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# Directors and executives take note: Delaware court voids Elon Musk's $55B Tesla pay package

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"Was the richest person in the world overpaid?" That is the question that the Delaware Court of Chancery answered in its Jan. 30, 2024, decision in the shareholder derivative action *Tornetta v. Musk, et al.*, C.A. No. 2018-0408-KSJM, 2024 WL 343699 (Del. Ch. Jan. 30, 2024). According to the Chancery Court, what developed into the richest compensation plan in the history of public markets was not "fair" to Tesla and its stockholders.

Of course, most boards of directors do not deal with compensation packages close to the $55.8 billion paid under the plan. However, the Chancery Court's decision to void Mr. Musk's pay has lessons, and implications, for boards deciding — and shareholders challenging — executive compensation.

Mr. Musk's compensation package was no doubt startling. It offered 12 tranches of options with a $55.8 billion maximum value and $2.6 billion fair value as of the grant date.

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For context, the compensation plan was 250 times larger than contemporaneous median peer compensation and over 33 times larger than the plan's closest historical comparison, which, ironically, was Mr. Musk's prior compensation plan. On June 5, 2018, Plaintiff Richard Tornetta, a Tesla stockholder, filed his derivative complaint challenging Mr. Musk's pay, asserting claims for breach of fiduciary duty, unjust enrichment, and corporate waste.

What makes the decision relevant is that the Chancery Court's analysis is rooted in well-established corporate governance standards and the requirement that when there is a possible conflict with the interests of shareholders and executives that the directors making these decisions be independent.

First, the Chancery Court determined that Mr. Musk controlled his compensation decision. Although not a majority shareholder, with his 21.9% ownership he is the largest Tesla shareholder. The Court found also that Mr. Musk kept "thick ties" with the other directors and the executives negotiating for Tesla, rendering them "beholden" to Mr. Musk.

For instance, Mr. Musk had a 15-year relationship with the compensation committee chair and regularly vacationed with other board members. The Court found evidence of Mr. Musk's dominance in the fact he controlled the compensation process, dictating the timing, analyses, and subject matter of the negotiations … or lack thereof.

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Because Mr. Musk "controlled" his own compensation decision, it was a conflict transaction under Delaware law; therefore, the Chancery Court applied the most stringent test for evaluating his compensation plan: the "entire fairness" standard. Under this standard, the court is instructed to consider a wide-ranging set of direct and indirect factors, such as the transaction's timing, structure, negotiation, and disclosures to stakeholders; as well as the company's assets, market value, earnings, projections of future performance, and other economic and financial factors.

The all-important "business judgment rule" that gives deference to the directors does not apply under the entire fairness test and the transaction is exposed to a much greater risk of being unwound. Equally important, the conflicted parties — i.e., Mr. Musk and Tesla's directors — bear the burden to prove the transaction is "entirely fair."

Mr. Musk and Tesla's directors fell far short of proving that the transaction was fair to Tesla. Their "most dramatic failure" was evidence of an arm's-length negotiation, the board having largely abdicated their role as Mr. Musk's adversaries and "instead worked alongside [Mr. Musk], almost as an advisory body."

The Chancery Court also doubted that the plan's milestones were as "audacious" as the board described. Rather, the plan's milestones merely aligned with Tesla's existing projections, which Tesla's board shared with investment banks and credit agencies and used to run Tesla.

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The sheer amount of Mr. Musk's compensation has garnered most of the public and media attention, and surely was critical context for the Court. However, the decision should leave no doubt in board members and executives dealing with compensation plans or other potentially conflict-of-interest transactions that they must carefully consider the process through which such transactions are approved — decisionmakers must be independent and appear to be independent.

The scrutiny applied to Mr. Musk's compensation is not limited to Delaware, with other states applying similar versions of Delaware's corporate governance standards.

For instance, under North Carolina law, the business judgment rule does not shield conflict-of-interest transactions. *Ehmann v. Medflow, Inc*., 2017 WL 4321107, *16-17 (N.C. Super. Ct. Sept. 26, 2017).

If not protected by statutory safe harbors like shareholder approval, directors and executives must demonstrate that the transaction was entirely fair to the company under a test similar to Delaware's. *Id.* at *49-50; *F-L Legacy Owner, LLC v. Legacy at Jordan Lake Homeowners Ass'n*, 2023 WL 2762357, *5-6 (N.C. Super. Ct. Apr. 3, 2023).

Further, "North Carolina courts frequently look to Delaware law for guidance on [corporate] legal issues," and the thorough scrutiny of Mr. Musk's compensation plan could influence North Carolina courts facing similar situations. *Wheeler v. Wheeler*, 2018 WL 6133510, *9 (N.C. Super. Ct. Nov. 15, 2018).

Securing approval of truly independent directors in an arm's-length process is critical to minimizing the risk of shareholder disputes and hostile court scrutiny. In Mr. Musk's case, to the tune of $55 billion.

## About the author

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