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DELAWARE CORPORATE LAW BULLETIN

Chancery Court Indicates Willingness to Extend *M&F* to Compensation Award to Controlling Stockholder

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But determines failure to implement dual protections of M&F Framework triggered application of entire fairness standard of review, resulting in denial of controlling stockholder's motion to dismiss

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INTRODUCTION

Delaware courts are tasked with reviewing breach of fiduciary duty claims arising from a variety of commercial transactions. No matter the type of transaction, however, the standard of review applied by the court is all-important to the disposition of the claim at the pleading stage. If the court reviews corporate conduct under the deferential business judgment rule, "the claim is unlikely to proceed beyond the proverbial starting line." If, on the other hand, the court reviews the conduct under the heightened entire fairness standard, "the claim is likely to proceed at least through discovery, if not trial." In fact, it is often said that selection of the "standard of review . . . will be outcome determinative." *See Tornetta v. Musk*, C.A. No. 2018-0408-JRS, 2019 WL 456693 (Del. Ch. Sept. 20, 2019) ("*Tornetta*").

On one side of the ledger, a board of directors' decision regarding executive compensation "is about as work-a-day as board decisions get." As such, they are typically "entitled to great judicial deference." "[E]ven greater deference" is extended when stockholders ratify the compensation decision. On the other side of the ledger, when a challenged transaction benefits the controlling stockholder of a corporation, a Delaware court typically applies the entire fairness standard of review. According to a long line of Delaware cases, controlling stockholders can "exert coercive influence over the board and unaffiliated stockholders," posing a substantial risk to "sound corporate governance." Accordingly, "[Delaware] law has required that [these transactions] be reviewed for substantive fairness even if the transaction was negotiated by independent directors or approved by the minority stockholders." Thus, under the iconic *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), the controlling stockholder must carry the burden of proving entire fairness—that is, the transaction exhibited both fair dealing and fair price.

In *Tornetta*, the Delaware Court of Chancery (the "*Chancery Court*") confronted "issues of first impression in Delaware" when an unhappy stockholder challenged a board's decision to grant an "extraordinary" compensation award to the corporation's chief executive officer ("*CEO*"), who also happened to be its controlling stockholder. The Chancery Court observed its "earnest deference to board determinations relating to executive compensation does not jibe with [a] reflexive suspicion when a board transacts with a controlling stockholder." Accordingly, the *Tornetta* Court considered the question of whether a compensation award to "a conflicted controlling stockholder . . . ought to provoke heightened judicial suspicion."

I. LEGAL BACKGROUND: THE *M&F* FRAMEWORK

Beginning with the groundbreaking *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) ("*M&F*"), Delaware courts have forged a path whereby controlling stockholder-led transactions may receive the benefit of review under the deferential business judgment rule. The *M&F* Court ruled that, if a controlling stockholder-led buyout is approved by *both* an independent board committee *and* a majority vote of the public stockholders, the standard of review shifts from entire fairness to business judgment. In so ruling, the *M&F* Court explained that:

> where the controller irrevocably and publicly disables itself from using its control to dictate the outcome of the negotiations and the stockholder vote, the controlled merger then acquires the shareholder-protective characteristics of third-party, arm's-length mergers, which are reviewed under the business judgment standard.

M&F requires satisfaction of six elements (the "*M&F Framework*") for controlling stockholders to obtain the benefit of the shift in the standard of review to business judgment:

> (i) the controller conditions the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders; (ii) the special committee is independent; (iii) the special committee is empowered to freely select its own advisors and to say no definitively; (iv) the special committee meets its duty of care; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.

While language in a footnote of *M&F* created doubt regarding whether adherence to the *M&F* Framework would facilitate dismissal at the pleading stage, the Chancery Court has since granted motions to dismiss on the basis of satisfaction of the *M&F* Framework on four separate occasions. (For a summary of these decisions, *see* Robert S. Reder & Elizabeth F. Shore, *Chancery Court Applies M&F Framework to Transactions in Which Controlling Stockholders Allegedly Received "Unique Benefits,"* 72 VAND. L. REV. EN BANC 221 (2019) ("*Reder & Shore Delaware Corporate Law Bulletin*").)

As in *M&F*, the archetypal transaction to which Delaware courts apply entire fairness is a controlling stockholder-led buyout of the shares owned by the corporation's public stockholders (i.e., those not affiliated with the controlling stockholder). In three post-*M&F* decisions, the Chancery Court considered extending applicability of *M&F* beyond controlling stockholder-led buyouts to circumstances in which controlling stockholders were alleged to have received a "unique benefit" relative to public stockholders:

- In *In re EZCORP Inc. Consulting Agreement Derivative Litigation*, C.A. No. 9962–VCL, 2016 WL 301245 (Del. Ch. 2016)

("*EZCORP Litigation*"), Vice Chancellor J. Travis Laster refused to dismiss an action "challeng[ing] the fairness of three advisory services agreements between" an affiliate of a controlling stockholder and the controlled corporation. As summarized by the *Tornetta* Court, the Vice Chancellor determined "entire fairness applies whenever the controller 'extracts a non-ratable benefit,' " but declined to apply *M&F* to shift the standard of review to business judgment because the challenged agreements had not been submitted for approval by a majority-of-the-minority stockholder vote.

- In *In Re Martha Stewart Living Omnimedia, Inc. Stockholder Litigation*, C.A. No. 11202–VCS, 2017 WL 3568089 (Del. Ch. Aug. 18. 2017) ("*Martha Stewart Litigation*"), Vice Chancellor Joseph R. Slights III, on the basis of "strict compliance" with the *M&F* Framework, dismissed an action alleging a third-party buyout provided the controlling stockholder with "greater consideration for herself than was paid to the other stockholders."

- In *IRA Trust FBO Bobbie Ahmed v. Crane*, C.A. No. 12742–CB, 2017 WL 7053964 (Del. Ch. Dec. 11, 2017) ("*IRA Trust Litigation*"), Chancellor Andre G. Bouchard, in the course of dismissing a challenge to a corporate reclassification allegedly structured to benefit a controlling stockholder, rejected plaintiff's contention *M&F* should not apply outside the "controlled merger scenario."

(The *EZCORP* Litigation, the *Martha Stewart* Litigation, and the *IRA Trust* Litigation are discussed in greater detail in Reder & Shore, 72 VAND. L. REV. EN BANC 221).

Although these decisions suggested *M&F* should not be narrowly cabined to controlling stockholder-led buyouts, none of these outcomes were considered determinative when the Chancery Court considered the applicable standard of review in *Tornetta*. In addition to concluding entire fairness was the appropriate standard of review under the circumstances, the *Tornetta* Court suggested *M&F* is applicable in circumstances beyond controlling stockholder-led buyouts to shift the standard of review from entire fairness to business judgment. Ultimately, the *Tornetta* Court denied pleading-stage dismissal, however, because the board did not follow the *M&F* Framework in approving the controlling stockholder's compensation package.

II. FACTUAL BACKGROUND

A. Elon Musk's Historical Compensation at Tesla

Tesla, Inc. ("*Tesla*" or the "*Company*") "designs, manufactures and sells electric vehicles and energy storage systems." Elon Musk ("*Musk*") is Tesla's largest stockholder, owning "approximately 21.9% of Tesla's common stock." Musk also is a member of the Tesla board of directors ("*Board*") and serves as the Company's CEO and Chief Product Architect. It is undisputed that "Musk is Tesla's controlling stockholder." (In fact, Musk was determined by the Chancery Court to be Tesla's controlling stockholder in *Tesla Motors, Inc. Stockholder Litigation*, C.A. No. 12711-VCS, 2018 WL 1560293 (Del. Ch. Mar. 28, 2018) ("*Tesla Motors*"). For a discussion of *Tesla Motors*, see Robert S. Reder, *Chancery Court Determines That 22.1% Stockholder Controls Corporation, Rendering Corwin Inapplicable*, 72 VAND. L. REV. EN BANC 61 (2018). Beyond Musk's roles with Tesla, he is "the majority shareholder, Chairman, CEO and Chief Technology Officer of" privately owned Space Exploration Technologies Corporation ("*SpaceX*"), "one of the world's most valuable private companies."

When Musk became Tesla's CEO in 2008, he "was paid $1 per year annual salary with no equity compensation." In December 2009, Musk received "options that vested on a three-year schedule contingent on his continued service with Tesla" together with other "options contingent on achieving certain operating milestones." Even after Tesla's initial public offering in 2010, Musk continued to receive $1 in annual salary with no equity awards in either 2010 or 2011.

In 2012, the Board's Compensation Committee ("*Compensation Committee*") "retained an outside consultant to review Musk's compensation." The Compensation Committee recommended "an entirely performance-based option award for Musk." The Board adopted this recommendation, structuring the resulting option grant ("*2012 Award*") with "ten tranches," with each tranche's vesting "entirely contingent on Tesla achieving both a market capitalization milestone and an operational milestone." Halfway through the 10-year term of the 2012 Award, "Tesla had achieved all of the market capitalization milestones and was on the verge of reaching all but one of the operational milestones." Accordingly, in 2018 the Compensation Committee retained outside legal and executive compensation advisors once again to review Musk's compensation.

B. The Award

In creating Musk's new compensation package, the Compensation Committee aimed "to keep Musk focused on Tesla given his other business interests," primarily SpaceX. The Compensation Committee used the 2012 Award as a model in creating a new compensation package with "a 10-year grant of stock options that would vest in twelve tranches." Like the 2012 Award, vesting of each tranche was contingent on Tesla reaching market capitalization and operational milestones. Over the course of 2017, Musk and the Compensation Committee "negotiated the milestones at which the options would vest, the overall size of the grant and how share dilution would affect the Award." At its January 2018 meeting, the Board approved the new compensation award ("*Award*").

The Award was contingent on "market capitalization milestones requir[ing] a $50 billion increase in Tesla's market capitalization." If all 12 milestones were reached, Tesla would likely become "one of the most valuable public companies in the world." In the event Tesla met each milestone, Musk's options would "vest with a maximum potential value of $55.8 billion." Of course, if Tesla fell short of each milestone, "Musk will earn nothing."

The Board conditioned the Award on "approval of a majority of the disinterested shares voting" at a March 2018 special meeting of Tesla stockholders. In February 2018, Tesla distributed proxy materials describing the Award and its conditions in detail and recommended approval by stockholders. The stockholders voted to approve the Award, with "80% of shares present and entitled to vote cast in favor," including "approximately 47% of the total disinterested shares outstanding" (that is, not including shares owned by the Musk family and affiliates).

C. Litigation Ensues

After Tesla publicly disclosed stockholder approval of the Award, a Tesla stockholder ("*Plaintiff*") "demanded to inspect certain books and records relating to the Award." Plaintiff thereafter filed his complaint in the Chancery Court, "alleging the Award [was] excessive and the product of breaches of fiduciary duty" by both Musk, "in his capacity as Tesla's controlling shareholder for causing Tesla to adopt the Award," and the other Board members "for approving the Award." All defendants moved to dismiss.

III. VICE CHANCELLOR SLIGHTS'S ANALYSIS

A. Applicable Standard of Review

Vice Chancellor Slights began his analysis by considering the proper standard of review for plaintiff's breach of fiduciary duty claims. In connection with this issue, Musk and the other director defendants readily acknowledged Musk's status as Tesla's "controlling shareholder" who, by virtue of that status, "dominated the Board and the Compensation Committee during the time the Award was negotiated and approved." Without more, the Vice Chancellor explained, he would be required to "review the Award for entire fairness."

Defendants argued the business judgment rule became applicable when Tesla stockholders "overwhelmingly approved all aspects of Musk's compensation." Plaintiff offered two counter-arguments: *first*, "the stockholder vote was structurally inadequate to ratify breaches of fiduciary duty because a majority of all outstanding disinterested shares did not vote to approve the Award," and *second*, even if the vote was properly structured, "it cannot, as a matter of equity, ratify an incentive compensation plan where the company's controlling stockholder is the beneficiary."

Structure of the Vote. As to Plaintiff's first contention, the Vice Chancellor explained the stockholder vote approving the Award was governed by the default voting requirement of Section 216 of the Delaware General Corporation Law ("*DGCL*") for "non-extraordinary stockholder action." As such, the only vote required to ratify the Award was "the affirmative vote of the majority of shares present . . . at the meeting and entitled to vote." A different result would have followed had another DGCL section or a provision of Tesla's charter documents required a higher vote, but that was not the case. Hence, "there is no basis to say the stockholder vote approving the Award did not produce a ratifying effect."

Availability of Stockholder Ratification. As to Plaintiff's second contention, the Vice Chancellor agreed "our courts will not allow the controller to rely upon stockholder approval of the transaction at the pleadings stage to 'cleanse' otherwise well-pled breaches of fiduciary duty." Further, the Vice Chancellor rejected defendants' attempt to distinguish grant of the Award from transactions that "alter the corporate contract," explaining there is "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." In

either case, "minority stockholders would have reason to fear controller retribution, e.g., the controller 'forc[ing] a squeeze-out or cut[ting] dividends.' "

Applicability of M&F Framework. Having rejected defendants' ratification argument, Vice Chancellor Slights raised the question: "What is a Controlling Stockholder/CEO to [d]o" to avoid application of entire fairness to compensation awards? He then offered the following answer: The *M&F* Framework "provides a roadmap that allows fiduciaries to engage in conflicted controller transactions worthy of pleadings stage business judgment deference."

Musk and the other defendants sought to limit *M&F*'s reach to the specific context of that decision—"a squeeze-out merger." To do otherwise, they argued, would "extend [*M&F*] beyond its intended bounds and ignore the Delaware law of stockholder ratification." While acknowledging he saw nothing in *M&F* to "suggest the Supreme Court intended to extend the holding to other transactions involving controlling stockholders," the Vice Chancellor recognized that both the *Martha Stewart* Litigation and the *IRA Trust* Litigation broadened *M&F* beyond its narrow context.

Defendants countered by pointing out these decisions, like *M&F*, involved "transformational conflicted controller transactions where the Delaware General Corporation Law requires the approval of both the corporation's managers and owners." The Vice Chancellor rebuffed defendants' attempt to distinguish granting of the Award from these other transactions. Further, he rejected the implication *M&F*'s "dual protections cannot be potent neutralizers in other applications." With the "dual protections" of the *M&F* Framework in place, "the Court's suspicions regarding the controller's influence would have been assuaged and deference to the Board and stockholder decisions would have been justified."

In a footnote, Vice Chancellor Slights clarified the key elements of the stockholder vote "required to satisfy the 'majority of the minority' prong" of the *M&F* Framework in connection with "non-transformational transactions" governed by DGCL § 216. Consistent with his earlier ruling, the Vice Chancellor proclaimed the required vote "need only be the majority of the minority shares voting after a quorum has been reached, not the majority of all minority shares outstanding."

M&F Framework Not Satisfied. Although he was willing to apply *M&F*, Vice Chancellor Slights observed "Plaintiff has well pled . . . Board level review was not divorced from Musk's influence." Because the pleadings failed to establish satisfaction of the *M&F* Framework, the Vice Chancellor concluded "[b]usiness judgment

deference at the pleadings stage" was not "justified." Rather, "[e]ntire fairness . . . must abide."

B. Plaintiff Adequately Pled Award Not Entirely Fair

Consistent with *Kahn v. Lynch Commc'n Sys. Inc.*, 638 A.2d 1110 (Del. 1994), Vice Chancellor Slights explained, approval of the Award by a "majority of the minority," while not sufficient to invoke *M&F*, nevertheless shifted the "burden of persuasion" to plaintiff "to demonstrate the Award is not entirely fair." This in turn required plaintiff to demonstrate "from well-pled facts that it is reasonably conceivable the Award is unfair to Tesla." In other words, the "Award was not the 'product of both fair dealing and fair price.' "

Predictably, Plaintiff focused on the price aspect of the Award, which he alleged was valued at "either $2.6 billion or $3.7 billion, dwarfing the compensation of 'the world's most successful technology executives.' " Defendants pointed to Tesla's desire to maintain Musk's focus given his other business interests. They also noted that, should the milestones built into the Award not be reached, "Musk will never see the full value of the Award." On the other hand, if the milestones were met "all stakeholders will have reaped the benefits of Musk's incentivized focus." These arguments were unavailing at the pleading stage, as the Vice Chancellor found "it is reasonably conceivable the Award is unfair" even though the pled facts were "lodged on the 'very outer margins of adequacy.' " Perhaps on a motion for summary judgment or at trial, defendants' arguments "may well carry the day." However, applying the entire fairness standard of review at the preliminary pleading stage, the Vice Chancellor denied defendants' motion to dismiss.

CONCLUSION

The issues raised in *Tornetta* were ones of "first impression" for the Chancery Court as the system works through application of the *M&F* Framework in a variety of circumstances. Significantly, Vice Chancellor Slights was prepared to apply the deferential business judgment standard of review had the Board scrupulously followed the *M&F* Framework, despite the contested transaction not "fundamentally alter[ing] the corporate contract" as in *M&F*, the *Martha Stewart* Litigation, and the *IRA Trust* Litigation.

Going forward, unless the Delaware Supreme Court questions *Tornetta*, corporate boards and their legal advisors would be well-served to employ the *M&F* Framework in all sorts of transactions

benefiting controlling stockholders—including executive compensation awards—even if the transaction in question is not a controlling stockholder-led buyout or one that otherwise provides "unique benefits" to the controlling stockholder.