

GRASSO'S MESSAGE TO COMPENSATION COMMITTEES (AND TO CEOs)

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Despite its unique facts, the recent, controversial decision in the *Spitzer v. Grasso* litigation is likely to have a spillover impact on the executive compensation practices of nonprofit hospitals and health systems. The Attorney General's complaint was framed in large part as an action seeking disgorgement of allegedly excessive compensation payments made to the chief executive officer of the New York Stock Exchange, at a time when the Exchange was a New York nonprofit (noncharitable) corporation. The Attorney General had argued that Mr. Grasso violated certain provisions of New York nonprofit law (which are similar to the nonprofit laws of most other states) as they related to compensatory benefits that are widespread in the nonprofit sector.

Specifically, Judge Ramos' "partial summary judgment" concludes that the chief executive has a fiduciary duty to regularly advise the compensation committee concerning the amount of his/her benefits. The decision also serves to sharpen the focus on the independence of committee members, prompt closer review of SERP arrangements, and remind all parties of the important inter-relationship between the different portions of the total compensation package (e.g., cash and retirement

benefits). On a broader scale, the decision can be expected to complicate the overall relationship between the chief executive and the compensation committee, and to contribute to the already heightened legislative and regulatory interest in nonprofit executive compensation practices.

I. BRIEF OVERVIEW OF THE CASE

The initial complaint was filed as a civil proceeding on May 24, 2004, amid great fanfare and with certain political undercurrents given the stature of the personalities involved. The complaint revolved around the decision of the Exchange Board's Compensation Committee to approve a compensation package for the chief executive officer totaling \$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). This amount represented only the value of the pension supplements and deferred compensation; other forms of compensation would be paid on an ongoing basis.

The Court focused on the \$139.5 million lump sum payment, because according to a public statement by then Compensation Committee chair H. Carl McCall, Mr. Grasso had agreed to waive the remaining \$48 million benefit. As part of this litigation, however, Mr. Grasso filed several cross-claims, one of which claimed the right to the remaining \$48 million benefit.

The comprehensive complaint reflected the Attorney General's broad concerns with respect to such issues as (i) conflicts of interest arising from Mr. Grasso's role in the selection of the compensation committee and his regulatory authority over Exchange members; (ii) the allegedly "objectively unreasonable" nature of the compensation; and (iii) whether the Exchange's Board was misled about the compensation arrangement.

The complaint included eight separate causes of action, six of which were directed at Mr. Grasso. The claimed bases for the causes of action against Mr. Grasso were (i) that the annual compensation and benefits were unlawful and ultra vires under New York not-for-profit law, (ii) that Mr. Grasso had received an unlawful conveyance by

knowingly receiving unreasonable compensation, (iii) that Mr. Grasso breached his fiduciary duty to the Exchange by accepting unlawful compensation, (iv) that Mr. Grasso received compensation not commensurate with his services, and thereby was unjustly enriched, (v) that the payments did not receive sufficient Board approval, and (iv) that certain payments under the retirement plans constituted unlawful loans. The Attorney General sought various forms of relief based upon the disgorgement theory, including the imposition of a constructive trust on the compensation; restitution of the unauthorized retirement plan payments, and return of the annual compensation and retirement benefits that Mr. Grasso allegedly knew to be unreasonable and unlawful.

II. THE SPECIFIC RULINGS

The October 19 decision was in response to the Attorney General's motion for summary judgment on all the claims of liability directed at Mr. Grasso. The portions of the decision most relevant to nonprofit hospitals and health systems are those that relate to the claims of additional benefits triggered by the type of termination that occurred: unjust enrichment, breach of fiduciary duty, unlawful loans, and unauthorized payments. Specifically, the Court ruled that:

1. The cross-claim by Mr. Grasso that he had been involuntarily terminated by the Exchange, and that as a result he had become vested in the remaining \$48 million of benefits (which the Exchange claimed had been waived by Mr. Grasso before his termination of employment), was dismissed. The Court ruled that, according to the employment agreement between Mr. Grasso and the Exchange, the Exchange could involuntarily terminate Mr. Grasso's employment only by means of a written notice. Because the termination in this case occurred by agreement of the parties, and was not evidenced in writing, the Court was not convinced that the termination was involuntary. The lack of a demonstrated involuntary termination of employment (by written notice) resulted in forfeiture of the remaining \$48 million benefit.

2. Mr. Grasso was not legally permitted to receive certain pre-termination withdrawals from his Supplemental Executive Savings Plan (SESP) account (i.e., a payment of nearly \$88 million in 2003). This in-service withdrawal, even though approved by the Compensation Committee and reflected in Mr. Grasso's 2003 employment agreement, violated the SESP's own prohibition on early distributions. Because the SESP was not amended to provide for in-service payment, the payment violated the SESP and amounted to unjust enrichment or an ultra vires action.
3. Certain advances to Mr. Grasso under the Exchange's Supplemental Executive Retirement Plan (SERP) amounted to the extension of unlawful loans in violation of New York nonprofit corporation law. Because the SERP supplemented benefits under the Exchange's broad-based defined benefit pension plan, and because Mr. Grasso had received SERP payments that later could have been negated by increases in value of his pension plan benefits, the Court considered the SERP benefit payment an advance that might have to be returned to the Exchange if at termination of employment the actual benefit were calculated as a lesser amount. The Court said that Mr. Grasso was "implicitly" agreeing to repay the SERP "advance," and as a result the advance amounted to an interest-free loan in violation of applicable nonprofit law. That Mr. Grasso paid tax on the SERP benefit payment did not sway the Court.
4. Mr. Grasso's failure to disclose to the Board all the relevant information regarding the value of his accumulated SERP benefits constituted a breach of his fiduciary duty to the Exchange. Specifically, the failure to disclose the amount of the SERP "thwarted the Compensation Committee from performing its duty of care and obedience. Year after year, it made decisions to pay [Mr. Grasso] without knowing his true compensation.... Mr. Grasso's duty is to be fully informed and to see to it that the Board was fully informed. He failed in this duty."

Mr. Grasso made several logical arguments in his defense of the fiduciary breach claim. These defenses included the following: (i) that the Committee was well aware of the SERP benefit (which the Court rejected because meeting minutes did not clearly state what the Committee knew), (ii) that it would be impossible to know the ultimate value of the SERP because of the impact of future variables (which the Court rejected because SERP benefits had in fact been projected), (iii) that he as an interested party could not influence the process by providing this information to the Committee (which the Court rejected because of the Committee's necessary and actual reliance on Mr. Grasso to provide all relevant information to the Committee for its deliberations), and (iv) that he was not keeping track of the value of his SERP benefit (which the Court rejected as insufficient to overcome the affirmative duty to keep the Committee informed).

Several other compensation-related summary judgment motions were denied and reserved for trial, as was the cause of action against the then-chair of the Compensation Committee.

III. ANALYSIS

A close examination of the case suggests the following lessons for nonprofit hospitals and health systems, and their compensation committees:

- 1.** 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.
- 2.** Because the type of employment termination will have profound consequences for the payment of termination-related compensation and benefits, the parties must be "crystal clear" in specifying the type of

termination that occurs and in following the termination procedures of any written employment agreement.

3. Any decision to accelerate benefit payments under a supplemental executive retirement plan (SERP) must be made in accordance with the plan document, or must be supported by an amendment to the plan document.
4. If an accelerated payment of SERP benefits will be an offset to the final calculation of SERP benefits when the executive terminates employment, the parties should clarify in writing whether they intend the accelerated payment to be treated as a loan. If the parties have no intention of requiring the executive to return the accelerated payment under any circumstances, the Compensation Committee, the written record and the SERP document should make this plain.
5. Where executive benefits under a SERP increase in value as compensation increases, the current and projected value should be calculated each year, and all calculations should be shared with and explained to the Compensation Committee. The Committee must have a complete understanding of the "multiplier effect" of pay increases on SERP benefits.
6. The CEO should make sure that the Compensation Committee has all available information to understand and evaluate every form of executive compensation and benefits, and all of information available to executives regarding their compensation and benefits should be provided to the Committee.
7. Full and complete minutes are a critical part of effective Compensation Committee practice. These minutes should clearly reflect the Committee's factual understanding and awareness when it approves compensation and benefits of executives.

It should be emphasized that this is a trial court decision decided at the summary judgment stage and that is being appealed. It should also be recognized that this is truly a “one-off” case, based on a highly unique set of facts and involving an amount of compensation that, while not uncommon in the for-profit sector, is without precedence in the non-profit sector. Nonetheless, the case involves the application of the same basic fiduciary duties that are applied under the nonprofit laws of most states and involves a compensation benefit (SERP) and a compensation process (compensation consultant, compensation committee) that is widely used in the nonprofit sector. Most importantly, the broader issue—oversight of executive compensation—is a “front burner” issue for both state charity officials and the IRS. For these reasons, the authors believe the decision offers useful guidance on the regulatory environment in which nonprofit organizations operate today.

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