



April 2025

## Tesla Board compensation derivative suit: Implications of the final judgment

On January 13, 2025, the Delaware Chancery Court issued a judgment (the “Final Judgment”) approving a settlement in a lawsuit brought against the non-employee directors of Tesla that alleged they awarded themselves outsized compensation.<sup>1</sup> Per the settlement, the directors would return approximately \$735 million of their past compensation (the “Settlement Amount”) to Tesla through a combination of stocks, options, and cash. Additionally, the directors also agreed to forgo their compensation for board service from 2021 to 2023, which was valued at \$184 million in the settlement agreement.

In the Final Judgment, the court approved attorneys’ fees of \$176 million to be paid from the settlement amount to the three law firms that filed the case.<sup>2</sup> The attorneys’ fees awarded were less than the \$230 million requested by plaintiff’s attorneys.<sup>3</sup> The reduction stemmed from a dispute between the plaintiff and Tesla over the value of the forgone compensation. The court ultimately excluded the forgone compensation from its calculation of the attorneys’ fees award.

In a prior [CRA Insights](#) piece, we discussed the key terms of the settlement and their effect on a director’s strategy to satisfy its requirements. We noted that the optimal combination of cash, stock, and options to be returned by each director depended on the stock price on the date of the return. However, because the court took the matter under advisement in October 2023 and later held all pending motions in abeyance in January 2024, the Final Judgment was not entered until January 13, 2025, despite the parties reaching a settlement agreement in July 2023.<sup>4</sup>

The delay in entering the Final Judgment exposed the value of the unexercised options to fluctuations in Tesla’s stock price between the settlement agreement and Final Judgment dates. Because the

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<sup>1</sup> *In re Police and Fire Retirement System of the City of Detroit v. Elon Musk et al.*, Case No. 2020-0477-KSJM, Order and final judgment, in the Court of Chancery of the State of Delaware, filed January 13, 2025 (the “Final Judgment”).

<sup>2</sup> Final Judgment, ¶ 12.

<sup>3</sup> Plaintiffs attorneys sought fees in the amount of 25% of the nominal \$919 million deal, or \$230 million. <https://www.law360.com/articles/1732438/tesla-class-attys-clash-in-del-over-230m-settlement-fee>, last accessed November 9, 2023.

<sup>4</sup> Letter to counsel from Chancellor McCormick, *in re Police and Fire Retirement System of the City of Detroit v. Elon Musk et al.*, Case No. 2020-0477-KSJM, January 31, 2024.

stock price increased during this period from \$260.54 to \$403.31, unexercised options held by the non-employee directors increased in value, while the value of the options to be returned remained fixed at the stock price on the settlement agreement date. As a result, by returning unexercised options instead of cash, the non-employee directors incurred a loss.

## Key terms of the settlement and the amounts returned to Tesla

The 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.<sup>5, 6</sup> 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.<sup>7</sup> The settlement prescribes specific methods to value returned cash, stock, and unexercised options:<sup>8</sup>

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 or the "Settlement Stock Price") and the actual strike price of each option.

The Final Judgement provided that "[t]he Director Defendants shall have sole discretion on the ratio of Returned Cash, Returned Stock, and Returned Options that they provide to Tesla, provided that the total value of Returned Cash, Returned Stock, and Returned Options... equals the Settlement Option Amount..."<sup>9</sup>

On February 26, 2025, Tesla's Chief Accounting Officer certified to the court that the non-employee directors returned approximately \$458.6 million in options and \$276.6 million in cash; no amount was returned in the form of stock.<sup>10</sup>

The value of the returned options was consistent with the amount specified in the settlement agreement. However, while the settlement agreement allowed the remaining \$276.6 million to be returned in the form of cash and/or stock, the directors chose to return the full amount in cash, with no portion returned in stock.

In the [prior Insights](#) piece, we noted that if the stock price on the return date exceeded the Settlement Stock Price, the directors would prefer to return cash rather than stock or options, consistent with the directors' subsequent decision to return a portion of the compensation in cash. However, their decision to

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<sup>5</sup> 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 (the "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.

<sup>6</sup> 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.

<sup>7</sup> Settlement, p. 18.

<sup>8</sup> Settlement, p. 17.

<sup>9</sup> Final Judgment, January 13, 2025, ¶¶ 11.

<sup>10</sup> Certification of Tesla's Chief Accounting Officer, *in re Police and Fire Retirement System of the City of Detroit v. Elon Musk et al.*, Case No. 2020-0477-KSJM, ¶¶ 5-7.

return \$458.6 million in options contradicts it, which suggests that the directors had likely pre-committed to returning this amount in options at the time of the Settlement Hearing.<sup>11</sup>

## Value lost by returning unexercised options

The Final Judgement provided that the directors “shall have sole discretion on the ratio of Returned Cash, Returned Stock, and Returned Options that they provide to Tesla”, as long as the total value of the returned amounts equals \$735 million using agreed upon valuation methods.<sup>12</sup> Setting aside idiosyncratic factors that might 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 flexibility in the form of repayment offered an optimal return strategy. Under this strategy, directors would be expected to return cash if Tesla’s stock price exceeded the Settlement Stock Price of \$260.54 and to return stock or options if the stock price fell below that threshold.<sup>13, 14</sup>

The court approved the Final Judgement on January 13, 2025, and provided directors 15 business days after its entry to return the settlement amount to Tesla. For this article, we assume the return date is January 13, 2025, when Tesla’s closing stock price was \$403.31 — significantly higher than the Settlement Stock Price of \$260.54.

The \$142.77 difference in price between the two dates was only valuable if the unexercised options remained with the directors. However, because they returned the options to Tesla, the excess value was *lost* as the returned options were valued at their intrinsic value as of June 16, 2023, which is based on the Settlement Stock Price. In hindsight, the directors would have been better off returning cash instead of options or stock.

The figure below shows the excess intrinsic value of \$142.77 per option had a director opted to retain the option and return the settlement amount in cash instead.<sup>15</sup>

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<sup>11</sup> The settlement stipulation required that if the director defendants to notify the court at least 5 business days before the Settlement Hearing if they returned a different combination of options, cash, and stock than specified in the agreement. Settlement, Section 2.6.

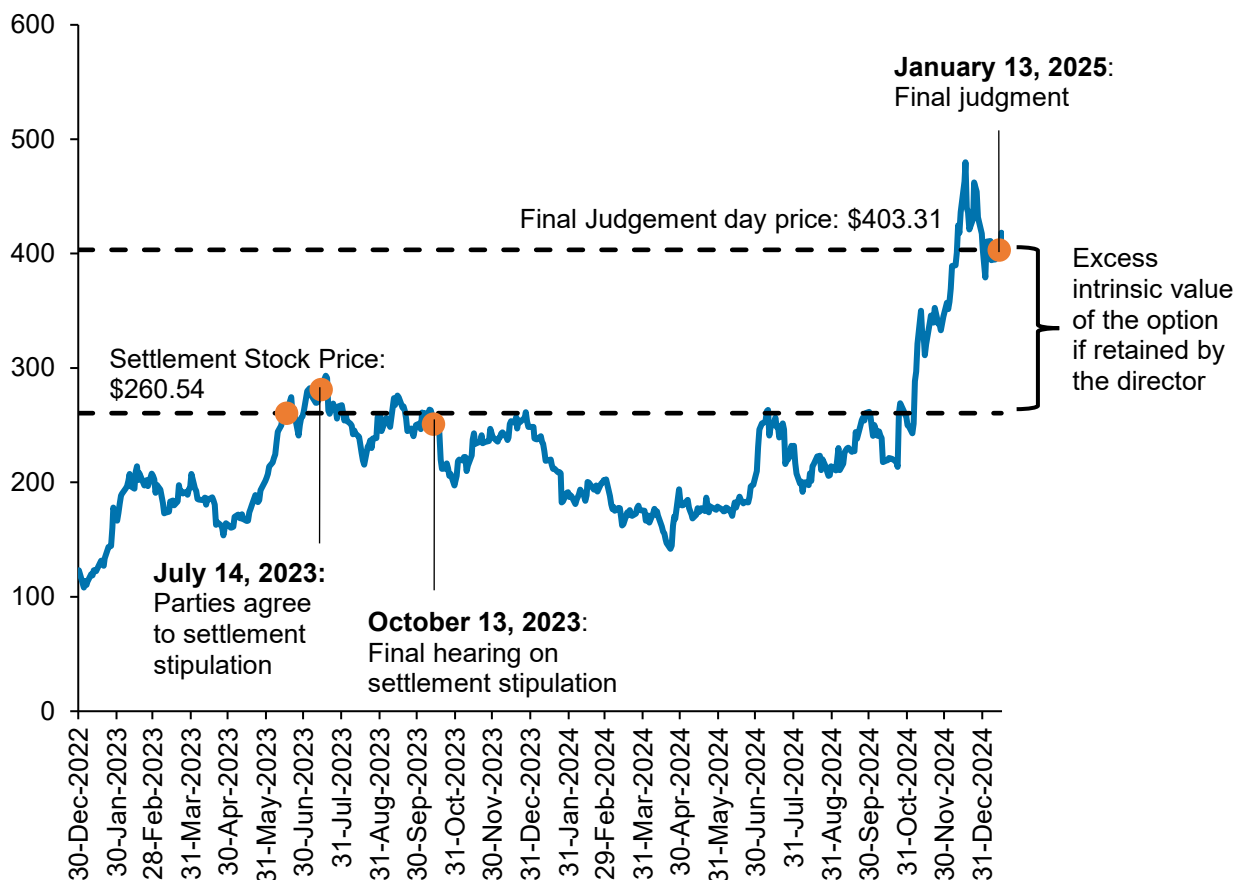
<sup>12</sup> Final Judgment, January 13, 2025, ¶ 11.

<sup>13</sup> 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.

<sup>14</sup> 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. When the stock price is below \$260.54, returning options or stock is optimal. However, the decision between the two depends on options strike price. If the strike price exceeds the Total Weighted Average Strike (as defined in the settlement), the intrinsic value of the option is lower than its value if returned as stock. Consequently, when the stock price is below \$260.54, it is optimal to return options if their strike price exceeds the Total Weighted Average Strike and to return stock if the strike price is below the Total Weighted Average Strike.

<sup>15</sup> The amount \$142.77 only reflects the intrinsic value, not the time value of the option, which is the present value of any future upside between the judgment date and the option expiration date.

**Figure 1: Excess intrinsic value per option had a director opted to retain the option and instead return the settlement amount in cash**



Returning the settlement amount in the form of cash, rather than options, would have benefited the directors in at least two ways.<sup>16</sup>

1. First, by exercising the options and using the proceeds to fund the cash portion of the settlement, directors could have retained the excess intrinsic value (the difference between the Final Judgment date price and the Settlement Stock Price).
2. Second, the taxable loss from the cash payment could have been used to offset against the taxable gain generated from exercising the options, creating a more favorable tax outcome for the directors.

### Value of forgone compensation

Another notable aspect of the settlement was the dispute over the value of forgone compensation. The directors had agreed to forgo their equity compensation from 2021 to 2023, which plaintiff's counsel valued at \$184 million based on an estimate of the intrinsic value of the foregone options as of the

<sup>16</sup> Prior to the settlement hearing, Tesla argued that its benefit from receiving options was limited to the amount expensed at the time the options were granted. Based on that argument, returning \$458 million in cash or stock would have provided greater value to Tesla than returning options. *In re Police and Fire Retirement System of the City of Detroit v. Elon Musk et al.*, Case No. 2020-0477-KSJM, Nominal defendant Teslas answering brief in opposition to Plaintiffs request for award of attorneys fees and expenses, in the Court of Chancery of the State of Delaware, filed September 29, 2023, pp. 9-10.

settlement date.<sup>17</sup> Additionally, plaintiff's expert calculated the fair value of the foregone options using the Black-Scholes model, estimating their worth at approximately \$685.8 million, as of the assumed grant dates and approximately \$779.3 million as of the settlement date. However, these higher valuations were not used in determining attorneys' fees.<sup>18</sup> In contrast, Tesla argued that the value of foregone compensation was effectively \$0 to Tesla because the options were never granted.<sup>19</sup> The Delaware court chancellor declined to assign a value, noting only that "[i]t's hard to quantify the value of compensation never awarded."<sup>20</sup>

Valuation of foregone compensation depends on a number of key inputs. The choice of valuation date (e.g., grant date, vesting date, settlement date, or hearing date), valuation method (intrinsic value or Black-Scholes fair value), and other key parameters involve a degree of judgment. Financial experts can apply widely accepted valuation models to estimate the value of foregone compensation, which courts may consider when awarding damages.<sup>21</sup>

## Valuation date

Valuing foregone equity compensation requires the selection of an appropriate valuation date. Plaintiff valued the foregone equity compensation as of the settlement date, which inherently factors in stock price changes that occurred but for the equity grants. This approach may require analyzing whether the quantity and absence of these grants had any impact on the actual stock price on the settlement date. Alternatively, the valuation could also be conducted as of the dates when the equity would have been granted, at the likely vesting dates, or at the estimated dates when the options would be expected to be exercised.

## Amount and form of but-for equity compensation

In the Tesla derivative suit, the plaintiff's expert assumed that the directors would continue receiving options under the pre-existing compensation policy. An alternative approach to estimating the amount and form of forgone compensation is to benchmark it against peer firms. This method involves three steps:

1. Selecting a group of direct competitors of similar size within the same industry.
2. Narrowing the list to companies that compete for similar skills and talent.

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<sup>17</sup> In valuing the forgone compensation, Plaintiff assumed that the directors would continue receiving options under the pre-existing compensation policy. Plaintiff applied the same valuation methodology set forth in the settlement stipulation to determine the value of those options. *In re Police and Fire Retirement System of the City of Detroit v. Elon Musk et al.*, Case No. 2020-0477-KSJM, Plaintiffs corrected opening brief in support of settlement approval, award of attorneys fees and expenses, and incentive award, in the Court of Chancery of the State of Delaware, filed September 8, 2023, p. 40.

<sup>18</sup> *In re Police and Fire Retirement System of the City of Detroit v. Elon Musk et al.*, Case No. 2020-0477-KSJM, Plaintiffs corrected opening brief in support of settlement approval, award of attorneys fees and expenses, and incentive award, in the Court of Chancery of the State of Delaware, filed September 8, 2023, p. 40.

<sup>19</sup> "Plaintiffs Counsel improperly include the value of options that the Director Defendants agreed to forgo in 2021, 2022, and 2023 (estimated at about \$184 million). *But nothing was paid by Tesla to the Director Defendants for those years, and nothing is being returned to Tesla as part of this Settlement.*" *In re Police and Fire Retirement System of the City of Detroit v. Elon Musk et al.*, Case No. 2020-0477-KSJM, Nominal defendant Teslas answering brief in opposition to Plaintiffs request for award of attorneys fees and expenses, in the Court of Chancery of the State of Delaware, filed September 29, 2023, p. 2.

<sup>20</sup> <https://www.law360.com/articles/2281210/chancery-awards-176m-atty-fee-in-tesla-board-pay-suit>, last accessed March 19, 2025.

<sup>21</sup> Accounting rules, specifically Accounting Standards Codification 718, provide guidance on selecting input parameters for valuation of employee stock compensation in companies financial statements.

3. Examining how director compensation is structured at these peer firms, particularly aspects like the balance between fixed pay and variable compensation.

This benchmarking approach provides a comparative range of compensation and offers insights into what directors at peer firms receive. This can be useful in determining a reasonable estimate for forgone compensation.

### Valuation method

As employee stock options are not publicly traded, there is no market price available to value them. In the absence of a market price, one straightforward approach is to calculate the options' intrinsic value, which represents the amount an option holder would receive if they exercised the option on the valuation date. Alternatively, the fair value of the options can be determined using an approach that incorporates both the intrinsic value and the present value of potential future gains. This fair value calculation is typically performed using models such as Black-Scholes.

The Black-Scholes valuation method depends on several factors, including the strike price, current stock price, stock price volatility, expiry date, and interest rate.<sup>22</sup> Some inputs, particularly stock price volatility and the expected term of the option (which factors the likelihood of early option exercise), can be debated but are subjected to economic analysis for support. While accounting standards provide guidance on acceptable valuation methods to determine these inputs, they allow for a broad range of acceptable assumptions.

In the Tesla director compensation lawsuit, plaintiffs' expert used the Black-Scholes model to value both the options to be returned and the forgone options.<sup>23</sup> The expert used parameters consistent with Tesla's own employee stock valuation under the relevant accounting rules.

### Conclusion

In this *Insights* piece, we examined the impact of the Final Judgment in Tesla's board compensation derivative suit on the value of the settlement. We also explored the methodologies experts use to value forgone compensation in litigation. The key takeaways are:

1. Because Tesla's stock price on the Final Judgment date exceeded the Settlement Stock Price, the options had greater value if they were held by the non-employee directors rather than returned to Tesla. As a result, returning the settlement amount in the form of options instead of cash led to a loss in value for the directors.
2. Valuing forgone compensation presents challenges due to uncertainties regarding both the amount and the form of compensation. Employee stock options, in particular, must be valued using valuation methods because they are not publicly traded. However, valuation methodologies such as the intrinsic value and Black-Scholes fair value models, provide reliable frameworks that experts can use for courts to consider. However, even within accepted valuation methodologies, a disagreement on key inputs can lead to significantly different valuation outcomes.

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<sup>22</sup> If the valuation is done on grant date, then one may need to consider the probability of forfeiture prior to vesting. Given a non-zero probability of forfeiture, the value of unvested options will be lower than the value of vested options.

<sup>23</sup> *In re Police and Fire Retirement System of the City of Detroit v. Elon Musk et al.*, Case No. 2020-0477-KSJM, affidavit of Carl S. Saba in support of settlement and award of attorneys fees and expenses, in the Court of Chancery of the State of Delaware, filed September 8, 2023.

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