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## HEALTH LAW

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### *Executive Compensation at Not-for-Profits Under Scrutiny — Part 2*

This is the second of a two-part column dealing with the issue of excessive executive compensation in not-for-profit corporations. As noted in Part 1, which appeared on Sept. 29 (The New York Law Journal, at p. 3), some of the highest salaries are those paid to executives of tax-exempt not-for-profit health care organizations. Part 1 went on to analyze the provisions of the Internal Revenue Code, Treasury regulations and guidelines applicable to executive compensation in not-for-profit organizations and also discussed the Internal Revenue Service's recently announced operation to examine — and if necessary sanction — excessive executive compensation.

In this column, we will review applicable provisions of the New York Not-for-Profit Corporation Law (N-PCL), some cases and recent activity by the New York attorney general's office.

#### **Not-for-Profit Corporation Law**

The general and special powers of a not-for-profit corporation include the power:

To elect or appoint officers, employees and other agents of the corporation, define their duties, fix their reasonable compensation and the reasonable compensation of directors, and to indemnify corporate personnel. Such compensation shall be commensurate with services performed. (N-PCL §202(a)(12)).

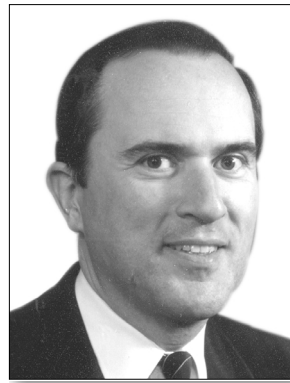
N-PCL §515(b) states, in part:

A corporation may pay compensation in a reasonable amount to members, directors or officers for services rendered . . .

And N-PCL §715(f) sets forth the process to be followed:

The fixing of salaries of officers, if not done in or pursuant to the bylaws, shall require the affirmative vote of a majority of the entire board unless a higher proportion is set by the certificate of incorporation or bylaws.

The insertion of "reasonable" in these statutes indicates that legislators are less tolerant of excessive compensation in the nonprofit area than they are in the business community.<sup>1</sup> However, "reasonable" executive compensation is not defined in the N-PCL or other laws. Setting executive compensation is left to the discretion of the governing body. This and all other decisions of



the board fall under the general fiduciary duty of care found in N-PCL §717(a):

Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill that ordinarily prudent men would exercise under similar circumstances in like positions.

As long as the governing body acts in good faith, with due care and in the absence of self-dealing, its business decisions, including those involving executive compensation, are generally protected by the "business judgment rule."<sup>2</sup> New York's attorney general is charged with policing the activities of not-for-profit corporations and he is authorized to conduct investigations and bring civil actions against directors and officers if they fail to properly administer the assets of their organizations.<sup>3</sup> With a few notable exceptions, however, the attorney general historically has left excessive executive compensation issues involving not-for-profits to the Internal Revenue Service.

Attorney General Eliot Spitzer recently filed suit against the New York Stock Exchange (NYSE), its former chairman Richard Grasso and its former compensation committee chairman Kenneth Langone over the allegedly excessive compensation package awarded to Mr. Grasso. This suit may signal a change in the attorney general's involvement in executive compensation matters. While the NYSE is legally a not-for-profit corporation, it is not a charity, is not organized or operated for charitable purposes and is not a tax-exempt organization. It cannot reasonably be compared to other not-for-profit organizations such as tax-exempt hospitals, museums or foundations. Yet there also seems to be little question about the attorney general's right to scrutinize executive compensation in charitable not-for-profit organizations and to take action if the compensation is so excessive that it amounts to a

misuse of the organization's assets. And given Mr. Spitzer's aggressive attacks on abuses in a variety of industry sectors, not-for-profit executive compensation could be a ready target for future investigations.

#### **'Committee to Save Adelphi'**

One of the few precedents in New York dealing with excessive executive compensation in the not-for-profit context comes not from a court case, but from a 1997 administrative action. It was brought by the New York State Board of Regents against the board of trustees of Adelphi University, a tax-exempt not-for-profit institution located on Long Island. This complicated case included accusations about financial conflicts of interest by board members, financial mismanagement and malfeasance in governance. But the bulk of the regents' decision concerned the compensation and benefits awarded to Adelphi's president, Peter Diamandopoulos. Over a 10-year period from 1985-95, the president's base salary went from \$95,000 to \$330,750; annual contributions to his retirement account went from \$12,350 to \$59,535; and annual contributions to his deferred compensation account went from \$50,000 to \$99,225. Besides free housing near campus, the university's board also authorized the purchase of a \$1.15 million Manhattan apartment (with another \$190,000 spent for furniture and improvements) and then gave Mr. Diamandopoulos an option to purchase the apartment for \$905,000. In 1996, a group of faculty, students and former trustees<sup>4</sup> petitioned the board of regents under Education Law §226(4) for the removal of the university's trustees, charging them with misconduct, neglect of duty and the failure to carry out Adelphi's educational purposes. A panel of three regents was formed to conduct a hearing and issue a report and recommendations. After 27 days of testimony, the panel issued a scathing report finding that Adelphi's trustees had failed to exercise care by making uninformed decisions about Mr. Diamandopoulos' compensation and by awarding him compensation that was not commensurate with his performance as president. The panel found that Adelphi's board:

- did not conduct a formal structured evaluation of the president's performance,
- did not articulate any performance expectations or measures,
- did not ask the president to evaluate his own performance,
- did not review comparable salaries, and
- did not approve or even familiarize

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itself with the terms of the president's compensation package.

The panel also found that, except for one year, the board never even reviewed or approved his compensation package. The one year that it did so, no attorney reviewed the president's contract on behalf of the university, and the board minutes indicated that the president himself — who was a voting member of the board — was present and did not recuse himself from the vote. Moreover, the panel noted that Mr. Diamandopoulos refused to disclose his compensation on the required annual IRS Form 990, which resulted in an IRS investigation and fines levied against the university.

In reviewing the overall status of the university, the panel found that during Mr. Diamandopoulos' tenure, enrollment had declined, fundraising efforts were stagnant and material changes to the university were lagging. In the meantime, colleges in the same geographic area did not suffer as steep a drop in enrollment. Yet the salary of Adelphi's president continued to rise.

The panel concluded that "a prudent board of trustees should have taken a hard look at [Mr.] Diamandopoulos' entire record and carefully measured it against the compensation awarded." Instead, the compensation arrangement was "without both a rational basis and far in excess of the value of services performed." Moreover, the panel determined that the business judgment rule did not shield the trustees from their "irrational decisions that [were] based on inadequate information or consideration."

Ultimately, the panel found that the board's failures in setting unreasonable and unjustifiably high compensation, along with various conflicts of interest and "the complete breakdown of the principles of governance" justified the removal of all but one of the members of Adelphi's board of trustees. The full board of regents then voted to accept the panel's report and authorized the trustees' removal. The attorney general later filed suit against the trustees to recover misspent funds.

Although the Adelphi University decision was an administrative action by the board of regents and not binding case law, a key element of this decision is the regents' application of many of the same principles applied by federal courts in evaluating for-profit executive compensation for tax purposes. (Discussed in Part 1 of this column.) The regents considered the overall health and performance of the college, the job responsibilities and performance of the president, the various conflicts of interest, the benefits paid to the president, the compensation data from comparable universities in similar geographical regions, and the lack of applied internal consistency in granting Mr. Diamandopoulos a generous sabbatical unavailable to other faculty members. In the regents' view, N-PCL §202(a)(12)'s standards of "reasonable compensation ... commensurate with services performed" were not followed by Adelphi's trustees.

## Case Law

Apparently, no reported decisions in New York have addressed the issue of what constitutes "reasonable compensation" in a not-for-profit context. However, case law from other contexts offers general guidance for the governing bodies of not-for-profits and may provide a road map for future court decisions.

Criteria for determining the reasonableness of compensation in relation to the performance of services in the commercial context were articulated by New York's Supreme Court in *Gallin*

*v. National City Bank*. There the court stated:

To come within the rule of reason the compensation must be in proportion to the executive's ability, services and time devoted to the company, difficulties involved, responsibilities assumed, success achieved, amounts under jurisdiction, corporation earnings, profits and prosperity, increase in volume or quality of business or both, and all other relevant facts and circumstances; nor should it be unfair to stockholders in unduly diminishing dividends properly payable.<sup>5</sup>

This test has been cited with approval in a number of subsequent cases<sup>6</sup> and could be applied in cases that raise issues of whether compensation was reasonable and commensurate with the services performed by the executives of a not-for-profit.

Other courts that have ruled on the reasonable-

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### *Requiring executive salaries to be compared to the average of a comparable group of peers is perhaps the most common standard.*

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ness of not-for-profit executive compensation also provide some guidance as to how New York courts may interpret the "reasonable compensation" standard. These decisions echo some of the standards found in the Internal Revenue Code and Treasury regulations. Requiring executive salaries to be compared to the average of a comparable group of peers is perhaps the most common standard.<sup>7</sup> Therefore, a not-for-profit should compare its executives' current salaries to those set by other similarly situated not-for-profits.<sup>8</sup>

Two caveats come with this approach. The first is that in cases involving for-profit corporations, courts have sometimes rejected peer group data offered by the parties. For example, in *Pereira v. Cogan*,<sup>9</sup> a bankruptcy court rejected both the plaintiff's and the defendant's comparator group studies. Instead, the court held that since the defendant company's structure was a "hybrid" of two different peer groups, no single group could adequately serve to evaluate the compensation of the defendant. Thus, when not-for-profits plan comparative studies of compensation formulas, they should take care to include only those peer groups that are sufficiently similar to themselves.

Second, a court may look to past decisions in an attempt to gauge what was reasonable for certain common positions. In *Church by Mail, Inc. v. United States*,<sup>10</sup> the U.S. Court of Appeals for the D.C. Circuit held that the defendant's pay was excessive when compared to previous compensation decisions involving church ministers. Therefore, whenever possible, not-for-profit boards should look to historical pay levels for job titles similar to those for which they are setting compensation.

In addition, when a board determines the value of a particular compensation package, any benefit should be valued at the current market value. In *Unionville-Chadds Ford School Dist. v. Chester County Bd. of Assessment Appeals*,<sup>11</sup> a Pennsylvania court determined that the compensation paid was not unreasonable, because the rent that executives paid for on-site housing was at market value, and not at an excessive discount. Additional

benefits such as discounted rent and company cars should be included in current market value compensation determinations.

## Conclusion

In the final analysis, defining excessive executive compensation in the not-for-profit arena may be as difficult a task as the Supreme Court's many efforts at defining what constitutes hard-core pornography. In struggling to define obscenity, Justice Potter Stewart famously said:

I shall not today attempt further to define the types of material I understand to be embraced ... [b]ut I know it when I see it ...<sup>12</sup>

When setting compensation levels, a not-for-profit should at least take the necessary steps to create a rebuttable presumption of reasonableness. The board of directors should have access to any and all information related to the compensation package, and the board should be sure to document the basis for all of its compensation decisions. In addition, salaries should be compared to those of other similarly situated executives of not-for-profits. Sometimes a not-for-profit may choose to go a step further by obtaining an outside opinion on the reasonableness of compensation. Independent consultation provides a stronger presumption against a conflict of interest, particularly when the executive involved has personal ties to the board.<sup>13</sup> Most importantly, the board should make an informed, objective decision on compensation, based in part on the fair market value of the executive's services, how he or she is performing, how the not-for-profit is doing financially, and how well it is fulfilling its mission.

1. N-PCL §202(a)(12) Legislative Studies and Reports. See also, 6 White on New York Corporations, ¶202.04.

2. 7 White on New York Corporations, ¶717.01.

3. N.Y. Estates Powers and Trusts Law, §8-1.4.

4. *The Committee to Save Adelphi et al. v. Peter Diamandopoulos et al.*, available at <http://www.regents.nysed.gov/Adelphi.html> (New York State Board of Regents, 1997).

5. 273 NYS 87, 114 (Sup. Ct. N.Y. Co. 1934).

6. See, e.g., *Cilco Cement Corp. v. White*, 390 N.Y.S.2d 178 (2d Dept. 1976); *Mann v. Luke*, 68 N.Y.S.2d 313 (1st Dept. 1947); *Baker v. Cohn*, 42 N.Y.S.2d 159 (Sup. Ct. N.Y. Co. 1942), mod. on other grounds, 40 N.Y.S.2d 623 (1st Dept. 1943), aff'd, 292 N.Y. 570, (1944).

7. *Pinnacle Health Hosps. v. Dauphin County Bd. of Assessment Appeals*, 708 A.2d 1284 (Pa. Commw. 1998) (Holding that appellant CEO's salary exceeded his "peer group" by approximately 25 percent, and was therefore excessive); *Church by Mail, Inc. v. United States*, 1988 U.S. Dist. 16464 (D.C. Cir. 1988) (Court held that compensation was excessive when compared to salaries paid to outside ministers.).

8. In *People v. Grasso*, No. \_\_\_ (Sup. Ct. N.Y. County 2004), Attorney General Eliot Spitzer relies on a comparative study of executives whose responsibilities are similar to those of Mr. Grasso. When comparing the two groups, Mr. Spitzer claimed that the data provided by Mr. Grasso was not accurate, and Mr. Spitzer alleged that when corrected, the data revealed that Mr. Grasso's compensation, when compared to the NYSE benchmark, was "grossly unreasonable". Complaint at 43-52.

9. 294 BR 449, 482-91 (SDNY 2003).

10. 1988 U.S. Dist. LEXIS 16464 (D.C. Cir. 1988).

11. 692 A.2d 1136 (Pa. Commw. 1997). Any discounts on rent were considered to be compensation by the court.

12. *Jacobellis v. Ohio*, 378 US 184, 197 (1964).

13. The independent consultant should be chosen by the board, and the consultant should report to the board. A not-for-profit that delegates hiring to the CEO may create a potential conflict of interest with a consultant who has been hand picked by a CEO.

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