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Delaware Court of Chancery Rescinds Musk's $55.8B Tesla Stock Option Grant in Key Decision on Corporate Transactions with Controlling Stockholders

On January 30, 2024, the Delaware Court of Chancery rescinded Tesla, Inc. ("Tesla")'s January 2018 grant to CEO Elon Musk of performance-based stock options with a potential $55.8 billion maximum value and a $2.6 billion grant date fair value (the "Grant").[1] The lawsuit was filed derivatively against Musk, in his capacity as Tesla's controlling shareholder and director, and against certain other Tesla directors.

In ruling in favor of the plaintiff, the Court, in a 200-page opinion authored by Chancellor Kathaleen McCormick, determined that the Grant constituted a conflicted-controller transaction on the grounds that Musk had "transaction specific control" of the Grant.[2] This determination was premised on a holistic analysis of "Musk's influence over managerial decisions, decision makers, and the process,"[3] as well as his ownership of 21.9% of Tesla's outstanding stock. This triggered the rebuttable presumption that the Grant would be reviewed under the "entire fairness" standard, Delaware's most onerous standard of review. Under the entire fairness standard, defendants would bear the burden of proof. The burden could have been shifted if the defendants had shown that the Grant was approved by either (1) a well-functioning committee of independent directors, or (2) a *fully informed* vote of the majority of the minority ("MOM") stockholders.[4] However, the Court found, in particular, that the independence of the committee was compromised. In addition, the disclosure regarding the Grant in Tesla's 2018 proxy statement was deficient because the actual and potential conflicts of interest of the Compensation Committee members were not adequately

[1] *Tornetta v. Musk, et al.*, C.A. No. 2018-0408-KSJM, 2024 WL 343699, --- A.3d ---- (Del. Ch. Jan. 30, 2024). Tesla directors were separately sued in relation to stock option and cash compensation packages granted since 2017. That portion of the suit was settled in 2023 with the directors agreeing to pay $735,266,505.

[2] *Id.* at *46 ("This unique suite of allegations makes it undeniable that, with respect to the Grant, Musk controlled Tesla."). The Court left the question open as to whether Musk could be deemed to have working control over the general business and affairs of Tesla ("general control"), rather than the narrower transactional control of the Grant on which the case turned. While a mathematical voting majority is the most straightforward path to general control, the Court notes that Section 203 of the Delaware General Corporation Law creates a presumption of control for any shareholder who owns 20% of the issued and outstanding voting securities of a company. The logic behind this presumption is articulated in *Voigt v. Metcalf*, No. CV 2018-0828-JTL, 2020 WL 614999, at *19 (Del. Ch. Feb. 10, 2020), which explores the mathematical amplification of large voting blocks as a consequence of meeting turnout rates that average around 80%, and quorum and approval rules that generally only require a majority of those in attendance and entitled to vote to carry the day.

[3] *Id.* *47.

[4] Depending on the outcome of the appeal process in *In re Match Group. Derivative Litigation*, C. A. 2020-0505-MTZ, 2022 WL 3970159 (Del. Ch. Sep. 1, 2022), the employment of either one of these cleansing devices may be sufficient to convert the entire fairness review standard to the business judgment review standard.

disclosed and material information regarding the process leading to the award of the Grant was omitted. Thus, the Court determined that shareholder approval of the Grant was not fully informed. Consequently, the defendants were required to prove the entire fairness of the Grant.

The "entire fairness test" consists of two interrelated prongs: (1) fair process and (2) fair price.[5] In evaluating the fairness of the process the Court applied the "*Weinberger* factors" and considered how the Grant was initiated, timed, structured, negotiated and approved.[6] In doing so, the Court pivotally determined that Musk controlled the negotiations, with the Compensation Committee "engaged in a 'cooperative [and] collaborative' process antithetical to arm's-length bargaining. Worse, the committee seemed to actively advance Musk's interests—doing 'what feels fair' for Musk . . . ."[7] [8] The Court noted that the Board did not make any meaningful pushbacks to the amount of the compensation or other material terms of the Grant. There was no attempt to benchmark the Grant against existing compensation packages for other CEOs.[9] The MOM approval of the Grant was deficient for the reasons discussed above and there were no other structural governance measures to counterbalance Musk's power. Therefore, the Court determined the process was one-sided and deficient.

In considering the fair price prong under *Weinberger*, the Court must first determine whether the actual deal terms fell into a "range of fairness" after considering all relevant factors.[10] Musk's primary argument for price fairness of the Grant, called the "give/get" argument by the Court, was that the Board gave 6% to get $600B of growth in stockholder value with no downside risk.[11] The Court was not persuaded, stating "the principal defect with Defendants' give/get argument (indeed, their fair price argument as a whole) is that it does not address the $55.8 billion question: Given Musk's pre-existing equity stake, was the Grant within the range of reasonable approaches to achieve the Board's purported goals? Or, at a minimum, could the Board have accomplished its goals with less, and would Musk have taken it?"[12] The Court stressed that Musk's equity stake by itself already provided a strong incentive for him to grow Tesla's capitalization and noted that other public company CEOs with similar pre-existing equity positions such as Zuckerberg, Bezos

[5] *Id.* at *67.
[6] *Id.*
[7] *Id.* at *71.
8 In fact, "many of the documents Defendants cited as proof of a fair process were drafted, pushed out, or endorsed by Musk's divorce-attorney turned-general-counsel Maron, whose admiration for Musk moved Maron to tears during his deposition." *Id.*
[9] The Court noted that the Grant was "the largest potential compensation opportunity ever observed in public markets by multiple orders of magnitude—250 times larger than the contemporaneous median peer compensation plan and over 33 times larger than the plan's closest comparison, which was Musk's prior compensation plan." *Id.* at *1.
[10] *Id*. at *72.
[11] *Id. at *73-76.*
[12] *Id.* at *76.

and Gates waived compensation altogether.[13] Holding this in contrast with the magnitude of the Grant – which weighed in at 250x the peer CEO median compensation – and the fact that the vesting milestones were determined by the Board at the time of the Grant to be 70% likely to be achieved and therefore not ambitious, the Court determined that the price was not fair.

Having determined that both process and price were not fair, the Court moved on to discuss remedies. In exercising its discretional power, the Court found rescission to be fair based on the facts, stating "[t]he Delaware Supreme Court has referred to rescission as the 'preferable' (but not the exclusive) remedy for breaches of fiduciary duty when rescission can restore the parties to the position they occupied before the challenged transaction."[14] Because Musk did not present evidence that a portion (as opposed to the entirety) of the Grant was fair, the Court refused to order a partial rescission of the Grant, citing as precedent its decision in *Valeant,*[15] in which a defendant, the recipient of a bonus that the Court determined was excessive, asked the Court to limit disgorgement "to the extent that the bonus was unfair." The Court in *Valeant* declined and instead ordered that the bonus be entirely disgorged, since the defendant had failed to adduce any objective basis for determining what portion of the bonus was "fair."[16]

Key Takeaways:

- When considering the grant of an executive compensation package to an officer who owns a relatively large block of a company's voting securities, especially one that approaches 20%, the board should assume that there is a risk that the grant will be treated as a conflicted-controller transaction and ensure that a committee of fully independent directors engages in a carefully documented and deliberative decision-making process that considers all relevant factors, including indicators of value, difficulty of meeting the applicable performance criteria, and possible alternative compensation structures.
- The board should not automatically assume that all directors who are characterized as independent in SEC filings are independent in relation to controller self-dealing transactions.
- The special committee should engage an outside expert to benchmark the compensation package, clearly articulate the goals of the package, and develop a negotiation matrix which calibrates the terms and conditions of the compensation package with those goals.
- Disclosure, disclosure, disclosure: It should be noted that an MOM approval has no burden-shifting effect in relation to the entire fairness standard applicable to a controller self-dealing transaction unless the shareholders are fully and candidly apprised of all relevant conflicts of interest and the process by which the transaction was negotiated and approved.

[13] *Id.* at *74.
[14] *Id.* at *4 (footnote omitted).
[15] *Valeant Pharms. Int'l v. Jerney*, 921 A.2d 732 (Del. Ch. 2007).
[16] *Id.* at *752.

Pierson Ferdinand attorneys are knowledgeable in corporate governance matters and are available to assist you in navigating conflicted-controller transactions. For additional information, please contact any of the following or your regular Pierson Ferdinand contact for assistance:

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