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Delaware Court of Chancery Invalidates Elon Musk's $55.8 Billion Equity Compensation Package

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This is a landmark decision under Delaware law that raises important considerations for Boards and independent directors when deciding upon significant compensation awards. In a 200-page decision following a five-day trial, Chancellor Kathaleen McCormick of the Delaware Court of Chancery ruled in favor of Tesla stockholders who had brought a derivative lawsuit challenging the multiyear compensation arrangement awarded to Tesla CEO Elon Musk.[1] The plaintiff-stockholders alleged that Tesla's directors breached their fiduciary duties by awarding Musk performance-based stock options in January 2018 with a potential $55.8 billion maximum value and a $2.6 billion grant date fair value (the "Grant"). The Court found that the defendants—Musk, Tesla, Inc. and six individual directors—failed to meet their burden to prove that the Grant was "entirely fair," the standard under Delaware law that the Court applied in light of the Court's determination that Musk held controlling stockholder status with respect to the Grant. As a remedy, the Court ordered the complete rescission of the Grant, which had been approved by a majority vote of disinterested stockholders.[2] The Court opened its opinion by asking: "Was the richest person in the world overpaid?" And the Court concluded that, yes, he was: "In the final analysis, Musk launched a self-driving process, recalibrating the speed and direction along the way as he saw fit. The process arrived at an unfair price."[3] **The Grant** On January 21, 2018, Tesla's Board of Directors (the "Board")[4] unanimously approved the Grant, which would vest based on Tesla's achievement of certain market capitalization goals, as well as operational milestones related to revenue and adjusted EBITDA targets. The Grant was "the largest potential compensation opportunity ever observed in public markets by multiple orders of magnitude—250 times larger than the contemporaneous median peer compensation plan and over 33 times larger than the plan's closest comparison, which was Musk's prior compensation plan."[5] The Board conditioned the Grant on approval by a majority vote of disinterested stockholders. A February 8, 2018 proxy statement (the "Proxy") notified stockholders of a vote on the Grant, which was held on March 21, 2018. Despite ISS and Glass Lewis recommending votes against approval of the Grant, stockholders (excluding Musk's and his brother's ownership) approved the Grant with 73% in favor. The Grant began vesting in 2020; as of June 30, 2022, the Grant was nearly fully vested, with all market cap and adjusted EBITDA milestones achieved, and three revenue milestones achieved, with one more deemed probable of achievement.[6] **Court found stockholder vote approving the Grant was not fully informed** The Court determined that it was "undeniable that, with respect to the Grant, Musk controlled Tesla"[7] and, therefore, that the Board's approval of the Grant was a conflicted-controller transaction. As a result, the Board's decision would be examined under an "entire fairness" standard?the Delaware courts' "most onerous standard of review."[8] However, Delaware law allows defendants facing an entire fairness standard to shift the burden of proof to the plaintiff by showing that the transaction was approved by a fully informed vote of the majority of the minority stockholders. The Court found that the stockholder vote approving Musk's Grant was ***not*** fully informed for two reasons:

- the Proxy inaccurately described key directors as independent, when several of them had extensive personal and professional relationships of long duration with

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Musk, including owing much of their personal wealth to Musk; and

- the Proxy misleadingly omitted details about the process by which Musk's Grant was approved, including material preliminary conversations between Musk and the Compensation Committee chairman, as well as Musk's role in setting the terms of the Grant and the timing of the Committee's work.

The Court concluded: "Put simply, neither the Compensation Committee nor the Board acted in the best interests of the Company when negotiating Musk's compensation plan. In fact, there is barely any evidence of negotiations at all. Rather than negotiate against Musk with the mindset of a third party, the Compensation Committee worked alongside him, almost as an advisory body."[9] **The "extraordinary nature of the Grant"**[10] In addition to the process of approving the Grant, the Court considered its "price." "The Board never asked the $55.8 billion question: Was the plan even necessary for Tesla to retain Musk and achieve its goals?"[11] The Court concluded that it was not for three key reasons:

- Musk already owned 21.9% of Tesla, which ownership stake gave him incentive to push Tesla to grow its market capitalization even without the additional compensation;
- there was no risk that Musk would depart Tesla without receiving the Grant, nor did the Board condition the package on Musk devoting any set amount of time to Tesla; and
- the Grant's performance conditions were not, in fact, ambitious and difficult to achieve.[12]

It was also significant to the Court that the Grant process lacked a traditional benchmarking analysis.[13] "The incredible size of the biggest compensation plan ever—an unfathomable sum—seems to have been calibrated to help Musk achieve what he believed would make "a good future for humanity" [related to Musk's goal of colonizing Mars]. …. [T]hat had no relation to Tesla's goals with the compensation plan."[14] **Observations and Considerations for Boards and Independent Directors** Much of Chancellor McCormick's decision may be unique to the "Superstar CEO"[15] status that Musk holds and the facts and circumstances at Tesla and its Board, as well as the Court's determination (for the first time in the Chancery Court) that Musk was a controlling stockholder. Nevertheless, the decision is a landmark one under Delaware law and raises important considerations for Boards and independent directors when deciding upon significant compensation awards.

1. *Document the Process*. The Court was very focused on the rushed, casual decision-making of Tesla's Compensation Committee. In their testimony, several Board members said they couldn't remember meetings where important elements of the Grant were discussed. If considering a significant award, boards and compensation committees would be better served by undertaking a thorough analysis, including rigorous benchmarking, and documenting that process through e-mails, detailed meeting minutes, formalized presentations, and other written records.
2. *Awards Should Have Clear Rationales*. Musk's award had no mechanism for actually keeping his attention focused on Tesla, as opposed to his other business interests. While the extent of Musk's outside interests may be a distinguishing factor, compensation committees going forward should be mindful of the concerns the Court expressed around that issue and consider whether and how to ensure that significant awards to executives are clearly and closely aligned to the Company's business objectives. Performance conditions for such awards will also be analyzed in retrospect so boards should be sure to pressure test the rigor of those goals and contemporaneously document why goals were determined to be challenging.

3. *Expect Extra Scrutiny of Independent Directors.* The Court was particularly disturbed by the close personal and business relationships of Tesla's Compensation Committee members with Musk, such that they viewed awarding the Grant as a collaborative process with Musk, rather than an arm's length negotiation. Expect, when considering significant compensation awards, that all elements of an independent director's connections with the executive-grantee—including length of board service—to be closely examined for indicia of objectivity.

__________ [1] *Richard J. Tornetta et al.* v. *Elon Musk et al.*, case number 2018-0408, in the Court of Chancery of the State of Delaware. [2] The Court noted that Musk had not yet exercised any of the options underlying the Grant. Opinion at 8. [3] Opinion at 7. [4] Tesla's nine-person Board included Musk, his brother Kimbal Musk, Brad W. Buss, Robyn M. Denholm, Ira Ehrenpreis, Antonio J. Gracias, Steve Jurvetson, James Murdoch, and Linda Johnson Rice. Tesla's Compensation Committee was comprised of Ehrenpreis (the committee chair), Buss, Denholm and Gracias. [5] Opinion at 1. [6] Opinion at 92. [7] Opinion at 112. [8] Opinion at 104. [9] Opinion at 128. [10] Opinion at 143. [11] Opinion at 6. [12] Opinion at 183. [13] Opinion at 144. [14] Opinion at 180. [15] Opinion at 120.

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