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# Corporate Governance Takeaways Following Rescission of Elon Musk's $55.8 Billion Equity Compensation Package

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"Was the richest person in the world overpaid?" That's how the Delaware Court of Chancery (the Court) began the 200-page opinion in *Tornetta v. Musk* to rescind Elon Musk's entire $55.8 billion 10-year equity compensation package after a ruling that the directors of Tesla breached their fiduciary duty in approving such a robust compensation package for its chief executive officer. The decision in the case and the factors focused on by the Court offer key lessons for boards and compensation committees and is a reminder of the importance of following and documenting the process for approving executive compensation.

On January 21, 2018, Tesla's board of directors (the Board) unanimously approved a grant to Musk of performance-based stock options that would vest upon Tesla's achievement of certain market capitalization goals and operational milestones, with a potential $55.8 billion maximum value and a $2.6 billion grant date fair value (the Compensation Package), which, as the Court noted, was the "largest potential compensation opportunity ever observed in public markets." For scale, this award was "250 times larger than the contemporaneous median peer compensation plan and over 33 times larger than . . . Musk's prior compensation plan."

The Board's approval of the Compensation Package was conditioned on the approval of a majority of Tesla's disinterested stockholders. Tesla submitted a proxy statement to the stockholders with a description of the Compensation Package. The Compensation Package was subsequently approved by 73% of the disinterested stockholders and more than 80% of votes cast (Musk was not allowed to vote his shares).

The plaintiff, a single Tesla stockholder who owned just nine shares at the time the action was filed, argued that the Compensation Package should be voided because Tesla's directors breached their fiduciary duties by approving it and because information provided to stockholders to secure their approval lacked sufficient material information for an informed stockholder vote. The Court agreed with the plaintiff and rescinded the entire Compensation Package. Among other things, the Court found that the proxy statement provided to stockholders inaccurately described certain Board members as independent and omitted key details about the process for determining the Compensation Package and Musk's control over the process. There are a number of takeaways from the Court's decision. Below are four that boards of directors and compensation committees should consider when making executive compensation decisions.

## 1. Be mindful of the entire fairness standard of judicial review.

The standard of review used by a court often determines the outcome, and that was certainly the case in *Musk*. Compensation determinations are usually given broad judicial deference, but because the Court found Musk to be a controlling shareholder, both mathematically by the shares of Tesla that Musk owns and effectively by controlling the business affairs of Tesla, the Court employed the highest level of judicial scrutiny under Delaware law—the "entire fairness standard". Under this standard, the defendants bore the burden of proving that the Compensation Package was fair in terms of price and process to the Company and its stockholders. Finding the shareholder disclosure to be flawed, the Court held that the Tesla Board failed to meet its burden of proof.

There is a lesson here for both public and private companies. Obtaining approval by disinterested shareholders can protect a board of directors from breach of fiduciary duty or conflict of interest claims, but companies need to be scrupulous about ensuring that shareholders receive complete and truthful information about the matter they are asked to approve. Otherwise, companies risk not having the shareholder approval respected.

## 2. Employ proper negotiations and conduct a benchmarking analysis.

The Court took issue with the process used by Tesla's compensation committee for determining the Compensation Package, specifically with the committee's failure to engage in proper negotiations, failure to use a traditional benchmarking analysis, and failure to ask the threshold question: Is this amount of compensation necessary to achieve the objective of retaining and incentivizing Musk? The Court found that the committee was unable to prove fair price or fair dealing.

In terms of negotiations, the Court found that "there is barely any evidence of negotiations at all." The Court noted that Musk proposed the Compensation Package and unilaterally amended it, thereby setting the size and structure of the Compensation Package himself. The Court also found that Musk set the terms of the Compensation Package and controlled the timing of approval. The Court cited to testimony from defense witnesses who dubbed the process a "collaboration" rather than a negotiation or an otherwise arm's-length transaction. Board and committee members could not remember meetings where important elements of the award were discussed.

In addition to failing to negotiate with Musk, the committee did not engage in a traditional benchmarking analysis that would have compared the proposed compensation plan to plans at comparable companies. Instead of granting Musk compensation for his roles with Tesla based upon a review of compensation plans for other similarly situated companies, the Court noted that the Compensation Package "seems to have been calibrated to help Musk achieve what he believed would make a 'good future for humanity,'" referring to Musk's goal of colonizing on Mars, which was unrelated to Tesla's goals. The Court stated that the awards should have rationales that clearly and closely align to the company's business objectives.

Putting aside the animosity for Musk that the Court's opinion suggests, there are takeaways for boards and compensation committees from the ruling. First, boards of directors and compensation committees would be well served to keep detailed documentation of the process that was undertaken to set the terms of, and to consider and approve, executive compensation. Documentation of the process should include records of any negotiations about the compensation with the subject executives as well as internal communications among members of the board or committee.

It may be too much to take away from the *Musk* decision that benchmarking is always required, but clearly boards of directors and compensation committees will be better armed to defend their decisions and the process by considering benchmarking analyses.

Likewise, facts and circumstances will naturally dictate how much negotiation over compensation will take place between compensation committees and key officers. The Court's opinion seems to suggest that such negotiations must be adversarial, but negotiations over executive compensation are more likely to occur over dinner than across a collective bargaining table. While offering an executive the lowest end of a range of compensation with the intention of increasing the offer if asked may show that there was an adversarial negotiation, compensation committees are likely to be concerned that such an approach would only lead to greater demands from an executive and ultimately a higher cost to the company. The approach could also make a key executive feel unappreciated and distract the executive from his or her corporate duties.

## 3. Ensure the independence of directors.

The Court found that Tesla's compensation committee was comprised entirely of directors who were not sufficiently independent to vote on the Compensation Package, and that only one member of the Board could be said to have "no compromising personal or business ties to Musk." The Court heavily considered that Musk had close personal and business relationships with every member of the committee. Some of the factors the Court considered when examining whether the directors were independent included: (i) the amount of Board compensation they received, (ii) length of their Board service, (iii) the amount of compensation they gained by investing in other companies controlled by Musk, and (iv) their regular socialization for holidays, life events and vacations with Musk.

Boards of directors and compensation committees should ensure that directors approving the compensation are independent, objective, and disinterested. Based on the Court's decision, directors should be mindful of having close personal relationships and/or co-investment activities with executives whose compensation they must approve. A director's independence should be regularly reviewed.

### 4. Be scrupulous with information provided to stockholders.

Seeking stockholder approval of a decision made by a conflicted board of directors is sensible. However, the Court's opinion demonstrates that even when a high percentage of voting stockholders approve a matter placed before them, that vote will not be respected if the disclosure to stockholders is not altogether accurate or if omissions are made that could influence the way that stockholders vote. Clearly, making sure that information provided to stockholders is accurate and complete is essential to being able to rely on the vote of stockholders.

### Conclusion

Whether or not the Court's decision is affirmed on appeal, boards of directors and compensation committees should heed the lessons of the Court's decision. Executive compensation decisions should be made by independent directors who control the compensation process. The process of determining, negotiating, and approving compensation should be scrupulously documented. Whenever possible, compensation decisions should be supported by benchmarking analyses. Should stockholder approval be sought for any matter, ensure that the disclosures to stockholders are full, complete, and accurate.

Lowenstein Sandler's Employee Benefits & Executive Compensation group regularly counsels public companies, compensation committees, and executives about executive compensation and related disclosures in proxy statements and other securities filings. Please contact the authors or any Lowenstein Sandler attorney with whom you regularly work if you have any questions.

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