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What The Elon Musk Pay Decision Means for Executive Compensation

A Delaware Chancery Court recently voided Elon Musk's Tesla compensation package, which on the strength of the company's extraordinary market success had made Musk an owner of Tesla stock valued at more than $50 billion.

By its own words, the court has gone where no Delaware court dared go before, overriding a favorable shareholder vote to find that an executive compensation package was fundamentally unfair. Tesla may appeal, and the broader implications, if any, will take some time to reveal themselves. However, here are three general themes of note from the decision.

The Moving Goalposts of Executive Compensation

What constitutes an enlightened executive compensation program has long been something of a moving target, informed by governance lessons of the past. First, we understood that it was better to pay senior executives largely in stock, more closely binding their personal outcomes with those of the company. Then we learned that those stock grants should be heavily contingent on long-term performance targets, to avoid perverse incentives for financial manipulation. Finally, we came to appreciate that those performance targets need to be sufficiently difficult, to require a true value add to the company commensurate with the proposed compensation.

Musk's Tesla compensation package appeared to pass these tests, at least on its face. It bound Musk's personal fortune to the fate

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of Tesla for a long period against what seemed at the time remarkably ambitious performance targets. As the Delaware court noted, the market capitalization targets required that Tesla grow essentially by the size of a Ford or GM for each tranche of Musk's stock to vest and for Tesla to maintain that market cap over time.

However, even discounting for the improbability of reaching the performance targets, the compensation package was independently valued at more than $2 billion at the time of the grant. Institutional Shareholder Services called the amount "staggering" and recommended that shareholders vote against it, despite the challenging performance goals. Shareholders ultimately did approve the plan, but the Delaware court found Musk's package was simply unfair and that even a favorable shareholder vote could not save it against the backdrop of a fatally flawed governance process.

The Substance of the Process Matters

The process for arriving at Musk's compensation plan seemingly adhered to governance norms. The board had a compensation committee composed of nominally independent directors that retained an outside compensation consultant and a valuation expert. There were extensive deliberations about performance targets and testing of those targets against long-term expectations. Many meetings were held over several months before the board ultimately approved the package and put it to a shareholder vote.

However, when the Delaware court looked closely at the governance process, they found what they considered to be significant deficiencies. The court concluded that the directors were not actually independent of Musk, the compensation consultant did not provide any meaningful benchmarking, and some of the performance targets were not as difficult as they may have seemed based on the company's own projections. Among other issues, the court found that several of the "independent" directors owed their personal wealth to Musk, among other close ties. These and other important details were not disclosed in the proxy, and thus the shareholder vote was not adequately informed. It then became Tesla's obligation to prove that the compensation package was fair. Tesla was not able to do so, as it was unable to provide evidence that the unprecedented compensation package was necessary to retain him.

What we do not know from this case is whether Musk's package would have survived judicial review with the benefit of a more rigorous process and more clearly independent directors. The court might never have reached the fundamental fairness of the compensation if it had found the proxy disclosures accurately described the governance process to shareholders.

Fairness and the Minority Shareholder

The plaintiff in the Tesla case was a small individual investor, but objections to Musk's compensation were not confined to a sole objector. Most significantly and as noted above, Institutional Shareholder Services recommended against the pay package and at least two significant institutional shareholders voted no.

Despite those objections, the Tesla board may have expected that the approval by a "majority-of-the-minority" of shareholders would support Musk's package. What they found instead was a reminder that the Delaware Chancery Court is a court of equity, and the equities will sometimes rule in favor of the aggrieved minority shareholders. This has long been an important trait of the Delaware judiciary.

What Comes Next

The implications for directors on boards other than Tesla's are less clear. While Musk's compensation package may be considered to have been such an outlier to not serve as an effective example, insureds should expect additional scrutiny on the independence of compensation committee members, reaching beyond the mere fact that they do not work for the company to encompass personal, social and outside business relationships with officers. This attention will be especially acute where a CEO holds considerable ownership, even if less than a majority.

Applied to more pedestrian circumstances, the Tesla decision if anything only further emphasizes the well understood importance of a truly independent governance process relying on external expert advice to craft carefully benchmarked and reasonable executive compensation programs with transparent shareholder disclosures.

It appears that over the last five years, there has been a notable uptick in the frequency of lawsuits initiated by stockholders against directors and executives concerning compensation-related issues. Plaintiffs are introducing innovative claims against boards in these instances. Moreover, courts are shifting towards employing the entire fairness standard of review instead of the traditionally more lenient business judgment standard, thereby enabling these compensation-related lawsuits to progress beyond the initial motion to dismiss phase. When claims withstand a motion to dismiss, the likelihood of reaching a settlement increases. This can potentially lead to substantial attorney fees and unfavorable publicity for the companies involved.

Such litigation brought by shareholders in their own interest or in the name of the company are typically covered under insurance. For a discussion on your specific business needs and comprehensive insurance solutions for directors and officers as well as those of the company, NFP's professionals are available to assist and navigate the diverse exposures your business may encounter.

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