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## INTRODUCTION

Michael Peregrine and Ralph DeJong have co-authored *What Nonprofits Can Learn from Spitzer v. Grasso* for this issue of *Health Lawyers Weekly* (HLW).

With the dismissal of all counts brought by the New York Attorney General against Richard Grasso, former New York Stock Exchange CEO, and Kenneth Langone, former chairman of the Exchange's compensation committee, this article provides a concise explanation of the proceedings, and pointers to be gleaned from the litigation challenging Mr. Grasso's compensation package.

As the Chair of the new AHLA Business Law and Governance Practice Group, I wanted to inform HLW readers that this is the kind of content that our Practice Group members will receive from the Practice Group on a regular basis, and I encourage you to join us. The Business Law and Governance Practice Group is committed to providing educational programming on a broad range of business law, finance, securities law, and transactional issues that impact the practice of health lawyers, whether in-house counsel or lawyers in private practice. The goal and commitment of the Practice Group is to enrich the educational experience of AHLA members so that they can better counsel their clients in a changing and dynamic health sector environment.

We want to thank Michael W. Peregrine, Esquire (McDermott Will & Emery) and Ralph E. DeJong, Esquire (McDermott Will & Emery) for their dedication in sharing with other colleagues their expertise by co-authoring this article.

*Stuart I. Silverman (chair of the AHLA Business Law and Governance Practice Group)*

## **What Nonprofits Can Learn From *Spitzer v. Grasso***

*By Michael W. Peregrine and Ralph E. DeJong, McDermott Will & Emery, Chicago, IL*

The most consequential nonprofit executive compensation litigation to date has ended, with incomplete results for the sector as a whole.<sup>[1]</sup>

On July 1, New York Attorney General Andrew Cuomo announced that he would not appeal either of the two losses the state suffered within the space of one week, effectively ending its nearly four-year long challenge to the compensation arrangements of former New York Stock Exchange Chief Executive Officer Richard Grasso.<sup>[2]</sup> Earlier on July 1, the New York Supreme Court's Appellate Division had dismissed the two remaining causes of action asserted against Mr. Grasso and Mr. Kenneth Langone, former chairman of the Exchange's executive compensation committee.<sup>[3]</sup> The previous week, the New York Court of Appeals upheld a May 2007 Appellate Division decision that the Attorney General lacked the authority to pursue four of the six causes of action originally asserted against Mr. Grasso.<sup>[4]</sup>

The Attorney General's decision not to appeal the recent decisions (and to end the case) represents a great victory for Mr. Grasso and Mr. Langone, but a less-than-clear result for the broader not-for-profit sector. *Spitzer v. Grasso* may well serve to limit authority of state charity officials to pursue allegedly excessive nonprofit executive compensation arrangements strictly on *parens patriae* (or similar non-statutory) grounds. However, because the case ended without a trial on the merits of the underlying allegations, no guidance is provided to the nonprofit sector on the fundamental questions relating to determination of reasonable compensation, and to appropriate compensation committee practices. It would thus be short-sighted for the nonprofit sector to interpret the resolution of *Spitzer v. Grasso* as somehow limiting the fundamental authority and interest of state charity officials in challenging instances of allegedly excessive executive compensation. Similarly, the resolution of the case provides no justification for more aggressive compensation practices by nonprofit corporations.

## Why We Care

The *Spitzer v. Grasso* litigation attracted the interest of the nonprofit sector because the core issues involved the determination of reasonable compensation of the chief executive officer of a not-for-profit corporation (the Exchange, at the time of the facts in controversy). This is, of course, at a time when executive compensation practices of such organizations remain under significant regulatory and public scrutiny.<sup>[5]</sup> The Attorney General had argued that Mr. Grasso and Mr. Langone violated certain provisions of the New York Not-for-Profit Corporation Law (N-PCL) and of state common law, respectively, as they related to forms of compensation that are common in the public sector. *Spitzer v. Grasso* has represented the most prominent state challenge to date to the executive compensation practices of a not-for-profit corporation and was interpreted by many as a possible framework for similar challenges to allegedly excessive compensation arrangements by charity officials in other states.<sup>[6]</sup>

## The Basics of the Case

The litigation was prompted by executive compensation payments made to Mr. Grasso during the period of 1997-2003, while he was the chief executive officer of the Exchange. During that time period, the Exchange was a New York not-for-profit (non-charitable) corporation.<sup>[7]</sup> Then Attorney General Spitzer filed a complaint in New York State court as a civil proceeding on May 24, 2004, which complaint was formed in large part as a cause of action seeking disgorgement of allegedly excessive compensation payments made to Mr. Grasso.<sup>[8]</sup> The complaint alleged an environment involving “a fundamental breakdown of corporate governance” predicated on numerous breaches of fiduciary duty, beginning with the composition of the compensation committee.<sup>[9]</sup> The Attorney General also alleged that information provided to the compensation committee and to board members regarding Mr. Grasso's compensation was “inaccurate, incomplete and misleading.”<sup>[10]</sup>

The original complaint included eight separate causes of action, six of which were directed at Mr. Grasso and one of which was directed at Mr. Langone, as (former) chair of the compensation committee. The Attorney General alleged that (1) Mr. Grasso's annual compensation and benefits were unlawful and *ultra vires* under the N-PCL; (2) Mr. Grasso had received an unlawful conveyance by knowingly receiving unreasonable compensation; (3) Mr. Grasso had breached his fiduciary duty to the Exchange by accepting and influencing awards of unreasonable compensation; (4) Mr. Grasso was unjustly enriched by receiving compensation that was not commensurate with his services; (5) the compensation payments did not receive sufficient board approval; and (6) certain payments under the Grasso retirement plans constituted unlawful loans. Also alleged was that Mr. Langone breached his fiduciary duty of care by failing to properly provide compensation committee members with necessary information to render an informed decision on Mr. Grasso's compensation.<sup>[11]</sup>

Two of these causes of action ((2) and (3) above, hereinafter the Statutory Causes of Action) were premised upon specific provisions of the N-PCL. The remaining four causes of action ((1), (4), (5) and (6), above, hereinafter the Non-Statutory Causes of Action) were so-called “hybrid” causes of action, because they alluded to the N-PCL and thus were not pure common law claims.

## Principal Preliminary Rulings

Observers have needed a scorecard to track the extensive preliminary activity in the case prior to the recent and final rulings. On October 19, 2006, the New York Supreme Court issued a “partial summary judgment” ruling, in which Mr. Grasso was found to have breached his fiduciary duty to regularly advise the compensation committee concerning the amount of his benefits.<sup>[12]</sup> He was ordered to return portions of his compensation, which could have exceeded \$100 million in value. The New York Supreme Court also denied the Grasso and Langone motions to dismiss the causes of action specifically authorized under the N-PCL (i.e., with respect to Mr. Grasso, the Statutory Causes of Action).<sup>[13]</sup>

On May 8, 2007, the Appellate Division of the New York Supreme Court reversed a portion of the October 19, 2006 decision, dismissing the four Non-Statutory Causes of Action asserted against Mr. Grasso, viewing them as an attempt by the Attorney General to circumvent the fault-based claims provided by the N-PCL.<sup>[14]</sup> The dissent had argued that the claims should have proceeded on the basis of the Attorney General's fundamental *parens patriae* power.<sup>[15]</sup>

On April 25, 2008, the Appellate Division of the New York Supreme Court denied Mr. Langone's appeal of the October 19, 2006 decision, concluding that “comparison of a party's conduct with the fiduciary standard of care is a matter of fact” to be resolved at trial.<sup>[16]</sup>

## Final Rulings

On June 25, 2008, the New York Court of Appeals unanimously affirmed the May 8, 2007 dismissal of the four Non-Statutory Causes of Action asserted against Mr. Grasso. In so doing, the Court of Appeals agreed with the prior conclusion of the Appellate Division that those Causes of Action circumvented the substantive standards for director and officer liability established by the N-PCL.

The Non-Statutory Causes of Action were based on an assertion of the Attorney General's *parens patriae* power to "vindicate the public's interest in an honest marketplace." However, the Court of Appeals declined to address the scope of such authority, relying instead on what it described as the inconsistency between the two sets of claims by the Attorney General. The four Non-Statutory Claims sought to ascribe liability based upon the size of the compensation arrangement. To the court, these claims featured a lower burden of proof than that specified by statute, and thus were inconsistent with the fault-based scheme established by the legislature to address nonprofit officer and trustee liability. In contrast, the two Statutory Causes of Action were based upon the fault-based elements established by statute (e.g., that the transferee knew of the unlawfulness of the compensation, or that an officer or director lacked good faith in executing his duties.) According to the court, to allow such inconsistency would establish a form of "strict liability" unintended by the legislature, no matter how unreasonable the compensation may appear on its face.<sup>[17]</sup>

The July 1, 2008 decision addressed the Grasso/Langone appeal of the October 19, 2006 "partial summary judgment." It focused on the Attorney General's authority to assert the Statutory Causes of Action, and in particular whether the Attorney General had lost standing to sue under the N-PCL because the Exchange had converted to for-profit status. The Appellate Division modified the 2006 ruling in several material respects, in favor of Mr. Grasso and Mr. Langone.

First, it found several errors (on issues of both fact and the law) in the New York Supreme Court's 2006 decision to grant the Attorney General summary judgment in the third (Statutory) cause of action (seeking restitution).<sup>[18]</sup> This cause of action alleged that Mr. Grasso had violated his fiduciary duty of care to the Exchange with respect to his participation in two distinct executive benefit plans provided by the Exchange (the "SERP" and the "SESP" plans).

Second, it agreed with Mr. Grasso's assertion that the Attorney General lacked jurisdiction to pursue the matter following the Exchange's reorganization.<sup>[19]</sup> The court did not question the right of the Attorney General to institute the Statutory Causes of Action, observing that the N-PCL authorizes the Attorney General to bring such an action "for the same reason it grants to the Attorney General extensive supervisory and enforcement authority . . . over not-for-profit corporations: the significant public interest in the management and affairs of not-for-profit corporations."<sup>[20]</sup> However, the critical issue to the court was the post-conversion status of the entity (the Exchange) on behalf of which the action was initially commenced. As a result of the conversion, the not-for-profit Exchange ceased to exist, and its successor is not an entity over which the Attorney General may exercise authority under the N-PCL. Further, because the sole remedy sought by the Statutory Causes of Action was restitution to the Exchange, the restitution would be made to a for-profit entity. Accordingly, the public policy reasons supporting the Attorney General's authority to institute actions on behalf of not-for-profit corporations ceased to exist with the conversion (and the restitution brought about by the State of New York would wind up in the hands of private owners of the successor to the Exchange).<sup>[21]</sup> For these and other reasons, it overruled the New York Supreme Court and dismissed the Statutory Causes of Action.

Following these two decisions, Attorney General Cuomo announced his intention not to appeal either the June 25 or the July 1 decision.

## Implications for Nonprofits and Executive Compensation

The Attorney General's decision to end any further litigation represents a tremendous victory for Mr. Grasso, Mr. Langone, and their skillful legal team. However, the implications of this important case to the broader nonprofit sector are more equivocal. Specific lessons to nonprofits, their executives, and compensation committees include the following:

1. The case *absolutely should not* be interpreted as encouraging more aggressive executive compensation practices by nonprofit corporations. The basis for the dismissal of the Statutory Causes of Action was unique to the circumstances—the ultimate conversion of the Exchange to for-profit status, which rendered an action on behalf of the Exchange beyond the relevant jurisdiction of the Attorney General.

2. There was *no resolution* of the fundamental allegations under the Statutory Causes of Action. The technical basis on which those causes of action were dismissed meant that the court did not resolve important questions such as what constitutes reasonable (or excessive) compensation; how appropriate comparability data may be identified for unique executive positions; and the expected standard of conduct for the chairman of the executive compensation committee.
  3. Forget the Eliot Spitzer connection. There should be no doubt that state attorneys have the fundamental authority to exercise oversight of executive compensation practices of a not-for-profit corporation and of its compensation committee, and to maintain enforcement actions as may be appropriate to protect the public interest in charitable assets.
  4. Compensation committee chairs should be particularly attentive to the adequacy of information provided to the compensation committee and to the ability of committee (and board) members to comprehend the information provided to them and render informed decisions. Full and complete minutes are a critical part of effective compensation committee practice. They should clearly state the information made available to and relied on by the committee, as well as the committee's full understanding and awareness of the information and issues, when it approves compensation and benefits of executives.
  5. Both the Appellate Division and the Court of Appeals essentially found that the Attorney General substantially overreached with the Non-Statutory Causes of Action. In so doing, the courts may have been sending a message that a "kitchen sink" pleading strategy is less than effective. Taking the same basic set of facts and creating multiple causes of action that involve essentially the same arrangement (i.e., that corporate assets were used to pay unreasonable compensation) is likely to prompt a court to scrutinize each cause of action and compare it to the authorizing statute, with a closer comparison than would ordinarily have been the case with more precise pleading.
  6. Future nonprofit executive compensation enforcement actions by attorneys general may seek remedies other than disgorgement or breach of fiduciary duty (e.g., an action for an accounting).
  7. Throughout the series of decisions was a sense that the various appellate level courts were influenced in part by a perceived lack of action by the Exchange itself. The appellate level courts appeared unwilling to authorize the Attorney General to act on behalf of the Exchange as an asserted extension of the statute when the statute directly authorized the Exchange to take action to preserve its assets. This perspective may prompt other attorneys general, when faced with similar situations in the future, to more closely scrutinize the board itself and its actions, in the hope of pressuring the board to pursue directly any cause of action authorized by the underlying statute.
  8. New York Supreme Court Judge Ramos' controversial 2006 ruling, namely that Mr. Grasso had a fiduciary duty to advise the compensation committee of the impact of compensation increases on SERP benefits, was not sustained on appeal. Nevertheless, a nonprofit CEO is well advised to make sure that the compensation committee has all available information to understand and evaluate every form of executive compensation and benefits (including a complete understanding of the "multiplier effect" of pay increases on SERP benefits and on other pay-based benefits). Committee knowledge of all the executive pay and benefit arrangements remains a critical issue, and the record must show the committee's knowledge and understanding of the actual and potential costs.
  9. Significant CEO influence over the selection of board members and compensation committee members, or demonstrated personal ties between the CEO and members of the committee, undermine the perceived independence of compensation approvals conducted by the committee. CEOs should remove themselves from the process of selecting committee members to the greatest extent possible.
  10. There are both tangible and intangible costs associated with defending aggressive compensation decisions against the inquiry of state charity officials. The *Spitzer v. Grasso* litigation lasted almost four years. The defendants were unique in the sense that they were wealthy individuals with extraordinary resolve. The reputations of many prominent individuals, as well as the organization itself, were negatively implicated by the case. It has been estimated that the parties' total legal fees exceed a staggering \$70 million. For these and other similar reasons, not-for-profit corporation boards should be very mindful of the many risks that may be involved when "pushing the envelope" on executive compensation.
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[1] *The People of the State of New York, by Eliot Spitzer, Attorney General of the State of New York v. Richard A. Grasso, et al.*

[2] Aaron Lucchetti, *Grasso Wins Court Fight, Can Keep NYSE Pay*, Wall St. J., July 2, 2008, p. A-1.

[3] 2008 NY Slip Op. 05970, decided on July 1, 2008, Appellate Division, First Department, McGuire, J. (July 1 decision).

[4] 2008 NY Slip Op. 05770, decided on June 25, 2008, New York Court of Appeals, Kaye, Chief Judge (June 25 decision). On April 25, 2008, the Appellate Division affirmed the prior decision of the New York Supreme Court, denying Mr. Langone's request for summary judgment on the state's allegation that he had breached his fiduciary duty in connection with his role as compensation committee chair, as it related to Mr. Grasso's compensation. This breach of duty allegation was ultimately dismissed by the Appellate Division in the July 1 decision.

[5] For example, (i) executive compensation is a major focus of the Internal Revenue Services' (IRS') new compliance initiative with respect to colleges and universities; (ii) the final version of the instructions of the Form 990 are expected to address many executive compensation issues; and (iii) the IRS' final report on executive compensation payable by tax-exempt hospitals is expected to be released this year.

[6] The relevant provisions of the N-PCL relied upon by Mr. Spitzer are similar to the nonprofit laws of other states.

[7] A "Type A" not-for-profit corporation, which may be formed for any lawful business purposes (N-PCL 201(b)).

[8] These included a total compensation package of \$187.5 million (\$139.5 million of which would be paid immediately, and the remaining \$48 million of which would be paid over four years of employment).

[9] June 25 decision, p. 3.

[10] *Id.*

[11] The specific allegation was that Mr. Langone violated N-PCL § 717(a), which prescribes the core fiduciary duty owed by all directors and officers of not-for-profit corporations.

[12] *People v. Grasso*, 13 Misc. 3d 1227 [A], 2006 NY Slip Op. 52019(u).

[13] *Id.*

[14] *People v. Grasso*, 2007 NY App. Div. Lexis 5719. **Note:** this decision did not affect the disgorgement order as provided for in the partial summary judgment dated October 19, 2006.

[15] *Id.*; see also, June 25 Decision, p. 9.

[16] *Spitzer v. Grasso*, 2008 NY Slip Op. 03722, April 24, 2008, New York Supreme Court, Appellate Division First Department.

[17] June 25 Decision, p. 10-11.

[18] July 1 Decision, p. 5-7.

[19] *Id.*, p. 9.

[20] *Id.*, p. 13.

[21] *Id.*, p. 14. "When, as here, the Attorney General seeks only a judgment that would inure to the benefit of a for-profit entity and its direct and indirect owners . . . N-PCL 720(b) does not authorize the Attorney General to continue prosecuting causes of action on behalf of a not-for-profit corporation that has been converted into a for-profit entity."

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