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## *U.S. Judge Voids Tesla Inc. Pay Package*

On January 30, 2024, judge Kathleen St. Jude McCormick of the Delaware Court of Chancery ("**McCormick**") issued a post-trial opinion rescinding a pay package awarded to Elon Musk ("**Musk**") by Tesla Inc. ("**Tesla**"). In so ruling, McCormick deemed the compensation package granted by Tesla's board (the "**Pay Package**") an "unfathomable sum" that was unfair to shareholders.

In early 2018, Tesla and Musk agreed to the Pay Package, which included stock option awards to Musk divided into 12 tranches, each representing 1% of Tesla's outstanding shares as of January 21, 2018. The options were to vest on increasingly challenging targets related to Tesla's market value, revenue, and adjusted EBITDA. The Pay Package included, among other things, requirements that Musk remained as Chief Executive Officer or Executive Chairman and Chief Product Officer at the time of vesting and included post-exercise minimum hold periods. The maximum value of the Pay Package was US\$55.8 billion, making it the largest known executive compensation deal to date.

The lawsuit contesting the Pay Package was filed in June 2018, shortly after its approval.

In the Delaware ruling, McCormick examined the compensation plan under the "entire fairness" standard and found that the defendants bore the burden of proving that the compensation plan was fair, which they failed to meet. Therefore, McCormick ruled to rescind the Pay Package.

Under Delaware law, the presumptive standard for review is generally the "business judgement rule" (the "**BJR**"), which creates a rebuttable presumption that directors acted in accordance with their fiduciary duties when making decisions. Under the BJR, the plaintiffs bear the

burden of presenting evidence that directors were inadequately influenced or motivated by other interests. Absent rebuttal of the BJR, courts generally refrain from second-guessing board judgements unless they are deemed irrational.

However, Delaware law recognizes unique risks inherent with a "conflicted-controller". In such transactions, the court applies a more onerous "entire fairness" standard of review. This standard shifts the onus of proof to the defendant directors to show that they did not violate their fiduciary duties by ensuring that the transaction is fair as to both "process" and "price".

McCormick held that Musk was a "conflicted-controller" in regards to the Pay Package despite not owning a majority of Tesla shares. Key to the decision was McCormick's finding that, in addition to possessing 21.9% voting control, Musk exerted general control over the business and affairs of Tesla, because, among other things:

- he was the paradigmatic "Superstar CEO", exercising outsized influence in the boardroom;
- he had strong ties with the directors tasked with negotiating on behalf of Tesla; and
- he dominated the process that led to board approval of the Pay Package; McCormick found that Tesla's compensation committee worked alongside him rather than negotiating against him.

Delaware law allows defendants to shift the burden of proof back to the plaintiff under the "entire fairness" standard where the transaction:

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(i) was approved by a well-functioning committee of independent directors; or (ii) was approved by a fully informed vote of the majority of the minority shareholders. In this case, McCormick found that the committee process was flawed and lacked independence. McCormick also held that the defendants failed to prove that the stockholder vote was fully informed because the proxy statement circulated in advance of the Pay Package vote inaccurately described key directors as independent and omitted details about the process.

McCormick stated that the "entire fairness" review was a holistic analysis that took into consideration two basic issues: "process" and "price". "Process" encompasses when the transaction occurred, how it was initiated, structured, negotiated, and disclosed to the directors, as well as how the approvals of the directors and the stockholders were obtained. "Price" concerns economic and financial considerations, encompassing assets, market value, earnings, future prospects, and other factors influencing the intrinsic or inherent value of a company's stock. McCormick noted that findings in one area may seep into the other and that an "unfair process can infect the price".

On "process", McCormick held that the approval process for Musk's pay package was significantly flawed. McCormick cited several factors:

- Musk had initiated and proposed the Pay Package terms at each negotiating stage;
- there was an absence of "adversarial" negotiations;
- he had longstanding relationships with the compensation committee chair and other compensation committee members, including personal relationships in some cases;
- while independent advisors were utilized by the compensation committee, such advisors did not play a role in negotiation and were not tasked with challenging the committee's thinking or presenting necessary alternatives;

- the working group, tasked with negotiating the Pay Package, included management members "beholden" to Musk; and
- the compensation committee did not use objective benchmarking data to compare the proposed Pay Package to plans at comparable firms.

McCormick also observed that the process, spanning nine months and involving ten compensation committee meetings, did not signify a thorough process as there was a lack of substantive work accomplished during these meetings.

On the "price" issue, the defendants argued that the board's primary objective with the Pay Package was to position Tesla for transformative growth through securing Musk's continued leadership. The board offered Musk an opportunity to increase his Tesla ownership by about 6%, only if Musk increased Tesla's market capitalization by US\$600 billion, while also hitting the operational milestones tied to Tesla's top-line (revenue) or bottom-line (adjusted EBITDA) growth.

McCormick determined that Musk's increased ownership stake was unnecessary to incentivize him to devote himself to Tesla, as Musk already owned 21.9% of Tesla when the board approved his Pay Package. Musk's existing ownership stake already provided him with a significant incentive to grow Tesla, as he stood to gain US\$10 billion for every US\$50 billion increase in market capitalization. Furthermore, the compensation plan did not require Musk to devote any specific amount of time to Tesla.

McCormick concluded that the only suitable remedy was to rescind Musk's Pay Package. She emphasized that rescission was the preferable remedy for breaches of fiduciary duty when no third-party interests are implicated and when the entire compensation plan sits unexercised and undisturbed.

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## **Going Forward**

We expect this decision will likely be appealed. Nonetheless, the decision highlights the

importance of applying a well-structured and independent process in executive compensation matters and other transactions involving interested parties.

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