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IN THE COURTS

Tornetta v. Musk: The Delaware Court of Chancery Reviews Executive Compensation to Controlling Stockholders

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In *Tornetta v. Musk*,[1] the Delaware Court of Chancery, addressing "issues of first impression in Delaware,"[2] held that the rigorous entire fairness standard of review applies to a board's executive compensation decisions in respect of a controlling stockholder, absent compliance with the so-called *MFW* procedural protections.[3] Those protections involve conditioning a controlling stockholder transaction, at the outset of negotiations, on the obtainment of *both* approval by a fully functioning special committee of independent, disinterested directors *and* a vote by a majority of the minority stockholders, acting on a fully informed basis.[4] Although the *MFW* test was developed and originally applied in the context of a controlling stockholder buyout, the *Tornetta* Court held that, due to the specter of structural coercion inherent in any conflicted controller setting, compliance with the *MFW* conditions "is key to allaying the court's suspicions" in a manner sufficient to restore the presumption of the business judgment rule.[5]

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Background

In *Tornetta*, the stockholder plaintiff brought direct claims on behalf of a class of stockholders as well as derivative claims on behalf of Tesla, Inc. challenging the Board's approval in 2018 of a compensation package to Elon Musk, the Company's Chief Executive Officer and Chief Product Architect. For purposes of a motion to dismiss in an unrelated action concerning Tesla's 2016 acquisition of SolarCity decided by the Court of Chancery in March 2018, Musk was considered to be a controlling stockholder of Tesla despite holding just over 20 percent of its outstanding stock.[6] "[O]ut of deference" to this decision, the defendants chose not to challenge Musk's alleged status as a controller at this stage of the proceedings.[7]

The Board's approval of Musk's compensation package has to be reviewed against the backdrop in which it was formulated. Musk's first compensation package, fixed in December 2009, included time-vested options as well as options contingent on operational milestones, nearly all of which had been reached by 2012. In that year, Tesla's compensation committee revisited Musk's pay package and approved an almost entirely performance-based package providing for annual option awards over a 10-year period, with awards in each period being made subject to the achievement of operational milestones. Within five years of the 2012 award, the milestones largely had been reached. By 2018, the compensation committee recognized that it would need to provide Musk a new pay package. As Musk, in addition to serving in his roles at Tesla, was serving as the Chairman, Chief Executive Officer, and Chief Technology Officer of Space Exploration Technologies Corporation, "one of the world's most valuable private companies,"[8] the compensation committee was keenly concerned with "how to keep [him] focused on Tesla."[9]

Using its 2012 award as a guide, the compensation committee again proposed a 10-year package providing for the grant of options vesting in multiple tranches, with each contingent on market capitalization and operational milestones. If all of the milestones were reached, the options would vest with a value of more than $55 billion. Due to the milestones and other features of the 2018 award, including the consequences of any milestone not being achieved, however, Tesla's preliminary estimate of the fair value of the award was roughly $2.6 billion.[10] On the recommendation of the compensation committee, the Board approved the 2018 award, but made its implementation subject to approval by the holders of a majority of the shares present in person or by proxy at a meeting of stockholders to vote on the proposal (other than shares held by Musk and his brother). At a special meeting, the stockholders ratified the 2018 award, with the holders of 64 percent of Tesla's outstanding disinterested shares entitled to vote present in person or by proxy at the meeting and the holders of 73 percent of the disinterested shares present (equating to 47 percent of the total outstanding disinterested shares) voting in favor of the proposal.

Legal Analysis

The plaintiff alleged principally that the Board breached its fiduciary duties in granting the 2018 award, which, it claimed, "dwarf[ed] the compensation of 'the world's most successful technology executives'" and was unfair to Tesla.[11] As the grant of the 2018 award constituted a transaction between Tesla and its controller, the plaintiff argued, it was subject to review for entire fairness. The defendants moved to dismiss on the grounds that the 2018 award, having been ratified by a disinterested stockholder vote, should be reviewed under the deferential business judgment standard. (On this point, the plaintiff countered that, even if a disinterested stockholder vote alone were sufficient to restore the presumption of the business judgment rule, the defendants' argument would still fail, as the 2018 award, although approved by the holders of a majority of the disinterested shares present and entitled to vote at the meeting, was not approved by the holders of a majority of the *outstanding* disinterested shares.) The defendants argued that the dual procedural protections contemplated by *MFW* to restore the presumption of the business judgment rule were required only to be obtained in situations involving "transformational" transactions where the Delaware General Corporation Law requires a stockholder vote—and not in situations where a voluntary vote of stockholders is sought.

Stating that Delaware law "recognizes the relationship between a controlling stockholder and minority stockholders is fertile ground for potent coercion," the Court rejected the defendants' argument that a disinterested stockholder ratification vote alone was sufficient to restore the presumption of the business judgment rule to an executive compensation decision in respect of a controller.[12] Declining defendants'

invitation to limit the need to obtain both of *MFW*'s procedural protections to only "transformational" transactions—and to apply instead a more lenient framework for other transactions involving controllers—the Court stated that it could

> discern no reason to think minority stockholders would feel any less coerced when voting against the controlling CEO's compensation plan than they would when voting to oppose a transformational transaction involving the controller.[13]

The Court noted that the risk that "'that those who pass upon the propriety of the transaction might perceive that disapproval may result in retaliation'" from the controller applies with equal force in the compensation setting, where the controller would remain in a position to retaliate, as it does in the controller-buyout setting.[14]

Although the Court agreed with the defendants' position that nothing in the Delaware Supreme Court's *MFW* opinion suggested that it was intended to be applied outside the context of a controlling-stockholder buyout, it stated that the defendants' argument did not necessarily lead to the conclusion that the dual protections would not provide "useful safeguards" in the context of setting the controller's compensation *qua* executive. According the Court, the *MFW* protections would serve to minimize the effects of structural coercion to a degree that would allow the Court to apply the deferential business judgment standard.[15] The Court explained:

> Had the Board ensured from the outset of "substantive economic negotiations" that both of Tesla's qualified decision makers—an independent, fully functioning Compensation Committee and the minority stockholders—were able to engage in an informed review of the Award, followed by meaningful (*i.e.*, otherwise uncoerced) approval, the Court's reflexive suspicion of Musk's coercive influence over the outcome would be abated.[16]

In reaching its key conclusions, the Court made important observations and findings on a few ancillary issues. As to the plaintiff's challenge to the adequacy of the minority-of-the-minority vote, the Court agreed with the defendants' view that, for approval of a transaction in which a voluntary vote is sought, as to which the default provisions of Section 216 of the Delaware General Corporation Law (DGCL) (or presumably the general voting standard under a corporation's certificate of incorporation or bylaws to the extent any such provision modifies Section 216's default standard) would apply, it is not necessary to obtain the vote of the holders of a majority of the minority shares that are outstanding to secure stockholder ratification.[17] Accordingly, as in the pre-*MFW* universe—where the use of either a special committee or a majority-of-the-minority vote could provide some procedural protection—Tesla's securing the majority-of-the-minority stockholder vote was sufficient to shift the burden of proof on the question of fairness from the defendants to the plaintiff.[18]

Next, despite the magnitude of the 2018 award, the Court expressed some skepticism with respect to the strength of the plaintiff's claims. Even after noting the relatively low bar set for the plaintiff at the pleading stage—*i.e.*, to allege well-pled facts from which the Court may infer it is reasonably conceivable that the 2018 award was unfair—the Court stated that the plaintiff "just barely" cleared the hurdle.[19] Although the Court was unwilling at this stage to consider at the pleading stage the defendants' arguments to the effect that the structure of the 2018 award, with its focus on the achievement of milestones over a relatively long period of time, provided built-in fairness, and ultimately found that the plaintiff had shown it was reasonably conceivable that the 2018 award was unfair, the Court did indicate that the plaintiff's claims were "lodged on the 'very outer margins of adequacy.'"[20]

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Conclusion

The Court's opinion in *Tornetta* represents a continuation of a trend in which the Delaware courts will review transactions in which controlling stockholders receive non-ratable benefits under the rigorous entire fairness standard (rather than the deferential business judgment rule), unless those transactions satisfy the *MFW* test. In the executive compensation arena, the opinion effectively means that, in order to ensure that the board's decision to compensate a controller will be protected under the business judgment rule, the board must determine, before substantive economic negotiations begin, that the implementation of the compensation package will be conditioned on approval by a special committee and a vote of a majority of the minority stockholders. As to the stockholder vote required, the Court clarified that, where the matter is not one requiring a stockholder vote under the DGCL, the voting standard for determining whether the majority-of-the-minority condition has been satisfied will be based on the vote required under Section 216 (which, in most cases, will be a majority of those present in person or by proxy at a meeting and entitled to vote on the matter, unless modified by the corporation's certificate of incorporation or bylaws), counting only the disinterested shares, rather than a heightened voting standard, such as a majority of the minority shares that are outstanding.

In spite of the *Tornetta* opinion's clear guidance, in many cases corporations and practitioners may determine that it is neither necessary or advisable to seek *MFW* protection—at least with respect to the majority-of-the-minority condition. Corporations may determine that the risk of a stockholder "no" vote is untenable—and that ensuring the procurement of services from the controller on the terms negotiated outweighs the risk of any fiduciary challenge. This will be relevant particularly in a case where the controller's stake is relatively high and veto power is concentrated in the hands of a small but powerful minority. Even if corporations forgo using *both* procedural protections under *MFW*, the *Tornetta* opinion suggests that the use of either a special committee or a disinterested stockholder vote will at a minimum shift the burden of proof from the defendants to the plaintiff. Moreover, the use of either procedural device, if implemented properly, should assist in bolstering any defense against procedural defects. Finally, in many cases, the risk of a fiduciary challenge—and the risk of a fiduciary challenge surviving through trial—may be mitigated through the design and implementation of a compensation package that is below or in line with compensation packages for peers and therefore difficult to assail.[21] Even in *Tornetta*, despite allegations that the pay package conceivably could exceed $55 billion (and, even on a fair value basis, was worth either approximately $2.6 billion or $3.4 billion and was in excess of packages for comparable executives), the Court stated that the plaintiff "just barely" met its pleading-stage burden.[22] In cases where the compensation awards are clearly in line with peers and include performance-based components and other structural protections designed to assure fairness to the corporation, any plaintiff likely would face a greater challenge in satisfying its pleading-stage burden—or might conclude that the amount of potential damages reasonably available does not warrant the significant investment required to prosecute the case through trial.

Notes

1. Tornetta v. Musk, 2019 WL 4566943, at *1 (Del. Ch. Sept. 20, 2019).
2. *Id.* Although styled as issues of first impression, the relevant questions were reviewed in detail in the Court's 2016 opinion in *In re EZCORP Inc. Consulting Agreement Derivative Litigation*, 2016 WL 301245 (Del. Ch. Jan. 25, 2016), where the Court found that, absent compliance with *MFW*'s procedural protections, the entire fairness standard would apply to transactions involving "non-ratable benefits" to the controller. *Id.* at *11. The *EZCORP* Court "collected some of the many Delaware precedents applying the entire fairness framework to controlling stockholder transactions other than squeeze-out mergers, including compensation arrangements and consulting

agreements." *Id.* at *23. The Court stated that the authoritative weight of those opinions tended to "undercut [the] persuasiveness" of two opinions, *Friedman v. Dolan*, 2015 WL 4040806 (Del. Ch. June 30, 2015), and *In re Tyson Foods, Inc. Consolidated Shareholder Litigation*, 919 A.2d 563 (Del. Ch. 2007), applying business judgment review to compensation decisions involving controllers.

3. In re MFW S'holders Litig., 67 A.3d, 496, 524–25 (Del. Ch. 2013), *aff'd,* Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014).
4. *Id.*
5. *Tornetta*, 2019 WL 4566943, at *2.
6. In re Tesla Motors, Inc. S'holder Litig., 2018 WL 1560293 (Del. Ch. Mar. 28, 2018).
7. *Tornetta*, 2019 WL 4566943, at *2 n.5. The Court nevertheless recognized the ability of the defendants to challenge the factual bases of the allegations that Musk is a controller and to bring a motion for summary judgment on this issue, which could "carry case dispositive consequences" if decided in favor of the defendants. *Id.* at *12 n.113.
8. *Id.* at *5.
9. *Id.* at *6.
10. *Id.* at *7. The plaintiff alleged that the fair value of the estimate was either $2.6 billion or $3.4 billion. While the defendants disputed this calculation, the Court found that it was "reasonably conceivable the present fair value of the Award is, as Plaintiff alleges, well in excess of that paid to Musk's peers." *Id.* at *15.
11. *Id.*
12. *Id.* at *10.
13. *Id.* at *11.
14. *Id.* (quoting Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997)); *see also* Citron v. E.I. DuPont de Nemours & Co., 584 A.2d 490, 502 (Del. Ch. 1990).
15. *Id.* at *13 ("Just as in the squeeze-out context, preconditioning a controller's compensation package on both the approval of a fully functioning, independent committee and an informed, uncoerced vote of the majority of the minority stockholders will dilute the looming coercive influence of the controller. With *MFW*'s dual protections in place, the minority stockholders can cast their votes knowing the controller has agreed at the outset to negotiate his compensation award with an independent, fully functioning committee of the board, to condition consummation of the award on that committee's endorsement, and to allow the unaffiliated stockholders to have the final say. Under these circumstances, the minority stockholders have far less reason to fear that the controller will retaliate if the committee or minority stockholder votes do not go his way.").
16. *Id.* at *14 (quoting Olenik v. Lodzinski, 208 A.3d 704, 715 (Del. 2019)).
17. *Compare id.* at *9–10 ("When a stockholder vote governed by Section 216 meets the prescribed quorum and voting requirements, the outcome 'shall be the act of the stockholders,' even though the number of shares voted in favor of the corporate action at issue may have been less than a majority of the outstanding shares entitled to vote. The stockholder vote approving the [2018] Award fell under the default quorum and voting threshold requirements of Section 216 because no other provision of the DGCL dictates 'the vote that shall be required for' the issuance of options or other compensation to directors or officers, and Tesla's charter and bylaws did not specify different requirements. Given these undisputed facts [that a quorum was present and the requisite vote obtained], there is no basis to say the stockholder vote approving the Award did not produce a ratifying effect. The vote met the quorum and voting threshold requirements of Section 216 even when considering only the disinterested shares: (1) a majority (64%) of Tesla's outstanding disinterested shares entitled to vote were present at the meeting, and (2) a majority (73%) of those disinterested shares were voted in favor of the Award. In the ordinary course, therefore, the stockholder vote would justify business judgment deference."), *with In re PNB Hldg. Co. S'holders Litig.*, 2006 WL 2403999, at *15 (Del. Ch. Aug. 18, 2006) ("The cleansing effect of ratification depends on the intuition that when most of the affected minority affirmatively approves the transaction, their self-interested decision to approve is sufficient proof of fairness to obviate a judicial examination of that question. I do not believe that the same confidence flows when the transaction simply garners more votes in favor than votes against, or abstentions from, the merger from the minority who actually vote. That position requires an untenable assumption that those who did not return a

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proxy were members of a 'silent affirmative majority of the minority.' That is especially so in the merger context when a refusal to return a proxy (if informedly made) is more likely a passive dissent. Why? Because under 8 *Del. C.* § 251, a vote of a "majority of the outstanding stock of the corporation entitled to vote" is required for merger approval, and a failure to cast a ballot is a de facto no vote. Therefore, giving ratification effect only if a majority of the disinterested shares outstanding were cast in favor of the transaction also coheres with § 251."), *and Gantler v. Stephens*, 2008 WL 401124, at *16 ("The court in *PNB Holding*, in the context of a ratification of a merger approved by interested directors, held that the appropriate vote should be a majority of the unaffiliated stockholders' shares eligible to vote, and not merely a majority of the unaffiliated shares that were actually voted. An unreturned proxy vote is akin to passive dissent; to not include a dissenting vote would contravene 8 *Del. C.* § 242, which requires a vote of a 'majority of the outstanding stock of the corporation entitled to vote' for charter amendment approval. Thus, for purposes of ratifying an amendment to a charter, Defendants must show that a majority of the unaffiliated shares eligible to vote voted in favor of the Reclassification."), *rev'd on other grounds*, 965 A.2d 695 (Del. 2009).

18. *Id.* at *14.
19. *Id.*
20. *Id.* at *15. In addition to expressing this view, the Court noted that "board decisions to award executive compensation are given great deference under our law, particularly when approved by unaffiliated stockholders." *Id.* at *1. Consistent with other recent cases regarding director compensation, the Court's decision could provide some support for the possibility of dismissing other entire fairness claims challenging executive compensation that fail to adequately allege unfairness. *See, e.g.*, Stein v. Blankfein, 2019 WL 2323790, at *7–8 (Del. Ch. May 31, 2019) (declining to dismiss entire fairness claims challenging director compensation where it was alleged that the directors were paid nearly twice as much as those in their peer group, the directors in that peer group had attended more meetings than the defendants, and the peer group companies had similar or better performance over the relevant period, but characterizing the complaint's allegations of unfairness as not "particularly strong" and explaining that "in light of the power the DGCL confers on directors to self-compensate," a plaintiff's pleading "burden in the self-compensation area cannot be simply conclusory" and that allegations of "above-average" compensation do not necessarily evidence unfairness); Oldfather v. Ells, C.A. No. 12118-VCL (Del. Ch. Dec. 7, 2016) (TRANSCRIPT) (dismissing a challenge to director equity awards valued at up to $120,000 on the pleadings and finding it inconceivable that compensation to directors of a public company at that level would fail to meet the entire fairness standard under the circumstances alleged).
21. *Cf. Stein*, 2019 WL 2323790, at *7 ("[S]etting salaries above the peer average is not evidence of excessive compensation—if it were, half of all companies would be overcompensating their directors.").
22. *Tornetta*, 2019 WL 4566943, a *14.

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