Paul, Weiss

Client Memorandum

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Delaware Supreme Court Restores Musk's Tesla Compensation

The Delaware Supreme Court has unanimously reversed the Court of Chancery's rescission of Tesla, Inc.'s 2018 stock compensation grant to Elon Musk based on breaches of fiduciary duty. Although the Supreme Court noted that the Justices had "varying views" on the lower court's liability determination, it did not address those underlying issues, including whether Musk exercised transaction-specific control over the 2018 grant and the application of the entire fairness standard to the transaction. Instead, it chose a narrower path to resolve the appeal by unanimously agreeing that rescission was an impractical and inequitable remedy because it would not fairly compensate Musk for the services he had provided under the assumed 2018 grant. Because the lower court's liability determinations remain standing, companies should continue to be mindful of process- and disclosure-related issues in the context of alleged controlling stockholder transactions, as well as the importance of assessing the independence of board members who are making decisions on executive compensation.

Background

In 2018, Tesla's board of directors and stockholders approved an equity compensation plan for Musk, which included 12 tranches of stock options tied to market capitalization and operational milestones. The 2018 grant was approved as Musk closed in on milestones under his prior, 2012 equity compensation awards. By January 2023, Musk had fully performed under the terms of the 2018 grant and therefore all options vested and were in the money.

A Tesla stockholder challenged the 2018 grant in the Delaware Court of Chancery, alleging that Musk, as a controlling stockholder, forced the board to grant him excessive compensation. The Court of Chancery, in a January 2024 post-trial opinion by Chancellor McCormick, found in favor of the plaintiff, concluding that Musk exercised transaction-specific control over the 2018 grant, applying the entire fairness standard and ordering the grant's rescission. Following the Court of Chancery's opinion, Tesla stockholders representing a majority of disinterested shares voted for a second time to approve the 2018 grant. The Court of Chancery, however, denied a motion to revise its earlier opinion, holding that the post-decision stockholder vote was insufficient to address the risks to the minority stockholders of a conflicted, controlling stockholder transaction and that the proxy for the second vote was materially misleading.

Delaware Supreme Court's Analysis

On appeal, the Delaware Supreme Court reversed the rescission remedy, holding that it was both impractical and inequitable:

1. *Impracticality of Rescission*. The court found that rescission was improper because it was impossible to restore all parties, including Musk, to the "*status quo ante*." Rescission did not restore Musk to his pre-2018 grant position and left him uncompensated for years of performance. He had already met all the milestones under the 2018 grant, and Tesla stockholders were rewarded for his work.

2. *Pre-Existing Equity Stake Not a Substitute*. The court rejected the argument that Musk's pre-existing equity stake was a substitute for restoring the original status quo. Although it was a "powerful incentive" and "relevant to his engagement with the company," the pre-existing equity was awarded under prior equity plans and did not serve as consideration for the services Musk provided under the 2018 grant. The court reiterated the longstanding concept that past consideration cannot support a separate promise in excess of those existing contractual obligations.

3. *Burden of Proof to Propose an Alternative Remedy Improperly Placed on Defendants*. The Court of Chancery had held that rescission of the 2018 grant was appropriate because the defendants did not offer a viable alternative or provide anything in the record to allow the court to fashion an alternative remedy. In placing the burden on defendants to offer alternatives, the Court of Chancery relied on precedent in the disgorgement context. The Supreme Court noted, however, that disgorgement is distinguishable from rescission because disgorgement as a remedy focuses on the defendants' unjust gain and does not require restoring both sides to the *status quo ante*. Therefore, the Court of Chancery's reliance on disgorgement precedent to shift the burden of proposing a remedy short of rescission to the defendants was misplaced.

With a rescission deemed improper, and no alternative remedy proven by plaintiff, the court awarded nominal damages in the amount of $1.

Takeaways

The Delaware Supreme Court's *Tesla* opinion underscores that rescission is an "extreme" remedy that should only be used when it is "clearly warranted." By resolving the dispute around Musk's 2018 grant on the narrow ground that rescission was an improper remedy under the circumstances, it left open numerous questions with respect to ratification-based arguments, whether Musk exercised transaction-specific control over the company, the application of entire fairness and fiduciary duty breaches by the board in approving the compensation grant. Thus, companies should remain mindful of the lower court's skepticism toward late-stage ratification defenses, as well as process- and disclosure-related concerns in the context of alleged controlling stockholder transactions and the importance of assessing the independence of board members who are making decisions on executive compensation.

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