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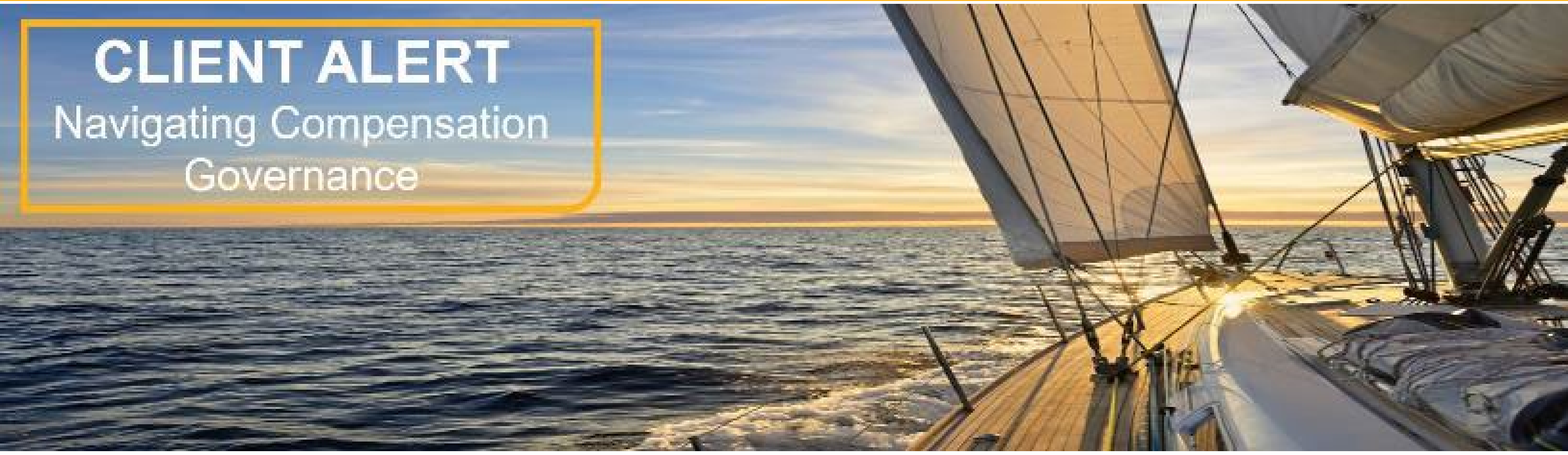

Delaware Court Strikes Down Musk's $56 Billion Pay Package

In what is believed to be a first of its kind ruling, a Delaware Court has rescinded an equity grant awarded to a public company's CEO (Elon Musk).

Despite receiving shareholder approval (in a binding vote), the equity grant did not survive judicial scrutiny.

The Delaware Court found that Tesla failed to fully inform shareholders about the equity grant, thereby requiring Tesla to prove the equity grant was "fair," which it was unable to do.

Outsized Option Grant Leads to Outsized Increase in Market Capitalization

In 2018, Tesla granted to Elon Musk stock options to purchase shares roughly equal to 12% of Telsa's then outstanding shares. The grant was approved by shareholders in a binding vote. The stock options would fully vest if Tesla's market capitalization increased 12-fold, from roughly $50 billion to $600 billion over the option's term. If this market capitalization milestone was reached, Mr. Musk's options would be worth roughly $56 billion, meaning that Mr. Musk would share in approximately 10% of the increase in Tesla's market capitalization from the date of grant.

By the filing of Tesla's 2023 proxy statement, Mr. Musk vested in the entirety of his stock options, which remain unexercised.

Despite this outsized gain in market capitalization, a Tesla shareholder filed a derivative shareholder suit in Delaware Court claiming that Musk and Tesla (and its Board and compensation committee) breached their fiduciary duty by awarding the stock options to Mr. Musk and asked the court to rescind the grant.

Delaware Court Rescinds a CEO's Stock Option Grant-a First

In a ponderous 200-page decision, the Delaware Court sided with the shareholder-plaintiff and ruled that the Tesla Board breached its fiduciary duty and that the appropriate remedy for this breach was the full rescission of Musk's stock option grant.

It is believed that this is the first time that a Delaware Court has struck down an equity grant to a public company CEO. This outcome would appear remarkable given that state courts typically afford significant judicial deference to corporate board decisions. In fact, the Delaware Court noted that "a board of directors decision on how much to pay a company's chief executive officer is the quintessential business determination subject to great judicial deference" under the ***business judgment rule***. As applied by the Delaware courts, this judicial deference would rarely result in a court second guessing the appropriateness of a public company board's decision on executive pay matters.

Unfortunately for Tesla and Mr. Musk, the Court determined that Tesla's board decision to grant the Stock Options should be assessed under the ***"entire fairness standard"*** which is far more demanding than the business judgment rule. The rationale for applying this higher standard and the Court's legal assessment of the board's decision in making the grant of stock options is explained below.

Delaware Court's Rationale for Striking Down Musk's Option Grant

Based on a fairly unique set of facts, the Delaware Court determined that the grant of Musk's stock options should be evaluated under the entire fairness standard and that Tesla and Musk failed to show the grant met this standard based on the following:

- Musk's status as a "controlling shareholder" changed the standard of review from the ***business judgment rule*** to the ***entire fairness standard*** and shifted the burden of proof from plaintiff to Tesla and Musk.
- Generally, approval of an option grant by "fully informed" shareholders would shift the burden of proof back to plaintiff and change the legal standard of review to the business judgment rule. However, the Delaware Court found that Tesla's shareholders were **not** fully informed about the stock option grant at the time they approved the grant. Therefore, the burden of proving the stock option grant met the ***entire fairness standard*** remained with Tesla and Musk.
- This then required Tesla and Musk to establish the entire fairness of the grant. To do so, the Delaware Court required Tesla and Musk to show (i) "fair dealing" in the determination of the stock option grant and (ii) "fair price" of the grant. The Delaware Court held that Tesla and Musk failed to meet either requirement.
- As a result, the Delaware Court determined that Tesla and Musk **breached their fiduciary duty** by granting the stock option and that the appropriate remedy for such breach was the **full rescission** of Musk's stock option grant.

Tesla and Musk have yet to indicate whether they will appeal the Court's decision, though a recent letter from plaintiff's counsel to the Court signals Mr. Musk's intent to appeal, as it disclosed that Mr. Musk plans to request a stay of the decision pending appeal.

Frequently Asked Questions

The following FAQs address some of the key issues raised by the Delaware Court decision.

1. **Does this decision have widespread application to corporate board's executive pay decisions?**

   No. The decision does not have widespread application to corporate board pay decisions, due to the relatively unique fact pattern underlying the Musk case. The cornerstone of the case was Musk's status as a "controlling shareholder." Absent that status, the Delaware Court would likely have assessed Musk's option grant under the more generous business judgment rule rather than the more requiring entire fairness standard. As more fully explained below, only a handful of public company CEOs could plausibly be labeled a controlling shareholder under the Court's analysis.

2. **What is the difference between the business judgment rule and the entire fairness standard?**

   As a general matter, a corporation would rather have a legal dispute decided under the business judgment rule than under the entire fairness standard. Under the business judgment rule, courts generally defer to the decisions of corporate directors and officers unless there is evidence of bad faith, self-dealing, or gross negligence. This principle recognizes that corporate decision-making involves a degree of uncertainty, and directors and officers should have the latitude to exercise their judgment without undue legal risk. Under this rule, courts will rarely second-guess pay decisions made by a corporate board.

   In contrast, the entire fairness standard is more stringent than the business judgment rule, as it places a heavier burden on corporate decision-makers to justify their actions in situations involving conflicts of interest. Under the entire fairness standard, the burden of proof falls on the directors and officers to demonstrate that a disputed transaction (i.e., pay decision) was fair, both procedurally and substantively. Unlike in the Musk case where this burden proved too great, companies with proper protocols in place regarding pay decisions (as discussed below) may be able to meet the burden of proof. However, the sticking point to whether such burden is met is left to the subjective judgment of the presiding court.

3. **Will this case embolden plaintiffs' bar to launch strike suits claiming a company CEO is a controlling shareholder; thereby subjecting a disputed pay decision to the entire fairness standard?**

   Maybe. Plaintiff attorneys could be emboldened to target any company where the CEO maintains significant share ownership position (rarely such ownership position would compare to Musk's but these positions at mega cap companies could be valued at anywhere between $100 million to over a $1 billion) and claim that such ownership level with other characteristics demonstrates the CEO is a controlling shareholder. Nonetheless, plaintiffs may find it difficult to bridge the distance between a CEO's share ownership and claims of the CEO being a controlling shareholder (see discussion below).

4. **Would a typical public company CEO be considered a controlling shareholder?**

   No. Generally, the overwhelming majority of public company CEOs would not likely be considered a controlling shareholder under Delaware law. In Musk's case, the Delaware Court found him to be "controlling shareholder" based, in part, on the following facts and circumstances:

   - "enormous influence" over Tesla,
   - 21.9% equity stake,
   - revered status as a "Superstar CEO",
   - "thick ties" with the directors tasked with negotiating on behalf of Tesla the stock option grant, and
   - domination of the process that led to board approval of the stock option grant.

   A typical CEO's circumstances would rarely be analogous to Musk's and Tesla's situation.

   However, given the apparent absence of a bright line rule used to determine whether Musk was a controlling shareholder, it is important to note that the Delaware Court made this determination solely on a subjective basis.

5. **In the case where a CEO owns a large equity stake, are there steps companies should take to lessen the possibility that the CEO could be deemed a controlling shareholder?**

   Yes. A company should consider taking the following steps to mitigate the possibility of a CEO who owns a large equity stake from being deemed a controlling shareholder:

   - The independence of lead director/independent board chair and compensation committee members should go beyond exchange requirements. Such board members should have no business or personal relationships with the CEO or the CEO's family.
   - The role of the compensation committee, committee consultant and management in formulating, reviewing and, in the case of the committee, approving CEO compensation should be well-understood and documented.
   - The process and timing for making CEO pay decisions should be well-documented.
   - The benchmark assessment of existing and proposed CEO compensation should be performed by an independent consultant hired by and reporting to the compensation committee.
   - The decision-making process for making CEO pay decisions should be well-documented and reflected in committee minutes.
   - The CEO should be excluded from any board/committee meetings when his compensation is subject to discussion.

   Of course, we would recommend that companies in the normal course follow the above protocols.

6. **Does the Delaware Court decision suggest that it is problematic for a company to grant equity grants to a CEO who holds a large equity position?**

   At the outset of its opinion, the Delaware Court asked, "Was the richest person in the world overpaid?" That set the underlying thesis of the Delaware Court's reasoning, in part, that the massive equity grant to Mr. Musk was not in the interests of Tesla or shareholders (and not needed) because Mr. Musk was fully motivated to enhance shareholder value due to his pre-existing enormous share ownership of Tesla.

   On its face, the Court's proposition rings true. However, in application, the proposition becomes problematic. When should a corporate board consider CEO share ownership too high to support the grant of additional equity awards? That question may become pertinent at share ownership levels far below Mr. Musk's. Should equity awards cease when a CEO holds shares with $1 billion or $500 million or $100 million or less? An argument could be made that a CEO at each of those share ownership levels is fully motivated to drive shareholder value without requiring further motivation through additional equity grants.

   We do not offer an opinion on that question but note that such philosophical issues are best left to the judgment of corporate boards and not to state judiciaries.

7. **What steps should companies take to ensure special equity grants are defensible in light of the Musk decision?**

   Special equity grants are grants in addition to (or sometimes in lieu of) normal annual cycle grants. These grants are made in a variety of forms and for a variety of reasons and include sign-on grants, out-of-cycle "retention" grants, and mega-grants. These grants are often characterized by their relatively large value and limited number of recipients (in some cases, limited to the CEO).

   Special equity grants often draw significant scrutiny from institutional shareholders and proxy advisors. With the Musk decision, special equity grants may come under even greater scrutiny and potential challenge. Therefore, it is important for compensation committees to develop these grants through a rigorous process such as the one described in question 5. However, more may be necessary, especially around the development of the size of the award. Benchmark data is sparse and non-uniform regarding special equity grants. Therefore, compensation committees will need to develop other means by which to justify the size of a special equity award. In addition, compensation committees will need to address the why – that a special equity grant is required in addition to an executive's regular pay package.

8. **Are there portions of the Delaware Court decision that do not square with governance practices associated with setting CEO pay?**

   Yes. The Delaware Court makes several observations and critiques that suggest a misunderstanding of the process used by large public companies to set executive compensation, some of which are listed below.

   - Apparently, the court believes the process for setting executive compensation should be through an **adversarial process** (the court noted that "there is no evidence of any adversarial negotiation with Musk concerning the size of the Grant"). While the adversarial process is the hallmark of U.S. litigation, such a process generally is not followed by compensation committees or Boards in the development of executive pay decisions and would likely be counterproductive. Rather a well-functioning compensation committee's role is to bring to bear its independent judgment to evaluate the appropriateness of a CEO's pay package. Disagreements between the committee and the CEO may arise from this evaluation but rarely do they devolve into an adversarial situation.

   - The court also expressed concerns that the working group charged with developing Musk's stock option grant included management members who were "beholden to Musk." It is unclear whether the court was concerned that any management members were included in the working group or that such members were beholden to Musk. In either event, the court's concerns run contrary to real world processes. Senior management, in particular senior HR and legal officials, is often charged with developing strawman pay designs (with supporting analysis) for the consideration of the CEO and compensation committee. This is routine and generally non-controversial.

     The court's concerns about management employees being presumably compromised because they are beholden to the CEO is frankly puzzling. By definition, senior management employees reporting to the CEO are beholden to the CEO for their continued employment and pay levels. Is the court suggesting that management should play no role in assisting in the development of the CEO's pay package (which is subject to independent review by the compensation committee and full board)?

- The strangest finding of the court concerns one of the rationales Musk and Tesla mounted in defense of the stock option grant. Tesla argued the grant of the stock option was fair because it worked (i.e., "Tesla thrived because of the [stock option grant]"). The court rejected this argument finding that Tesla failed to prove that Musk's "less-than-full time efforts" for Tesla were solely or directly responsible for Tesla's growth, or that the grant of the stock option was solely or directly responsible for Musk's efforts. The court harshly found that this defense was "empty rhetoric, not evidence of fair price." Perhaps the argument does not provide evidence of fair price. However, the notion that the argument fails due to Tesla's inability to show a causal link between the grant and Tesla's growth (and between the grant and Musk's efforts) demonstrates a court reaching for a rationale to support its conclusion. Unless a CEO is on a commission-based pay program (i.e., the more widgets the CEO sells the greater the CEO's compensation), no incentive program exists where the court's requisite causation can be proved.

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