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1025 Connecticut Avenue, NW, Suite 600
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***SPITZER V. GRASSO II* AND THE LIMITS OF CHALLENGING EXECUTIVE
COMPENSATION**

Michael W. Peregrine

McDermott Will & Emery LLP
Chicago, IL

Ralph E. DeJong

McDermott Will & Emery LLP
Chicago, IL

The long running *Spitzer v. Grasso* litigation continues to provide substantial guidance on the application of corporate law to the executive compensation practices of not-for-profit corporations, including hospitals and health systems.

In the most recent (May 8, 2007) decision in the case, the New York State Supreme Court (Appellate Division) dismissed four of the six causes of action that the Attorney General had asserted against Mr. Grasso with respect to his compensation.¹ In doing so, the court concluded that the Attorney General lacked authority under state not-for-profit corporate law to assert those four causes of action. The remaining causes of action require a higher burden of proof for the Attorney General to prevail. It remains to be seen whether this decision will influence the efforts of other attorneys general to challenge not-for-profit executive compensation arrangements that they believe to be unreasonable. The decision may, however, prompt counsel to not-for-profit organizations to consider more closely the statutory basis of any such challenges to compensation arrangements of their clients.

¹ 2007 N.Y. App. Div. LEXIS 5719.

I. BACKGROUND

The case is based upon executive compensation payments made to Mr. Grasso, then the chief executive officer of the New York Stock Exchange, at a time when the Exchange was a New York not-for-profit (noncharitable) corporation. Attorney General Spitzer filed a complaint in New York state court in 2004, which complaint was formed in large part as a cause of action seeking disgorgement of allegedly excessive compensation payments made to Mr. Grasso. The Attorney General had argued that Mr. Grasso violated certain provisions of the New York Not-for-Profit Corporation Law (N-PCL) (which are similar to the not-for-profit laws of most other states) as they related to forms of compensation that are common in the public sector.

In a “partial summary judgment” ruling issued October 19, 2006 by the New York State Supreme Court (Ramos, J.), Mr. Grasso was found to have breached his fiduciary duty to regularly advise the compensation committee concerning the amount of his benefits. He was ordered to return portions of his compensation, which could have exceeded \$100 million in value.²

While this new decision on appeal did not directly address Judge Ramos’ October 19 decision, it raises substantial questions as to whether Judge Ramos’ decision, and the disgorgement order, will be sustained on appeal.

II. BRIEF OVERVIEW OF CASE, ON APPEAL

The principal issue on appeal was whether the Attorney General had the legal authority to assert against Mr. Grasso four of the six causes of action asserted against him in the Attorney General’s complaint. The original complaint included eight separate causes of action, six of which were directed at Mr. Grasso. 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

² For a further discussion of the Partial Summary Judgment decision and of the basic nature of the Attorney General’s complaint, see Peregrine, DeJong and Schwartz, “Grasso’s Message to Compensation Committees (and to CEOs)”, American Health Lawyers Executive Summary (Corporate Governance Task Force) November, 2006.

knowingly receiving unreasonable compensation; (3) Mr. Grasso breached his fiduciary duty to the Exchange by accepting, influencing, and accepting 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.³

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. The attached charts provide a more detailed description of the relationship of the six causes of action to the N-PCL.

III. THE SPECIFIC RULINGS

The court focused its analysis on the narrow issue of whether the specific statutory language in the N-PCL effectively prohibited the four Non-Statutory Causes of Action. In so doing, it deliberately chose not to address the broader question of whether the Attorney General may institute actions against not-for-profit officers and directors other than those the state legislature authorized it to institute. (By footnote, the court noted that it is conceivable that ample precedent could exist supporting the authority of the Attorney General to bring some cause of action that the N-PCL does not allow it to bring.) In holding that the Attorney General lacked the authority to assert the Non-Statutory Causes of Action, the court observed that:

1. The N-PCL expressly authorizes the Attorney General to bring specific causes of action (*e.g.*, the Statutory Causes of Action), and also provides other forms of judicial redress for unlawful payments to directors and officers (*e.g.*, rights that may be asserted by the corporation or a director thereof).

³ A particular significant – from a corporate governance perspective – course of action was directed at Mr. Kenneth G. Langone, former Chair of the NYSE Compensation Committee, for breach of fiduciary duty with respect to his actions relating to approval of the Grasso compensation.

2. It is of “decisive importance” that the Non-Statutory Causes of Action were “plainly inconsistent” with the legislative intent of the N-PCL, in that they circumvented the substantive standards for director and officer liability established by statute. For example, the first and fourth causes of action would impose liability on Mr. Grasso without regard to the specific fault-based requirements under the legislative scheme (e.g., that Mr. Grasso knew of the unlawfulness of the payments and failed to discharge his fiduciary duty). Similarly, the fifth and sixth causes of action were dismissed because the Attorney General is not authorized by the N-PCL to bring the causes of action as specified. One of the ways a court may diminish the authority of an attorney general to address unreasonable compensation is to permit a cause of action only if the statute expressly names the attorney general as a permitted plaintiff, which it did not in this case.

3. The fundamental flaw of the Attorney General’s position was its inconsistency with the principle of separation of powers, in that only the legislature is entitled to eliminate the fault-based requirements of statute in the name of sound public policy.

4. This “separation of powers” inconsistency also served to dispose of reliance by the Attorney General on the broad common law principle of *parens patriae*.⁴ “The authority to assert a cause of action hardly entails the authority to amend the elements of a cause of action.”⁵

IV. ANALYSIS

A. Despite its unique facts (e.g., the amount of compensation involved and the non-charitable nature of the Exchange’s not-for-profit status), the *Spitzer v. Grasso* litigation can be expected to have a significant carryover

⁴ This doctrine provides standing to the state to assert a cause of action that otherwise can properly be brought only by private parties [e.g., the nonprofit corporation or its directors] where the state can (i) “articulate an interest apart from the interests of [the] particular private parties,” (ii) “express a quasi-sovereign interest,” and (iii) “allege injury to a sufficiently substantial segment of its population.” Fn.

¹, *supra*.

⁵ *Id.*

effect on the broader not-for-profit sector. It is the most prominent current case applying not-for-profit corporation statutory law to executive compensation arrangements.

- B. The significance of the litigation is heightened by the enormous current regulatory, legislative, media, and public policy focus on the proper executive compensation practices of a not-for-profit corporation. Unless this May decision is overturned on appeal,⁶ it represents a significant setback to regulatory efforts to exercise oversight over not-for-profit executive compensation because of the general similarity between the N-PCL and the not-for-profit laws of other states.
- C. Here, the court essentially found the Attorney General to have substantially overreached with the four flawed causes of action. In so doing, the court may be 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 argument (*i.e.*, that corporate assets were used to pay unreasonable compensation) is likely to prompt a court to parse 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.
- D. The first of the two Statutory Causes of Action that survived requires the Attorney General to prove that the compensation benefits were unlawful and that Mr. Grasso knew them to be unlawful. This is a very high burden of proof, and indicates that the New York legislature purposely set a high standard for disgorgement of payments from the recipient. This is in direct contrast to the federal intermediate sanctions structure, under which the Internal Revenue Service can force disgorgement simply by assessing the “first tier” of excise tax.

⁶ As of the publication date, the authors are unaware of any decision to appeal.

- E. The second of the two Statutory Causes of Action that survived permits an action against an officer or director to compel that officer or director to account for any violation of duties in the management or disposition of corporate assets. (Many state not-for-profit laws have similar provisions.) It is unclear whether the court believed that an accounting could lead to a money judgment of restitution or disgorgement representing excess compensation (as sought by the Attorney General).
- F. The court was clearly influenced by the lack of action by the Exchange itself. It was 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 itself to take action to preserve its assets. This conclusion may prompt attorneys general, when faced with similar situations, to more closely scrutinize the board itself and its actions, in the hopes of pressuring the board to pursue a cause of action authorized by the underlying statute.
- G. Not-for-profit corporations and their counsel should not necessarily interpret this decision as limiting the Attorney General's authority to exercise oversight of executive compensation payable by a not-for-profit corporation. There should be no doubt that the Attorney General has "an historic right and duty to supervise" the assets of not-for-profit corporations and charitable trusts and to maintain such actions as may be appropriate to protect the public interests therein.⁷ The recent "spike" in controversies involving executive compensation practices of charities and other not-for-profit corporations provide ample public policy supporting vigorous oversight thereof by the Attorney General and state charity officials.⁸

⁷ *Brown v. Memorial Nat. Home Foundation*, 162 C.A. 2d 513, 536-537 (1958).

⁸ In this regard, it should always be remembered that the AHERF controversy predated Enron and WorldCom, among others.

H. Unless reversed on appeal, the “Grasso II” decision may prompt attorneys general to focus more closely on the authority granted them by underlying statutes to regulate the payment of allegedly unreasonable compensation. Where these statutes do not provide what the attorneys general believe to be adequate causes of action or remedies, expect them to lobby the legislatures for an expansion of these powers and statutory causes of action. The decision may also prompt counsel to not-for-profit corporations to more closely review the statutory authority for any related challenges to allegedly unreasonable compensation.

The authors wish to acknowledge with gratitude the contributions of their colleague, Stacie Phillips, to the preparation of the chart which is attached to this article.

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New York Supreme Court Decision
*New York v. Richard A. Grasso*¹
 May 2007

No.	Cause of Action	New York Statutory Language ¹	Essential Elements for Liability	Supreme Court's Decision
1	<ul style="list-style-type: none"> ▪ Grasso's annual compensation and other benefits received were neither reasonable nor commensurate with the services he performed, and to the extent that they were not reasonable or commensurate, the compensation and benefits were unlawful, <i>ultra vires</i> and against public policy, and unjustly enriched Grasso. 	<ul style="list-style-type: none"> ▪ N-PCL 202(a)(12) permits not-for-profit corporations, among other things, to establish reasonable compensation for directors and officers, provided that it is "commensurate with services performed." ▪ N-PCL 515(b) also permits payment of reasonable compensation to members, officers and directors for services, rendered (as an exception to the prohibition on not-for-profit corporation from paying dividends, income or profits to members, directors or officers). 	<ul style="list-style-type: none"> ▪ It must be proven that the compensation was unreasonable and not commensurate with the services performed. 	<ul style="list-style-type: none"> ▪ This cause of action differs from the second only in that it does not allege that Grasso knew that the payments were unlawful. ▪ Under this claim, the only factual showing that the Attorney General would have to make to recover from Grasso is that the annual compensation and other benefits were not reasonable and not commensurate with the services Grasso performed. ▪ The fundamental problem with the Attorney General's position in this claim is its inconsistency with separation of powers. Although the Attorney General is entitled to deference from the judiciary in his exercise of powers, the legislature is charged with making critical policy decisions, while the executive branch is responsible to implement those policies.

¹ Supreme Court, Appellate Division, First Department, May 2007, 8719, Index 401620/04.

² Not-For-Profit Corporation Law (N-PCL)

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2	<ul style="list-style-type: none"> ▪ Payment to Grasso of annual compensation and other benefits constituted an unlawful conveyance, assignment or transfer of corporate assets. 	<ul style="list-style-type: none"> ▪ N-PCL 720(a)(2) expressly authorizes a cause of action against a director or officer of a not-for-profit corporation “to set aside an unlawful conveyance, assignment or transfer of corporate assets, where the transferee knew of its unlawfulness.” ▪ N-PCL 202(a)(12) permits not-for-profit corporations, among other things, to establish reasonable compensation for directors and officers, provided that it is “commensurate with services performed.” ▪ N-PCL 515(a), (b) permits reasonable compensation as an exception to the prohibition on not-for-profit corporations paying dividends, income or profits to directors/officers. ▪ N-PCL 720(b) expressly authorizes the Attorney General, among others, to bring this cause of action. 	<ul style="list-style-type: none"> ▪ The payments must be proven to be unlawful. ▪ It must be proven that Grasso knew the payments were unlawful. 	<ul style="list-style-type: none"> ▪ The legislature, in authorizing the Attorney General to bring this cause of action, expressly required the Attorney General to prove that the annual compensation and other benefits were not reasonable and not commensurate with the services Grasso performed and that Grasso knew that the conveyance, assignment or transfer of corporate assets was unlawful.
3	<ul style="list-style-type: none"> ▪ Grasso violated his fiduciary duties to the NYSE by influencing and accepting awards of excessive 	<ul style="list-style-type: none"> ▪ N-PCL 720(a)(1)(A), (B) expressly authorizes an action against an officer or director “to compel the defendant to account for his official conduct in 	<ul style="list-style-type: none"> ▪ It must be proven that the director or officer violated his duties. 	<ul style="list-style-type: none"> ▪ The legislature, in authorizing the Attorney General to bring this cause of action, expressly specified that a

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	<p>compensation during his tenure as Chairman and CEO.</p>	<p>the following cases: the neglect of, or failure to perform, or other violation of his duties in the management and disposition of corporate assets committed to his charge; or the acquisition by himself, transfer to others, loss or waste of corporate assets due to any neglect of, or failure to perform, or other violation of his duties.”</p> <ul style="list-style-type: none"> ▪ N-PCL 717(a) defines the scope of a director's or officer's duties, which are to “discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions.” ▪ N-PCL 717(b) states that “in discharging their duties, directors and officers, when acting in good faith, may rely on information, opinions, reports or statements ... prepared or presented” by various individuals, including peers or other agents of the corporation. If the directors and officers rely in good faith, they have no “liability by 	<ul style="list-style-type: none"> ▪ It must be proven that the director or officer discharged his duties in bad faith. 	<p>director “shall not be liable ... if, in the circumstances, he discharged his duty to the corporation under Section 717.”</p>

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		<p>reason of being or having been directors or officers of the corporation.”</p> <ul style="list-style-type: none"> ▪ N-PCL 720 expressly authorizes the Attorney General, among others, to bring this cause of action. 		
4	<ul style="list-style-type: none"> ▪ Grasso's annual compensation and other benefits were not reasonable and not commensurate with the services Grasso performed, and because they were neither reasonable nor commensurate, restitution of the unlawful compensation would promote the purposes of the N-PCL and would keep Grasso from being unjustly enriched by retaining the fruits of unlawful compensation, which would support equity, good conscience and public policy. 	<ul style="list-style-type: none"> ▪ N-PCL 202(a)(12) permits not-for-profit corporations to, among other things, establish reasonable compensation for directors and officers, provided that it is “commensurate with services performed.” ▪ N-PCL 515(a), (b) permits reasonable compensation as an exception to the prohibition on not-for-profit corporations paying dividends, income or profits to directors/officers. 	<ul style="list-style-type: none"> ▪ It must be proven that the compensation was unreasonable and not commensurate with the services performed. 	<ul style="list-style-type: none"> ▪ This cause of action differs from the first only in formal terms. ▪ Under this claim, the only factual showing that the Attorney General would have to make to recover from Grasso is that the annual compensation and other benefits were not reasonable and not commensurate with the services Grasso performed. ▪ The fundamental problem with the Attorney General's position in this claim is its inconsistency with separation of powers. Although the Attorney General is entitled to deference from the judiciary in his exercise of powers, the legislature is charged with making critical policy decisions, while the executive branch is responsible to implement those

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				policies.
5	<ul style="list-style-type: none"> ▪ A majority of the entire board of directors did not approve either certain compensation payments to Grasso or certain compensation payments that Grasso had not received, but claimed were owed to him under his 2003 employment agreement, and thus, Grasso should pay restitution to the NYSE of all payments he received that lacked the required board approval and make a declaration that any future payments to be made by the NYSE board that lack the required approval are void. 	<ul style="list-style-type: none"> ▪ N-PCL 715(f) provides that “the fixing of salaries of officers, if not done in or pursuant to the by-laws, shall require the affirmative vote of a majority of the entire board unless a higher proportion is set by the certificate of incorporation or by-laws.” ▪ N-PCL 715(b) authorizes the corporation itself, in certain circumstances, to “avoid the contract or transaction” between it and one or more of its directors or officers, unless a “good faith disclosure of the material facts as to the director’s or officer’s interest in the contract or transaction ... is made to the directors ... or known to the board or committee ... authorizing such contract or transaction,” then the contract or transaction may not be avoided. Absent such disclosure or knowledge, or if the vote or authorization of the interested director or officer “was necessary for the authorization of such contract or transaction at a meeting of the board or committee at which it 	<ul style="list-style-type: none"> ▪ It must be proven that the fixing of salaries was not done pursuant to the by-laws or by an affirmative vote of a majority of the board. ▪ It must be proven that no good faith disclosure was made by the director or officer to the board or that the material facts were not known to the board or committee in connection with the transaction at issue. 	<ul style="list-style-type: none"> ▪ No provision of N-PCL 715 authorizes the Attorney General to bring suit against a director or officer. ▪ N-PCL 715 authorizes the NYSE to avoid the relevant transactions and agreement pursuant to which the compensation either was paid or is assertedly due if, among other things, there was no good faith disclosure of material facts to the directors or such material facts were not known to the directors at relevant times, unless Grasso were able to establish that the transactions and agreement were fair and reasonable for the corporation at the time it was authorized. ▪ Similar to the first and fourth claims, the fundamental problem with the Attorney General’s position in this claim is its inconsistency with separation of powers. The Attorney General is going beyond the stated legislative policy in N-PCL.

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		<p>was authorized, the corporation may avoid the contract or transaction unless the party or parties thereto shall establish affirmatively that the contract or transaction was fair and reasonable as to the corporation at the time it was authorized by the board, a committee or the members.”</p>		<ul style="list-style-type: none"> ▪ This is a “watered-down version” of the cause of action that the legislature expressly recognized as one the corporation, rather than the Attorney General, is authorized to bring.
6	<ul style="list-style-type: none"> ▪ Grasso received payments in 1995 and 1999 from the NYSE, which he agreed to repay through a deduction from his pension benefits payable when he retired. These payments represented advance disbursements of lump sum benefits to which he was not entitled under his employment agreements, and as such, each payment was a prohibited loan under the N-PCL. 	<ul style="list-style-type: none"> ▪ N-PCL 716 prohibits not-for-profit corporations from making any loans, “other than through the purchase of bonds, debentures, or similar obligations of the type customarily sold in public offerings, or through ordinary deposit of funds in a bank,” to its directors or officers. 	<ul style="list-style-type: none"> ▪ It must be proven that a loan was made to the director or officer that was not through the purchase of bonds, debentures, or similar obligations of the type customarily sold in public offerings, or through ordinary deposit of funds in a bank. 	<ul style="list-style-type: none"> ▪ N-PCL 716 does not itself authorize anyone to bring suit for violation of its terms. ▪ Other provisions of N-PCL authorize the Attorney General and others to bring actions against directors who vote for or concur in certain action such as making a loan as prohibited in N-PCL 716, but only if, “in the circumstances,” the director or officer did not discharge his duty to the corporation (as set forth in N-PCL 717), which also provides directors and officers with a defense of good faith. ▪ This cause of action asserts a right to recover against Grasso without regard to whether, “in the

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				<p>circumstances," he discharged his duties (under N-PCL 717).</p> <ul style="list-style-type: none"> ▪ Similar to the first and fourth claims, the fundamental problem with the Attorney General's position in this claim is its inconsistency with separation of powers. The Attorney General is going beyond the stated legislative policy in N-PCL.