

## The Bright Light: Director Payments to Themselves and the Entire Fairness Test

A recent Delaware case, *Valeant Pharmaceuticals International v. Jerney*, is an important reminder of the care which should be taken by directors in considering bonuses that include payments to themselves. Delaware courts in particular are focusing heavily on issues of director independence and *Jerney* is the latest example of the bright light which the courts will bring to bear on directors' self-interest.



Valeant, a biotech company, adopted a stock option bonus program (which included directors) at a time when the company's fortunes were flying high and the value of the bonus stock options did not look significant in the context of the board's view of the company's enterprise value. When shareholder opposition to the option grants emerged, the compensation committee reworked the option program into a cash bonus pool. Subsequent to the adoption of the bonus pool, there was a significant downturn in the biotech sector. Following an IPO at a reduced market value, the board did not revisit the bonus plan in that light.

Although Delaware law provides "safe harbors" with respect to transactions in which directors have a self-interest, none of the safe harbors were utilized by the board in this case. Accordingly, the transaction was required to comply with the "entire fairness test" in Delaware which requires a showing that the decision was "entirely fair" when made. The Court criticized the process by which the directors arrived at the cash bonus plan and their failure to reconsider it following a change in the fortunes of Valeant. As a result, the Court ordered one of the directors, Jerney, to disgorge the entire bonus paid to him, to pay his pro rata share of the cost of a special investigation, and pay his pro rata share of bonuses paid to non-director employees. The Court also ordered the director to repay one-half of the \$3.75 million advances that were made to fund the defense of the claim.

This decision is indicative of the significant risks that directors face when the entire fairness test is the standard of review. The opinion also shows the dangers of transactions that confer material benefits on outside directors, thereby resulting in the loss of business judgment rule protection. Although compensation decisions made by independent boards are subject to great deference, that deference diminishes when the entire fairness test is the standard.

The lessons to be taken are numerous. Notably, boards of directors should navigate carefully when considering and approving executive compensation and bonus payments, especially when such plans confer material benefits on outside directors. Boards should (i) ensure that such payments are approved in advance by an independent

compensation committee of disinterested directors to preserve the protections of the business judgment rule, (ii) consider whether shareholder approval is required or appropriate, and (iii) seek and rely on the advice of independent compensation consultants and counsel.

Had the directors in *Jerney* followed the above guidelines, the Court would not have required them to prove that their decision was entirely fair. Rather, the defendants would only have needed to show that they met the reasonableness standard of the business judgment rule.

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