Securities Regulation Daily Wrap Up, EXECUTIVE COMPENSATION—Del. Ch.: Musk's pay package may not be entirely fair, (Sept. 23, 2019)

Securities Regulation Daily Wrap Up

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By Anne Sherry, J.D.

Delaware courts usually defer to a board's compensation decisions, but Elon Musk's status as Tesla's controller warrants greater skepticism towards his pay package of up to $56 billion.

A Tesla stockholder's challenge to Elon Musk's multi-billion-dollar pay package survived a motion to dismiss. In a matter of first impression, the Delaware Court of Chancery held that Musk's status as a controller subjected his compensation plan to entire fairness review rather than the deferential business judgment standard. The court also extended the rationale of *M&F Worldwide* as a framework for how a board can structure a controller's compensation package to earn the business judgment presumption (*Tornetta v. Musk*, September 20, 2019, Slights, J.).

Tesla's board approved an incentive-based compensation plan for Musk in January 2018 and recommended that stockholders do the same. The stockholders who voted at the special meeting to consider the plan overwhelmingly approved the award. Under the plan, Musk may receive up to $56 billion if the company meets significant market capitalization and operational milestones under his leadership. The plaintiff, who brought direct and derivative claims for breach of fiduciary duty, calculated the present value of the compensation package at several billion dollars, well above what Musk's peers make.

No business judgment deference. The chancery court wrote that typically a board's compensation decision is "about as work-a-day as board decisions get" and "entitled to great judicial deference," especially when stockholders approve the award. Furthermore, as Musk and the other director defendants argued, the stockholder vote satisfied the governing statute, Delaware General Corporation Law Section 216. Section 216 does not require that a majority of all outstanding shares approve the award, just a majority of the shares present and entitled to vote at the special meeting, distinguishing the situation from the plaintiff's principal supporting authority. "In the ordinary course," this vote would justify business judgment deference, the court wrote.

However, Delaware treats transactions involving controlling stockholders differently, recognizing that the control structure leaves minority stockholders susceptible to coercion. Coercion is a risk even with a compensation award, where minority stockholders may fear that the controller will react to a no vote by forcing a squeeze-out or cutting dividends. The plaintiff also pleaded that the compensation committee and board processes were subject to Musk's coercive influence, leading the court to conclude at the pleadings stage that the award was not duly approved by either of Tesla's qualified decision makers (that is, the independent, disinterested board and the unaffiliated stockholders), and that entire fairness was the appropriate standard of review.

Extending the *MFW* framework. The court's opinion also provides an option for controlling stockholders to secure business judgment deference by adopting the "dual protections" of *MFW*. *MFW*, a case of first impression, involved a going-private merger that required the approval of two factions: a properly empowered, independent committee and an informed, uncoerced majority of minority stockholders. Although it had previously applied the entire-fairness standard to deals that involved only one of those protections, the Delaware Supreme Court likened the *MFW* deal's dual-protection structure to an arm's-length transaction under DGCL Section 251 and applied the deferential business judgment rule.

The defendants argued against extending the application of *MFW* beyond the context of a squeeze-out merger, observing that the framework mimics Section 251 and is irrelevant to transactions where approval is not required at both the board and stockholder levels. The court rejected this "statutory symmetry" argument. While nothing in *MFW* suggests the Supreme Court intended to hold that the dual protections are required in all controlling stockholder transactions to trigger business judgment review, the protections can still provide useful safeguards in other situations. If the Tesla board had, at the outset of the compensation negotiations, ensured that both an independent compensation committee and the minority stockholders were able to make an informed review of the award, followed by an uncoerced approval, this would have "abated the Court’s reflexive suspicion of Musk’s coercive influence over the outcome" and triggered business judgment review at the pleadings stage.

Unfair price. As this did not happen, the appropriate standard was entire fairness, and the plaintiff adequately pleaded that the award was not entirely fair because the present value of the award was so much higher than the compensation paid to Musk’s peers. The defendants countered that the award is entirely performance-based and aligns Musk’s incentives with those of other stockholders. Furthermore, the milestones are so substantial that Musk may never see the full value of the award. These arguments "may well carry the day" if the court has occasion to consider them on summary judgment or at trial, but on the pleaded facts, it was reasonably conceivable that the pay package is unfair.

The case is No. 2018-0408-JRS.

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