Securities Regulation Daily Wrap Up, EXECUTIVE COMPENSATION—Del. Ch.: Court rescinds Musk's $56 billion compensation package, (Jan 31, 2024)

By Rodney F. Tonkovic, J.D.

The compensation package is "the largest potential compensation opportunity ever observed in public markets by multiple orders of magnitude," the judge said.

Was Elon Musk overpaid? A Delaware Chancery judge took the side of a Tesla shareholder who said that he was. Tesla's directors awarded Musk a performance-based compensation plan with a $55.8 billion maximum value. In this case, the defendants had to prove the fairness of the largest potential compensation plan in the history of the public markets and failed to do so. The court ordered that the plan be rescinded after concluding that the company board was unable to show that the plan was fair, particularly in light of Musk's control over Tesla (*Tornetta v. Musk*, January 30, 2024, McCormick, C.).

Compensation plan. Tesla's board unanimously approved an incentive-based compensation plan (the "Grant") for Musk in January 2018 and recommended that stockholders do the same. Under the plan, Musk could receive up to $55.8 billion if Tesla met certain market capitalization and operational milestones under his leadership. Specifically, Musk could secure 12 tranches of options; for a tranche to vest, Tesla's market capitalization would have had to increase by $50 billion, and the company would have had to hit adjusted EBITDA or revenue targets in four consecutive quarters. The Grant came with a five-year hold period during which Musk would be unable to sell his stock. The shareholders approved the Grant at a special meeting on March 21, 2018.

The complaint. The original complaint in this action was filed by a Tesla shareholder on June 5, 2018, and asserted counts for breach of fiduciary duty against Musk and Tesla's directors, unjust enrichment, and waste. The defendants moved to dismiss, but the Delaware Court of Chancery denied the motion. According to the court, Musk's status as a controller subjected the Grant to entire fairness review (the most onerous standard) rather than the deferential business judgment standard. The judge also rejected the argument that the complaint failed to plead that the plan was unfair.

At its core, the complaint in this action says that the Grant was a breach of fiduciary duty. Because the Grant was a conflicted-controller transaction and because it was approved by a majority conflicted board, the entire fairness standard should govern, the plaintiff argued. The shareholder asked the court to invalidate or rescind the Grant either in its entirety or in part.

Musk as controller. As a threshold issue, the court concluded that the entire fairness standard applied because Musk exercised control over the Grant. Noting that the Delaware courts have previously confronted the issue of Musk's control without definitively resolving it, the judge in this case took the plunge and concluded that at least as far as this transaction was concerned, Musk controlled Tesla.

Musk, the court said, had a relationship with Tesla and its directors that afforded him "enormous influence." In addition to his significant stock ownership, Musk was a "Superstar CEO," holding influential corporate positions such as CEO and founder. His status created a "distortion field," and Tesla was highly dependent on him, the court said. And, importantly, Musk had close ties to the directors negotiating on Tesla's behalf, with half of the board lacking independence from him, and was able to dominate the process leading to approval of the Grant.

In particular, the court pointed out that there were no adversarial negotiations about the size—or other terms—of the Grant, which was initially proposed by Musk himself. Indeed, the defense witnesses described the negotiation process as cooperative and collaborative rather than arm's-length negotiation.

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Entire fairness review. As a result, the defendants bore the burden of proving that the Grant was entirely fair. If they could show that the stockholder vote was fully informed, the burden could be shifted, but the court found that this was not so.

The court explained that the record showed (as described above) that the proxy failed to disclose the compensation committee's potential conflicts with respect to Musk and omitted material information about the process. In addition, because Tesla disclosed aspects of the process, it had an obligation to provide full and fair information about the process. For many of the same reasons, the court found that the defendants failed to prove that the Grant was the product of fair dealing.

The court also concluded that the Grant did not meet the fair price element. The defendants said that the court should look at what Tesla "gave" versus what it "got," arguing that the deal was "all upside" for the stockholders. That is, Tesla would be positioned for transformative growth by securing Musk's leadership. The court rejected this argument, observing that Musk's pre-existing equity stake was already a powerful incentive to stay. There was also no evidence that the magnitude of the Grant was necessary.

Rescission. The plaintiff sought rescission as a remedy for the fiduciary breaches, which the court found was a reasonable and appropriate remedy. In Delaware, rescission is the preferred remedy where it can restore parties to the positions occupied before the transaction. That is the case here, where there are no third-party interests, and the entire compensation plan is unexercised and undisturbed.

The court accordingly entered judgment in favor of the shareholder. The parties were ordered to confer on an order implementing this decision.

The case is C.A. No. 2018-0408-KSJM.

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