

Delaware Court Voids Elon Musk's \$55.8 Performance Based Giga Grant under its “Entire Fairness Standard”

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Discussion Items

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- Why does the Delaware Chancery Court, J McCormick, get to decide on the "Musk" giga-grant of options pay package?
- Is this second-guessing a pay-for-performance business decision?
 - Tesla granted a similar pay package in 2012
- Was it the sheer size of the Package and Corporate Governance used to justify the decision?
 - Is Tesla More than Just a Car Company?
 - Mkt cap for Ford & GM both <\$50B, lower than size of Award
- Who is Judge McCormick: Grad of Harvard/Notre Dame Law & decided the Twitter Case
- Quid pro quo for a Public company that sells shares to the public: certain duties/responsibilities

Practical Effects of Decision

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- Market value of Tesla went from \$60B in 2012 to over \$650B in '23
 - Value exceeded \$1T in 2021
 - Option value is 4x Tesla NI in 2021-22 (\$5.5 and \$12.6B)
- Rising Tide argument: SHs (inc. Musk) made \$ from stock appreciation attributable to the “Super Star CEO” status
- Erases about 1/4 of Elon's Wealth: 28+% to about 22%*
- Future Package to replace the voided pay deal will be similar in any event so why go through the effort?
- Is a "Do Over" practical: Will SHs vote for a new package now that value has been realized?
 - New Package may impose Guardrails to require Musk to dedicate more time to Tesla to the exclusion of other ventures such as Space X

* Twitter 13%+12% = 25% goal

What was the Legal Basis of Decision?

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- The pay package was presented to the shareholders & 73% of the shareholders (excluding Musk) voted in favor
 - Isn't this enough in itself to demonstrate fairness?
- Did the Proxy Statement contain material misrepresentations & omissions?
- Assertion of “independence” by the Board?
 - Questioned whether the Compensation Committee was truly acting independently

Fiduciary for All Stakeholders: Entire Fairness Standard

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- Elon holds 21.9% of the shares & plaintiff has only 9 shares
 - Stated goal: to exceed 25% ownership (+6% to 28.3% holding)
 - Looked to secure twelve tranches upon meeting stretch capitalization & operational milestone - He achieved 11 out of 12.
 - Did Elon err by not proposing 2 classes of shares, to retain voting control?
- DE law is considered “pro-business” & long history of ‘business judgment rule’
 - A board’s judgment of how to pay a “Founder CEO” is a quintessential determination subject to great judicial deference
 - DE law focuses on risks arising from “controlled party” transactions
 - Presumptive standard of review is the “entire fairness standard”

Entire Fairness Standard (1)

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- Settled principles & precedents of DE Corporate law
- Court Concern with both Process and Price
- No meaningful benchmarking was made for TESLA
 - Comparables: Facebook, Amazon, Microsoft
 - No car companies
 - 250X medium & >30x greater than the nearest comparable (Elon)
- Compensation Committee Conflict - Obligation to disclose a relationship with Elon
 - 2018 SEC Settlement added two independent directors
 - No meaningful negotiations with friendly directors
 - Any “independent directors”
- Was the Proxy timetable rushed?

Fairness Standard (2)

- Court found that “attention, engagement, & alignment inherently exist”
 - Perhaps a lesser Pay award would have been sufficient?
- Tesla is the largest % of Musk's fortune so has incentive to align his interest
 - Problem with “Super Star CEO”!
- Musk is Tesla's chief asset & there is a risk to sustaining it's value if he leaves
- Given other business interests, is there a need to focus his innovation, strategy, & leadership primarily on Tesla?
 - Retention is not an issue since Musk stated he had no intention of leaving: “Significantly involved for life”
- No effort to show & prove “causation” i.e. the Giga Grant Pay Plan caused Musk to stay
- No succession plan to replace Musk was instituted then or since
- Does the new board represent all shareholders rather than Musk's interest alone?
- SOX requires independent directors & disclosure of related party deals

Attorney's Contingency Fee Controversy

- Could be ~\$20 B award if 33% of the rescission order (based on ~\$56B)!
- Is this a stand-alone issue or should the Fee await the “Do Over”?
- The outstanding request reduced \$6B
 - Calculates to \$288k/hour
 - Outrageous by any measure!
- What is the reward for the Plaintiff? - Tornetta owns only 9 shares
 - A share of the above or simply his stock appreciation?

Michael Jenson, HBR : Asset accumulation vs Creation of SH Value

- Focus on S/H value from the 1990's not managers of asset growth
 - Examples: Harold Geneen for Asset accumulation & Carl Icahn et al for Value-creation
- Corporate Raiders in the 1990s focused the mind of C Suite participants
- Argument is to get C Suite to behave more like owners
- C suite ownership succeeded in focusing on one factor: ***S/H growth***

Other Factors contributing to S/H Value Focus

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- 1993 IRS law limited deductions of Salary over \$1M but Options were excluded
- 401(k) had regular workers invested in the market & interested in increasing S/H value
- CFO & HR needed innovative ways to increase C suite payout
- Role of Compensation Consultants incentivized to increase C suite's comp to gain additional engagements
 - With existing & new clients

Warning from the Peltz Case:

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- Peltz had \$ zero base pay but significant award of options
- Some of his options were issued at 85% of the existing market value
- Stock prices continued to go down so 5 years of options became worthless
- Eventually received a "cash bonus" of \$2M

- 2001 Paper: Paying People to Lie:
 - https://papers.ssrn.com/sol3/papers.cfm?abstract_id=267651
- Hyper-focused on increasing stock price & Income-enhancing tricks
- Some led to major scandals, e.g. Lucent \$70/share to \$0.55/share, Worldcom, Enron, et al

Move to Texas Threat or Real?

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- DE has a history of business law precedents & being a shareholder-friendly state
 - TX differs in many ways; not least the lack of case law?
- Move Tesla to Texas: is this for SH value or Musk value?
- DE has no tax whereas TX franchise tax collects 0.75% of revenue/year to State:
 - Motive: it's in plain sight, how to explain to shareholders?
 - Move to TX costs an additional \$600M/year!
- CEO serves at the luxury of S/Hs, not the opposite- where CEO gets to decide who his S/H is
 - Clearly a conflict of interest requiring independent directors
- Litigation may ensue like AI/OpenAI/Altman suit

Market Impacts of the Legal Case

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- Elon Musk & Tesla Corp inextricably tied
 - Some supporters may love him more
 - May have lost others support by appearing greedy
- Conservative position of Court vs. Interventionist position
- Executive comp plans are up to the Company & its shareholders to decide
- Courts may intervene when they feel it is “unjust”?
- Be aware of Executive Comp plans when voting shares in the Proxy
- Separately, Tesla may be viewed more now as a Car Co than an AI play
 - With significantly different valuations!
 - Beware of BYD China EV imports!
 - Short or Long TSLA?

Did Musk Fulfill his Goals & Objectives? – Fundamental Fairness

- Yes, he met almost every one of his objectives spelled out in the Proxy Statement
- Stock appreciated >10X over the Comp period
- This would have more than covered any share dilution had they been issued
- Musk received no cash compensation

Take Aways to AAII Members

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- No “Mirror image for everything”: Musk v Peltz v Lucent
 - Limitations to “Might making Right”
- Fiduciary Duties/Corporate Governance
- Guardrails for CEO pay
- Bold visionary genius on products/risk tolerance but certain shortfalls in SEC compliance arena
 - Example: stating that he had sold Tesla to Saudis caused SEC to clamp down on approval procedures - including fines & independent directors
 - Strange family arrangements – See Walter Isaacson recent biography on Musk

Comments, Questions & Answers