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Executive Compensation

Tesla's Stock Option Grant to Elon Musk: Part 2

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On May 1 this column reported on the \$2.6 billion stock option granted earlier this year by Tesla, Inc. (Tesla) to its Chairman and CEO, Elon Musk, representing 12 percent of Tesla shares outstanding on the option grant date (the “Musk Option”). Mr. Musk is one of the founders of Tesla, as described in Tesla’s proxy statements.

Today’s column compares Mr. Musk’s ownership and certain of his arrangements at Tesla with those of “Founder CEOs” at 10 other high-tech companies. “Founder CEOs” are CEOs (or, in two cases, Executive Chairmen who had previously served as CEO) who founded or co-founded the enterprise. The column also comments on legal aspects of the award under Delaware law. Finally, it discusses briefly the stockholder class action derivative complaint regarding the Musk Option filed under seal on June 5 (a redacted version was made public on June 7) in the Delaware Chancery Court against Tesla directors including Mr. Musk and Tesla as nominal defendant. Tornetta v. Musk et al, No. 2018-0408.

Mr. Musk’s Stock Ownership and Pay **Compared to Other Founder CEOs**

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1. Comparator Companies.

The 10 high-tech companies examined are Amazon, Alphabet (Google's parent), Facebook, Oracle, Nvidia, Netflix, Salesforce, Akamai Technologies, Garmin and Monolithic Power Systems. The median market cap for the 10 companies as of June 15, 2018, was approximately \$166 billion. Tesla's market cap as of June 15, 2018, was approximately \$61 billion.

2. Stock Ownership Compared.

Mr. Musk owns approximately 20 percent of the outstanding shares of Tesla (outstanding stock options were not included in calculating this percentage). Based on Tesla's market cap of approximately \$61 billion, as just noted, Mr. Musk's shares had a value on June 15, 2018, of approximately \$12 billion.

The median of the percentages of outstanding shares owned by Founder CEOs of the 10 comparator companies was approximately 5.2 percent, based on their most recent proxy statements. (Outstanding stock options and other forms of equity awards were not included in calculating this percentage.) The median value of Founder CEO stock ownership among the comparator companies as of June 15, 2018, was approximately \$5.2 billion.

3. Pay Compared.

In comparing Mr. Musk's pay at Tesla with the pay of the Founder CEOs at the 10 comparator companies, we looked at the Founder CEOs' pay for the last five fiscal years of their respective companies. The rationale for using five years of pay data is that on January 21, 2018, when the Musk Option was granted, approximately five years had elapsed since Tesla granted a significant stock option to Mr. Musk.

(a) Musk Option Compared to Equity Awards to Other Founder CEOs.

The value of the Musk Option, \$2.6 billion, was estimated by Tesla, as noted in the May 1 column, using a so-called Monte Carlo option-pricing model (an alternative to Black Scholes).

The median of the total values of equity awards over the last five fiscal years provided by the 10 comparator companies to their Founder CEOs was approximately \$32.6 million (based on grant-date values as reported in proxy statements). The value of the Musk Option is approximately 80 times the median just noted. Significantly, four of the 10 comparator companies did not make equity grants to their Founder CEOs during their last five fiscal years (Alphabet, Amazon, Facebook and Garmin).

Special Note regarding Tesla’s Prior Option Grants to Mr. Musk. In August 2012, Tesla awarded Mr. Musk a stock option to acquire 5 percent of Tesla shares then outstanding. Like the current Musk Option the 2012 option grant has significant market cap and operating performance hurdles. Prior to that, in December 2009, Tesla awarded Mr. Musk a stock option to acquire 8 percent of Tesla shares then outstanding. Fifty percent of the option was subject to performance-vesting, 37.5 percent of the option was subject to time-vesting (over a three-year period) and 12.5 percent of it was fully vested upon grant.

(b) Salary and Annual Bonuses: Mr. Musk Compared to Other Founder CEOs.

During the five-year period ending December 31, 2017, Mr. Musk received no salary or annual bonus. (Tesla’s proxy statements indicate that Mr. Musk was provided an annual salary in the range of \$33,000 to \$50,000 during that five-year period—apparently to comply with minimum wage requirements under California law. They also indicate that Mr. Musk did not accept the salary.) The median of the total amounts of salary and annual bonuses paid over the last five fiscal years by the 10 companies to their Founder CEOs was approximately \$1.6 million (based on amounts as reported in proxy statements). Four of the 10 comparator companies paid a salary of only \$1 to their respective Founder CEOs and two of those four paid no annual bonus to the Founder CEO.

In summary, the median salary and annual bonus of \$1.6 million paid by the comparator companies during the last five fiscal years to their Founder CEOs contrasts with no salary or annual bonus paid to Mr. Musk at Tesla. On the other hand, the value of the Musk Option “overwhelms” the value of stock options and other equity grants made by the comparator companies to their Founder CEOs.

Issues Under Delaware Law

A number of issues are raised by the Musk Option under Delaware law. These include:

1. Corporate Waste.

A claim of corporate waste would exist if the extraordinary value of the Musk Option bears no reasonable relationship to the value of what it was meant to achieve: added motivation of Mr. Musk in attainment of Tesla goals and greater likelihood of Tesla’s retaining him as its leader.

A claim of corporate waste might include the following:

- Mr. Musk already owns approximately 20 percent of the shares of Tesla. How much more motivation and incentive to remain as the leader of Tesla does the new stock option provide Mr. Musk?
- The value of the Musk Option “overwhelms” the median of the values of the equity grants to Founder CEOs of companies in the comparator group. As noted above, during their last five fiscal years, four of the 10 comparator companies did not make any equity award to the Founder CEOs.
- The terms of the Musk Option do not restrict Mr. Musk as to activities outside of Tesla. (Apparently Mr. Musk is subject to “Tesla’s standard confidentiality agreement” and a “Proprietary Information and Inventions Agreement,” both referenced in Mr. Musk’s 2008 employment offer letter from Tesla.) Mr. Musk’s current activities outside of Tesla include serving as chief executive officer at a major rocket company, SpaceX, and at two recent start-ups, The Boring Company (a tunnel-construction company) and Neuralink (a company in the business of artificial intelligence).

In support of the Musk Option, it can be argued that, like any option, the Musk Option will deliver value to its holder, Mr. Musk, only if Tesla shareholders generally benefit from growth in the stock price of Tesla. In addition, as noted above (and discussed in greater detail in the May 1 column), the Musk Option vests only if challenging market cap and operating performance targets are met (e.g., if all targets necessary for full vesting are met Tesla would have a market cap of \$650 billion and be one of the largest corporations in the world). Also, Mr. Musk must hold for five years any shares he acquires upon exercise of the option.

2. Independence of Directors.

Controlling Shareholder Issue. Are the Tesla directors so much under the control of Mr. Musk that they could not make an objective judgment regarding his compensation? In rejecting a motion to dismiss a complaint, in a case involving Tesla’s acquisition of SolarCity Corporation, the Delaware Chancery Court, based on allegations contained in the complaint, and subject to further proceedings in the matter, ruled in March that “it is reasonably conceivable that Musk, as a controlling stockholder, controlled the Tesla Board in connection with the Acquisition.” In re Tesla Motors, Inc. Stockholder Litigation, C.A. No. 12711-VCS (Del. Ch. Mar. 28, 2018).

Extraordinary Size of Tesla Director Compensation. Underscoring the issue of director independence, the compensation of the Tesla directors is extraordinary. Option grants to eight of the nine directors (this does not include Mr. Musk who does not receive additional compensation for serving as a director) had grant-date values (as reported in the proxy statements) in the range of approximately \$1.9 million to \$9.8 million, six of which were over \$4.9 million. (The Chairman of the Compensation Committee received

an option with a grant-date value of approximately \$7.2 million). The Tesla Equity Incentive Plan, under its triennial option grant program for outside directors, provides for additional awards to be made in June 2018. In addition to a basic option grant for 50,000 shares to each outside director, the Plan provides for additional option shares for specific roles such as lead director and chairman or member of a Board committee. The Plan has been approved by Tesla shareholders.

Tesla Shareholder Approval of Musk Option. On March 21, Tesla shareholders, at a special meeting, approved the Musk Option grant. Approximately 73 percent of the shares voted (Mr. Musk and his brother Kimbal did not vote) approved the grant, representing approximately 47 percent of all shares outstanding other than those held by Mr. Musk and his brother. Did the shareholder vote “cure” whatever issues may have existed as to the independence of directors? If the issue arises in a litigation of the Musk Option (see next section), it is possible that the Delaware Chancery Court might discount the shareholder approval in view of Mr. Musk’s controlling shareholder status.

Complaint Filed in Delaware Chancery Court Regarding Musk Option

As noted above, on June 5 (unsealed on June 7 in redacted form) a complaint was filed against the directors of Tesla including Mr. Musk and against Tesla as the nominal defendant. Tornetta v. Musk et al, supra.

The complaint seeks, among other things, rescission of the Musk Option grant (or reformation to bring it “in line with comparable CEO pay packages”), change in the composition of the Board and damages against the defendant directors and against Mr. Musk as the recipient of the grant. It describes the grant as “massive, unfair and unprecedented.” The complaint cites corporate waste by the directors, unjust enrichment of Mr. Musk and dilution of complainants’ economic and voting power in Tesla. It asserts breach of fiduciary duties by the directors and by Mr. Musk as a controlling stockholder. It also asserts that the outside directors are not protected under the business judgment rule, claiming that those directors were not independent due to their business and social connections with Mr. Musk and the extraordinary levels of directors’ fees paid to them. According to the Chancery Court Dockets, the judge assigned to this case is Vice Chancellor Joseph R. Slights, III, who also is the judge in the SolarCity case, In re Tesla Motors, Inc. Stockholder Litigation, supra.

An answer to the complaint can be expected shortly. Tesla, in response to the complaint, is reported as stating that the complaint “seeks to take the power from our shareholders and instead give it to plaintiffs lawyers. We will respond accordingly.” The complaint does not explain what the future of Tesla would be without Mr. Musk. The complaint itself cites a statement made by Ed Kim, vice president of industry analysis at AutoPacific, that “Elon is Tesla, Tesla is Elon.” Mr. Musk is a visionary leader of Tesla

and Tesla very much depends on his outstanding talents in the design, production and marketing of Tesla vehicles. Mr. Musk is extraordinary. The option is extraordinary. The debate will be interesting.