

# Delaware Court of Chancery Orders Rescission of Compensation Award

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In a 200 page opinion after trial, the Delaware Court of Chancery invalidated a \$55.8 billion compensation award by Tesla, Inc. to Elon Musk, its CEO, Chair and founder, on the basis that the award was unfair to Tesla. While the facts of the case—*Tornetta v. Musk et al.*, C.A. No. 2018-0408-KSJM (Del. Ch. Jan. 30, 2024)—are highly idiosyncratic to Musk and Tesla, the decision nonetheless offers some interesting lessons to directors, companies and controllers navigating conflicts of interests.

First, the decision is a useful reminder that **a minority stockholder can be a controller**. The court found that Musk, a 21.9% stockholder, exercised “transaction-specific control” over Tesla with regard to the compensation award at issue. Musk’s control derived not from his large minority stock ownership alone, but also because he was “the paradigmatic ‘Superstar CEO’”—wielding “the maximum influence that a manager can wield over a company”—with extensive ties to the members of the Tesla board responsible for negotiating the compensation plan. The court found that Musk dominated the “deeply flawed” process by which Tesla’s board approved that plan. As a result of its conclusion that Musk controlled Tesla, the court evaluated the compensation award under the entire fairness standard—the most searching standard of review used by Delaware courts—which considers holistically whether the process and economic terms of the transaction were entirely fair to the company. The court found both the process and the price to be unfair, and ordered rescission of the award.

Second, **the benefits of a majority-of-the-minority stockholder vote are lost if the stockholders are not fully informed**. The Musk compensation plan was subject to stockholder approval. Under Delaware law, approval of the plan by the fully informed majority vote of the disinterested stockholders would shift the burden of proof on the question of entire fairness to the plaintiffs. While approval of the plan by a disinterested majority was in fact obtained, the court found that Tesla’s proxy statement “inaccurately described key directors as independent and misleadingly omitted details about the process,” with the result that the burden of proof of entire fairness remained with the defendants. The court also found that, because of the disclosure violations, the vote did not provide evidence of economic fairness.

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Third, **social, professional and economic ties to a controller—as well as a “controlled mindset”**—can all compromise director independence. Of the Tesla directors other than Musk and his brother, all but one, including at least half the members of the compensation committee, had economic or personal ties (or both) that compromised independence. In the case of one member of the compensation committee, the court found that either his business ties or his personal relationship with Musk, standing alone, would have sufficed to compromise independence. Similarly, longstanding personal and professional relationships between the chair of the compensation committee and Musk were “too weighty” in light of the director’s role in connection with the challenged grant. Another director was found to lack independence as a result of a long-time friendship, including repeated family vacations together.

The court also focused on the vast wealth Tesla directors amassed from their compensation as directors. While acknowledging that ordinarily market-rate compensation does not compromise independence, the court noted that the amounts received were “life-changing” for one director and a large portion of the wealth of another.

The court assessed these relationships in the context of the directors’ behavior relative to Musk. It found “multiple aspects” of the process to reveal that the directors had a “controlled mindset,” working under a “recklessly fast” timetable dictated by Musk and failing to negotiate the most basic terms of the award, including its size. According to the court, “there is barely any evidence of negotiations at all.” The court also criticized the directors for failing to undertake a benchmarking analysis. Finally, the court observed that the testimony of the defendant directors indicated that they did not view themselves as being in an arm’s-length negotiation against Musk, but rather in a “cooperative, collaborative process” in which there was no “positional negotiation.” The court characterized this testimony as “perhaps as close to an admission of a controlled mindset as a stockholder-plaintiff will ever get.”

Fourth, **disclosures about director conflicts must include not only actual conflicts, but also potential conflicts.** The court found that Tesla’s proxy statement described the members of the compensation committee as independent, and failed to disclose any actual or potential conflicts—including their personal and economic ties to Musk. According to the court, the fact that all of the directors acted under a controlled mindset called into question their disclosure of conflicts—but the court stopped short of saying that the directors were required to disclose more than their relationships with Musk and the board’s determination as to whether those ties compromised independence.

The court also faulted the proxy statement’s disclosure of the process leading to approval of the compensation award, especially an undisclosed discussion between the chair of the compensation committee and Musk in which Musk established the key

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terms of the grant. It also criticized the proxy statement's failure to disclose material non-economic terms of the award.

Finally, **fairness of price needs to take into account the benefits of the transaction to the counterparty**—in this case to Tesla. The court was not persuaded that Musk, by virtue of his existing 21.9% ownership stake, needed additional incentives to stay at Tesla and increase its value. The court observed that there was already a “powerful incentive for Musk to stay and grow Tesla’s market capitalization,” pointing out that, even without the compensation grant, Musk would receive a \$10 billion benefit for every \$50 billion increase in Tesla’s market capitalization.

In many ways Tesla, and, in particular, Elon Musk, are *sui generis*. However, Musk is not the first minority stockholder found to be a controller, the Tesla board is not the only board found to have operated under a controlled mindset, and the Tesla stockholder vote is not the only one found not to be fully informed. The legal principles that apply to ordinary companies, operating non-transformational businesses, controlled by large but non-billionaire stockholders and run by non-Superstar CEOs, are the same as those that resulted in the world’s richest man forfeiting the world’s largest compensation award.

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Please do not hesitate to contact us with any questions.



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