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The Entire Fairness of Paying a Bonus to Yourself

PLUS A DELAWARE COURT'S PRONOUNCEMENTS ON DEAL PROTECTION DEVICES, BANKERS FEES AND APPRAISAL RIGHTS

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In this month's issue of Snell & Wilmer's *Corporate Communicator,* we discuss two recent rulings by Delaware courts that cover topics of interest to both public and private companies.

Interested Director Transactions

In *Valeant Pharmaceuticals International v. Jerney,* decided on March 1, 2007, the Delaware Court of Chancery issued a post-trial opinion in a case involving claims asserted against a director arising out of a board of directors' decision to pay the board members and certain other executives and employees large cash bonuses in connection with a corporate restructuring. The court's decision began with an analysis of Section 144 of the Delaware General Corporation Law, which provides three safe harbors that may be followed to avoid the nullification of transactions that may be beneficial to a corporation simply because of director self-interest. Under Section 144, where a director or officer has a financial interest in a transaction with the corporation, the transaction is not void or voidable if:

- The transaction is approved by a committee of disinterested directors in good faith;
- The transaction is ratified by a fully informed majority vote of the disinterested stockholders; or
- The transaction is fair to the corporation as of the time it is authorized.

In this case, because all members of the board received the bonuses, and because the bonuses were not approved by stockholders, the court applied the entire fairness test to analyze whether the awarding of the bonuses was the result of fair dealing and whether the bonuses themselves were at a fair price. In conducting this analysis, the court found that the bonus proposal had been initiated by, and the approval process dominated by, the company's Chairman. Further, each member of the compensation committee was slated to receive one of the proposed bonuses and, thus, interested. In addition, despite the fact that the compensation committee had retained a compensation consultant to advise on the bonuses, the court found that such retention had occurred at the direction of management and that, rather than advising on a bonus proposal, the consultant's role had instead been to devise a rationale, based on information provided by management, to support management's predetermined bonus plan. The court further notes that the minutes of the compensation committee reflect the committee's consideration of "the question of what rationale is appropriate to support the award," rather than consideration of whether the award itself is appropriate. Accordingly, the court found that the process was unfair and, after considering evidence regarding the size of the bonus awards, that the price was unfair as well. Accordingly, the defendant director was not able to prove entire fairness and was required to pay back the bonus plus additional monetary penalties.

While the conduct of the directors and management in this case was abysmal, and the decision no surprise, a few aspects of the decision are nevertheless interesting and worth emphasizing:

- *Focus on the process.* Where unfair dealing is found, it is still possible for the pricing terms to be so fair as to render the transaction entirely fair. The two components of the entire fairness test, however, are not independent. Rather, the fair dealing prong of the test informs the court as to the fairness of the price obtained through that process. Stated differently, it will be the very rare case where a fair price could result from an unfair process.
- *Use of experts is not a defense.* Under Section 141(e) of the Delaware General Corporation Law, directors, in the performance of their duties, are protected in relying in good faith upon the advice of experts. The court reaffirmed the Delaware view, however, that reasonable reliance on experts is only one pertinent factor in evaluating whether a transaction is entirely fair and is not a defense under an entire fairness analysis.

Deal Protection Devices, Advisors Fees and Special Dividends

In the *Express Scripts v. CaremarkRx* case, decided February 23, 2007, the Delaware Court of Chancery addressed several issues arising in the Caremark takeover battle in which Caremark sought to preserve a merger agreement with CVS in the face of Express Scripts' higher offer.

"Standard" deal protection devices. The Caremark-CVS merger agreement contained "a full complement" of deal protection devices, including a "force the vote" provision (which requires a board to submit an agreement for a shareholder vote even if it changes its recommendation), a "no shop" provision (which prevents a board from speaking with a competing bidder unless a proposal is received that is superior or likely to be superior), a "last look" provision (which allows each party a chance to top a competing superior proposal), and a break up fee (in this case, reciprocal $675 million breakup fees that equaled roughly 3% of the deal size). Though not relevant

to the decision in this case, in an interesting sidebar the court, in a footnote, discusses the deal protection structure, including the parties "passionate" defense of the deal protection provisions and their argument that such provisions constituted "a customary set of devices employed regularly by market participants and their lawyers." In its discussion, the court makes the following points:

- *There is no bright line 3% rule on break up fees.* While the Delaware courts have often upheld such fees, and higher fees in some cases, Delaware courts "do not presume that all business circumstances are identical or that there is any naturally occurring rate of deal protection, the deficit or excess of which will be less than economically optimal." While a 3% rule for termination fees "might be convenient for transaction planners, it is simply too blunt an instrument, too subject to abuse, for this Court to bless as a blanket rule."
- *There is no customary set of deal protection devices that past muster on every deal.* Rather, a court will undertake a fact-intensive analysis of a number of factors, including, without limitation, (i) the size and percentage of the fee, (ii) the benefit to shareholders, including a premium, that the directors seek to protect with the fee, (iii) the absolute size of the deal and relative size of the parties to the deal, (iv) the degree to which a counterparty found such protection to be crucial to the deal, bearing in mind differences in bargaining power, and (v) the preclusive or coercive power of all deal protections. Parties, when negotiating deal protection provisions, must be careful to ensure that they bear some relationship to "the real world risks and prospects confronting [directors] when they agreed to the deal protections."

Advisors Fees Involving a "Double Contingency." Caremark hired UBS and JP Morgan to render fairness opinions on the deal. Under their agreements, each would receive $1.5 million for rendering the opinion, regardless of the conclusion reached, and then stood to receive an additional $17.5 million upon the consummation of the Caremark/CVS transaction or an alternative transaction occurring within the specified tail period. The tail period provision applied, and the $17.5 million fee would be payable, "in the event that, following the public announcement of [the Caremark/CVS transaction,] [Caremark] pursues a transaction structured in a manner contemplated by the definition of "Transaction" herein, with a third party other than [CVS] . . . within nine months." Accordingly, the court concluded that each banker had to provide a favorable fairness opinion in order to get the larger fee -- without an initial favorable opinion, there could be no initial public announcement of the transaction (which would occur only following an initial favorable opinion) and, therefore, no trigger for the larger fee.

In finding that the merger proxy statement had inadequate disclosure about the fees, the court noted:

- *Fees may be subject to two types of contingency.* The successful conclusion of a transaction may not be the only contingency in a banker's agreement. Rather, the agreement must be analyzed to determine whether the ability to qualify for a success fee is itself conditioned on delivery of a favorable fairness opinion.
- *All contingencies must be disclosed.* Knowledge of financial incentives on the part of the bankers is material to shareholder deliberations.

Special Dividends as Merger Consideration. Section 262 of the Delaware General Corporation Law grants

appraisal rights to stockholders who are required, by the terms of a merger, to accept any consideration other than shares of stock of the surviving company, shares of stock listed on a national securities exchange, or cash received as payment for fractional shares. The Caremark transaction involved a situation where the value of an all stock merger to the target's shareholders was increased through the target's declaration of a pre-closing special cash dividend. The parties structured this special dividend so that it would be declared prior to the shareholder vote on the merger, but only "payable upon or after the effective time of the merger and conditioned upon the occurrence of the effective time of the merger." Plaintiff's asserted that the dividend triggered appraisal rights, while defendants claimed that, since the dividend was payable by the target pre-closing, it had independent legal significance and should not be recognized as merger consideration.

The court held that special dividends that are contingent upon the merger are merger consideration. In this case, by structuring the special dividend to be conditioned on the merger, the parties essentially colluded to "launder" a cash payment and that a "special dividend" of the type contemplated "is simply cash consideration dressed up in a none-too-convincing disguise." Since the deal consideration was, in fact, part stock and part cash, appraisal rights applied.

Our Las Vegas Office is Moving…

Snell & Wilmer's Las Vegas, Nevada office is moving. The following is our new address and contact information, effective April 30, 2007.

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UPCOMING SEMINAR

Topic: Focus on the Workplace

Date: Thursday, April 26, 2007

Time: 7:00-11:45 AM

Location: Snell & Wilmer, L.L.P.
One Arizona Center | Phoenix

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