Data Brokers and Pretexting: Who Has Access to Your Private Records?: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce*, 109th Cong. (2006) (prepared statement of the Federal Trade Commission) *at* http://energycommerce.house.gov/reparchives/108/Hearings/ 09292006hearing2047/Winston.pdf.

[43] *Id*. at 4.

[44] *See* Richtel, *supra* note 39. Though the FTC cites anecdotal evidence of more sinister purposes: suspected mobsters obtaining the home phone numbers and addresses of Los Angeles Police Department detectives to use the information to intimidate the police officers and their families. *See* Prepared Statement of the Federal Trade Commission, *supra* note 42, at 4 n.10.

[45] H.R. REP. NO. 109-395, at 3 (2006) (footnote omitted).

[46] Since 1999, it has been illegal to use pretexting to obtain financial information. Part of the Gramm-Leach-Bliley Act prohibits obtaining customer information of a financial institution by false pretenses. Pub.L. 106-102, Title V, § 521, Nov. 12, 1999, 113 Stat. 1446, codified at 15 U.S.C. § 6821 (2007).

[47] 15 U.S.C. § 45(a)(2) (2007).

[48] *See* Prepared Statement of the Federal Trade Commission, *supra* note 42, at 3, 6-7.

[49] H.R. 4709, 109th Cong., Pub.L. 109-476, Jan. 12, 2007, codified at 18 U.S.C. § 1039 (2007).

[50] *See Bush Signs Legislation to Punish Fraudulent Acquisition of Call Data*, 75 U.S. L. WK. 2431 (Jan. 23, 2007).

[51] H.R. REP. NO. 109-395, at 5 (2006).

[52] 18 U.S.C. § 1039(a) (2007).

[53] 18 U.S.C. §§ 1039(b) & (c) (2007).

[54] H.R. REP. NO. 109-395, at 5-6 (2006).

[55] 18 U.S.C. §§ 1039(a), (b), & (c) (2007). The Act also provides for enhanced penalties, additional fines and/or imprisonment for an additional 5 years, for anyone violating the Act with the knowledge that the information will be used in furtherance of certain offenses or crimes of violence. 18 U.S.C. § 1039(e).

[56] *See* Ryan Singel, *MPAA Kills Anti-Pretexting Bill*, WIRED NEWS, Dec. 1, 2006, *at* http://www.wired.com/news/technology/0,72214-0.html.

[57] *See* http://info.sen.ca.gov/pub/05-06/bill/sen/sb_0201-0250/sb_202_bill_20060929_chaptered.html.

[58] Hewlett-Packard's headquarters are located in California.

[59] Cal.Penal Code § 538.5 (West Ann. 2006).

[60] Cal.Penal Code § 530.5(5) (West Ann. 2006).

[61] Cal.Penal Code § 502(c)(2) (West Ann. 2006).

[62] *See* People of the State of California v. Patricia C. Dunn, et al., *supra* note 34.

[63] *See* United States of America v. Bryan C. Wagner, CR-07-00016, Dist. Ct. N.D. Cal. (Jan. 10, 2007).

[64] *First Conviction in Hewlett Packard Pretexting Investigation* (press release of U.S. Dept. of Justice, Northern Dist. of Calif.), Jan. 12, 2007, *at* http://www.usdoj.gov/usao/can/press/2007/2007_01_12_Wagner.plea.press.html.

[65] *See* Babington, *supra* note 19.

[66] *See id*.

[67] *See id*. (quoting DeLia's attorney as stating that he was unaware of any federal investigation in the matter). *But see* Howard Mintz, *HP Still Could Face Federal Charges Although State Case Dissolved, Company Must Deal With Ongoing U.S. Attorney's Office Investigation*, CONTRA COSTA TIMES, March 17, 2007, at F4 (indicating that the U.S. Attorney's General Office was still investigating the matter).

[68] Michael J. Borden, *The Role of Financial Journalists in Corporate Governance*, 12 FORDHAM J. CORP. & FIN. L. 311, 360 (2007).

[69] *A Pre-Case for Pretexting*, S.F. CHRON., March 19, 2007, at B6.

[70] Damon Darlin, *Journalists Intend to Sue Hewlett-Packard Over Surveillance*, N.Y. TIMES, May 7, 2007, at C4.

[71] *See id*.

[72] *See* The 1199 SEIU Greater New York Pension Fund, et al. v. Patricia C. Dunn, et al., Consolidated Shareholder Derivative Complaint for Breach of Fiduciary Duties, Abuse of Control, Gross Mismanagement, Waste of Corporate Assets, Violations of the California Corporations Code, Misappropriation of Information and Unjust Enrichment, Case No. 1:06-cv-071186, Superior Court of the State of California, County of Santa Clara, Nov. 29, 2006, 2006 WL 3616991.

[73] Upjohn Co. v. United States, 449 U.S. 383, 392 (1981) (citations omitted).

[74] Michael P. Kenny & William R. Mitchelson, Jr., *Corporate Benefits of Properly Conducted Internal Investigations*, 11 GA. ST. U. L. REV. 657, 658 (1995).

[75] Thomas R. Mulroy & Eric J. Muñoz, *The Internal Corporate Investigation*, 1 DEPAUL BUS. & COMM. L. J. 49, 49 (2002).

[76] *Id*.

[77] *See* Theodore R. Lotchin, *No Good Deed Goes Unpunished? Establishing a Self-Evaluative Privilege for Corporate Internal Investigations*, 46 WM. & MARY L. REV. 1137, 1140 (2004).

[78] *See* Mulroy & Muñoz, *supra* note 75, at 51.

[79] Submission of Patricia C. Dunn, *supra* note 11, at 5.

[80] *See id*.

[81] *See* Packard, *supra* note 9, at 165.

[82] *See id*. at xi-xii.

[83] Jeswald W. Salacuse, *Corporate Governance in the New Century*, Comp. Law. 2004, 25(3), 69-83, 71, *referencing*, ADOLF BERLE, JR. & GARDNER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (New York: Macmillan, 1932).

[84] Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response To Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1762 (2006) (footnotes omitted).

[85] Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998).

[86] *See supra*, text accompanying notes 21 & 22.

[87] *See supra*, note 25 at accompanying text.

[88] *See* Patricia Dunn, *The H-P Investigation*, WALL ST. J., Oct. 11, 2006, at A14 (Commentary) (claiming that throughout the investigation she was assured the methods of the investigation were "legal, proper and consistent with the H-P way of performing investigations.").

[89] *See* John R. Emshwiller, *Hewlett-Packard Was Far From First to Try "Pretexting,"* WALL ST. J., Dec. 16, 2006, at A1.

[90] *See* Michael Orey, *Corporate Snoops*, BUS. WK., Oct. 9, 2006, at 45.

[91] *See Pretexting & the Law: Investigations and Privacy in a Post-HP World*, 2006 CORP. SECURITY, No. 12, Dec. 2006.

[92] *Id*. *See supra*, text accompanying notes 21 & 22.

[93] *Pretexting & the Law: Investigations and Privacy in a Post-HP World*, *supra* note 91.

[94] Kim Cameron, *Good or Not Bad: Standards and Ethics in Managing Change*, 5 ACAD. OF MGMT. LEARNING & EDUC., 317, 317 (2006) (writing specifically about individuals in industries recently plagued by scandals—energy-trading, telecommunications, financial services, and accounting).

[95] *See id*. at 317-18.

[96] *See* Tam, *supra* note 37.

[97] *See, e.g.*, *supra*, text accompanying notes 2-5.

[98] *See* Submission of Patricia C. Dunn, *supra* note 11, at 29.

[99] *Id*.

[100] *See* Paula J. Dalley, *To Whom It May Concern: Fiduciary Duties and Business Associations*, 26 DEL. J. CORP. L. 515, 520 (2001).

[101] *See* Submission of Patricia C. Dunn, *supra* note 11, at 21-25.

[102] *Id*. at 29.

[103] H-P Investor Relations-Highlights, *at* http://h30261.www3.hp.com/phoenix.zhtml?c=71087&p=irol-govhighlights.

[104] *See* Murray, *supra* note 12, at 131.

[105] *See id*. at 131-32.

[106] *See* Michelle Quinn & Therese Poletti, *Fiorina Dishes the Dirt on HP Board*, MERCURY NEWS, Oct. 6, 2006, at http://www.mercurynews.com.

[107] *See* Murray, *supra* note 12, at 132.

[108] Ryan Blitstein, *Dunn's Lawyer Blasts Perkins*, MERCURY NEWS, Mar. 1, 2007, at http://www.mercurynews.com.

[109] *See* Tom Perkins, *The "Compliance" Board*, WALL ST. J., Mar. 2, 2007, at A11.

[110] *See* James B. Stewart, *The Kona Files*, THE NEW YORKER, Feb. 19 & 26, 2007, at 152, 157.

[111] *Id*.

[112] Perkins, *supra* note 109.

[113] *Id*.

[114] *Id*. (paraphrasing Jack Welch). The implication is that the "rough patch" relates to company performance rather than a compliance or legal issue. To further emphasize this dichotomy, it is reported that what ultimately led to the Hewlett-Packard board requesting the resignation of Carly Fiorina is that she wanted to address the first leak, since it revealed confidential strategy, before addressing the board's perceived failure of Fiorina to execute that strategy. *See* Murray, *supra* note 12, at 55.

[115] The first leak of confidential information involved detailed information regarding the board's dissatisfaction with then-CEO Carly Fiorina's performance. *See* Murray, *supra* note 12, at 54-56.

[116] *See* Amended and Restated Bylaws of Hewlett-Packard Company (A Delaware Corporation), May 17, 2007, at http://media.corporate-ir.net/media_files/irol/71/71087/May07/BylawsMay07.pdf.

[117] Except as otherwise noted through footnotes, the information contained in this section is summarized from In re The Walt Disney Company Derivative Litigation, 907 A.2d 693, 699-740 (Del. Ch. 2005).

[118] CAA's strength was its ability to package talent for a movie. For example, CAA represented the screenwriter for *Rain Man*, which won the 1989 Academy Award for Best Picture. To get the movie made, CAA packaged the screenwriter with other CAA talent: Dustin Hoffman, Tom Cruise, and director Barry Levinson.

[119] Many corporate executives are given the option to purchase shares of the company's stock as part of their compensation package. The shares are priced on a particular date and the executives must usually wait a few years before being able to buy the shares at that price. The date at which the executives are allowed to buy the shares is the date they "vest." In theory, the price of the shares will be lower than the market value of the shares when they vest. For example, if the shares are priced at $35 per share and their market value is $45 per share when they vest, an executive realizes an immediate gain upon vesting of $10 per share.

[120] JAMES B. STEWART, DISNEYWAR 226 (2005).

[121] *Id*. at 214.

[122] *Id*. at 218.

[123] *See, e.g.*, *id*. at 220-21, relating how Ovitz upset Joe Roth, Disney's head of its TV studios, by trying to negotiate a deal with a TV producer. "It's taken exactly six hours for my fears to be realized," Roth is quoted as telling Eisner regarding Ovitz's conduct. *Id*. at 221.

[124] Eisner is reported to have told Ovitz within a few days of his arrival:

> You've got to slow down and take a deep breath. You need to learn to walk before you can run. There's no need to do everything at once, and there's no reason for us to make deals that create headlines, only to have them come back to haunt us later.

Id.

[125] Ovitz was in the habit of giving gifts to entertainers and hosting lavish parties. *See, e.g.*, *id*. at 234-35 (relating Ovitz giving the Actor Tim Allen a $1,500 print by artist Roy Lichtenstein and unsuccessfully seeking reimbursement from Disney, after Ovitz had helped convince Allen to return to the set of his television show "Home Improvement" after Allen had walked off the set over various grievances), and at 223-24 (relating Ovitz hosting a party celebrating his contract with Disney, then submitting the $90,000 cost to Disney for reimbursement).

[126] In re The Walt Disney Company Derivative Litigation, 906 A.2d 27, 35 (Del. 2006).

[127] *Id*.

[128] *Id*. at 46-47. The derivative action also included claims against Ovitz, in his capacity as an officer and director of Disney, claiming he breached his duty of loyalty to the company by: negotiating for and accepting the NFT provisions of his employment agreement; and negotiating a full NFT payout in connection with his termination. As to the claim that Ovitz breached his fiduciary duty to Disney by negotiating and entering into his employment agreement, the Delaware Supreme Court upheld the Court of Chancery's conclusion that Ovitz owed no duty to Disney at that time because he was not yet an officer or director of Disney. *Id*. at 47-49. The Delaware Supreme Court also upheld the Court of Chancery's ruling that Ovitz did not breach his fiduciary duties when he accepted the NFT because (1) he played no part in the decision to terminate him and (2) the termination was without cause (which triggered the NFT). Put another way, Ovitz did not leave Disney voluntarily, nor did he arrange with Eisner to structure his departure as a termination without cause. *Id*. at 49-51.

[129] *Id*. at 52, *quoting* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[130] *See id*. In the Disney derivative litigation, the plaintiff-appellants did not allege a breach of the duty of loyalty (except as to Ovitz alone—*see supra*, note 128; therefore the business judgment rule presumption could only be rebutted by evidence of the board breaching its duty of care or by not acting in good faith. *See In re The Walt Disney Company Derivative Litigation*, 906 A.2d at 52.

[131] *Id*. at 53 (footnote omitted).

[132] *Id*. at 53-54 (footnote omitted).

[133] *Id*. at 56.

[134] *Id*. at 58. The Delaware Supreme Court did describe what it considered would have been a "best practices" scenario for Disney's compensation committee:

> all committee members would have received, before or at the committee's first meeting …, a spreadsheet or similar document prepared by (or with the assistance of) a compensation expert …. Making different, alternative assumptions, the spreadsheet would disclose the amounts that Ovitz could receive under the OEA in each circumstance that might foreseeably arise. One variable in that matrix of possibilities would be the cost to Disney of a non-fault termination for each of the five years of the initial term of the OEA. The contents of the spreadsheet would be explained to the committee members, either by the expert who prepared it or by a fellow committee member similarly knowledgeable about the subject. That spreadsheet, which ultimately would become an exhibit to the minutes of the compensation committee meeting, would form the basis of the committee's deliberations and decision.

Id. at 56.

[135] *Id*. at 64.

[136] *See id*.

[137] *Id*.

[138] *Id*. at 65.

[139] *See id*. at 66.

[140] *Id*.

[141] *See id*. at 67.

[142] *In re The Walt Disney Company Derivative Litigation*, 907 A.2d at 755 (footnotes omitted; emphasis in original).

[143] *See In re The Walt Disney Company Derivative Litigation*, 906 A.2d at 68. Although the board, including the compensation committee, had the authority to terminate Ovitz, it was not required to exercise that authority. *See id*.

[144] *See id*. at 70-73.

[145] *Id*. at 73.

[146] *See id*.

[147] *Id*. at 74, *quoting* Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000).

[148] *Id*., *quoting Brehm, id.* (emphasis added).

[149] *Id*. (footnote omitted).

[150] It is reported that when Eisner and Ovitz were first discussing Ovitz joining Disney, Ovitz expressed concern as to whether Disney's board would approve him. Eisner reportedly laughed at the notion, assuring Ovitz that Disney's board would do whatever Eisner wanted. *See* Stewart, *supra* note 120, at 173.

[151] *In re The Walt Disney Company Derivative Litigation*, 907 A.2d at 697.

[152] *Id*. at 698.