The Problems with Tesla's Pay

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Chancellor Kathaleen McCormick of the Delaware Court of Chancery recently struck down CEO of Tesla Elon Musk's 2018 pay package of performance-based options because she found issues with proxy disclosures, the process of setting pay, the lack of compensation consultant involvement and the lack of director independence among many other reasons. But what was the pay package that caused so much trouble?

Musk received 20 million stock options at an exercise price of over $350 each. Each award was for options over shares equal to 1% of outstanding stock, and the whole award's grant date market value was $2.3 billion; though the proxy noted that if all the performance conditions were met it could be worth more than $55 billion. The award was conditioned upon a series of 12 market capitalization milestones, each adding $50 billion to Tesla's value, and 16 other performance milestones (eight based on revenue targets and eight based on adjusted EBITDA over 10 years). The operational milestones were substantially met by September 2022.

There was some carping about the fact that the adjusted EBITDA target excluded non-cash charges for stock-based compensation, not just Musk's, but all employees' stock compensation. At the time, Musk alone had made a profit of $1.34 billion on the exercise of stock options in 2016, and had a potential profit of $1.68 billion in outstanding options from a prior award from 2012 that closely resembled this so-called one-of-a-kind pay package. So the non-cash charge exclusions could make the performance targets substantially easier.

My initial reaction at the time to the news that Tesla was going to give Musk over 20 million stock options was, what on earth does someone who already owns then over 36 million Tesla shares, 22% of the company, need with more shares?

A possible answer was provided by comments Musk made to the NYT Dealbook's Andrew Ross Sorkin. Musk said he was not after dynastic wealth creation, but that he wanted to do some "pretty big things." "I want to contribute as much as possible to humanity becoming a multi-planet species. That obviously requires a certain amount of capital."

Coincidentally, according to ESGAUGE statistics, the next highest paid CEO in 2018 also received 12 performance- based stock option awards. The CEO of taser manufacturer Axon Enterprise, Inc., Rick Smith, received performance-based options that also measured performance over 10 years against market capitalization, revenue, and EBITDA targets and had a grant date value of $246 million. But not only was the CEO eligible for Axon's eXponential Stock Performance Plan (XSPP), so were all the company's other employees.

According to press reports, Musk's award was a direct inspiration for Smith's, but Axon's 2019 proxy outlines an extensive shareholder outreach program prior to the vote. "Shareholders tended to favor broad-based employee-wide plans over highly concentrated plans among senior management, and favor using performance-based share-based compensation, rather than cash, in delivering market-competitive total pay," says the proxy. The company also addressed dilution concerns by adopting "a dilution guardrail of 3% annual share count growth, calculated on a daily basis…."

Axon's eXponential plan has not been challenged in the courts.

Coincidentally, Apple CEO Tim Cook's pay package, indeed the pay of the whole top executive team, was subject to a legal challenge, though U.S. District Judge Jennifer Rochon in Manhattan dismissed the lawsuit just days after Musk's pay was struck down. Ironically, Apple had just added Tesla to its compensation peer group – the group of companies against which Apple executives' pay is compared and set.

Tesla does not disclose the members of its peer group, but ESGAUGE's executive compensation module allows users to identify what it calls reverse peers – companies that identify Tesla as a peer even though Tesla does not identify them. As well as Apple, the list includes: Porsche, luxury vehicle manufacturer Lucid Group, Microsoft, Netflix, Rivian Automotive, Uber and Volkswagen.

But including a peer such as Tesla, with its rarefied approach to compensating its CEO, creates considerable problems for compensation committees and their consultants. While the pay of other executives at Tesla can be easily used as comparators, what do you do with a 10-year award of performance stock options valued at between $2.3 billion and more than $50 billion. Annualizing it over the period would help, but even so would distort both the average and median compensation for peer group CEOs. Now that it has been struck down to zero, it will have an equally distorting effect.

But making the assumption to annualize Musk's pay over 10 years also presents problems. His 2012 pay package was supposed to last for 10 years, but another award was made just six years later. A change that would necessitate compensation consultants to recalculate peer CEO pay over the period. While it would be simpler to exclude companies like Tesla from peer groups altogether, the decision to include it will need to be carefully managed.