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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Elon Musk Risks Conflicts In Move To Insure Tesla's Board

By **Jeff Sistrunk**

Law360 (April 30, 2020, 7:57 PM EDT) -- Tesla CEO Elon Musk's decision to personally insure the company's board rather than purchase traditional directors and officers insurance is a rare move that raises the potential for conflicts of interest, given that Musk's ability to pay D&O claims may be tied to Tesla's financial status.

In an amended annual report filed with the U.S. Securities and Exchange Commission on Tuesday, Tesla revealed that it had determined not to renew its D&O insurance policy for the 2019-2020 policy year "due to disproportionately high premiums quoted by insurance companies."

In lieu of traditional D&O insurance — which is designed to defray legal costs that companies, board members and executives incur in securities lawsuits and certain other types of civil and criminal actions — Musk has agreed to "personally provide coverage substantially equivalent to such a policy" for one year, according to the report.

Tesla told the SEC that its decision to use Musk's self-funded D&O insurance program would not "impair the independent judgment of the other members of the board" because it is governed by an agreement that Musk does not have "unilateral discretion" to execute.

The SEC filing did not provide any further details on the structure of the D&O program or its governing agreement, and Tesla representatives did not respond to repeated requests for comment.

Insurance experts who spoke to Law360 said that, despite Tesla's assurances to the SEC, the automaker's insurance arrangement raises the specter of conflicts of interest between Musk and other board members, whose decisions may directly impact the Tesla CEO's compensation and role within the company.

"To the extent Musk has any voice in how policy proceeds are spent, that certainly raises questions about the independence of the rest of the board in situations where you are really going to need D&O coverage," said Manire Galla Curley LLP partner Michael Manire, who serves as co-chair of the D&O and management liability committee at the American College of Coverage Counsel, an association of insurance lawyers.

Experts noted that Tesla is currently facing numerous suits that could implicate the company's D&O coverage. Earlier this month, a California federal judge **refused to dismiss** nine consolidated securities fraud suits alleging Musk misled investors in 2018 with tweets about taking the automaker private. In addition, Musk is expected to **go to trial** later this year to defend himself against stockholder claims challenging Tesla's $2.6 billion merger with SolarCity.

If Tesla were to suffer a large court judgment, the hit to the company's finances could compromise Musk's ability to pay out claims under the self-funded insurance program, experts said.

"If there were a dramatic reversal of fortune that significantly reduced the enterprise value of Tesla and undermined the value of Musk's stock in a way that affected his ability to provide this D&O coverage, then you could conceivably have a situation where the event that triggers coverage also impairs Musk's capacity to respond," said Kevin LaCroix, executive vice president of specialty insurance brokerage firm RT ProExec and author of the D&O Diary blog. "For that reason, the board would appear to have a stake in Musk maintaining his financial ability to honor this commitment."

Neal Gerber & Eisenberg LLP partner Seth Lamden, who also co-chairs the ACCC's D&O and management liability committee, remarked that this type of insurance arrangement is "only as good as the assets backing the commitment."

"If a catastrophic event happens that decreases the value of the assets backing the commitment, board members could be left without protection," Lamden said.

To illustrate the potential pitfalls of a self-funded D&O insurance program like Musk's, LaCroix shared a cautionary tale regarding a similar arrangement that was in place at a privately held commercial bank he advised at the outset of the 2008 financial crisis.

According to LaCroix, the bank lacked traditional D&O coverage, and its founder, chairman and largest shareholder personally provided indemnification to other board members. But because the founder's wealth was tied up in the bank, when the crisis hit its full stride, his money dried up and he and the board members were left unprotected, LaCroix said.

"At the moment that bank was in crisis, it occurred to the board that perhaps D&O insurance wasn't such a bad idea after all. That is a precarious position to be in," LaCroix said. "That doesn't mean that will happen to Tesla, or that this is an inherent flaw in this type of arrangement. It just shows the differences between what may occur under this type of arrangement versus a conventional D&O insurance contract."

Jassy Vick Carolan LLP partner William Um told Law360 that, while Musk's D&O insurance program presents substantial risks, it could also have upsides. For one thing, by cutting out a traditional D&O insurance carrier, Musk and Tesla will have "absolute control in how to approach claims," and can choose whether to settle or proceed with litigation instead of having to first seek an insurer's input, Um said.

"Musk can say, 'I don't like this claim that has been brought, so we are going to fight it,'" Um said.

In addition, he said, Tesla's cost savings will likely be significant, since it does not have to pay D&O premiums or transactional costs associated with policy renewals and claims submissions.

"Ultimately, you are rolling the dice, but if no claims come in, you are saving a lot of money on premiums, which is a huge upside," Um said.

However, Um cautioned that, if other companies are similarly frustrated with the price of D&O coverage from the traditional market — which saw premiums surge in 2019, due in large part to the nationwide explosion in shareholder litigation — there are alternative options that are less risky than Tesla's unique arrangement.

According to Um, well-capitalized companies could consider purchasing D&O policies with lower limits, higher deductibles or only "Side A" coverage, which applies to certain claims against directors and officers that cannot be indemnified by the company itself.

"You could, for example, have a program designed where there is a very high retention. That would bring a company's costs down," he explained. "Some would argue with that kind of retention, you are effectively self-insuring anyway. That type of program could give directors and officers the comfort of having insurance in place, while also avoiding any potential conflict of interest issues."

--Additional reporting by Dean Seal and Rose Krebs. Editing by Philip Shea and Kelly Duncan.
