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TESLA'S SUPER-CHARGED EQUITY AWARD TO ELON MUSK UNPLUGGED BY DELAWARE COURT

CAUTIONARY TALE FOR BOARDS AND EXECUTIVES

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WHAT HAPPENED

The Delaware Chancery Court invalidated a substantial equity award to Elon Musk – the largest in history. It applied the entire fairness test instead of the more deferential business judgment rule, finding that Musk "controlled" Tesla and dominated the grant approval process.

Key factors included:

- Musk's 22% stock ownership.
- His "superstar" status with influential positions as CEO, Chair and founder and managerial authority over the company, often disregarding the board.
- "Thick ties" with directors negotiating on behalf of the company, rendering them non-independent.
- His domination of the process leading to board approval of the compensation award.

Even though Tesla conditioned the award on approval by a majority of disinterested stockholders, the burden of proof did not shift to plaintiffs. The court determined stockholders were not "fully informed" because of misleading statements and omissions in the proxy statement, including:

- Inaccurately describing key directors as independent despite their actual or potential conflicts with Musk.
- Failing to discuss Musk as initiating the proposal, the lack of negotiation by the board, and the absence of benchmarking to comparable or peer companies.
- Describing the financial performance targets as "ambitious" and "challenging," when internal projections showed many of them were likely to be achieved.

TAKEAWAYS

Even recognizing that Musk may appeal, the ruling provides lessons for companies and their boards when making compensation decisions:

Carefully evaluate the independence of directors handling material compensation matters.

- Consider the extent of personal and business relationships with management.
- Consider whether to disclose relevant relationships, even if the board does not view them as impairing independence.

Establish that directors satisfy their duty of care to act deliberately and on a fully informed basis.

- Ensure the board "acts deliberately" to manage the compensation process and takes appropriate time – not rushing decisions.
- Demonstrate that directors act on a "fully informed" basis:
  - Document the active participation of directors, engaging with the working group.
  - Engage independent advisors, as needed, document the rationale for any advice, and address the consideration of alternatives.
  - Establish the basis for concluding that a compensation proposal is "reasonably calibrated" to achieve its goals, such as incentivizing and/or retaining executives.
    - Memorialize changes made in response to negotiations or deliberation.
    - Utilize benchmarking, as appropriate.
    - Address the impact of existing holdings of executives when making equity awards.

Pay attention to disclosures of compensation proposals to stockholders.

- Consider the relevance of information beyond specific terms or economics of compensation programs, including factors such as those cited by the court: the board process, conflicts of interest and incentives for executives.
- Review descriptions of the board process to ensure alignment with the actual record.
- Consider how changes to drafts of disclosures can be perceived. For example, the court highlighted the deletion of disclosure that Musk had initially established the initial compensation terms himself.

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Background

In 2018, Tesla awarded Elon Musk a performance-based equity-compensation plan that stockholders approved at the annual meeting. The plan offered Musk the opportunity to receive twelve tranches of options, each representing 1% of Tesla's total outstanding shares. For a tranche to vest, Tesla's market capitalization needed to increase by $50 billion and Tesla needed to achieve either an adjusted EBITDA target or a revenue target in four consecutive fiscal quarters. According to the board and Musk, the plan provided "all upside" for stockholders – they risked nothing – and gave "6% for $600 billion." With a $55.8 billion maximum value and $2.6 billion grant date fair value, the plan was the largest potential compensation opportunity in history.

In June 2018, the plaintiff filed his complaint asserting breaches of fiduciary duty and waste against the defendants and unjust enrichment against Musk. The court dismissed the waste claim but found for the plaintiffs on the others.

Although Delaware law does not automatically require rescission due to material disclosure failures, the court concluded that invalidation of the award was appropriate because no third-party interests were implicated, it had not been exercised and any exercised shares would be subject to the five-year holding period.

Business Judgment Rule Not Available; Entire Fairness Test Applied

The court applied the Delaware entire fairness test instead of the more lenient business judgment rule because Musk "controlled" Tesla and dominated the grant approval process. The finding of Musk's control was based on (1) his 22% stock ownership; (2) his "superstar" status with influential positions as CEO, Chair and founder and with managerial authority over the company, often disregarding board authority; (3) "thick ties" with directors negotiating on behalf of the company, rendering them "beholden to him" and therefore non-independent, and (4) his domination of the process leading to board approval of the compensation plan.

Application of Entire Fairness Test

The court examined both elements of the entire fairness test: process and price.

"Deeply Flawed" Board Process. The court found that the board approval process was "deeply flawed," citing, among other things:

- The lack of independence of directors leading discussions with Musk. For example:
  - A 15-year relationship of the compensation committee chair, who held $75 million of interests in other Musk companies and other longstanding personal and professional relationships.

  - A 20-year business relationship of a committee member, who acquired “dynastic or generational wealth” from investing in Musk companies, often only by personal invitation, and who had a close personal relationship, including regularly attending vacations and weddings with Musk’s family.
  - A committee member who owed 44% of his wealth to Musk entities.
  - A committee member for whom a majority of her wealth came from compensation as a Tesla director.

- The General Counsel’s subservience to Musk as his former divorce attorney and his strong adulation of him, while serving as primary point person for the company in formulating Musk’s award.
- Musk dictated the timing of the process. Although lasting nine months, and encompassing ten board and committee meetings, discussions only took place during discrete segments under significant time pressure imposed by Musk, who often made last-minute changes.
- The board’s failure to engage in meaningful negotiation over the size of the grant or any other significant terms, instead treating the process as a “cooperative venture”.
  - Musk proposed the terms and later unilaterally reduced the size. Final changes did not result from negotiation.
  - The committee’s independent advisors played no role in negotiations and were not asked to present alternatives to Musk’s proposal.
  - The committee did not consider alternatives.
  - The GC and committee members did not recognize any conflict of interest between the company and Musk.

- The committee’s failure to request or consider objective benchmarking data.
- The committee relied more on conflicted management employees such as the GC than on outside advisors.
- Five of the six directors voting to approve the plan were beholden to Musk or had compromising conflicts.

Failure to Calibrate Size or Structure of Plan. The court also criticized the price – the design of the plan – which would reward Musk with up to an additional 6% ownership if Tesla’s market capitalization increased $600 billion while also achieving certain revenue and adjusted EBITDA growth metrics. Key failures included:

- No meaningful consideration of whether the size of the award was calibrated to achieve the company's goals: whether the plan was needed to retain Musk and achieve the financial targets. The court highlighted his existing 22% ownership stake and his declared intention to remain with the company.
  - A slide presentation for one committee meeting included the "key question" ("Is additional compensation for the CEO required given his current ownership and its potential appreciation with Company performance?") but the committee did not discuss it.
  - An agenda for a discussion with Musk included the topic "Should some type of commitment be included as part of comp structure?". However, the issue was not raised with him.
  - The court noted examples of other "visionaries" with large equity stakes, such as the founders of Meta, Alphabet and Amazon, who had not received equity awards due to their existing stock ownership.
- No requirement that Musk devote any specific amount of time to the company.
  - The grant allowed Musk to step down from CEO to the role of "chief product officer" – and without any time commitment.
  - The grant did require Musk to hold the shares after vesting for another five years, but the court found that term was only included so that the company could apply a larger discount on the publicly disclosed value of the grant.

No Burden Shifting due to Disclosure Failures

Tesla conditioned the plan on approval by a majority of disinterested stockholders. Under Delaware law, that would normally allow defendants to shift the burden of proof – even if, as here, the committee was not independent. However, the court found that defendants were unable to prove that the stockholder vote was fully informed because the proxy statement:

- Inaccurately described key directors as independent despite their actual or potential conflicts with Musk, as discussed above.
- Misleadingly omitted key details about the process, such as
  - Musk having established and proposed the key terms of the award and controlling the timing.
  - The lack of negotiation by the board after receiving Musk's proposal.

- The board's failure to benchmark the award to comparable or peer companies.
- Internal projections of the company showing many of the target metrics were likely to be achieved, despite disclosing that they were "ambitious" and "challenging." For example, in its next 10-Q, the company determined that three of the metrics were "probable of achievement," i.e., 70% likelihood within one year of grant date.

The court also rejected various arguments made by defendants, finding they did not satisfy their burden of proof with respect to establishing:

- That the financial targets were ambitious and difficult to achieve.
- The relevance of private equity compensation plans for purposes of comparison to Tesla.
- That the metrics bore any causal relationship to the company's actual performance.
- Any rationale for the 1% equity increments, as opposed to a lesser portion of increased market capitalization.

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MEET THE TEAM

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