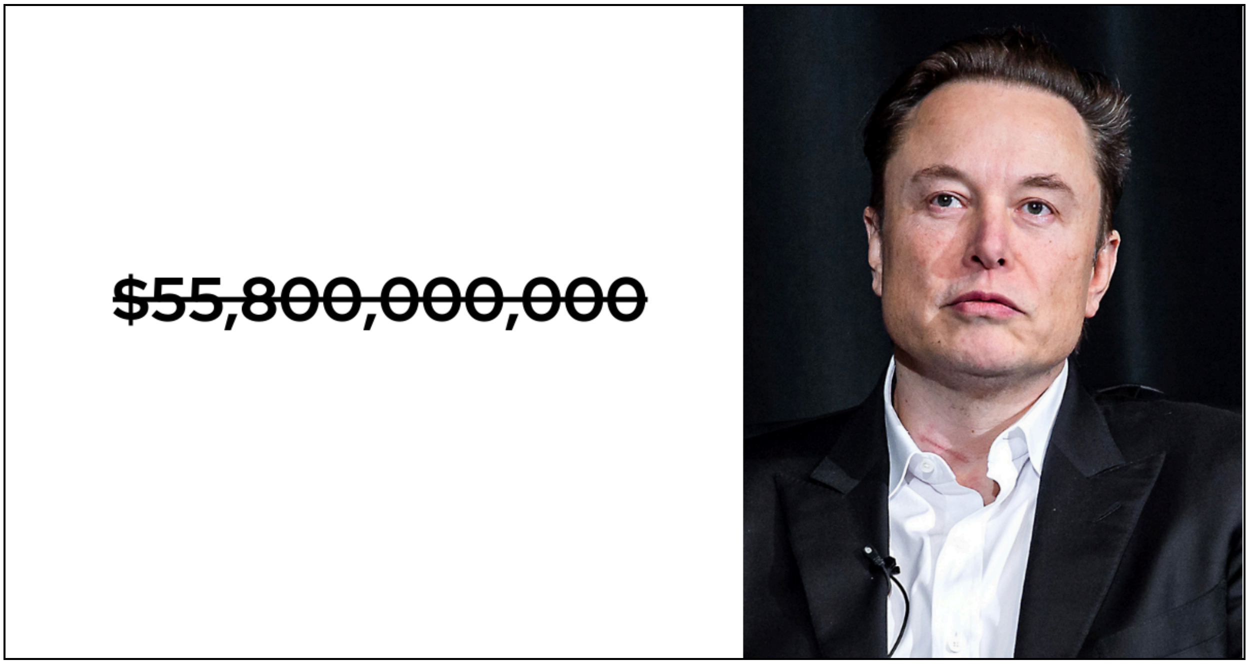
$56B of skin in the game



Tesla's process around Musk's compensation package was flawed. The principle behind it, however, was sound.

The world's wealthiest man was set to earn the largest payday in the history of publicly traded U.S. firms. The courts, however, decided otherwise. At the end of January, a Delaware judge struck down a $55.8 billion pay package for Elon Musk, ruling that the process by which Tesla's board of directors devised the CEO's compensation plan was "deeply flawed." The decision set off a frenzied discussion about the makeup of the company's board and its ties to its

The Ferguson Perspective: *While the process to get to Musk's pay package was clearly problematic and needs an overhaul, the underlying principle is sound: leaders who deliver off-the-charts results may indeed be entitled to extraordinary compensation – provided shareholders are in the know. In this case, Musk would effectively have been paid* ***six cents on the dollar of shareholder value*** *created. With the right compensation framework in place and clear communication to stakeholders throughout, that may have been warranted. Perhaps a good reference point here is private equity, which typically utilizes a "promote" structure – the person running the deal garners a larger share of the profits once a certain baseline return is achieved. In such a structure, there tends to be an unlimited upside, more akin to what Musk received – the higher the performance, the more one earns.*

larger-than-life founder, and also sparked a broader debate about how to adequately reward leaders who produce extraordinary results.

A moonshot

Musk's 2018 compensation plan gave him the ability to receive tranches of options – 12 in all, each representing 1 percent of Tesla's total outstanding shares at the time. In order for a tranche to vest, Musk would have to guide the electric carmaker to a $50 billion increase in market capitalization, plus meet certain key revenue and profitability milestones. The reward was, by any measure, outsized – it was 33 times larger than Musk's previous plan, and a whopping 250 times larger than the median peer compensation package – but so was the ask.

> From the proxy statement: *Elon will receive no guaranteed compensation of any kind — no salary, no cash bonuses, and no equity that vests by the passage of time. Instead, Elon's only compensation will be a 100% at-risk performance award, which ensures that he will be compensated only if Tesla and all of our stockholders do extraordinarily well. The award consists of stock options that vest only if Tesla achieves specific milestones, which if fully achieved would make Tesla one of the most valuable companies in the world with a market capitalization of at least $650 billion — more than 10x today's value.*

Musk, then, was leaving it all on the field. There was no coasting, no maneuvering that would let him earn even a fraction of the reward: Either he took Tesla to a place of unqualified success, or he'd have nothing to show for it. It was a moonshot, perhaps apt for an executive who's built his maverick reputation on them. And, crucially, it was one in which the leader's interests were fully aligned with that of shareholders.

Musk delivered. Tesla cleared the last of the hurdles in 2022, which entitled Musk to the full $55.8 billion amount. Over the five-year period, shareholders saw their stock jump more than tenfold, and Musk may have felt entitled to his reward.

But after a shareholder sued to nullify the package, the case was heard by the Delaware Court of Chancery, and a judge ruled that Tesla's process did not meet adequate fairness and transparency standards. Musk, wrote Chancellor Kathaleen McCormick, exercised too much influence over the directors tasked with negotiating the pay package, given his perception as the

“Superstar CEO” and his sizable stake (21.9 percent) in the firm, and threw his weight around during the process.

“At least as to this transaction, Musk controlled Tesla,” McCormick wrote, unable to resist a little automotive pun. “In the final analysis, Musk launched a self-driving process, recalibrating the speed and direction along the way as he saw fit.”

As Frederic Lambert of influential clean technology publication Electrek wrote: “Proper governance is the basis of a modern public company, and Tesla has always played fast and loose with the relationships between its shareholders.”

The court of public opinion is another factor to consider: Musk is a polarizing figure, to say the least, and the idea that someone of his wealth and influence would be taking home a fortune equivalent to the GDP of a small country likely stuck in the craw of some shareholders.

A sounder process

What this saga underscores is the need for organizations to have clearly defined and communicated compensation mechanisms in place. Rather than present an ad-hoc justification for the compensation plan when challenged, as happened here, those negotiating Musk’s compensation should have released a defensible pay analysis in advance, one that provided clear reasons as to why it deserved to be that high: for example, its total alignment with shareholder interests and its lack of an escape hatch.

The other elephant in the room was the lack of independence of board members: had the plan been approved by a committee of independent directors, rather than those perceived as Musk associates, “the defendants would not have had the heavy burden of proving fairness of ‘the largest compensation plan in the history of public markets,’” attorneys for Fried Frank told Bloomberg Law. The attorneys (not involved in the trial) also suggested that compensation committees “should engage in an active, ‘adversarial’ (the court’s word) negotiation process with an executive to set compensation—and should maintain a record of those efforts.”

The ruling could trigger governance changes. “It is too risky for the board to carry on as it is,” Jefferies analyst Philippe Houchois told the FT. “I think it won’t be rubber stamping [Elon’s wishes] any more." Others, however, see it differently: "He did it, and no one else in the world could have done it, and if the price tag is $56 billion, that's the price tag," one former Tesla executive told the publication, referring to Musk hitting the improbable targets. "He's Ronaldo, he's Messi. He can ask for what he wants."

Moreover, Musk couldn't just take the money and run. His compensation plan includes a five-year post-exercise holding period, meaning that any options he exercised he'd have to hold for five years before selling them. This becomes relevant in the face of the news of Tesla reporting a decline in quarterly deliveries in Q1, a quarter in which it also missed Wall Street estimates. Shares were down 5.2% the afternoon of the news, representing a $30 billion decline in market capitalization. Musk's exercised options took a hit as well, further illustrating how his payday is aligned with shareholder success.

Risk and reward

It is unequivocal that a company of Tesla's size and import needs solid governance to avoid any accusations of being run as a fiefdom of one of the world's most powerful, recognizable and wealthy individuals. However, assuming all that is in place, the question of the fairness of the reward itself is less clear-cut. In the face of extreme regulatory and market uncertainty, Musk eschewed all standard compensation in favor of a major payday if outlier (and shareholder-enriching) targets were met. It stands to reason then, that he should be rewarded commensurate with that risk and outlier performance.

This principle certainly plays out in other industries. Consider real estate private equity, in which it is standard practice for a fund sponsor to get an outsized share of the rewards, known as the "promote," if certain targets are exceeded.

A simple example: An investor (known as a limited partner or LP) and the fund sponsor and management (known as the general partner or GP) have a split whereby the LP first gets their money back plus the first 8-10% of profits or internal rate of return (IRR). Thereafter, each dollar value created is split whereby the LP gets 80% and the GP gets 20%, of which that GP shares the profits to various degrees with key executives/employees. The higher the profits/IRR, the greater the GP's split.

Now, real estate private equity has yet to produce a fund that has resulted in a trillion-dollar outcome. But suppose it did, would an investor be opposed to the architect and driving force of such a strategy taking home roughly six cents on the dollar, or $55 billion in that instance? It seems a reasonable reward for the GP’s enterprise, labor and salesmanship that made the investment an off-the-charts success.

The world of Hollywood might provide an even more vivid parallel. A-list actors and filmmakers often relinquish their hefty upfront salaries in order to help the film come in under budget. Instead, they opt to take “points,” i.e. a percentage of the film’s net profits. If the film flops, that’s money they never see, but if it’s a hit, the reward could be outsized. Consider 1994’s “Forrest Gump,” in which star Tom Hanks and director Rober Zemeckis both opted for points, and even covered the costs of some of the film’s more extravagant scenes out of their own pockets. The movie went on to win Best Picture at the Oscars and grossed nearly $700M; thanks to his points, Hanks’ share of that was close to $65 million.

As Gump says in the film’s most iconic line: “Life is like a box of chocolates 🍫 - you never know what you’re going to get.” But if you do everything right, you should at least have a shot at the box.

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Further reading

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