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# The Tesla Executive Compensation Ruling: What Directors Need to Know

This week the Delaware Court of Chancery struck down the largest public company compensation grant in history: Elon Musk's $55 billion pay package at Tesla. The ruling comes more than a year after a five-day trial in 2022, with tone set in the first sentence of the court's 200-page ruling asking, "Was the richest man in the world overpaid?"

The ruling, if not appealed, will significantly diminish Musk's wealth, likely bringing him down to the third-richest person in the world. It could also put the fate of his other companies in question. Beyond the newsworthiness of the decision, board directors—and particularly those on public company compensation committees—should pay careful attention as the court took a fairly atypical position by second-guessing director decision-making and ordering a complete rescission of a payout.

We outline below our review of the key facts and elements from this opinion. While the size of the grant and facts of the case are highly idiosyncratic, there are important takeaways for governance generally and specifical for public board members.

## Background

In this derivative case, a plaintiff-stockholder claimed that Tesla's directors breached their fiduciary duties by awarding Musk a performance-based equity plan in 2018 that offered Musk the opportunity to secure 12 total tranches of options, each representing 1% of Tesla's total outstanding shares as of 2018.

According to the plan, in order for a tranche to vest, Tesla's market cap had to increase in $50 billion increments, and Tesla was required to achieve either an adjusted EBITDA target or a revenue target in four consecutive fiscal quarters—goals which Musk had characterized as "all upside." With a $55 billion maximum value and a $2.6 billion grant-date fair-value, this was the largest potential compensation opportunity ever observed in public markets by a landslide. (For context, it was approximately 250 times larger than plans for median peer companies and 33 times larger than the plan's closest comparison, which was in fact Musk's prior compensation plan.)

The plan was presented to stockholders and approved by 73%, excluding shares held by Musk and his brother. The targets were met although Musk did not exercise any of the options as they vested.

## The Outcome and Rationale

In the first step of its analysis, the court determined that the plan would not be reviewed under the business judgment rule, which would have given far more deference to the board's decision-making process on Musk's compensation. Rather, because Delaware law recognizes that there are unique risks inherent in a company's transactions with its controlling stockholder, the court reviewed this case under the less deferential entire fairness standard. This standard shifted the burden to Musk to prove the compensation plan was fair—a burden which he failed to meet.

Rationale for the court's ultimate decision to rescind the award was based on the following concepts:

**Director Conflicts:** Conflicts of interest tainted the board's consideration of the pay plan. All of the directors (except one) including most members of the compensation committee, had economic and/or personal ties that compromised independence, despite the fact that they may have been viewed as "independent" by regulatory standards. The court specifically pointed out the 15-year personal and professional relationships between the chair of the compensation committee and Musk, calling it "too weighty" in light of the director's role in connection with the challenged grant. Many of the directors had longstanding friendships with Musk, attending family weddings and vacations with him. Aside from personal relationships, many of the directors amassed great wealth as a result of their ties to Musk, Tesla, and/or his other business ventures.

**Lack of Process:** The court found that there was a complete lapse in governance in considering and approving the grant. In combination with the personal and economic conflicts noted above, the court concluded that the board acted with a "controlled mindset" rather than acting on behalf of the company and its stockholders. As a "superstar CEO," Musk was far too influential in the process leading up to the grant. Specifically, Musk was the first to engineer the pay package and he controlled the timing of when the committee and board would discuss his package, sometimes accelerating a review of the pay package and sometimes cancelling a meeting without substantive notice. Testimony revealed that the directors viewed pay package assessment as a cooperative, collaborative process rather than a negotiation or at the very least controlling the process themselves. At one point Musk even stated that he was "negotiating against himself" as he proposed differed versions of the package.

**Lack of Reasonableness and Rationale**: Clearly the outsized package was the headline in this case, but the court seemed to find final affront in the complete lack of rationale or justification for the award. The court found no evidence that the historically unprecedented compensation plan was necessary to motivate Musk to stay with the company or for the company to achieve transformative growth. The package was not motivated by retention concerns and did not even require Musk to spend most of his time on behalf of Tesla (as opposed to his other ventures). As Musk already owned 21.9% of the company prior to the grant, the court noted that he already had enough of a stake in the company to motivate him to achieve the same market cap milestones and transformative growth. The court questioned why none of the directors discussed his pre-existing ownership stake before putting additional equity on the table. Furthermore, the court highlighted lack of any substantive benchmarking analysis, and rejected claims that the package should have been compared to private-equity deals as this is very much a public company.

**Inaccurate Disclosure:** Tesla put the Musk compensation plan to stockholder approval at a special meeting, and it was approved by 73% (excluding Musk and his brother). Under Delaware law, this would typically shift the burden of proof on the question of entire fairness to the plaintiffs. However, the court found that the proxy statement on which the stockholders relied inaccurately characterized the directors as independent. It also found the description of the process leading up to approval of the package failed to describe the true nature of Musk's involvement in the process. Moreover, the court took issue with the proxy's description of the mechanics of the plan. It represented that many of the key milestones described as very difficult were in fact expected based on Tesla's confidential projections shared with banks and rating agencies. As a result, the court did not allow the burden of proof to shift to the plaintiffs despite the stockholder vote.

**No Complexity in Unwinding:** While it was not a legal basis for the decision, the court noted that since the options were unexercised (and would have been subject to a five-year hold even if exercised), and there were no stakeholders in the plan other than Musk, voiding the entire plan was not overly complex.

## What Do Directors Need to Know?

There are a large number of take-aways for boards and specifically their compensation committees. While any plan remotely resembling the Musk/Tesla plan is highly unlikely for any other company, there may be circumstances when a plan is outside market norms, quite possibly for a good reason. Boards should be able to definitively check off these guiding points:

- **Ensure a Clean Process:** Executives should not have a heavy hand in the compensation plan design process. While there may be discussions between the board and the executive with input from the executive, the committee should drive the process and decisions following significant analysis of the plan and its impact. It is the committee or board's responsibility to control discussions and meetings, and approve modifications, timing, and ultimately plan adoption.
- **Demonstrate Reasonableness and Rationale:** Boards should be prepared to demonstrate the consideration the executive gives back in the plan design discussions, recognizing that "upside" to stockholders is not enough. There should be ample evidence that any package put forth is needed in order to sustain the executive's employment or attention. If the executive already has a considerable ownership stake, boards should ask whether additional shares are needed to motivate the executive.
- **Be Certain of Independence:** Board members, but especially compensation committee members, should be independent both in form and substance. This court focused on interpersonal and business relationships outside of Tesla.
- **Disclosures Must Not Be Misleading or Contradictory:** Make sure the words used to describe targets accurately reflect reality. They should align with disclosures made to other parties such as banks and rating agencies.
- **Recognize the Limits of Stockholder Approval:** Even if stockholders approve a compensation plan, a positive vote may not matter if the disclosure on which the stockholders relied is deemed to be inaccurate.

In closing, a key lesson is that size matters but its impact may be mitigated by proper governance. This was obviously an extreme case with compensation so outsized that it is hard to imagine an analogous situation. Nevertheless, the case offers guidance on proper governance channels that could possibly have led to a different outcome.

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