CORPORATE GOVERNANCE
LAW ALERT
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The "Grasso" Case and Its Implications for Executive Compensation

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The much anticipated ruling on total compensation which had been approved for former NYSE Chairman Richard A. Grasso has identified new issues for those who serve as corporate executives and on Boards. While the decision addressed the question in the context of a not-for-profit corporation, the key considerations on which the decision is based will reverberate in all company boardrooms. Coupled with the newly adopted rules regarding disclosure of compensation for key public company executives and Board members, it is clear that the days of unfettered compensation will give way to more serious consideration of the amount of total compensation.

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The recently announced SEC disclosure requirements for executive and Board compensation make it clear that there should be a correlation between pay and performance. Under those rules, companies will identify and quantify non-monetary and deferred compensation, including the growth in value of previous stock grants. This will result in greater focus on total economic benefits derived from compensation – past, present and future. While the final determination of what amount is reasonable remains within the discretion of the Board, the disclosure obligations will force greater scrutiny. Justification for pay (in all its forms) will need to be explained in a simple, straightforward fashion.

In the context of total economic value, the ruling in the *Grasso* case should come as no great shock. Justice Ramos issued a lengthy, well reasoned decision in the *Grasso* case, brought by then Attorney General Eliot Spitzer. Although the key allegation was that Mr. Grasso had breached his fiduciary duties, the basis for this allegation – failing to disclose that the amount in his Supplemental Executive Retirement Plan ("SERP"), a deferred compensation program, had exceeded $100 million – proved fatal. Mr. Grasso had allowed that account to grow while continuing to accept a large salary. In reviewing Compensation Committee Minutes, Judge Ramos concluded that Mr. Grasso had left the NYSE Board unaware of his true ***total*** compensation.

Justice Ramos concluded that, as an officer, Mr. Grasso was under a duty to be both fully informed as to the nature and scope of his total compensation and ***to see to it that the Board was fully informed.*** Although Mr. Grasso argued that he did not "know" the amount in his SERP account until 2002, the court found this "affirmative defense of neglect to be shocking. That a fiduciary of any institution, ***profit or not-for-profit,*** could honestly admit that he was unaware of a liability of over $100 million... a clear violation of the duty of care." Justice Ramos held an executive cannot, as a matter of law, accept a payment from his corporation pursuant to his employment contract ***unless he makes an affirmative effort to ensure that the board knows all the facts,*** even if he acts in good faith.

Moreover, the Court's broad reference to "fiduciaries" holds even greater implications for all Board members of any company. Justice Ramos specifically noted that "[t]his Court is not imposing a new corporate standard to review annual benefits assessments….[but rather is] acknowledging the fundamental duty of each member of a board to understand the business of the company upon whose board they sit."

Of course, it has long been held that board members have fiduciary duties, however, Justice Ramos' particularly critical assessment of the NYSE Board and the compensation committee confirms that attention to detail is necessary. Specifically, there was noted confusion among the Board's members regarding the Supplemental Executive Savings Plan ("SESP"), and Grasso's request for a SESP distribution upon the renewal of his contract with the NYSE, rather than at his termination. Some Board members and consultants involved in the development of Grasso's compensation benefits packages and the drafting of his employment agreements testified that the SESP was either never amended to permit for a distribution to Grasso, or that they were unaware that the SESP had to be amended to allow for pre-termination distributions. Clearly, the Board did not fully apprise themselves on this issue and may have been acting *ultra vires,* or outside of the scope of their abilities, by approving a distribution from this plan.

While the Court did not further discuss the approval of the SESP distribution due to unresolved factual issues, the issue of *ultra vires* acts on the part of the Board has serious implications. For example, if the NYSE acted outside the bounds of their power, and Kenneth Langone, who served as the head of the NYSE compensation committee until earlier this year, is implicated in this *ultra vires* act, then he may be jointly and severally liable for the excessive amount paid to Mr. Grasso.

This ruling will force those charged under the new rules adopted by the SEC for disclosure of compensation to probe into total compensation and, at the same time, compel those executives to assure their Compensation Committees that all aspects of compensation have been considered and properly valued. It also provides an answer to one of the more perplexing issues created by the new rules – how does the CEO or CFO certify Compensation Committee compliance when they are not participants in the determination. The Grasso decision concludes that even if officers are not participants, they are under a fiduciary duty to ensure that the Board understands "total" compensation. Thus, the new "Compensation Discussion and Analysis" ("CD&A"), which requires management to provide a comprehensive description of compensation programs, as well as the other disclosures required in tabular form, conforms with the underlying philosophy of the ruling on the *Grasso* case.

The new rules force companies to provide a more detailed discussion of how top earners are paid. In the past, Compensation Committees have supplied only broad statements or boiler-plate about a company's compensation practice, focusing on the current cash and stock-based grants of executive pay. The new CD&A, however, requires a more lengthy narrative outlining what compensation is designed to reward, how the company determines the formula for each compensation, and what corporate performance is considered in making compensation policies and decisions. More significantly, investors are to be provided with one number for ***total*** annual compensation for each named executive officer. Thus, under the new rules, situations akin to the nondisclosure of Mr. Grasso's true total compensation should not occur. Instead, the one number provided for compensation would need to include all forms of compensation to assure that the investors have all the material information they need. Further, as fiduciaries, all executives must play an active role in assuring that their true compensation is represented in the CD&A.

With the *Grasso* decision, companies must accelerate their focus on compensation issues. Among those things we recommend be done are:

- Complete the Compensation Discussion and Analysis (CD&A) so that the rationale for compensation-related programs can be evaluated;
- Confirm whether pay and performance are properly reflected in the company's total rewards strategy, including perquisites, benefits from poison pill provisions and the possible impact of severance provisions;
- Review the compensation committee guidelines and educate compensation committee members of their responsibilities;
- Assure proper recordkeeping for compensation issues; and
- Review all existing agreements and identify all possible benefits which may be deemed part of ***total*** compensation.

Input from counsel in identifying and reviewing existing agreements will be important to assure satisfactory compliance.

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