

XIII. Going Private or Not—Tesla’s U-Turn Backfires

A. Introduction

On August 7, 2018, Tesla, Inc. (Tesla) posted a tweet announcing plans to take the company private.¹ Immediately following the official tweet, Tesla’s CEO Elon Musk (Musk) confirmed the plan with “investor support.”² Unexpectedly, on August 24, 2018, Tesla abruptly abandoned the plan to go private, choosing instead to remain public.³ This quick turnaround had a huge impact on Tesla’s stock price.⁴ The stock price soared with the original announcement on August 7, but dropped sharply after Tesla abandoned the plan.⁵ Meanwhile, investors have been filing lawsuits seeking significant damages⁶ and accusing Tesla and Musk of making materially false and misleading statements, as well as manipulating the market.⁷

Several factors, including Tesla’s financial problems, shaky management, and highly shorted stocks, may have led to Musk’s decision of taking the company private.⁸ However, despite Musk’s announcement on social media that funding was secured, little evidence revealed if his statement was sound. Indeed, the Securities

¹ Tesla, Inc. (@Tesla), TWITTER (Aug. 7, 2018, 12:28 PM), <https://twitter.com/Tesla/status/1026912973120462848> [<http://perma.cc/6KLM-RQR7>] (“Taking Tesla Private[.]”).

² Elon Musk (@elonmusk), TWITTER (Aug. 7, 2018, 12:36 PM), <https://twitter.com/elonmusk/status/1026914941004001280> [<http://perma.cc/93BG-HUKD>] (“Investor support is confirmed.”).

³ Tesla, Inc. (@Tesla), TWITTER (Aug. 24, 2018, 8:15 PM), <https://twitter.com/Tesla/status/103319100203381376> [<http://perma.cc/U5XZ-WU3M>] (“Staying Public[.]”).

⁴ Dean Seal, *Tesla Hit with Stock-Drop Suit over Privatization Tweets*, LAW360 (Aug. 30, 2018, 3:14 PM), <https://www.law360.com/articles/1078271/tesla-hit-with-stock-drop-suit-over-privatization-tweets>.

⁵ *Id.* (reporting that Tesla stock prices rose \$35.78 after the initial tweet announcing Tesla going private, but prices then fell \$9.23 after the board announced that it was still evaluating the possibility of privatizing Tesla).

⁶ RJ Vogt, *Investor Hits Tesla, Musk with Fraud Claims over Tweet*, LAW360 (Aug. 10, 2018, 9:41 PM), <https://www.law360.com/articles/1072460/investor-hits-tesla-musk-with-fraud-claims-over-tweet>.

⁷ *Id.*

⁸ Tom Zanki, *Elon Musk Says Saudis Expected to Fund Tesla Buyout*, LAW360 (Aug. 13, 2018, 6:39 PM), <https://www.law360.com/articles/1072636/elon-musk-says-saudis-expected-to-fund-tesla-buyout>.

and Exchange Commission (SEC) began an investigation regarding Musk's August 7 tweet about "secured" financing for a private buyout of the company.⁹ The Department of Justice (DOJ) also stepped into the investigation.¹⁰

The quick reversal of the "going private" decision was not the only recent noteworthy event at Tesla. On September 7, 2018, Musk announced adjustments in Tesla's management personnel, aiming to reform its product development and talent growth.¹¹ On September 27, 2018, however, the SEC filed a complaint in a federal court in New York, alleging that Musk misled shareholders when he secured funding of Tesla's buyout and seeking to force Musk out of Tesla.¹² On September 29, 2018, the SEC filed another complaint against Tesla, accusing the failure of Tesla to disclose Musk's abused use of his Twitter account.¹³ Later the same day, the SEC announced that Tesla and Musk had settled the charges, agreed that Musk would step down as Tesla's Chairman, and pronounced that Musk and Tesla would each pay a twenty million dollar penalty.¹⁴

⁹ Matthew Goldstein et al., *Tesla Is Said to Be Subpoenaed by S.E.C. over Elon Musk Tweet*, N.Y. TIMES, Aug. 16, 2018, at B3 ("Federal securities regulators have served Tesla with a subpoena . . .").

¹⁰ Tom Schoenberg & Matt Robinson, *Tesla Is Facing U.S. Criminal Probe over Elon Musk Statements*, BLOOMBERG (Sept. 18, 2018, 11:42 AM), <https://www.bloomberg.com/news/articles/2018-09-18/tesla-is-said-to-face-u-s-criminal-probe-over-musk-statements>.

¹¹ Elon Musk, *Company Update*, TESLA (Sept. 7, 2018), <https://www.tesla.com/blog/company-update> [<http://perma.cc/32SN-G5NN>].

¹² Complaint at 1, U.S. Sec. & Exch. Comm'n v. Musk, No. 1:18-cv-8865 (S.D.N.Y. Sept. 27, 2018) [hereinafter *Compl. Musk*] (alleging Musk made false and misleading statements which caused harm to investors); see 15 U.S.C. § 78j(b) (2012) (stating that it is illegal for anyone to use in connection with a purchase of a security any manipulative or deceptive device); see also 17 C.F.R. § 240.10b-5 (2018) (stating that it is illegal for anyone "to employ any device, scheme, or artifice to defraud" in connection with any national securities exchange).

¹³ Complaint at 5, U.S. Sec. & Exch. Comm'n v. Tesla, Inc., No. 1:18-cv-8947 (S.D.N.Y. Sept. 29, 2018) [hereinafter *Compl. Tesla*] (alleging pursuant to Section 21(d) of the Exchange Act, seeking to enjoin "the transactions, acts, practices, and courses of business alleged in this Complaint . . ."). See 15 U.S.C. § 78u(d) (2012).

¹⁴ Press Release, U.S. Sec. & Exch. Comm'n, *Elon Musk Settles SEC Fraud Charges; Tesla Charged with and Resolves Securities Law Charge* (Sept. 29, 2018), https://www.sec.gov/news/press-release/2018-226?mod=article_inline [<https://perma.cc/92H9-FANH>] (clarifying that Musk would not be eligible to

This article aims to provide a brief analysis of Tesla's quick reversal from its decision of taking the company private to its abrupt abandonment of the plan, and such reversal's impact on investors, market, and the company itself, under the current federal regulation. First, Section B explains potential reasons why Tesla decided to go private. Section C then analyzes the federal regulations and current enforcement trend regarding Tesla's activities. Section D summarizes the most recent lawsuits brought up by Tesla investors and the settlement with the SEC, and provides analysis on the outcome of cases. Finally, Section E concludes with the challenges Tesla is facing and predicts the company's future endeavors.

B. Brief History

1. *Tesla's Financial Troubles*

Financial problems at Tesla may have driven Musk to take Tesla private. In the first quarter of 2018, Tesla's "free cash flow ballooned to a negative \$1 billion" from "a negative \$277 million in the fourth quarter" of 2017.¹⁵ Tesla's performance in the stock market has not been very optimistic, either.¹⁶ In March 2018, a rating agency Moody's "downgraded Tesla's credit rating from B2 to B3," hurting Tesla's stock price badly.¹⁷ The downgrading move also "reignited concerns" over whether Tesla might eventually go bankrupt.¹⁸ Further,

be re-elected Chairman for three years, and that the monetary penalties would be "distributed to harmed investors"). The press release further announced that Tesla would appoint two new independent directors to its board and would "establish a new committee of independent directors and put in place additional controls and procedures to oversee Musk's communications." *Id.*

¹⁵ Ciara Linnane & Tomi Kilgore, *After Eight Years as a Public Company, Tesla Still Has Teething Problems*, MARKETWATCH (July 1, 2018 10:21 AM), <https://www.marketwatch.com/story/after-eight-years-as-a-public-company-tesla-still-has-teething-problems-2018-06-29> [<http://perma.cc/3NCH-UWPE>].

¹⁶ See Mark Matousek, *Tesla's Problems Are Growing—Here's Everything That Has Gone Wrong So Far This Year*, BUSINESS INSIDER (June 1, 2018, 9:22 AM), <https://www.businessinsider.com/tesla-challenges-in-2018-2018-4> ("The move hurt Tesla's stock price and drew attention to the frequency with which the company has spent and raised money.").

¹⁷ *Id.*

¹⁸ *Id.* See also Tim Higgins et al., *Some Tesla Suppliers Fret about Getting Paid*, WALL ST. J. (Aug. 20, 2018, 4:48 PM),

on May 2, 2018, during Tesla's "unusual first-quarter earnings call," Musk rejected questions from two Wall Street analysts regarding Tesla's financial health.¹⁹ Musk's behavior did not please the investors and shareholders, which eventually led to Tesla's "stock dropp[ing] 8% in after-hours trading. . . ."²⁰

Being a publicly traded company subjects Tesla to a quarterly earnings cycle, which according to Musk, has put "enormous pressure on Tesla to make decisions that may be right for a given quarter, but not necessarily right for the long-term."²¹ Musk stated that "wild swings in [Tesla's] stock price . . . can be a major distraction for everyone working at Tesla, all of whom are shareholders."²² Because private equity holders would be likely to commit to long-term ownership of the funds, going private would have provided Tesla with the opportunity to focus on long-term issues and a more stable shareholder base, further benefiting the company's finances and boosting confidence among employees.²³ Going private also provides advantages in financing to the corporations because private companies tend to be "substantially more leveraged than public companies," and had Tesla gone private, the additional use of leverage would more frequently "yield higher returns" to its investors and likely provide Tesla with greater funding.²⁴ Additionally, going private could help Tesla avoid the substantial costs of complying with securities and corporate governance rules, which generally apply only to public companies.²⁵

<https://www.wsj.com/articles/some-tesla-suppliers-fret-about-getting-paid-1534793592> (stating that a majority of respondents to a recent survey conducted by "a well-regarded automotive supplier association to top executives" believed that Tesla "is now a financial risk to their companies").

¹⁹ Matousek, *supra* note 16.

²⁰ *Id.*

²¹ Elon Musk, Taking Tesla Private, TESLA (Aug. 7, 2018), <https://www.tesla.com/blog/taking-Tesla-private> [<http://perma.cc/E279-JULK>].

²² *Id.*

²³ Scott J. Davis, *Would Changes in the Rules for Director Selection and Liability Help Public Companies Gain Some of Private Equity's Advantages?*, 76 U. CHI. L. REV. 83, 88–89 (2009).

²⁴ *Id.* at 91–92 ("[T]he additional use of leverage will frequently yield higher returns to the investors in [Private Equity] Portfolio Companies than those to public company shareholders.").

²⁵ *Id.* at 92–93 (explaining that private companies are not subject to the Sarbanes-Oxley Act and thus, do not bear compliance costs).

2. *Tesla's Shaky Management*

As of May 2018, three high-profile employees of Tesla had either left the company or taken a leave of absence.²⁶ In April, Tesla informed the public that its “former head of [the] Autopilot division” would leave the company.²⁷ In May, when Tesla struggled with its Model 3 production, the company’s senior vice president of engineering took a leave of absence,²⁸ and its “main technical contact with U.S. safety investigators” left to join a rival company.²⁹

Meanwhile, mounting regulatory and legal woes have plagued Musk. Since early 2018, the SEC has been investigating how Tesla communicated its production issues regarding the Model 3.³⁰ On August 15, 2018, federal securities regulators served Tesla and Musk with a subpoena regarding Musk’s August 7 tweet about “secured” financing for a private buyout of the company.³¹ Investors also filed lawsuits as a result of Musk’s going private announcement.³²

If Tesla went private, the managerial problems may be resolved by raising managers’ pay. Unlike public companies where top executive pay is publicly reported and boards may hesitate to adopt incentive pay plans, a private company is able to deliver pay plans that reward managers hugely, which can be equivalent to a percentage of

²⁶ Matousek, *supra* note 16.

²⁷ *Id.*

²⁸ Tim Higgins, *Tesla's Engineering Chief Takes Leave of Absence at Pivotal Moment*, WALL ST. J. (May 11, 2018, 8:06 PM), <https://www.wsj.com/articles/teslas-engineering-chief-takes-leave-of-absence-at-pivotal-moment-1526082594>.

²⁹ Tim Higgins, *Tesla Executive Leaves for Alphabet Self-Driving-Car Unit Waymo*, WALL ST. J. (May 12, 2018, 6:15 PM), <https://www.wsj.com/articles/tesla-executive-leaves-for-alphabet-self-driving-car-unit-waymo-1526160814>.

³⁰ Dave Michaels et al., *SEC Probes Tesla over Model 3 Production Disclosures*, WALL ST. J. (Aug. 16, 2018, 9:40 PM), <https://www.wsj.com/articles/sec-probing-tesla-directors-for-details-on-communications-with-elon-musk-1534450010> (“Securities regulators began investigating last year whether Tesla, Inc. misled investors about its Model 3 car production problems . . .”).

³¹ Goldstein et al., *supra* note 9.

³² Vogt, *supra* note 6.

the company's increase in value.³³ Therefore, going private would enable Tesla to come up with plans including incentive onboarding bonuses and variable executive compensation to attract high-level talent.³⁴

3. *Vulnerability to Short Sellers*

Listed on the Standard & Poor's 500-stock index, Tesla is "among the most shorted stocks."³⁵ Notably, "more than a quarter of Tesla's shares valued at about \$13 billion are being shorted."³⁶ Like other stocks favored by short sellers, Tesla stock has the characteristics of "unpredictable earnings, volatile share price, high trading liquidity, rapidly growing assets and expensive valuations," but historically, heavily shorted stocks tend to underperform.³⁷ Among the socially harmful effects of short selling summarized by financial economists,³⁸ short selling particularly diminishes the underlying value of Tesla by affecting the operation of Tesla through short-term share price changes.³⁹ Due to the "self-confirming" and "contagious" nature of short selling activities, Tesla faced challenges to "maintain its capital base[s]" for production when short sellers shorted its stocks at a regular basis.⁴⁰

Recognizing that being public subjects Tesla to a great deal of short-selling, Musk reasoned that taking Tesla private would make the company operate "at its best, free from as much distraction and short-

³³ Geoff Colvin, *Going Private: Take This Market and Shove It*, FORTUNE (May 17, 2016, 6:30 AM), <http://fortune.com/going-private> [<https://perma.cc/2A3V-347U>].

³⁴ Davis, *supra* note 23, at 89–90 (explaining that private companies "appear able to pay more and offer better working conditions to talented managers than public companies," while public companies "face effective constraints in paying for talent").

³⁵ Stephen Grocer, *Elon Musk Is Beating Short-Sellers, for Now*, N.Y. TIMES, Aug. 9, 2018, at B2.

³⁶ *Id.*

³⁷ Dimitris Melas & George Bonne, *Why Is Tesla a Short-Selling Target?*, MSCI, <https://www.msci.com/www/blog-posts/why-is-tesla-a-short-selling/01078305315> [<http://perma.cc/6MG4-ZK3E>].

³⁸ Merritt B. Fox et al., *Short Selling and the News: A Preliminary Report on an Empirical Study*, 54 N.Y. L. REV. 645, 652–59 (2009).

³⁹ *Id.* at 654–55.

⁴⁰ *Id.* (discussing how short-selling is contagious, self-confirming, and capable of eroding a firm's capital base).

term thinking as possible”⁴¹ If Tesla went private, short sellers could no longer take advantage of the company’s public shares, nor would they speculate based upon negative inside information.⁴² Consequently, Tesla’s investors and employees would face decreased turbulence, and private ownership could enable the company to operate in a more efficient manner.⁴³

Hence, for Tesla, being a private company has advantages over staying public.⁴⁴ Most importantly, going private would likely benefit Tesla with more flexible and secure funding for the company’s operation, incentivize its executives to create maximum value and positive social images for the company, and subject the company to less drastic market changes.

C. Federal Regulation

After Musk’s tweets about taking Tesla private and having “funding secured” for the deal, the SEC opened a fraud investigation.⁴⁵ On September 18, 2018, Tesla confirmed that it had “received a voluntary request for documents from the DOJ and [had] been cooperative in responding to it”⁴⁶ On September 27 and 29, 2018, the SEC filed complaints separately against Musk and Tesla, accusing Musk for making “a series of false and misleading statements,”⁴⁷ and Tesla for its failure to “implement disclosure controls” over Musk’s social media use.⁴⁸

⁴¹ Musk, *supra* note 21.

⁴² Fox et al., *supra* note 38, at 659.

⁴³ *Id.*

⁴⁴ Davis, *supra* note 23, at 84–85.

⁴⁵ Schoenberg & Robinson, *supra* note 10.

⁴⁶ *Id.*

⁴⁷ Compl. Musk, *supra* note 12 (stating that the SEC filed a complaint against Musk in federal court on September 27, 2018).

⁴⁸ Compl. Tesla, *supra* note 13, at 1 (“This case involves the failure of Tesla . . . to implement disclosure controls or procedures to assess whether information disseminated by its Chief Executive Officer . . . was required to be disclosed . . .”).

1. Rule 10b-5

The SEC claimed that Musk violated Section 10(b) of the Exchange Act⁴⁹ and Rule 10b-5 promulgated thereunder by the SEC,⁵⁰ by misleading investors in connection with the purchase of shares.⁵¹ Rule 10b-5 prohibits “any person, directly or indirectly,” by any means to “defraud,” which includes “misrepresentations, half-truths, omissions, and concealments of after-acquired information.”⁵² A statement by a corporation can be misleading whenever it is made by way of financial news media in a manner “reasonably calculated to influence [the] investing public,” if it is “false or misleading or [so] incomplete,” regardless of motivation.⁵³

Rule 10b-5 is not violated if corporate management demonstrates that it is “diligent in ascertaining that the information it published was the whole truth” and the “diligently obtained information was disseminated in good faith”⁵⁴ However, where it is “far from certain” that news released by a corporation is “encouraging,” courts will determine the character of the release in light of the facts existing at the time of release by applying the standard of “whether a reasonable investor, in exercise of due care, would have been misled by it.”⁵⁵

When deciding whether enough data was disclosed, courts consider several supplementary factors.⁵⁶ These factors include, but are not limited to, whether the statement is materially misleading, whether the aggregating of minor facts renders the overall statement misleading, and whether the statement was accurate at the time it was made.⁵⁷

⁴⁹ See 15 U.S.C. §78j (2012) (prohibiting the employment of manipulative or deceptive devices in connection with any national securities exchange).

⁵⁰ See 17 C.F.R. §240.10b-5 (2018) (stating it unlawful for anyone “to employ a device, scheme, or artifice to defraud” in connection with any national securities exchange).

⁵¹ Compl. Musk, *supra* note 12, at 21.

⁵² *Id.*; see Arnold S. Jacobs, *What Is a Misleading Statement or Omission Under Rule 10b-5?*, 42 FORDHAM L. REV. 243, 243 (1973).

⁵³ SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 861 (2d Cir. 1968).

⁵⁴ *Id.* at 862.

⁵⁵ *Id.* at 862–63.

⁵⁶ Jacobs, *supra* note 52, at 251 (presenting a number of principles supplementing the tests for whether enough data is disclosed).

⁵⁷ *Id.* at 251–53 (listing various factors that courts consider, such as whether the statement is materially misleading, how many minor imperfections there are, and if there is “puffing” or “sales talk”).

Circumstantial evidence, such as market price movements, is another important consideration in deciding whether a release had an impact on the stock price.⁵⁸

By tweeting “funding secured”⁵⁹ and confirming “investor support”⁶⁰ for Tesla going private on August 7, 2018 without revealing any sources or details, Musk may have exposed himself to legal risk. On August 13, 2018, Musk stated that the basis for his statement was conversations with the Saudi Arabian sovereign wealth fund, which “strongly expressed [its] support for funding a going private transaction for Tesla”⁶¹ However, Musk’s update never expressly mentioned the exact date or amount of funding that the Saudi fund would provide Tesla.⁶² Further, Musk claimed he was hesitant to provide “full details of the plan” to take Tesla private because it would be “premature” at that early stage.⁶³ Musk not only omitted material facts regarding funding, but his statements—that Tesla actually secured the enormous amount of funding to become a private company—were likely misleading.⁶⁴ Therefore, knowing or recklessly not knowing that his statements were “false and misleading,” Musk unlikely showed “diligence” to ascertain information, and thus violated Rule 10b-5.

In addition, the market responded rapidly to Musk’s tweets since his announcement of taking Tesla private.⁶⁵ Tesla’s stock price soared with Musk’s statements on August 7, but drastically dropped after Tesla abandoned the plan.⁶⁶ Through reliance on Musk’s material statements to the company’s going private action, many investors

⁵⁸ *Id.* at 253 (“[M]arket price movements have been inspected to ascertain whether a release [of information] was bullish or bearish.”).

⁵⁹ Elon Musk (@elonmusk), TWITTER (Aug. 7, 2018, 9:48 AM), <https://twitter.com/elonmusk/status/1026872652290379776> [<http://perma.cc/UU6G-MHL5>] (“Am considering taking Tesla private at \$420. Funding secured.”).

⁶⁰ Musk, *supra* note 2.

⁶¹ Elon Musk, Update on Taking Tesla Private, TESLA (Aug. 13, 2018), <https://www.tesla.com/BLOG/update-taking-tesla-private> [<http://perma.cc/9Z5G-USQZ>].

⁶² *See id.*

⁶³ *Id.*

⁶⁴ Compl. Musk, *supra* note 12, at 21.

⁶⁵ Peter J. Henning, *How the S.E.C. May Pursue a Case Against Elon Musk and Tesla*, N.Y. TIMES (Aug. 24, 2018), <https://www.nytimes.com/2018/08/24/business/dealbook/tesla-elon-musk-sec.html>.

⁶⁶ Seal, *supra* note 4.

claimed damages from Tesla stock and have filed lawsuits against Musk and the company.⁶⁷

2. Rule 13a-15

The SEC complained that Tesla “failed to maintain controls and procedures designed to ensure that information required to be disclosed in the [company’s] reports,” in a timely or effective manner,⁶⁸ thus, violating Rule 13a-15 of the Exchange Act.⁶⁹ Pursuant to the Exchange Act’s requirement that public companies must make information available to investors “on a regular basis through a series of periodic reports,” Rule 13a-15 establishes management’s affirmative duties to evaluate “disclosure controls and procedures” and “internal control over financial reporting.”⁷⁰

Musk uses his personal Twitter to act as Tesla’s spokesman and has published a series of statements about Tesla’s going private action since August 2018.⁷¹ As a result, Tesla’s investors and the public reacted immediately and strongly upon Musk’s tweets, seeking clarification from the company regarding Tesla’s going private action.⁷² However, Tesla’s corporate policies never intended to have “controls or procedures” pertaining to Musk’s use of Twitter or more general presence on social media to “disseminate information about Tesla.”⁷³ Therefore, Tesla likely breached its affirmative duty under Rule 13a-15 by failing to design or maintain “control and procedures” necessary to comply with federal securities regulations.⁷⁴

3. Section 20(a) of the Exchange Act

Because of Musk’s executive position at Tesla, control person liability under Section 20(a) also comes into play.⁷⁵ However, in

⁶⁷ *Id.*; Vogt, *supra* note 6.

⁶⁸ Compl. Tesla, *supra* note 13, at 8.

⁶⁹ 17 C.F.R. § 240.13a-15 (2018).

⁷⁰ David S. Ruder et al., *The Securities and Exchange Commission’s Pre- and Post-Enron Responses to Corporate Financial Fraud: An Analysis and Evaluation*, 80 NOTRE DAME L. REV. 1103, 1152–53 (2005).

⁷¹ Compl. Tesla, *supra* note 13, at 3–5.

⁷² *Id.* at 6.

⁷³ *Id.* at 7.

⁷⁴ *Id.* at 8.

⁷⁵ See 15 U.S.C. § 78t (2012).

determining whether there is control person liability, circuit courts split between two tests: “culpable participation” and “potential control.”⁷⁶ The Second, Third and Fourth Circuits apply the “culpable participation” test where a controlled person violates the Exchange Act as a “primary violator,” if the defendant has exercised control over the primary violator, and the controlling defendant has culpably participated in the fraud.⁷⁷ The majority of circuits, however, employ a less rigorous “potential control” test, focusing on whether the defendant has the “potential to,” or actually controls the primary violator.⁷⁸ The Ninth Circuit, in particular, defines control persons as having “participated in operations or exerted some influence therein.”⁷⁹ Section 20(a) requires control persons of a company to “act in good faith,” and take sufficient precautions to prevent securities violations of the company.⁸⁰

D. Current Enforcement Trend

Despite Musk’s failure to back up his seemingly misleading statements, the current enforcement trend under the SEC might have benefitted Tesla during the investigation.⁸¹ Public companies have been hit with fewer and much less costly penalties by the SEC since

⁷⁶ Erin L. Massey, *Control Person Liability under Section 20(a): Striking a Balance of Interests for Plaintiffs and Defendants*, 6 HOUS. BUS. & TAX L.J. 109, 114 (2005) (spelling out the current tests that determine control are: (i) culpable participation and (ii) potential control).

⁷⁷ *Id.* at 114–15 (discussing that under the culpable participation theory of control, a § 20(a) claim has three elements: (i) violation of the Exchange Act by a controlled person, also known as the primary violator; (ii) the defendant exercised primary control over the primary violator; and (iii) the controlling person must have culpably participated in the fraud).

⁷⁸ *Id.* at 118–22 (analyzing varying approaches adopted by majority of circuits pursuant to the potential control test).

⁷⁹ *Id.* at 121 (citing *Peltz v. Polyphase Corp.*, 36 Fed. Appx. 316, 321 (9th Cir. 2002)).

⁸⁰ 15 U.S.C. § 78t(a) (giving controller defendants a defense if they acted in good faith and “did not directly or indirectly induce the act . . . constituting the violation of cause of action”).

⁸¹ Alison Frankel, *Tesla, Musk Face SEC Wrist Slap at Worst, Experts Say: Frankel*, REUTERS (Aug. 16, 2018 5:31 AM), <https://www.reuters.com/article/us-tesla-musk-sec-column/tesla-musk-face-sec-wrist-slap-at-worst-experts-say-frankel-idUSKBN1L10YN> [<http://perma.cc/B4PF-5LWA>].

Donald Trump became president.⁸² In the first half of Fiscal Year 2018 (FY 2018), “monetary settlements imposed on all defendants in public company and subsidiary actions . . . decreased substantially from prior fiscal years.”⁸³ Specifically, “the maximum monetary settlement” imposed on public companies in the first half of FY 2018 was fourteen million dollars, which was “by far the lowest maximum monetary settlement in any half year in the database,” and “the average monetary settlement” was \$4.3 million, “significantly below the next lowest semiannual average of \$13.3 million.”⁸⁴ Additionally, most monetary settlements were “imposed on public company and subsidiary defendants, not individual defendants.”⁸⁵ Because the SEC under President Trump has moved away from “leveling huge monetary penalties against corporations,” that enforcement trend could have meant a relatively lighter monetary penalty for Tesla and Musk.⁸⁶

Nevertheless, in the settlement relief of fraud charges with the SEC, Musk and Tesla—both individual and public company defendants—are held liable, and each imposed with a separate twenty-million dollar penalty.⁸⁷ The settlement terms are tougher than what the SEC initially offered to Musk on September 27, 2018, which “called for a two-year bar on serving as chairman and a \$10 million fine.”⁸⁸ It is likely that because Musk rejected the initial settlement terms, and never admitted his action constituting fraud, the SEC went

⁸² *Id.* (“Even if the commission ultimately concludes Musk’s tweet was unfounded, the Tesla CEO’s potential penalty would probably be less than \$200,000, according to two securities law professors and a defense lawyer who tracks SEC enforcement at the SEC Actions blog . . .”).

⁸³ CORNERSTONE RESEARCH, SEC ENFORCEMENT ACTIVITY: PUBLIC COMPANIES AND SUBSIDIARIES—MIDYEAR FY 2018 UPDATE 2 (2018) <https://www.cornerstone.com/Publications/Reports/SEC-Enforcement-Activity-Public-Companies-and-Subsidiaries-Midyear-FY-2018-Update> [<http://perma.cc/F28L-WF2Y>].

⁸⁴ *Id.* at 8.

⁸⁵ *Id.* at 8–9 (pointing out that “only one action in the top 10 monetary settlements” included an individual defendant, which “accounted for \$1 million of the \$551 million total”).

⁸⁶ Frankel, *supra* note 81 (explaining that the lighter monetary penalties can be in Tesla and Musk’s favor).

⁸⁷ Press Release, *supra* note 14.

⁸⁸ Matthew Goldstein, *Elon Musk Steps Down as Chairman in Deal with S.E.C. over Tweet About Tesla*, N.Y. TIMES, Sept. 30, 2018, at A27.

harsher on Musk and Tesla.⁸⁹ Compared to the monetary penalty imposed by the SEC in the first half of FY 2018, the much heavier penalty imposed on Musk and Tesla may likely be an example that the SEC is using to deter public companies' irresponsible acts and false or misleading statements.⁹⁰

E. Litigation and Investigation

1. Recent Securities Fraud Litigation

Shortly after Tesla's announcement to go private, a securities fraud class action was filed by a short-selling investor on August 10, 2018.⁹¹ In *Isaacs v. Musk*, the Plaintiffs sought to recover damages against Musk and Tesla for "knowingly or recklessly, directly or indirectly" violating Section 10(b) and Rule 10b-5.⁹² Because Musk's statements artificially inflated the company's stock price, short sellers, including the Plaintiffs, were "forced to purchase artificially inflated shares" in the market to "cover their positions."⁹³ The Plaintiffs also alleged that Musk, as a CEO of a public company, violated his duty to "disseminate accurate and truthful information with respect to Tesla's financial condition," and "to correct promptly any public statements which had become materially false or misleading" under Section 20(a) of the Exchange Act.⁹⁴

Similarly, in a complaint filed on August 30, 2018, class action Plaintiffs in *Sodeifi v. Tesla, Inc.*, allegedly suffered damages in connection with their trading of Tesla securities during the period when the company announced that it was going private.⁹⁵ In addition

⁸⁹ *Id.* (reporting that the initial settlement terms called for a two-year bar on serving as chairman and a ten million dollar fine, but after Musk rejected the offer, the terms increased).

⁹⁰ *Id.* (quoting Jay Clayton that the settlement sent a message that "when companies and corporate insiders make statements, they must act responsibly, including endeavoring to ensure the statements are not false or misleading").

⁹¹ Class Action Complaint, *Isaacs v. Musk*, No. 3:18-cv-04865 (N.D. Cal. Aug. 10, 2018), ECF No.1.

⁹² *Id.* at 17–19 (alleging violations under Section 10(b) of the Exchange Act and SEC Rule 10b-5).

⁹³ *Id.*

⁹⁴ *Id.* at 19–20; see 15 U.S.C. § 78t (2012).

⁹⁵ Class Action Complaint for Violation of the Federal and Securities Law, *Sodeifi v. Tesla, Inc.*, No. 2:18-cv-07575 (C.D. Cal. Aug. 30, 2018), ECF No.

to alleging that Musk and Tesla violated section 10(b) of The Exchange Act and Rule 10b-5 for artificial inflation and depression of Tesla securities,⁹⁶ the Plaintiff also accused Musk of violating Section 20(a) of the Exchange Act by virtue of his position as controlling person of the company.⁹⁷

Shortly thereafter, a complaint filed as *Left v. Tesla, Inc. et al.* by Citron Research Executive Editor Andrew Left on September 6, 2018, accused Tesla of “artificially manipulating the price of Tesla securities with objectively false tweets,” therefore injuring short selling investors “as the price of Tesla securities deteriorated rapidly.”⁹⁸ Likewise, the claims arose under Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5.⁹⁹

On September 12, 2018, both *Isaacs* and *Left* were entered into a Related Case Order, together with a list of six other recently filed lawsuits against Tesla and Musk.¹⁰⁰ On September 13, 2018, “for the convenience of the parties and witnesses,” the *Sodeifi* Court filed the action to be transferred to the same district court that issued the Related Case Order.¹⁰¹

2. *Settlement with the SEC’s Securities Fraud Charge*

Besides the monetary penalty imposed on Musk and Tesla, the SEC settlement terms require that an independent Chairman replace Musk as Tesla’s Chairman and Musk is ineligible to be re-elected for three years.¹⁰² In addition, Tesla is required to appoint two new independent directors to its board, and establish a new committee of independent directors who will “put in place additional controls and procedures to oversee Musk’s communications”¹⁰³ According to the SEC, the terms were “specifically designed” to alarm Tesla to

1 (filing class action complaint against Tesla and Musk for violating Sections 10(b) and 20(a) of the Securities Exchange Act).

⁹⁶ *Id.* at 9–12.

⁹⁷ *Id.* at 12–13.

⁹⁸ Complaint for Violation of the Federal Securities Law, *Left v. Tesla, Inc.*, No. 3:18-cv-05463 (N.D. Cal. Sept. 6, 2018).

⁹⁹ *Id.* at 19–21.

¹⁰⁰ Related Case Order, *Isaacs v. Musk*, No: 3:18-cv-04865-EMC (N.D. Cal. filed Sept. 12, 2018), ECF No. 23.

¹⁰¹ Stipulation to Transfer Venue; [Proposed] Order, *Sodeifi v. Tesla, Inc.*, No: 2:18-cv-07575-DDP-JPRx (C.D. Cal. Sept. 13, 2018), ECF No. 11.

¹⁰² Press Release, *supra* note 14.

¹⁰³ *Id.*

strengthen its “corporate governance and oversight,” and to “prevent further market disruption and harm to Tesla’s shareholders.”¹⁰⁴

3. *Relevance and Implications*

In securities fraud cases like those described above, a heavy burden is placed on plaintiffs to prove the element of loss causation pursuant to Rule 10b-5.¹⁰⁵ To prove loss causation, the alleged misrepresentations by defendants need to necessarily be the “substantial cause” of plaintiff-shareholders’ losses, and such losses “were not attributable to other factors such as changing market or industry conditions.”¹⁰⁶ In 2014, the Ninth Circuit issued a key ruling in *Loos v. Immersion Corp. et al.*, which expressly required “a securities fraud plaintiff to allege that the market ‘learned of and reacted to th[e] fraud, as opposed to merely reacting to reports of the defendant’s poor financial health generally.’”¹⁰⁷ The Ninth Circuit did not accept that mere announcements of investigation by government regulators could satisfy the loss causation requirement, either.¹⁰⁸ Therefore, to prevail on the securities fraud cases against Musk and Tesla—even with Musk’s settlement with the SEC in place¹⁰⁹—the plaintiff-shareholders may still need strong proof to meet the Ninth Circuit’s stringent requirement, which requires the market’s reaction to the fraud sufficient enough to constitute a substantial cause to plaintiffs’ losses.

Another implication from the SEC settlement is the urgency of corporate governance reform within Tesla. With Musk stepping down, Tesla’s board must soon decide on and appoint a new Chairman to

¹⁰⁴ *Id.*

¹⁰⁵ Litigation Alert from Fenwick & West LLP, Susan S. Muck et al., Litigation Alert: Ninth Circuit Issues Key Ruling on Pleading of Loss Causation in Securities Class Actions (Aug. 8, 2014), <https://www.fenwick.com/publications/Pages/Ninth-Circuit-Issues-Key-Ruling-on-Pleading-of-Loss-Causation-in-Securities-Class-Actions.aspx> [<http://perma.cc/3CGP-T9WM>] (explaining the Ninth Circuit affirmed that mere announcement of an internal investigation, standing alone, is insufficient to establish loss causation, and plaintiffs are required to plead additional facts).

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ Goldstein, *supra* note 88.

ensure the company's smooth transition and operation.¹¹⁰ Because Tesla's lack of disclosure controls and procedures remain a special concern of the SEC, the board, in addition to closely watching Musk's communications with investors, will also need to establish a permanent committee responsible for monitoring disclosures.¹¹¹ Experts and commentators are skeptical about how effective the board can be in executing such a reform, given Musk's "erratic temperament and his dominant role in the company."¹¹² Nevertheless, in addressing disclosure control reforms, Tesla has the options to seek securities lawyers acceptable to the SEC to review all social media communications by its senior officers, implement mandatory procedures and controls over Musk's social media communications and pre-approve all such written communications that could contain material information, and certify such compliance supported by the SEC requirement.¹¹³

F. Conclusion

After the DOJ probe, Tesla shares dropped 3.4% on September 18, 2018.¹¹⁴ The SEC's filing of complaints in federal courts on September 27, 2018 directly resulted in Tesla's stock tumbling 9.9% in after-hours trading on Nasdaq.¹¹⁵ Tesla and Musk's settlement with the SEC on September 29, 2018 seemingly clears a "big headache" for Tesla, but other problems remain.¹¹⁶ Though the criminal investigation conducted by the DOJ is still "in its early stages" and Tesla has "highly rated consumer products,"¹¹⁷ Tesla's stock will likely suffer

¹¹⁰ James B. Stewart, *Elon Musk's Ultimatum to Tesla: Fight the S.E.C., or I Quit*, N.Y. TIMES, Oct. 2, 2018, at B1 (referring to the settlement terms that "the board has 45 days before Mr. Musk must resign").

¹¹¹ *Id.* (explaining that the company will "put mechanisms in place to curb [Musk's] increasingly impulsive behavior" as well as monitor Musk's communications closely).

¹¹² *Id.*

¹¹³ P.J. Himelfarb & Alicia Alterbaum, *The Tesla/Musk Settlements*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 10, 2018), <https://corpgov.law.harvard.edu/2018/10/10/the-tesla-musk-settlements/> [http://perma.cc/99HD-JA4W].

¹¹⁴ Schoenberg & Robinson, *supra* note 10.

¹¹⁵ Dave Michaels et al., *SEC Sues Elon Musk for Fraud, Seeks Removal from Tesla*, WALL ST. J. (Sept. 27, 2018, 10:37 PM), <https://www.wsj.com/articles/elon-musk-sued-by-the-sec-for-securities-fraud-1538079650>.

¹¹⁶ Goldstein, *supra* note 88.

¹¹⁷ Schoenberg & Robinson, *supra* note 10.

additional swings.¹¹⁸ Investors have filed numerous securities fraud lawsuits since Tesla's announcement to go private, which may lead to a trust crisis among shareholders.¹¹⁹ In addition, the SEC has been continuing its investigations regarding Tesla's "past claims about its production goals."¹²⁰

However, Musk and Tesla do not seem discouraged. Though no longer in his role as chairman, Musk remains a board member, and has refreshed Tesla's management team.¹²¹ On September 7, Musk announced "a number of management changes" in a Company Update.¹²² Numerous managers have been appointed or promoted to target Tesla's production goals, improve its talent management, and enrich its global outreach.¹²³ The likelihood that Tesla's management change will mitigate its financial and reputational tensions remains unknown, but Musk's positive tone throughout the press release demonstrates the company's instillation of optimistic messaging and willingness for improvement.¹²⁴

Yuanyuan (Lola) Tang¹²⁵

¹¹⁸ See Michaels et al., *supra* note 115.

¹¹⁹ See Vogt, *supra* note 6.

¹²⁰ Goldstein, *supra* note 88.

¹²¹ *Id.*

¹²² Musk, *supra* note 11.

¹²³ *Id.* (stating that the personnel development includes a new President of Automotive, VP of People and Places, VP of Gigafactory Operations, VP of Environmental Health and Safety, Senior Director of Global Communications, and a Director of Diversity and Inclusion Program and Global Recruiting).

¹²⁴ *Id.* (emphasizing that Tesla is "about to have the most amazing quarter in our history, building and delivering more than twice as many cars as we did last quarter").

¹²⁵ Student, Boston University School of Law (J.D. 2020).