Blogs
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In a **lengthy opinion** that unwound an eye-popping $55 billion compensation grant, the Delaware Court of Chancery's Chancellor Kathaleen McCormick invalidated Tesla's huge compensatory equity grant to Elon Musk, its Chair and CEO. We have distilled this 200-page opinion down to three practical "best practices" for directors to apply in reviewing the important - but less extraordinary – equity grants that CEOs and executive teams typically receive each year. These three tips apply to compensation committee members and their advisors, of public companies as well as private, and generally, whether formed in Delaware or elsewhere.

What happened in the Tesla boardroom and in the Delaware court?

In January 2018, Tesla's board approved a performance-based equity compensation plan for CEO Elon Musk. The equity award consisted of 12 "tranches" of options, each for about 1% of Tesla equity, that would vest as Tesla reached very ambitious levels of market capitalization plus EBITDA or revenue goals. Success in all of the dozen tranches would have provided value, as the court described it, of up to $55.8 billion to Mr. Musk. (Tesla now has a market capitalization of over $600 billion, well above the $60 billion at the time of the equity compensation plan was approved.)

Because of the size and the unusual nature of the plan, and because Mr. Musk, a founder, CEO and 22% shareholder, so strongly influenced the company and board, the board called for a fully informed vote by a majority of disinterested Tesla stockholders, hoping to protect the board's decision to approve the equity plan by shifting the burden of proof for any challenge to the grant to the plaintiff rather than the defendants. Tesla prepared - and the court carefully scrutinized - a proxy statement for a March 2018 stockholder meeting. Ultimately 74% of the shares not held by Mr. Musk or his brother approved the plan. The grant was made, and by 2022, most of the metrics for the 12 tranches of options had been achieved.

Objecting to the grant - and the process by which it was approved - a Tesla stockholder brought a derivative action in Delaware Chancery Court to challenge the grant. At the end of January 2024, after a five-day trial, Chancellor McCormick issued her 200-page decision invalidating the equity grant.

Why did the Tesla grant "flunk" its Delaware court test?

Generally, a compensation decision by a board is reviewed under the highly deferential, board-favorable "business judgment rule," in which a court defers to the judgment of the board. Alternatively, when a corporation enters a transaction with a "controller" (someone who controls the corporation by share ownership or other means), such transactions generally involve a conflict of interest and are reviewed under the more stringent "entire fairness" standard. Chancellor McCormick applied the "entire fairness" standard, finding Mr. Musk to have "transaction specific" control over the equity grant. She found that, as to the equity grant, Mr. Musk "dominated the process" that led to board approval and so "controlled Tesla."

Chancellor McCormick determined that defendants – and not the plaintiff – had the burden of proving the "entire fairness" of the plan because the plan had not been approved by a fully informed vote of a majority of the disinterested stockholders, concluding that the stockholder vote was invalid, and therefore the entire equity grant was invalidated, because the stockholder vote was "not fully informed."

The court's conclusion was based principally on misstatements concerning the independence of Tesla's directors in the proxy statement distributed to stockholders. In particular, the court found that directors whom the board described in the proxy as "independent" directors were in fact beholden to Mr. Musk. The court also found that the negotiation of the compensatory equity grant had been directed at all stages by Mr. Musk, not led by the board, and that this had not been disclosed to stockholders in the proxy statement.

The court then determined that Tesla had not met its burden of showing the transaction was entirely fair. To assess fairness, the court considered both process and price. As to process, the Chancellor concluded: that the board did not adequately consider its own independence; that the board allowed Mr. Musk to initiate and control the negotiations; that the board did not adequately take the lead in those negotiations with Mr. Musk; and that the board did not ask such critical questions as to whether there was a valid and less expense alternative to this plan.

As for price, the Chancellor noted that the board failed to consider: whether the compensation plan was necessary to keep Mr. Musk at Tesla, and whether the compensation plan was necessary in order for Tesla to achieve the financial goals associated with the equity awards.

What three "best practices" for directors emerge from this court decision?

1. **Ask - and create a record documenting the asking – and answering – key questions.**Similar to the court's criticism of the board for not asking "mission critical risk" questions about food safety in the ***Blue Bell Creamery* decision**, Chancellor McCormick focused on the Tesla board's failure to ask the critical questions, namely: "Was this package necessary? Was this the best compensation package for Tesla at this time for this executive?"

2. **Consider alternatives.** Chancellor McCormick criticized the board for simply accepting the proposal that Mr. Musk gave the board. Instead, she suggested that the board should have considered all alternatives to achieve its goals. It was up to the board to ask Mr. Musk to consider alternative options rather than simply reacting to the controller's proposal. As noted on page 140 of the opinion, "Delaware law recognizes that 'asking the controlling stockholder to consider alternative options can change the negotiating dynamic.'"

3. **Create a robust record of board independence.** The Court concluded that social friendships and compensation earned as a result of opportunities derived from Mr. Musk, as well as long board service, should have been weighed in determining independence and should have been disclosed in the proxy statement.

   Despite the existence of these factors, a particular director could perhaps have been found to be independent – but there should be a robust record that the board had fully considered each factor in weighing independence. The board's records – in minutes, in emails, in proxy disclosure – can support this.

   There are many ways to create an effective record. Minutes are the simplest – and under Tesla's circumstances, the court's decision likely would have been influenced if the board had maintained minutes documenting: consideration of all factors that could have called director independence into question, "mission critical" questions that had been asked and answered, and consideration of alternatives to achieve the company's financial goals.

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