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Tesla Board compensation derivative suit settlement

In July 2023, non-employee directors of Tesla[1], Inc. (Tesla) agreed to return $735 million in the form of cash, shares, and options to settle a lawsuit that alleged they awarded themselves outsized compensation. This *CRA Insights* piece focuses on a timeline of relevant events and key terms of the settlement and their effect on a director's strategy to satisfy its requirements.

Litigation timeline

On June 17, 2020, shareholders filed a derivative lawsuit in Delaware Court of Chancery against Tesla, alleging that members of its board of directors breached their fiduciary duties by awarding themselves excess and unfair compensation between 2017 and 2020.[2]

On June 20, 2023, the parties accepted a recommendation from a mediator for 12 directors to: return a portion of their past compensation, permanently forego stock option awards for 2021 and 2022, permanently forego any further compensation for board service for 2021 or 2022, and permanently forego any compensation for board service for 2023.[3]

Prior to the mediator's recommendation, Tesla's directors had unanimously approved and adopted resolutions to forego option awards for 2021 and 2022.[4] Those resolutions were adopted following director compensation policy reviews in 2020 and 2021.[5] The reviews were prompted by Tesla's exceptional performance and commitment to a compensation structure that ensures directors' interests are aligned with those of shareholders.[6]

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1 The current and former non-employee directors that will return compensation are Brad Buss, Robyn M. Denholm, Ira Ehrenpreis, Lawrence J. Ellison, Antonio J. Gracias, Stephen T. Jurvetson, Kimbal Musk, James Murdoch, Linda Johnson Rice, Kathleen Wilson-Thompson, and Hiromichi Mizuno. Stipulation and agreement of compromise and settlement between plaintiff and settling defendants, *in re Police and Fire Retirement System of the City of Detroit v. Elon Musk et al., Case No. 2020-0477-KSJM,* filed July 14, 2023 ("Settlement"), p. 2.

2 Settlement, p. 3.

3 Settlement, p. 6.

4 Settlement, pp. 3 and 4.

5 Tesla Official Notification to Shareholders of Matters to be Brought to a Vote ("Proxy"), June 23, 2022, p. 59.

6 Tesla Proxy, June 23, 2022, p. 59.

On July 14, 2023, the parties in the lawsuit reached a settlement with a nominal value of $919 million.[7] Pursuant to the settlement, directors consented to return stock options valued at $735 million. The settlement also valued the foregone compensation related to service between 2021 and 2023 at $184 million.[8]

Plaintiff's attorneys sought fees in the amount of 25% of the nominal $919 million deal, or $230 million.[9] The final terms of the settlement are subject to court approval. A final hearing on the settlement, including fees and expenses, was held on October 13, 2023.[10] Directors were required to notify the court of any adjustments to the settlement's stipulations on the form in which the $735 million would be refunded, no later than five business days prior to the settlement hearing.[11] If the settlement is approved, directors will be required to return the $735 million within 15 business days following entry of the final judgment approving the settlement.[12]

Key terms of the settlement

Directors agreed to return the value of 3,130,406 stock options (Settlement Options) to Tesla in the form of cash, unrestricted common shares of Tesla stock, and/or unexercised options.[13,14] The settlement values the Settlement Options at $735 million, with $458.6 million from returned unexercised options and $276.6 million from returned cash and stock.[15] The settlement prescribes specific methods to value returned cash, stock, and unexercised options:[16]

1. **Returned cash:** Each Settlement Option will be converted to $235.9114.
2. **Returned stock:** Each Settlement Option will be converted to 0.906 Tesla shares.
3. **Returned unexercised options:** Each returned unexercised option will be valued at its intrinsic value on June 16, 2023, that is, the difference between Tesla's stock price on June 16, 2023 ($260.54) and the actual strike price of each option.

Several important considerations arise from the settlement's valuation approach. First, the specific methods used to value returned cash, stock, and unexercised options all rely on Tesla's stock price on June 16, 2023. These methods do not account for any changes in Tesla's stock price that occur after that date. Second, an option's total value consists of two components: (i) intrinsic value, or the amount realizable if the option were exercised immediately,[17] and (ii) time value, or the value of holding the

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7 Settlement Exhibit B, p. 2.

8 Settlement Exhibit B, p. 8; Reuters, "Lawyers who sued Tesla board for excess pay want $10,000 an hour," September 21, 2023. There is limited information available on how the $184 million was calculated, especially as it pertains to compensation that was never paid.

9 https://www.law360.com/articles/1732438/tesla-class-attys-clash-in-del-over-230m-settlement-fee, last accessed November 9, 2023.

10 Settlement Exhibit B, p. 15.

11 Settlement, p. 18.

12 Settlement, p. 19.

13 Settlement, p. 16. The current board also agreed to adopt and maintain various corporate governance reforms and internal control changes for a period of five years from the effective date of the settlement. Settlement Exhibit B, pp. 9-11.

14 For comparison, non-employee directors were awarded a total of 11.33 million options during the alleged excess compensation period. Elon Musk, the company's Chief Executive Officer and chair of the board is listed as one of the defendants in the lawsuit. He was granted 303.96 million options during the alleged excess compensation period.

15 Settlement, p. 18.

16 Settlement, p. 17.

17 Intrinsic value is calculated as the higher of zero and the difference between the underlying stock price as of the valuation date and the option's strike price for a call option (and the higher of zero and the difference between the option's strike price and the underlying stock price for a put option). Options with positive intrinsic value are said to be "in-the-money."

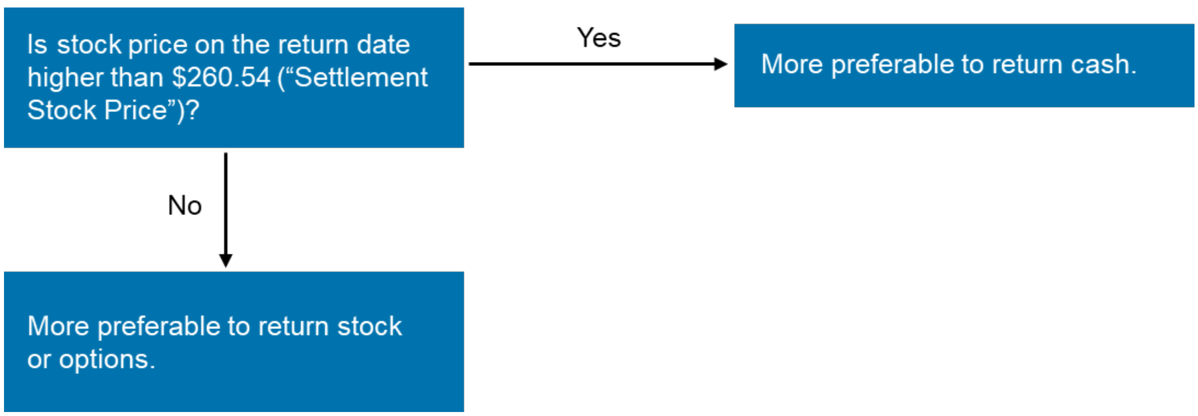
option to exercise it later at a potentially higher stock price.[18] The settlement only considers the intrinsic value of returned unexercised options and excludes their time value.

Directors have discretion in the mix of cash, stock, and unexercised options they return to Tesla, provided that the total value of the returned amounts equals $735 million using the agreed valuation methods.[19] In the case of options, directors can also decide whether to return options that were granted earlier or later in the alleged excess compensation period. If the directors choose to return a different mix of cash, stock, and unexercised options that does not equal $458.6 million for unexercised options and $276.6 million for cash and stock, they must notify the court before the settlement hearing.[20]

Directors' optimal compensation return strategy

Setting aside idiosyncratic factors that may influence a director's choice of returned compensation (e.g., liquidity needs or the tax implications of returning previously taxed compensation), the settlement's valuation methods and discretion in the mix of cash, stock, and options that directors can return suggest the optimal compensation return strategy shown below.

Figure 1: Compensation return strategy decision tree



Directors are incentivized to return cash (stock or options) when Tesla's stock price is above (below) the June 16, 2023 level of $260.54.21.[22] This concept is illustrated in Table 1 below, which compares the settlement's valuation of a returned unexercised option that was granted in the final year of the alleged excess compensation period to the actual value relinquished by the director for a range of stock prices on the return date.

[18] Time value, also known as extrinsic value, depends on the amount of time remaining on the option's life and market factors affecting the probability of future increases in the stock price (e.g., interest rates, stock volatility, and dividends).

[19] Settlement, p. 18.

[20] Settlement, p. 18.

[21] Each Settlement Option is valued at 0.906 shares of Tesla. The conversion ratio is fixed and is based on Tesla's stock price on June 16, 2023, of $260.54. The fixed conversion ratio means a director does not receive extra credit for returning a higher-valued share if Tesla's stock price exceeds $260.54 on the return date. Consequently, it is preferable to return stock if Tesla's stock price is below $260.54 and to return cash if the stock price exceeds $260.54.

[22] Similar reasoning applies to returned options, which are valued at their intrinsic value on June 16, 2023. If the stock price on the return date exceeds $260.54, the returned option has a higher intrinsic value than that calculated on June 16, 2023. However, the director does not receive additional credit for the increase in intrinsic value. Consequently, it is preferable to return cash when the stock price exceeds $260.54 and return options when it is below $260.54.

Table 1: Comparison of settlement's valuation of a returned option that was granted in the final year of the alleged excess compensation period to actual value relinquished[23]

		Tesla's stock price on option return						
		$200.54	$220.54	$240.54	$260.54	$280.54	$300.54	$320.54
[A]	*Intrinsic value*	*$74.73*	*$94.73*	*$114.73*	*$134.73*	*$154.73*	*$174.73*	*$194.73*
[B]	*Time value*	*$15.57*	*$13.19*	*$11.34*	*$9.88*	*$8.74*	*$7.83*	*$7.11*
[C] = [A] + [B]	Total value forfeited on option return	$90.30	$107.92	$126.07	$144.61	$163.47	$182.56	$201.84
[D]	Option value according to settlement	$134.73	$134.73	$134.73	$134.73	$134.73	$134.73	$134.73
[E] = [D]-[C]	Additional value credited (forfeited) in settlement	$44.43	$26.81	$8.66	($9.88)	($28.74)	($47.83)	($67.11)

Notes:
[1] The settlement values each returned option at its intrinsic value on June 16, 2023.
[2] The option in this table has a strike price of $125.81 and was granted in the final year of the alleged excess compensation period.

As shown in Table 1, directors forfeit more value than was agreed to in the settlement when they return options if Tesla's stock price is above $260.54, making the choice to return cash preferable.[24] Similar intuition applies for returned stock.

Directors also need to consider option grant date when returning options

When returning options, there are several reasons why directors also need to consider when those options were granted during the alleged excess compensation period. First, options granted earlier in the alleged excess compensation period have less time remaining until expiration, resulting in a proportionately lower time value (because of the lower likelihood of the stock price moving favorably). Second, options granted earlier in the alleged excess compensation period have a higher intrinsic value because their strike price is lower than those granted later.

So, all else equal, a director prefers to return options that were granted earlier in the alleged excess compensation period. This preference arises for two reasons. First, since the settlement values options based only on their intrinsic value, returning options granted earlier in the alleged excess compensation period implies forfeiting fewer options to meet the agreed settlement amount, given their higher intrinsic value. Additionally, options granted earlier in the alleged excess compensation period have lower time value compared to those granted later. Because the settlement only considers options' intrinsic value, a director forfeits less time value by returning options granted earlier in the alleged excess compensation period compared to those granted later.[25] Options granted in the first year of the alleged excess compensation period have time value of only $0.71.

[23] Stock prices in Table 1, as well as in all other analyses, have been adjusted for stock splits that occurred on August 31, 2020 and August 25, 2022.

[24] In Table 1, if a director returns an option when Tesla's stock price is $260.54, the returned option's intrinsic value (row [a]) matches the settlement's valuation of the option (row [d]). Despite this match, a director still forfeits value at this stock price because the option has time value, which the settlement does not take into account. For stock prices above $260.54, returning options results in forfeiture of a portion of intrinsic value and the entirety of time value.

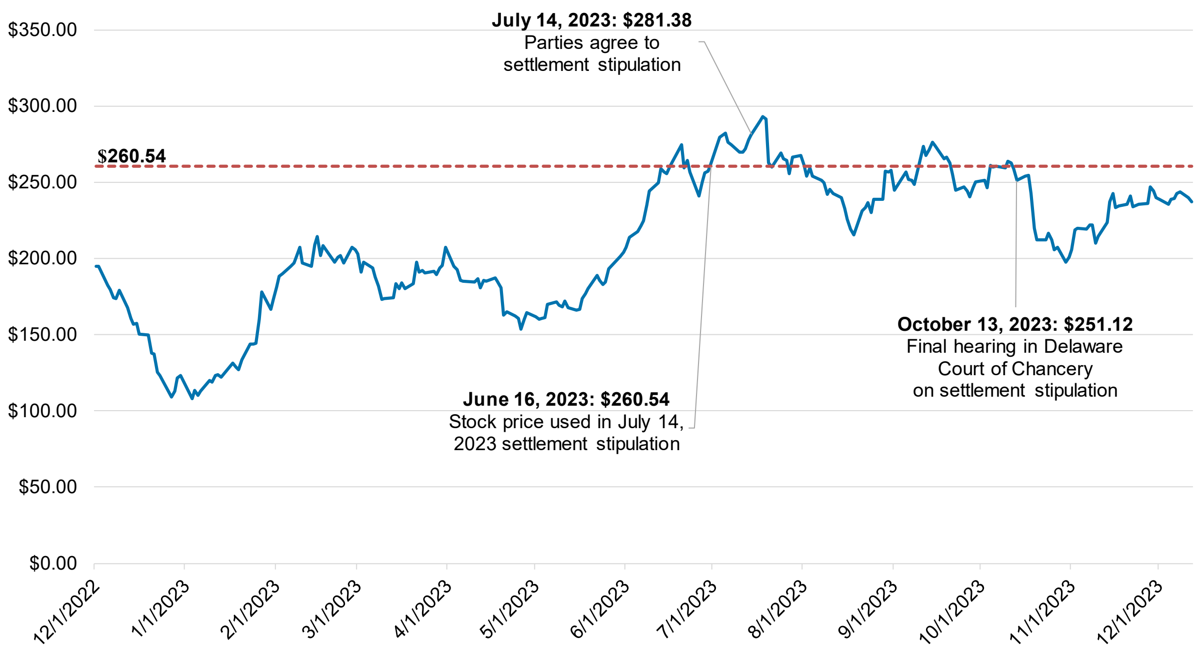
[25] Note that directors may not subjectively value an option's time value, particularly if they are undiversified with respect to Tesla. The impact of the settlement excluding time value is negligible for options granted earlier in the alleged excess compensation period but could be more significant for those granted later.

Factors affecting directors' optimal compensation return strategy

A director's optimal compensation strategy is affected by the lack of a specified compensation return date and the potential for unfavorable (or favorable) movement in Tesla's stock price after locking in the amount of cash, stock, and options to return. Directors committed to either return cash, stock, and options based on the settlement's specified combination or opt for an alternative combination, as long as they notified the court of any adjustments no later than five business days before the settlement hearing on October 13, 2023. Consequently, a director may have committed to a combination of cash, stock, and options based on an assessment of the likelihood of Tesla's stock price exceeding or falling below $260.54. This assessment may have been informed by recent trends in Tesla's stock price at the time the director committed to the specific combination, but the price on the compensation return date may differ significantly.

Figure 2 below shows Tesla's stock price fluctuation in the last year. On July 14, 2023, when the parties agreed to the settlement, Tesla's stock price was $281.38. The settlement values returned compensation using the stock price on June 16, 2023, which was $260.54. Following the parties' agreement to the settlement, Tesla's stock price fell below $200 on October 30, 2023, and has yet to exceed the level it reached on July 14, 2023.

Figure 2: Tesla – Daily share price ($)



Confirming that directors face a real risk of adverse stock price fluctuations, Figure 2 above shows that although Tesla's stock price has stayed below $260.54 (suggesting a preference to return stock and options) for much of the year, it has, in fact, surpassed this level on multiple occasions.

Ultimately, whether a director's chosen combination of cash, stock, and options is in fact optimal depends on Tesla's stock price on the date of return. For example, if a director expected Tesla's stock price to exceed $260.54 on the compensation return date, as described in Figure 1, the director would prefer to commit to returning cash. However, if the stock price on the actual return date is below $260.54, the director would have been better off returning stock or options instead of cash. Therefore, a determination of the optimality of a director's chosen combination of cash, stock, and options depends on the stock price on the date of return, which is an uncertain factor. Finally, directors also face the risk that the settlement may not be approved or that the court could materially alter the settlement.

Conclusion

Several insights emerge from Tesla's board compensation derivative suit settlement:

1. First, the flexibility granted to directors in the settlement allows them to opt for a different mix of cash, stock, or options than was specified in the settlement. For example, they can reduce the number of options they return and increase cash or stock.
2. Second, the settlement's specified valuation methods lead to a set of guidelines that can be used to determine which financial instruments (cash, stock, or options) directors may prefer to return to satisfy the settlement's requirements. It is optimal for directors to return cash (stock or options) when Tesla's stock price exceeds (falls below) $260.54. Further, with respect to returning options, it is preferable to return those that were granted earlier in the alleged excess compensation period.
3. Third, the lack of a specified compensation return date and the potential for unfavorable movements in Tesla's stock price after locking in the amount of cash, stock, and unexercised options can affect directors' optimal compensation return strategy. The optimality of a director's chosen mix of cash, stock, and options depends on Tesla's stock price on the date compensation is returned. Directors can attempt to mitigate this risk by holding the mix of compensation they committed to return but may still face the risk that the settlement could not be approved by the court or that the court could materially alter the settlement.

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