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# The Board's Role in Making Great Acquisitions

June 2022



# **Addressing Conflicts: A Case Study of Tesla and SolarCity**

# *In re Tesla Motors, Inc., Stockholder Litigation*

*C.A. No. 12711-VCS (Del. Ch. Apr. 27, 2022)*

- Court rejected derivative claims against Elon Musk alleging breach of the duty of loyalty, unjust enrichment and waste in his capacity as a purported controlling stockholder and a member of Tesla’s board in connection with Tesla’s acquisition of solar energy company SolarCity, which Plaintiffs allege was insolvent at the time of acquisition.
- At the time of the acquisition, Elon Musk was the chair of SolarCity and its largest stockholder. SolarCity was founded by Musk’s cousins, Peter and Lyndon Rive.
- Many of Tesla’s directors allegedly had conflicts in connection with the consideration of the acquisition of SolarCity, including Musk’s brother, Kimbal Musk, who was a shareholder of SolarCity and had significant margin loans on his SolarCity shares at the time of the acquisition.
- Other board members had direct or indirect interests in SolarCity as shareholders, directors or through their relationship with SpaceX, which was the largest owner of SolarCity bonds.

# Result

- Prior to trial, all directors other than Elon Musk settled for \$60 million, funded by insurance.
- After trial, the court, assuming for purposes of its decision that the transaction was subject to entire fairness review rather than business judgment review, concluded that the SolarCity acquisition was entirely fair to Tesla and its shareholder.

“[I]f Chancery opinions are ‘parables,’ let this be a parable of unnecessary peril, despite the outcome.” (Slip Op. at 87)

# Process Flaws

- No special committee of independent directors to negotiate the acquisition.
- Elon Musk did not fully separate himself from the consideration of the acquisition and the court found he “participated in the deal process to a greater degree than he should have been.” (Slip Op. at 91)
  - Undisclosed to the board, Musk had several communications directly with SolarCity management
  - Musk promised a bridge loan to SolarCity without getting board approval.
  - Musk participated in the selection of Tesla’s outside deal counsel.
  - Musk reviewed Tesla’s offer letter and market communications concerning the transaction before they were issued.
  - Musk was involved in preliminary discussions of price and explained why a 30% premium, higher than Tesla’s bankers were suggesting, might be necessary.

## Process Flaws (continued)

- Musk published a Tesla strategy plan called the Master Plan Part Deux during negotiations in an apparent attempt to garner shareholder support while the board was considering its options.
- Musk regularly communicated with Tesla’s bankers outside the boardroom and the bankers informed Musk that it was recommending lowering the offer before it met with the board.
- Musk was present at parts of the board meeting where a revised offer was discussed.
- Before the stockholder vote, Musk touted a product called the Solar Roof that was expected to be launched after a potential acquisition and made promises about the timing of the product launch.
- Musk’s brother Kimbal and other arguably conflicted directors were not recused from considering and voting on the acquisition.
- “If these facts comprised the entirety of deal process, one would be justified in characterizing the process as broken. But they do not.”  
(Slip Op. at 94)

# Process Strengths

- Although not required by Delaware law, the Tesla Board conditioned the acquisition on an affirmative vote by the majority of the minority of Tesla's disinterested shareholders. Approximately 85% of votes cast were in favor of the deal. This was found to be “compelling evidence that the price was fair.” (Slip Op. at 117)
- The board pushed back on the acquisition initially to suit Tesla's timing, after the Model X rollout.
- Tesla retained high quality legal and financial advisors.
- Musk and one of Tesla's directors who served on the SolarCity board were recused from final decision-making on price and voting on the acquisition.

## Process Strengths (continued)

- Due diligence was used by Tesla to lower the offer.
- The board showed that it was not dominated by Musk in multiple instances, including by refusing to provide the bridge loan Musk promised to Solar City.
- The market and the board were aware of SolarCity's liquidity challenges.
- One director, Robyn Denholm, who had no conflicts, “emerged as an independent, powerful and positive force during the deal process who doggedly viewed the Acquisition solely through the lens of Tesla and its stockholders.” (Slip Op. at 101)

# Lessons

- In addressing conflicted transactions, consider delegating the consideration of the deal to a committee of independent directors.
- Exclude conflicted directors from discussion and consideration of transactions.
- It may be appropriate to condition a transaction on a vote of non-conflicted shareholders.
- Hire independent and well-respected advisors.
- Put independent directors in control of the process.
- Even if you choose not to follow best practices, make sure you are always doggedly viewing a transaction through the lens of your company and its stockholders – Although it can be expensive and messy, entirely fair transactions will be approved even if the process is lacking.

# Importance of Process in Making Great Acquisitions

# Process Offers Legal Protection...

- Process is critical in all acquisitions, not just conflicted transactions
- The Board’s fiduciary duty to shareholders has two fundamental elements

## 1 Loyalty

Act in the good faith belief that actions are in the best interests of the corporation and its shareholders

## 2 Care

Act on an informed basis after due consideration of all relevant information

- As a practical matter, ensure your board:
  - Has the relevant **information** needed to make the acquisition decision
  - Devotes **sufficient time** to consideration of that information

# ...And Enables the Board's Collective Wisdom

- While offering protection as a legal matter, more importantly, good process serves to leverage the Board as a strategic business asset
- Insist on comprehensive **information**

## Material business *and* legal terms of any deal under consideration

- ✓ Strategic rationale (context, competitive dynamics and fit)
- ✓ Valuation, financial model (and assumptions) and ability to pay
- ✓ Deal structure and risk allocation provisions
- ✓ Advice of internal and external subject matter experts

- Ensure **sufficient time** for consideration
  - Multiple meetings to deliberate as process progresses
    - Responsiveness to due diligence findings and negotiation developments
  - Materials distributed well in advance of meetings

***Constructive skepticism and candid Board discussion are vital***

# Complex Transactions: Earnouts

# What is an earnout?

- Purchase price that is made contingent upon a target business achieving pre-set performance targets following the closing of transaction

**“What an earn-out (and particularly a large one) typically reflects is disagreement over the value of the business that is bridged when the seller trades the certainty of less cash at closing for the prospect of more cash over time. In theory, the earn-out solves the disagreement over value by requiring the buyer to pay more only if the business proves that it is worth more.**

**But since value is frequently debatable and the causes of underperformance equally so, an earn-out often converts today’s disagreement over price into tomorrow’s litigation over the outcome.”**

*Vice Chancellor Laster  
Airborne Health, Inc. v. Squid Soap, LP*

# Why use an earnout?

- Bridge valuation gap
- Incentivize seller management
- Allow sellers to exit now, but share in upside later
- Allow buyers to offload risk and/or finance transaction with future earnings
- Provide a mechanism for buyers to enforce indemnification obligations

# How often are earnouts used?

- In 2020-21, 20% of deals included earnouts (down from 27% in 2018-19)\*
- Much more common in certain industries such as biotech and medical device

\* 2021 ABA Private Target M&A Deal Points Study

# What are the risks?

- Litigation risk (“I would have earned this but for...”)
- Adds complexity to negotiation and documentation
- May delay integration or impose restrictions on business
- Incentives may not align with building long term value of the business
- Accounting consequences can result in earnings volatility

## Key questions the Board should be asking:

- What are our obligations (express or implied) and to what extent could they be burdensome or introduce litigation risk?
- Do the financial incentives of the earnout align with our strategic goals for the acquired business and the company as a whole?

# Additional Information

- [“Using Earnouts to Find an Exit”](#) February 2014
- [“Revisiting Earnouts During Coronavirus Pandemic”](#) May 2020

# Speakers



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**THANK YOU**

