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# Conflicted Controllers, the "800-Pound Gorillas": Part I—*Tornetta*

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In the past quarter, two important Court of Chancery decisions—*Tornetta* and *BGC*—have highlighted the "reflexive skepticism" with which the Delaware courts approach transactions involving conflicted controllers.

- In *Tornetta*, a case of first impression according to the court, Vice Chancellor Slights held that unless a board's decision on executive compensation for a controlling stockholder–CEO complies with the protections outlined in the seminal *MFW* decision, the entire fairness standard of review (which is the strictest standard) applies to the court's evaluation of a stockholder challenge to the compensation. The court so decided notwithstanding that, until now, a) business judgment review has applied to compensation decisions made by independent directors and b) *MFW*-compliance has been required for business judgment review of conflicted controller transactions only in the context of transactions that are "transformational" for the corporation.

- In *BGC*, Chancellor Bouchard applied what seems to be a more stringent standard than in the past for evaluating whether putatively independent directors can be presumed to be capable of acting independently from a controller in the context of evaluating demand futility. ("Demand futility" means that a stockholder who wishes to bring claims against a controller need not first make a demand on the board—for the board to bring the claims on behalf of the corporation—if doing so would be "futile" because the directors' conflicts or lack of "independence" suggest that they might not be capable of making the decision impartially.) The Chancellor appeared to focus on the sense of owingness that a director could feel toward a controller if the director's general status or positions of importance in the company or the community were a result of his or her connection with the controller.

The court emphasized in these cases the potential for "coercive influence" by controllers—"800-pound gorillas" (in the words of Chief Justice Strine, quoted in *Tornetta*)-—over directors (who the

controller typically can remove or not reappoint) and unaffiliated stockholders (who the controller can harm through retributive acts such as a squeeze-out merger or the cutting of dividends). There is "an obvious fear that even putatively independent directors may owe or feel a more-than-wholesome allegiance to the interests of the controller, rather than to the corporation and its public stockholders," the Chief Justice had explained in a previous case. The court reinforced in *Tornetta* and *BGC* that this concern is not necessarily eliminated even where the controller has no intention to be coercive, the transaction is negotiated by "outside" directors, and/or the transaction is stockholder-approved.

Below, we discuss *Tornetta* and offer practice points arising from the decisions.

**In a Case of First Impression, the Court of Chancery Holds a Board's Decision on a Controller's Executive Compensation Will be Subject to Business Judgment Deference Only If MFW Requirements Are Met—*Tornetta***

In *Tornetta v. Elon Musk, Tesla, Inc. et al* (Sept. 20, 2019), at the pleading stage of litigation, Vice Chancellor Slights denied the defendants' motion to dismiss the shareholder lawsuit challenging Tesla, Inc.'s compensation plan for Elon Musk, the CEO and largest stockholder of Tesla, who was deemed to be a controller. The 10-year incentive-based plan had been approved by the Tesla board and by a majority of the minority stockholders.

## Key Points

- **The court applied the "entire fairness" standard of judicial review to the board's executive compensation for a controller.** The court held that, even though a board's executive compensation decisions typically are accorded "great judicial deference," entire fairness applies to transactions with conflicted controllers where the process was not structured to nullify the potential for "coercive influence" by the controller.
- **The court held that business judgment deference would have applied if the process had been MFW–compliant**. Although the compensation plan had been approved by the board and by the minority stockholders, in the court's view those approvals could be free of the "inherent coercion" resulting from the presence of a controller only if the additional safeguards provided by the *MFW* framework (in this case, an independent special committee of the board) had been in place.
- **The decision expands the applicability of MFW beyond "transformational" transactions**. The decision extends *MFW* to a board's executive compensation decisions ("about as work-a-day as board decisions get," Vice Chancellor Slights conceded). The court acknowledged that neither the Court of Chancery nor the Delaware Supreme Court had provided any indication that their *MFW* holdings were to apply—and in fact *MFW* has not previously been applied—outside the context of "transformational" transactions.

## Background

In January 2018, the Tesla board approved a compensation plan (the "Award") for Elon Musk, the company's founder, CEO, Chief Product Architect, recent longtime Chairman, and largest stockholder (with a 21.9% interest at that time). The board submitted the Award to the stockholders for approval after describing it in detail in the company's proxy statement. The

stockholders overwhelmingly approved it at a special meeting. After Tesla implemented the Award, a Tesla stockholder brought this suit, making direct and derivative claims against Musk and the directors who approved the Award. The plaintiff claims that the Award is excessive (Musk has the potential to receive stock options worth $55.8 billion) and is the product of breaches of fiduciary duty by Musk and the directors.

The board consisted of seven "outside" directors, as well as Musk and Musk's brother. For purposes of the motion to dismiss (only), the defendants did not contest, and the court assumed as true, the plaintiff's allegation that Musk is a controller and that he dominated the board and the compensation committee during the time the Award was negotiated and approved.

The court ruled that, because the Award related to compensation for a controller, the applicable standard of judicial review would be "entire fairness" rather than the deferential business judgment. Business judgment review typically has been applied to a board's executive compensation decisions–even when the recipient of the compensation is a controlling stockholder so long as the decision was made by an independent compensation committee (and especially when the decision was approved by the stockholders). The court characterized the standard of review issue as one of "first impression" for the court, and ruled that business judgment deference should be accorded to compensation decisions for a controller *only if* the prerequisites of *MFW* are met. The Tesla board admittedly did not follow the *MFW* roadmap (*e.g.*, there was no special committee of independent directors). The court found that the plaintiff had alleged facts that supported ("albeit just barely") a reasonable inference that the compensation plan was *not* entirely fair to Tesla. Accordingly, the court denied the defendants' motion to dismiss the suit.

**The Compensation Plan.** The Award is a 10-year grant of stock options to Musk that would vest in 12 tranches, each contingent on the company's having reached market capitalization and operational milestones. If *every* milestone is reached, options will vest with a maximum potential value of $55.8 billion. If any milestone is not met, no options will vest. In its proxy statement, Tesla estimated the Award's preliminary aggregate fair value at $2.615 billion. The Award provides as follows:

- *High milestones*. Each of the market capitalization milestones requires a $50 billion increase in Tesla's market capitalization. Reaching the first market capitalization milestone "would roughly double Tesla's market capitalization as of the date the Award was approved, and reaching all 12 would likely make Tesla one of the most valuable public companies in the world." The operational milestones require annual increases in revenue ranging from $20 billion to $175 billion, and annual increases in adjusted EBITDA ranging from $1.5 billion to $14 billion. The milestones will be adjusted if Tesla makes acquisitions having a material impact on reaching any milestone ("ensuring the milestones will be met through organic growth, not acquisitions").
- *Vesting*. Upon reaching the twin milestones corresponding to each tranche of the Award, options held by Musk representing 1% of Tesla's current total outstanding shares will vest. Any options that do not vest within the 10 years are forfeited, and no options will vest if, at the time the relevant milestone is met, Musk is not serving as CEO (or as both Executive Chairman and Chief Product Officer, with the CEO reporting directly to him).
- *Sale restrictions*. Musk cannot sell vested shares for five years ("tying him more closely to Tesla").

- *Dilution borne by Musk*. By tying the shares Musk receives to outstanding shares at the time of the grant (rather than the fully diluted shares at the time of vesting), Musk bears the cost of dilution.

## Discussion

**The board's process appears to have been thorough**. The background context for the Award included (i) Musk not having taken any compensation for many years after founding Tesla, (ii) in 2012, Musk having reached almost all of the operational milestones set for him in the option grant he had been awarded in 2009, and (iii) by 2017, Musk having already met almost all of the very high market capitalization and operational milestones set forth in his 10-year 2012 stock option award. Also, importantly, in 2018, the board was faced with the problem of "keeping Musk focused on Tesla" given his many other business interests, including his role as CEO of SpaceX (another company he had founded which is among the largest private companies in the world and is of great personal interest to him). Using Musk's 2012 award as a model, the compensation committee crafted the Award with outside counsel and Tesla's regular outside compensation consultant. The board tied the operational milestones to increases in total revenue and adjusted EBITDA after conferring with Tesla's largest institutional investors. Over a series of meetings, Musk and the compensation committee negotiated the milestones, the overall size of the grant, and how share dilution would affect the award. The full board approved the Award in January 2018. The board conditioned implementation of the Award on the approval of a majority of the disinterested shares voting at a special meeting in March 2018. To that end, the proxy statement conditioned approval of the Award on a majority of the shares not affiliated with Musk voting in favor. The Award was approved by the shareholders, with 80% of the shares voting cast in favor. Of the disinterested shares (those not affiliated with Musk), 73% of those voting voted in favor (which equated to 47% of the total disinterested shares outstanding).

**The court held that the standard of judicial review applicable to executive compensation decisions for a controller is "entire fairness" rather than business judgment.** The court concluded that, although a board's compensation issues are entitled to great deference, as the Award constitutes a transaction *with a controlling stockholder*, "it ought to provoke heightened judicial suspicion." The Vice Chancellor wrote:

- "This court's earnest deference to board determinations relating to executive compensation does not jibe with our reflexive suspicion when a board transacts with a controlling stockholder."
- "Without doubt, our law recognizes the relationship between a controlling stockholder and minority stockholders is fertile ground for potent coercion" even where no coercion is intended.
- A controlling stockholder's "coercive influence is no less present and no less consequential, in instances where the board is negotiating the controlling stockholder's compensation than it is when the board is negotiating with the controller to effect a 'transformational' transaction. In my view, stockholder ratification, without more, does not counterpoise the risk of coercion in either context."
- "While stockholders generally would have no reason to feel coerced when casting a non-binding, statutory Say on Pay vote, or when asked to approve a board-endorsed executive compensation plan, I 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. In both instances, the minority stockholders would have reason to fear controller retribution [such as] forcing a squeeze-out or cutting dividends."

We observe that the court's view that entire fairness applies to decisions on a controller's executive compensation is not necessarily surprising given the Delaware Supreme Court's holding in *In re Investors Bancorp* (December 2017), which limited the extent to which the business judgment rule protects directors when they determine their own compensation. (*In Investors Bancorp*, the Supreme Court held that a challenge to awards that directors grant to themselves—even when they are made under equity plans that contain "meaningful limits" on awards—will be reviewed under entire fairness if the plaintiff has alleged facts that support an inference that the directors may have breached their fiduciary duties when determining the awards. The Supreme Court found such an inference in that case based on the awards appearing to have been "excessive" given that they were significantly higher than the directors' past compensation and the compensation at peer companies.)

**The court held that business judgment review would have applied if the MFW prerequisites had been met.** The court acknowledged that *MFW* was decided in the context of a squeeze-out merger and that "nothing in *MFW* or its progeny would suggest the Supreme Court intended to extend the holding to other transactions involving controlling stockholders." The court observed that *MFW* has been held to apply to the merger of a controlled company with a third party and to a reclassification of stock, but that both were "transformational transactions" (involving a "fundamental alteration of the corporate contract"), while compensation decisions are *not* transformational. However, the court stated, *MFW* can "provide useful safeguards" in this context. Preconditioning a controller's compensation package on *MFW*'s "dual protections"—*i.e.*, 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 the dual protections in place, the court wrote, "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," the court wrote. We note that in this way the decision is consistent with the seminal *Corwin* decision—which provides for business judgment deference for any board decision that is approved by stockholders (in a fully informed, uncoerced vote), but which expressly does *not* apply in the case of a decision relating to a controller.

**The court discussed past precedent where the court had applied business judgment deference to board compensation decisions for controllers.** In a footnote, Vice Chancellor Slights stated that neither party had cited *Friedman v. Dolan* (2015), where Vice Chancellor Noble had determined that business judgment review was appropriate in connection with a board's decision to award allegedly excessive compensation to a controlling stockholder-CEO. Vice Chancellor Slights, without much discussion, stated that he found *Dolan* to be "distinguishable and unpersuasive" for the same reasons, he stated, that Vice Chancellor Laster had articulated in *EZCORP* (2016), where *Dolan* was discussed at length. In *EZCORP*, Vice Chancellor Laster emphasized that *Dolan* and the few subsequent decisions that relied on it were not consistent with the "weight of authority" which held that conflicted controller transactions (including those

involving consulting agreements and management agreements, or where the controller otherwise "extracts a non-ratable benefit" from the corporation) are subject to entire fairness.

**The court found that the plaintiff met the bar for non-dismissal at the pleading stage—but suggested that the defendants' arguments could well ultimately prevail.** As the Award had been approved by a majority of the minority stockholders (satisfying one prong of *MFW*'s dual protections), the burden of proof shifted to the plaintiff to prove that it is reasonably conceivable that the Award is *not* entirely fair to Tesla (*i.e.*, that it was "not the product of both fair dealing and fair price"). The court found that the plaintiff "ha[d] cleared the bar, albeit just barely." The court cited the plaintiff's allegations that the Award is "well in excess of that paid to Musk's peers," and emphasized the low bar to meet the "reasonably conceivable" standard applicable at the pleading stage. At the same time, the Vice Chancellor observed that, while he was declining to dismiss the case at the pleading stage, the defendants' arguments "may well carry the day" in the context of a summary judgment motion or trial. The defendants' arguments were that (i) the Award is entirely performance-based and aligns Musk's incentives with the interests of the other stockholders (especially given Musk's several other business interests that might distract him from his work at Tesla); (ii) it is quite possible that Musk will never obtain the full value of the Award given the "extraordinary" milestones; and (iii) if the milestones are met, Tesla would be one of the world's most valuable companies and all stockholders then will have reaped the benefits of Musk's "incentivized focus."

**Practice Points**

- **A company and its controller should be prepared for the potential that a transaction of any type pursuant to which the controller obtains a non-ratable benefit as compared to the other stockholders may be reviewed by the court under the entire fairness standard.**
- **Is it possible that there is a continuum of compensation decisions for controllers such that they would not all necessarily be subject to entire fairness?** The court characterized executive compensation decisions as "work-a-day" decisions of a board and not "transformational"—but nonetheless applied entire fairness. We observe that the compensation decision in *Tornetta* was, if not transformational, certainly highly significant given the extreme importance of Musk to the company and the extreme amount awarded to him (potentially $55.8 billion). Query whether more mundane compensation awards for controllers (or other types of garden-variety transactions with controllers) necessarily would be subjected to the entire fairness standard under *Tornetta*—and, if entire fairness were applied, whether the court might be more inclined to find that the award (or other transaction) was entirely fair.
- **A controller should consider the benefits of including independent directors on the board.** Tesla engaged in a quite thorough and reasonable process in crafting and approving the compensation award at issue. The critical missing piece was that a special committee of independent directors had not considered and approved the award. The decision highlights the potential benefits of having some number of independent directors on a board so that *MFW* compliance is an option. We note that there is judicial skepticism as to one-person special committees, thus it may be advisable to appoint more than one clearly independent director.
- **Tornetta does not necessarily lead one to conclude that MFW compliance typically should be pursued in connection with a board's decision on compensation for a**

**controller.** Indeed, *Tornetta* suggests that, if the process is reasonable and there are good reasons for the compensation award made (even if it is in excess of the compensation received by the controller's peers), the court is likely to find the award entirely fair (although it may not be likely that it will dismiss the case at the early pleading stage). At the same time, we note that compliance with *MFW* should be less risky in the context of a compensation decision for a controller than a going-private transaction with a controller. In the compensation decision context, it is unlikely that there would be interference by a third party attempting to block the minority stockholder vote for "holdup value" (*i.e.*, to obtain better terms for the proposed transaction or to permit the third party to do accomplish its own proposed transaction instead).

- **A person who may be deemed to be a controller should, whenever possible under the facts and circumstances, present arguments as to why he or she is not a controller.** Out of "respect" for Vice Chancellor Slight's prior ruling in another case (at the pleading stage) to the effect that Musk likely is a controller of Tesla, Musk did not contest the plaintiff's allegation in this case (for purposes of the motion to dismiss) that he is a controller. We would observe that in almost every case where, based on the facts and circumstances, one can argue that he or she is not a controller, those arguments should be made, even if only to preserve the issue in the event there is an appeal.