The Case of CEO Richard Grasso and the NYSE: Proposals for Controlling Executive Compensation at Public Nonprofit Corporations

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I. INTRODUCTION

In August 2003, for the first time in its 200-year history, the New York Stock Exchange (NYSE) announced the compensation package for its Chairman and Chief Executive Officer. The NYSE’s Board of Directors revealed in a press release that it had distributed $139.5 million in deferred compensation to its CEO Richard Grasso. This payment was in addition to a base salary of $1.4 million with an annual bonus of $1 million. Due to the Exchange’s status as a nonprofit corporation, Grasso’s payout “led to an outcry, as [his compensation was] more in line with what chief executives of public corporations are paid and [was] far above the pay of top officials at the Securities and Exchange Commission, NASD [National Association of Securities Dealers] and even NASDAQ, a primary competitor.” While Grasso’s total compensation for his first three years as CEO, including bonuses, was $17.82 million, his total compensation from 1999 to 2002 jumped to a staggering $80.7 million. Notably, during this latter period, Grasso’s close friend Ken Langone served as Chairman of the Compensation Committee.

Three weeks after the Board’s press release, Grasso resigned. Following his resignation, the Board began to examine its own

1. Landon Thomas, Jr., Big Board Chief Will Get a $140 Million Package, N.Y. TIMES, Aug. 28, 2003, at C1.
3. Id. (explaining that “[t]he NYSE for many years has maintained several deferred compensation, retirement and savings plans for its executives, including a Supplemental Executive Retirement Plan (‘SERP’) to supplement benefits under the NYSE Retirement Plan, and a Supplemental Executive Savings Plan (‘SESP’) to provide the executives with the ability to supplement the NYSE Savings Plan and to defer and invest additional compensation’); see also Plaintiff’s Complaint, at 12-16, Spitzer v. Grasso (N.Y. Sup. Ct. May 24, 2004) (No. 04-CIV-4565) [hereinafter Complaint] (giving a more detailed analysis of each element of Grasso’s compensation package).
5. Thomas, supra note 1, at C1 (also noting that “[c]orporate governance experts said . . . that the big payout was highly unusual for the head of a regulatory body’); see also infra notes 213-215 (discussing these CEO’s pay packages).
8. Id.
structure and propose various changes and reforms. The Board's new interim CEO also requested that the SEC and New York Attorney General Eliot Spitzer investigate the matter, handing over to both parties a report written by an attorney hired by the Exchange. In May 2004, Spitzer sued Grasso, Langone, and the NYSE to recover the excessive compensation paid to Grasso under New York's nonprofit corporation law.

This Note will use the lawsuit brought by Spitzer as a case study for proposing changes to New York's nonprofit corporation law. Because New York models its nonprofit corporation law after its for-profit corporation statute, Part II will argue that use of this model is questionable by focusing on the structure of the NYSE. Part III of this Note will focus on the Grasso lawsuit and make predictions about the outcome of the case under the current law. To make predictions, this Note relies on the leading nonprofit executive compensation case in New York. Part III also will show how the for-profit corporation model may not effectively control executive compensation in the Grasso case. Finally, Part IV will propose modifications to the nonprofit corporation law to ensure that suits challenging executive compensation can be brought successfully without increasing costs to the corporation.

II. BACKGROUND

A. The NYSE

1. A Unique Nonprofit Corporation

The NYSE exists under New York law as a nonprofit corporation. Founded in 1792 by twenty-four New York brokers and

10. See Press Release, New York Stock Exchange, NYSE Outlines Proposals to Strengthen Governance and Names Candidates for New Board of Directors (Nov. 5, 2003), at http://www.nyse.com/frameset.html?displayPage=press/2-2005.html. Now, a year and half later, many of these changes have been implemented. See infra Part II.D.

11. Peter Elkind, The Fall of the House of Grasso, FORTUNE, Oct. 18, 2004, at 312 (explaining that the new NYSE CEO John Reed "hired former federal prosecutor Dan Webb to investigate the pay fiasco" and then "turned the report over to Spitzer and the SEC, calling on them to investigate").


merchants, the NYSE was formed to serve its members. Following the passage of the Securities Exchange Act of 1934, the NYSE registered as a national securities exchange with the Securities and Exchange Commission (SEC). In 1938, to serve its members more effectively, the NYSE adopted a "private club structure" as a model, thus setting the foundation for the structure it maintains today. In 1971, the NYSE incorporated as a nonprofit organization.

"The defining characteristic of a nonprofit organization is that it is barred from distributing profits, or net earnings, to individuals who exercise control over it, such as its directors, officers, or members." While all nonprofit organizations have this in common, there are many different types of nonprofit companies. Professor Hansmann has classified nonprofit corporations in "two dichotomous" ways, developing four types of corporations: mutual commercial, mutual donative, entrepreneurial donative, and entrepreneurial commercial.

Hansmann's first dichotomy is donative or commercial. Donative nonprofit organizations receive income in the form of donations, whereas commercial organizations receive their income from goods or services that they produce or provide. The second dichotomy is mutual benefit or public/entrepreneurial benefit. Mutual benefit organizations have members and provide services to these members at a fee. In addition, the members typically control the organization. Public or entrepreneurial benefit organizations, however, normally do not have members, but rather benefit the public at large. Even if they have members, those members do not have

17. Id. at 11.
20. Hansmann, supra note 18, at 501.
21. Id. at 502.
22. Id.
23. Id. at 503.
24. Lee, supra note 19, at 931.
25. Hansmann, supra note 18, at 503.
control. Included in the public category are most hospitals and organizations that serve the poor or disadvantaged, like the Salvation Army.

While many states' nonprofit corporation laws do not make distinctions based on these categories, New York's Not-for-Profit Corporation Law (N-PCL) divides its nonprofit corporations into four different types based on their purpose. One of the four is a Type A corporation, which is most similar to Hansmann's mutual commercial organization. According to Hansmann, "social clubs and various similar membership organizations" like the Automobile Association of America (AAA) or country clubs are considered mutual commercial organizations. Type A corporations are "intended to cover the usual membership type organization where the organization's support derives from a limited class called 'members' and where the non-pecuniary benefits flow primarily to such limited class." Whereas the "public" nonprofit organizations described above operate to provide important public services, that the government fails to do, mutual benefit nonprofit corporations operate solely for a limited group of individuals.

Members of Type A corporations are like shareholders in public corporations because both exercise some control over the corporation, but do not actually run the corporation. Due to this similarity, members of Type A corporations have many of the same protections as shareholders of for-profit corporations. Like shareholders in a for-profit corporation, members in a Type A corporation have both voting power and standing to sue. Suing and voting are two ways in which members can influence corporate decisionmaking regarding compensation. Another similarity is the right to receive an annual

27. Hansmann, supra note 18, at 503.
28. Id.
29. Id. at 530.
31. § 201(b) ("Type A—A not-for-profit corporation of this type may be formed for any lawful non-business purpose or purposes including, but not limited to, any one or more of the following non-pecuniary purposes: civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural, animal husbandry, and for a professional, commercial, industrial, trade or service association.").
32. Hansmann, supra note 18, at 582, 584.
33. § 201 cmt.
34. §§ 623, 613 (granting members standing to sue and voting rights).
35. Id.
report from the board of directors detailing such things as assets, liabilities, expenses, and disbursements.37 Also like shareholders of a for-profit corporation, members of a New York nonprofit organization are entitled to distribution of their share of the assets of the corporation upon dissolution.38

The NYSE is registered as a Type A corporation under the N-PCL; however, the NYSE is unique among Type A corporations because of its size and role.39 First, unlike other member organizations where membership is based on superficial characteristics40 or easily attained through a small fee,41 the Exchange's 1,366 members are the specialists and brokers that trade on the floor of the Exchange.42 Each member bought a "seat" on the trading floor, "[met] rigorous professional standards set by the Exchange,"43 and must pay regular fees to the Exchange.44 In addition, the Exchange members' livelihood depends on their membership, which entitles them to conduct for-profit business on the trading floor.

Second, unlike typical Type A corporations, which include smaller organizations like social and fraternal clubs,45 the NYSE is "the world's largest equities market . . . . On an average day, 1.46 billion shares, valued at $46.1 billion, trade on the NYSE."46 One commentator noted that "many large nonprofits are indistinguishable from for-profit companies because, among other things, they have multimillion dollar investments and they charge for their services."47 The NYSE has both these features.48 Finally, the NYSE is more

37. N.Y. NOT-FOR-PROFIT CORP. LAW § 519 (McKinney 2003).
38. § 1000 et seq. This is further assured to all "regular members" of the Exchange in its Certificate of Incorporation. Certificate of Incorporation, NYSE, § 13, at 3, available at http://www.nyse.com/pdfs/certificateofincorporation.pdf.
40. Two examples would be social clubs or country clubs.
41. One example would be AAA.
43. Id.
44. See Letter from Darla C. Stuckey, Corporate Secretary, NYSE, to Jonathan Katz, Secretary, SEC 6 (June 30, 2004) (discussing member fees in the context of a proposed SEC rule).
45. Hansmann, supra note 18, at 582, 584.
similar to Hansmann's public category despite its classification under New York law as a mutual benefit-type nonprofit organization.49

Because Type A corporations award rights to members, which place them in a position analogous to shareholders of for-profit corporations, the for-profit corporation law seems like a good model upon which to base non-profit corporation law. But, the NYSE, as the "world's largest equity market,"50 is hardly the typical Type A corporation. As will be shown in the following section, its role as a regulator makes it a good case study for modest reforms to the N-PCL.

2. Serving the Public as a Regulator

Although the Exchange can be considered a mutual benefit organization,51 it is not so easy to categorize.52 "[I]t is a Type A nonprofit . . . under New York law. Yet, it derives much of its power from federal securities laws. '[T]he NYSE and its officers often act as a de facto agency, or at the least at the direction of the SEC.'"53 Under SEC rules, the NYSE is a self-regulating organization (SRO).

As an SRO, the NYSE promulgates rules and regulations for both its members and the listed companies. The NYSE conducts field examinations of any members alleged to have violated the Exchange's rules and regulations.54 "These examinations are designed to review each firm's: Financial integrity, Operational stability, Timelines and accuracy of books and records, Compliance with customer protection rules, and Sales-practice compliance programs."55 The Exchange also promulgates rules and regulations for its listed companies. By setting standards by which companies can list on the Exchange, the NYSE has great power over these companies. For example, in the Fall of 2003, the SEC approved NYSE-created corporate-governance regulations for each listed company.56 These regulations included provisions as broad as requiring each listed company to include a majority of independent directors on its board of directors and as

49. See infra Part II.A.2.
50. See supra note 46.
51. See supra notes 31, 39 and accompanying text.
53. Id. (quoting Judge Lynch, a federal judge, who ruled against Grasso's attempt to remove the case to federal court).
55. Id.
specific as setting the frequency with which those directors must meet.\textsuperscript{57} Thus, the NYSE can have a significant effect on the internal operations of listed companies by exercising its power to set listing requirements.

The NYSE's regulation of both its members and the listed companies affects public shareholders who own and trade stock in these companies. Regulation of members can shape how public stocks are traded, while regulation of listed companies' internal operations can influence their profits and thereby the public's share in these profits through stock. These regulatory features make the Exchange similar to nonprofit corporations that fall into Hansmann's public category.\textsuperscript{58} By serving a "quasi-public" function,\textsuperscript{59} the Exchange does more than act like a membership organization that operates only to benefit its own members.

**B. Questionable Use of the Business Corporation Law as a Model**

The New York N-PCL is modeled after New York's Business Corporation Law and thus provides causes of action for breaches of fiduciary duty that are nearly identical to those under the Business Corporation Law.\textsuperscript{60} As noted above, the Exchange is similar to a for-profit corporation due to its size, position as a world market, and members with rights similar to public shareholders.\textsuperscript{61} Beyond these similarities, however, there are key differences between the NYSE and other similar public nonprofit corporations, and for-profit corporations.

First, "a nonprofit corporation has no 'owners' or private parties with a pecuniary stake to monitor and scrutinize actions by the directors."\textsuperscript{62} Although members in commercial nonprofit organizations like the NYSE often "exercise direct control over the affairs of the organization,"\textsuperscript{63} the members of the Exchange lack a financial incentive to sue for excessive compensation because, as noted above, nonprofit organizations are prohibited from distributing profits

\textsuperscript{57} Id.

\textsuperscript{58} See supra notes 26-27 and accompanying text.

\textsuperscript{59} See Bobelian, supra note 52, at 1.

\textsuperscript{60} Compare N.Y. NOT-FOR-PROFIT CORP. LAW §§ 623, 715, 717, 720 (McKinney 2003), with N.Y. BUS. CORP. LAW §§ 626, 713, 717, 720 (McKinney 2003); see also In Re Manhattan Eye, Ear & Throat Hosp. v. Spitzer, 715 N.Y.S.2d 575, 592 (N.Y. Sup. Ct. 1999) (noting that "[n]ot-for-profit corporations operate under legal regimes designed for traditional for-profit corporations").

\textsuperscript{61} See supra Part II.A.1.

\textsuperscript{62} Manhattan Eye, Ear & Throat Hosp., 715 N.Y.S.2d at 592.

\textsuperscript{63} Hansmann, supra note 18, at 582.
to members. Only upon dissolution can members share in the assets of the corporation. This lack of control is even more problematic at traditional public nonprofit organizations, like charities, because they do not have any members to bring suit.

Second, "nonprofits are seldom obliged to disclose substantial information about their financial affairs, either to patrons or to the state officials nominally responsible for overseeing the organizations." In the case of the NYSE, it was not until 2003 that the Exchange first released information about the salary paid to its chairman and CEO, evidencing the lack of disclosure requirements at the NYSE. Furthermore, this information was only released after intense media coverage pressured the Board to disclose.

Third, the financial press does not relentlessly cover most nonprofit organizations until after scandals arise. Although much has been published about Grasso's compensation, this publicity did not occur until after the Exchange released his salary. Unlike the for-profit sector, financial analysts do not track every transaction made by the Exchange or other public nonprofit corporations in the same way that they follow for-profit corporations. Analysts and financial organizations lack a financial incentive to do so because its actions affect only its 1,366 members, rather than the public at large. This argument against public scrutiny is weaker for the Exchange because of its position as a world market; however, it is surely true for other public nonprofit organizations that do not have a strong commercial presence like the Exchange.

Fourth, nonprofits lack certain market mechanisms that promote caution. For example, "[i]n the for-profit context, having to compete on an organizational level (against other businesses providing similar products or services) and on a personal level (for directorial jobs and prestige) causes directors to be more diligent in their duties, for fear of being ousted from their positions." While the NYSE has

64. Id. at 501.
65. See supra note 38 and accompanying text.
66. Hansmann, supra note 18, at 568.
67. See Elkind, supra note 11, at 310 (noting that "there was no way the news of Grasso's huge payout wouldn't leak; the board had to announce it").
68. Matthew D. Caudill, Piercing the Corporate Veil of a New York Not-for-Profit Corporation, 8 FORDHAM J. CORP. & FIN. L. 449, 481 (2003); Deborah A. DeMott, Self-Dealing Transactions in Nonprofit Corporations, 59 BROOK. L. REV. 131, 139 (1993) (explaining that "[n]onprofit directors... make decisions in a less transparent environment [than for-profit directors] and information about their decisions is not regularly exposed to the scrutiny of a broad audience [and]... become visible only in the wake of scandal.").
69. Press Release, supra note 2.
70. Lee, supra note 19, at 957.
faced competition recently, it has a substantial market share and therefore does not face the same competition as many public companies. Moreover, other public "nonprofits face far less competition than business corporations, and .... 'In a world in which managerial performance is not based on easily observable criteria (like profits or share prices),' the nonprofit market for skilled managerial talent is not as effective in inducing directors to behave properly.' Nonprofit organizations, therefore, may be more likely to have reckless or negligent directors who engage in unlawful behavior.

Finally, the NYSE is different from the typical for-profit corporation due to its function as an SRO. By serving a quasi-governmental role, the Exchange has a greater responsibility to the public at large:

With 1,500 employees and revenues of less than $1 billion, the NYSE is tiny compared with corporate giants. In fact, it isn't a normal profit-seeking business at all, but operated more like a public utility, charging fees to both its listed companies and the firms that operated on the exchange. There are other important differences: The exchange doesn't face market risk the way companies do every day. It doesn't have publicly traded stock. Besides, it is a regulatory body.

While the Business Corporation Law in New York was developed to protect "corporate giants," the NYSE is not one of these giants. Being "a regulatory body," it should be subjected to stricter standards than traditional large public corporations.

These differences between public nonprofit corporations like the Exchange and for-profit corporations suggest that the Business Corporation Law serves as a poor model for guarding against abuses by directors and officers of public nonprofit corporations.

C. Precedent: The Adelphi Case

Richard Grasso certainly is not the only nonprofit executive to receive an excessive compensation package, but there is scant precedent in New York applying the N-PCL to an excessive compensation case. There is one case, however, on which many expect Spitzer to rely heavily: the Adelphi University scandal that arose in

71. Mara Der Hovanesian & Ben Elgin, The NYSE: A Thousand Cuts, Bus. WK., Jan. 26, 2004, at 78-79 (noting that although the NYSE's share of trading in its listed stocks has slipped substantially in the wake of the Grasso scandal, it remains at 78.5%).

72. Lee, supra note 19, at 957.

73. See supra Part II.A.2.

74. Elkind, supra note 11, at 296.

75. Kate Kelly, Grasso Takes More Heat on Pay, WALL ST. J, Apr. 20, 2004, at C1 (noting that "regulators are studying two 1997 suits with parallels to the NYSE case," one of which was the Adelphi case); John C. Coffee, Jr., Unfinished Business at the NYSE, 231 N.Y. L.J. 3, 3 (2004)
the late 1990s involving its President and board of trustees. After Adelphi's President Peter Diamandopoulos was reported to be the second highest paid college president in the United States, two actions were brought against Diamandopoulos and the Board of Trustees charging them with "excessive compensation paid to the university's president; a failure to review the president's job performance; refusal to abide by university's bylaws... board misconduct; and impermissible conflicts of interest."  

The Committee to Save Adelphi, a group comprised of "faculty, students and former members of Adelphi's board of trustees," initiated the first proceeding. The group petitioned the New York State Board of Regents for removal of the trustees. The Board of Regents ultimately recommended the removal of eighteen of the nineteen trustees, including Diamandopoulos. 

The second proceeding was an action "commenced by the Attorney General to hold the individual... members of the Board of Trustees of Adelphi University financially accountable for mismanagement of the assets of the University, in violation of the Not-For-Profit Corporation Law." This action ultimately settled; therefore, there is just one published opinion from the attorney general's action, which only addresses preliminary motions.

Both the Board of Regents decision and the New York trial court analyze some of the N-PCL sections, which Spitzer has relied on in the Grasso complaint. Because the Adelphi case will be the primary precedent used by Spitzer, this Note will focus on these two decisions in discussing the merits of Spitzer's suit.
D. Internal Reform at the NYSE

Following the Grasso scandal, interim chairman John S. Reed advocated an overhaul of the Exchange's governing structure. After incorporation as a nonprofit corporation in 1971, the NYSE created a Board of Directors to "include ten directors from the securities industry, ten public directors, and a full-time Chairman and Chief Executive Officer to be elected by the Board."83 Until November 2003, the Board remained virtually the same, with twenty-seven members: twelve directors from the securities industry, twelve public directors, the Chairman and CEO, and two Presidents, who act as co-COOs and Executive Vice Chairmen.84

The most significant change promoted by Reed was to use two separate bodies to govern the Exchange: a Board of Directors and a Board of Executives.85 The Board of Directors, composed of completely independent directors "has full fiduciary responsibility and will supervise the Exchange's regulation, governance, compensation and internal controls."86 The Board of Executives, representing "key NYSE constituents" such as specialists, floor brokers, and listed companies,87 will play an advisory role to the Board of Directors and will be focused more on the operations of the Exchange.88

Another important change is the separation of "the NYSE's regulatory function from its marketplace function and from influence by members and member organizations."89 To accomplish this separation, the NYSE created a new position, called Chief Regulatory Officer (CRO).90 The CRO will report directly to an independent committee of directors who will in turn report to the Board of Directors.91

While these changes may prevent some abuses, there are two arguments that these reforms are insufficient. First, one expert in corporate governance argues that the CRO will "remain subject to the NYSE's chief executive officer [because] . . . the NYSE's CEO will

83. HECKMAN, supra note 14, at 11.
86. Id.
87. Id. at 40 tbl.
88. Id. at 40.
89. Id. at 41.
90. Id.
91. Id.
control, or at least primarily influence, the institution's budget and resources.\textsuperscript{92} Therefore, as Grasso is alleged to have done,\textsuperscript{93} the CEO may still try to influence his own compensation awards. Second, "the NYSE's major competitors still fear that the NYSE can use its enforcement powers to retaliate against broker dealers who move order flow away from the Exchange."\textsuperscript{94} So long as the Board can still pressure its members, the members alone will not serve as an effect tool to curb Board abuses.

III. SPITZER V. GRASSO: WHO WILL WIN?

A. Standing to sue

In the for-profit world, when shareholders believe that an officer or director has received excessive compensation, they "almost invariably file derivative actions claiming an injury to the corporation that indirectly harms its shareholders."\textsuperscript{95} Similarly, under the N-PCL, members of a nonprofit corporation can bring "an action . . . in the right of a . . . corporation to procure a judgment in its favor."\textsuperscript{96} Shareholders in for-profit corporations must either hold 5 percent of the outstanding shares in the corporation or have shares with a fair market value greater than $50,000 to have standing.\textsuperscript{97} Member actions similarly require that 5 percent of the total membership file suit in order to initiate the action.\textsuperscript{98} However, unlike shareholders, who can overcome the 5 percent ownership hurdle by paying "security" for expenses incurred by the corporation in defending the action, members of nonprofit corporations must strictly comply with the 5 percent requirement.\textsuperscript{99}

As noted above, the members of the NYSE include the brokers and specialists who trade on the stock exchange floor.\textsuperscript{100} The 5 percent rule would require nearly 70 of the 1,366 brokers and specialists to

\begin{itemize}
  \item \textsuperscript{92} Coffee, \textit{supra} note 75, at 6.
  \item \textsuperscript{93} See, e.g., Complaint, \textit{supra} note 3, at 8-9.
  \item \textsuperscript{94} \textit{Id}.
  \item \textsuperscript{95} Thomas & Martin, \textit{supra} note 36, at 576.
  \item \textsuperscript{96} N.Y. NOT-FOR-PROFIT CORP. LAW § 623 (McKinney 2003).
  \item \textsuperscript{97} N.Y. Bus. CORP. LAW § 627 (McKinney 2003).
  \item \textsuperscript{98} NOT-FOR-PROFIT CORP. LAW § 623; see also Hofert v. Dank, 389 N.Y.S.2d 101, 102 (N.Y. App. Div. 1976) (finding that § 623's five percent membership rule applies with equal force to § 720 despite language in § 720(b)(3) stating that an action may be brought against a director or officer "by one or more members thereof.").
  \item \textsuperscript{99} \textit{Id}.
  \item \textsuperscript{100} See \textit{supra} text accompanying note 42.
\end{itemize}
initiate a suit against the Exchange; however, because 518 organizations accounted for all members in 1991, it is possible that only one or two firms could represent 5 percent of all members and bring suit against the Exchange. Presuming that one firm could get the support of each of its individual brokers and specialists, the members of the Exchange likely would not have problems meeting the 5 percent requirement.

These brokers and specialists, however, may lack an incentive to sue the Exchange. First, unlike shareholders, “members have little incentive to sue... [because] any damages obtained will be awarded back to the nonprofit, an organization in which the member has no direct monetary stake.” Shareholders, on the other hand, receive financial benefit because they have an ownership interest in the corporation and directly benefit from increased revenue at the corporation. Members of the NYSE have a financial incentive only to the extent that they may receive lower membership fees. If filing a suit results in lower compensation for its executives, then presumably the NYSE would have reduced expenses and could lower its annual membership fees; however, the Exchange could just as easily decide to maintain the high membership fees and spend the money on something else entirely.

Second, members may be reluctant to sue because they are regulated by the NYSE board. Members of the NYSE must abide by a strict set of standards. Because of the Exchange’s role as an SRO, members may fear retaliation for bringing a suit. Unlike members of other mutual nonprofit organizations, like AAA or country clubs, these members’ jobs and livelihoods depend upon their continued membership in the Exchange.

102. Lee, supra note 19, at 934.
103. In a derivative action, the money is awarded back to the corporation, and the shareholder’s financial benefit is indirect.
104. See Elkind, supra note 11, at 294 (noting that “Grasso’s seat holders also feared him .... Even though they owned the exchange, he was their primary regulator”); cf. Coffee, supra note 75, at 6 (arguing that the CEOs who served on the compensation committee may have wanted to “curry favor” with Grasso because they “knew that the NYSE was one of their primary regulators”).
106. Holman W. Jenkins, Jr., Bored of Directors, WALL ST. J., May 26, 2004, at A17 (noting that “some NYSE ‘specialist’ firms will tell you they were afraid of Mr. Grasso”).
The state attorney general also can bring an action on behalf of the corporation. More importantly, "the responsibility of enforcing nonprofit law generally rests solely with the state attorney general, whose task is to protect the public interest," particularly for non-member public corporations. For example, in the Adelphi case, it was the New York State attorney general who sued to recover monetary damages. Plaintiffs alleging wrongdoing at nonprofit corporations often call upon the attorney general to sue on behalf of the corporation. "Unfortunately, the monitoring of nonprofits is frequently understaffed and lowly prioritized, given the many tasks that the attorney general's office must juggle with limited resources." In addition, "[w]ith a few notable exceptions, the attorney general historically has left excessive executive compensation issues involving not-for-profits to the Internal Revenue Service." Although that is not the case here, as Spitzer filed suit against Grasso, Langone, and the NYSE in May of 2004, the Grasso case is not a typical nonprofit case, having received intense media coverage since the summer of 2003.

To summarize, the members of the NYSE probably could garner the 5 percent needed to bring an action against the Board; however, those same members may lack the incentive to do so because they are unlikely to receive financial benefit from the suit and because it would mean bringing a suit against the body that regulates them. The attorney general remains the best party to bring suit. Unfortunately, the attorney general has limited resources and public nonprofit corporations that lack members are forced to rely solely on the

107. N.Y. NOT-FOR-PROFIT CORP. LAW § 720(b)(1)-(4) (McKinney 2003) (also providing for standing by the corporation, any director, officer, bankruptcy receiver or trustee, or judgment creditor, among others.); see also N.Y. NOT-FOR-PROFIT CORP. LAW § 112 ("authorize[ing] the Attorney General to maintain an action to restrain a not-for-profit corporation from conducting unauthorized activities").

108. Lee, supra note 19, at 932-33 (emphasis added).

109. Vacco v. Diamandopoulos, 715 N.Y.S.2d 269, 270 (N.Y. Sup. Ct. 1998) ("This action was commenced by the Attorney General to hold the individual defendants ... financially accountable for mismanagement of the assets of the University, in violation of the Not-for-Profit Corporation Law."); Vacco v. Armony, 220 N.Y. L.J. 22, 22 (Aug. 7, 1998) ("The Attorney General commenced this action in March 1995 ... seek[ing] a judgment (1) directing the defendants to account for all funds they obtained as a result of their wrongdoing; (2) surcharging defendants for any losses to UWA resulting from their misconduct, with interest . . . .").

110. Lee, supra note 19, at 932-33.


112. Kate Kelly & Susanne Craig, Spitzer Files Suit Seeking Millions of Grasso Money, WALL ST. J., May 25, 2004, at A1 (noting that Spitzer's decision to file suit against the Exchange, Grasso, and Langone came after a four month investigation.).
attorney general for enforcement. In cases which are not as high-profile or as egregious as Grasso's and Adelphi, the attorney general may not exercise his right to sue. Thus, although the N-PCL, provides for some parties to have standing, in practice these standing provisions do not provide sufficient means to curb abuses like excessive compensation.

B. Demand

When shareholders choose to bring a derivative suit challenging the payment of excessive compensation to executives, they are required to make demand on the corporation or show that demand would be futile.\textsuperscript{113} Once the shareholder makes demand, the corporation must decide whether to comply with the demand, i.e., whether to pursue the case.\textsuperscript{114} "Typically, a board will move to dismiss derivative litigation... and if the board appears to have acted independently and to have conducted a reasonable investigation... a court will generally grant this motion."\textsuperscript{115} To avoid that likelihood, most shareholders seek to excuse demand by showing that it would be futile.\textsuperscript{116}

Under New York law, members of a nonprofit corporation are no different than shareholders and must make demand on the corporation.\textsuperscript{117} In the case of Grasso, the members would probably not need to show that demand was futile because the current board asked the SEC and the New York attorney general to file suit against the Exchange,\textsuperscript{118} suggesting that it probably would not dismiss a member suit. If a court did require the members to prove demand futility, they could be faced with a fairly substantial burden.\textsuperscript{119}

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{113}Thomas & Martin, supra, note 36, at 576; see also Marx v. Akers, 666 N.E.2d 1034, 1037 (N.Y. 1996) (explaining that the three purposes of the demand requirement "are to (1) relieve courts from deciding matters of internal corporate governance by providing corporate directors with opportunities to correct alleged abuses, (2) provide corporate boards with reasonable protection from harassment by litigation on matters clearly within the discretion of directors, and (3) discourage 'strike suits' commenced by shareholders for personal gain rather than for the benefit of the corporation.").
\item \textsuperscript{114}Thomas & Martin, supra note 36, at 576-77.
\item \textsuperscript{115}Id.
\item \textsuperscript{116}Id. at 577.
\item \textsuperscript{117}N.Y. NOT-FOR-PROFIT CORP. LAW § 623(c) (McKinney 2003) (stating that in any action by members "the complaint shall set forth with particularity the efforts of the plaintiff or plaintiffs to secure the initiation of such action by the board or the reason for not making such effort."); cf. N.Y. BUS. CORP. LAW § 626(c) (McKinney 2003) (using the same language).
\item \textsuperscript{118}Landon Thomas, Jr., Exchange Said to Want Move on Grasso Pay, N.Y. TIMES, Jan. 8, 2004, at C1.
\item \textsuperscript{119}As one court explained:
\end{enumerate}
\end{footnotesize}
Nonetheless, in cases like Grasso’s, it seems unlikely that demand will be a significant issue in cases alleging executive compensation at nonprofit organizations. First, no section of the N-PCL requires the attorney general to make demand. Second, in high-level cases like Grasso’s, where excessive executive compensation is alleged, the majority of the board members who oversaw the executive compensation would likely resign amidst the controversy, leading members to elect a new board. This new board may be less likely to dismiss members’ claims, but instead, as happened in the Grasso case, may insist on a full investigation of the matter.

C. The N-PCL’s “Reasonable” Compensation Requirement

N-PCL § 202(a)(12) provides:

Each corporation . . . shall have the power in furtherance of its corporate purposes . . . 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 § 515(b) also provides that “[a] corporation may pay compensation in a reasonable amount to members, directors, or officers for services rendered.” Unlike the Business Corporation Code, “[t]he 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.” The N-PCL therefore provides an additional protection against abuse in the area

In New York, a demand would be futile if a complaint alleges with particularity that (1) . . . a majority of the board of directors is interested in challenged transaction . . . (2) . . . the board of directors did not fully inform themselves about the challenged transaction to the extent reasonably appropriate under the circumstances . . . (3) . . . the challenged transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors.

Marx v. Akers, 666 N.E.2d 1034, 1039, 1040 (N.Y. 1996). In order to allege these three elements with particularity, the members would have to gather many facts and be able to prove each of these three elements. This burden can provide a substantial hurdle to the members before their case even goes to trial.

120. Kate Kelly, Reed Will Remain NYSE Chairman for Another Year, WALL ST. J., Apr. 2, 2004, at C1 (explaining that Reed, Grasso’s successor, installed a new “more independent board of directors”).

121. See supra note 11 and accompanying text.


123. § 515(b) (emphasis added).

124. Serbaroli, supra note 111, at 3.
of compensation, beyond that contained in the Business Corporation Law.\textsuperscript{125}

Notwithstanding this additional protection, it is not clear how courts will interpret this provision. "\textquote{\textquoteright[\textquoteright]Reasonable\textquoteright\textquoteright executive compensation is not defined in the N-PCL or other laws."\textsuperscript{126} In addition, "no reported decisions in New York have addressed the issue of what constitutes 'reasonable compensation' in a not-for-profit context."\textsuperscript{127} Professor Coffee suggests that there are two possible interpretations.\textsuperscript{128}

First, Professor Coffee argues that § 202(a)(12) is in tension with N-PCL § 715, which permits a majority of the board to approve interested director transactions following full disclosure.\textsuperscript{129} He posits that "one could imagine . . . Mr. Grasso arguing that, so long as there was no fraud and the directors approving the transaction were disinterested, he had no other legal obligation and could negotiate at arm's length for the highest possible salary."\textsuperscript{130} Under this interpretation, § 715 would trump § 202(a)(12) by allowing disinterested directors to approve transactions involving interested directors. Under this approach, Grasso would be more likely to prevail because the NYSE board unanimously approved Grasso's pay.\textsuperscript{131}

Second, Professor Coffee cites \textit{Adelphi} for an alternative interpretation.\textsuperscript{132} He points out that in the trial court proceeding of the \textit{Adelphi} case, the court did not interpret § 715 to trump § 202(a)(12).\textsuperscript{133} Rather, the court found that "the fiduciary seemingly cannot simply negotiate at arm's length, but rather has a duty not to seek or receive unreasonable compensation."\textsuperscript{134} Although the court

\textsuperscript{125} § 202(a)(12) cmt. (explaining that "[this section] is an adaptation of the Bus.Corp.L. § 202(a)(10). The word 'reasonable' has been added to qualify compensation of officers and of directors. A sentence has been added requiring that such compensation shall be commensurate with services performed.").
\textsuperscript{126} Serbaroli, \textit{supra} note 111, at 3.
\textsuperscript{127} Id.
\textsuperscript{128} Coffee, \textit{supra} note 75, at 6.
\textsuperscript{129} Coffee, \textit{supra} note 75, at 6 (explaining that the tension results from the fact that § 715 "could be read either to make the business judgment rule fully applicable or simply to remove the common law's prophylactic prohibition against fiduciaries contracting with their own corporation").
\textsuperscript{130} Id.
\textsuperscript{131} Elkind, \textit{supra} note 11, at 310 ("Ultimately a split board decided to proceed [with Grasso's final large compensation award], before agreeing to have the vote recorded as unanimous.").
\textsuperscript{132} Coffee, \textit{supra} note 75, at 6.
\textsuperscript{133} Id.
\textsuperscript{134} Id.
never ruled whether Diamandopoulos’ pay was substantively reasonable because the parties ultimately settled, this interpretation suggests that § 202(a)(12) creates a separate legal duty for directors to neither accept nor award unreasonable compensation. And, according to Professor Coffee, “[o]n this basis, Mr. Grasso has a problem. Not only was his compensation high by any standard, ... [B]ut Mr. Grasso’s compensation virtually matched the NYSE’s revenues in some years .... [T]his looks problematic.”

Unsurprisingly, Spitzer adopts this interpretation, while adding his own linguistic twist. He calls § 202(a)(12) a guiding “principle,” rather terming it a separate legal duty. The Board of Regents in the Adelphi case analyzed § 202(a)(12) similarly. The first line of Spitzer’s complaint reads, “This action is brought to enforce the public’s interest in effectuating the principle, articulated in New York’s [N-PCL], that officers of not-for-profit corporations be paid only that compensation that is ‘reasonable’ and ‘commensurate with the services performed.’” He argues that a violation of this “principle” will lead to a fiduciary duty violation due to the three purposes of this “principle”:

1. To protect not-for-profit corporations, such as the NYSE, from dissipation of their assets;
2. To assure that the assets of not-for-profit corporations are used for the benefit of their members or the public; and
3. To prohibit officers and directors from benefiting from private inurement and enriching themselves to the detriment of their corporations.

Spitzer seems to envision § 202(a)(12) as an umbrella provision that protects corporations and their assets by prohibiting self-interested behavior by corporate officers. He expresses in terms of idealistic “purposes” more than as a legal duty, but the end result is the same.

In four of the six causes of action against Grasso and in the one cause of action against the Exchange, Spitzer cites § 202(a)(12). In

135. Grundfest, supra note 81, at A21. The Board of Regents, as will be discussed below, also relied on § 202(a)(12) to support its holding that the trustees violated their duty of care. Comm. to Save Adelphi v. Diamandopoulos § II.D.2. (Bd. of Regents of Univ. of N.Y. Feb. 10, 1997), available at http://www.regents.nysed.gov/adelphi.html.
137. Complaint, supra note 3, at 1 (emphasis added).
138. See infra Part III.D. (analyzing the Board of Regent’s interpretation of each fiduciary duty).
139. Complaint, supra note 3, at 48.
140. Id.; see infra Part III.D. (discussing fiduciary duties).
141. Complaint, supra note 3, at 48.
142. Id. at 43-48, 52. Notably, Spitzer did not cite § 202(a)(12) in his cause of action against Langone for breaches of his duties of care and loyalty. Id. at 50-52.
each breach of fiduciary duty claim, § 202(a)(12) is implicated.\textsuperscript{143} In discussing waste claims, Spitzer alleges "Grasso knew or is legally chargeable with knowing that the compensation he received was unlawful under N-PCL §§ 202(a)(12) and 515(b)."\textsuperscript{144} Spitzer also argues that Grasso violated both his duties of loyalty and care because "[a]s a fiduciary of a not-for-profit corporation, Grasso could not accept compensation without considering whether it was lawful and not \textit{ultra vires} under N-PCL § 202(a)(12)."\textsuperscript{145}

While the first interpretation of § 202(a)(12) will be most helpful to Grasso's case, the latter two interpretations suggest that Spitzer is more likely to prevail regardless of whether § 202(a)(12) is seen as a separate duty or merely a "guiding principle."

\textbf{D. Fiduciary Duty Violations}

"In those cases where the plaintiff can survive the procedural hurdles [of standing and demand], suits challenging compensation practices still face important substantive hurdles."\textsuperscript{146} These substantive hurdles in the for-profit area are "proving a claim for breach of duty of care, waste, or a breach of the duty of loyalty."\textsuperscript{147} Nonprofit corporation members or the attorney general can bring each of these three claims under the N-PCL,\textsuperscript{148} and Spitzer raised each one in his complaint.\textsuperscript{149}

\textbf{1. Duty of care}

"Claims of the breach of the duty of care attack the procedures that a board has used, and the information that the board has considered, in making its decision about the challenged executive compensation package."\textsuperscript{150} In its business corporation statute, New York codified this duty of care with a requirement that directors and officers perform their duties "in good faith and with that degree of care which an ordinarily prudent person in a like position would use under

\begin{itemize}
\item[143.] Outside of the fiduciary duty violations, Spitzer also argued both for the imposition of a constructive trust and restitution because Grasso's compensation was unlawful and \textit{ultra vires} under § 202(a)(12). Complaint, \textit{supra} note 3, at 44, 48.
\item[144.] Complaint, \textit{supra} note 3, at 45.
\item[145.] \textit{Id.} at 46.
\item[146.] Thomas & Martin, \textit{supra} note 36, at 581.
\item[147.] \textit{Id.} at 573.
\item[148.] N.Y. NOT-FOR-PROFIT CORP. LAW §§ 715 (duty of loyalty); § 717(a) (duty of care); § 720(a)(1)(B) (waste) (McKinney 2003).
\item[149.] \textit{See infra} Part III.D.1-3. (discussing Spitzer's claims for each fiduciary duty).
\item[150.] Thomas & Martin, \textit{supra} note 36, at 581.
\end{itemize}
similar circumstances.” The N-PCL follows the Business Corporation Law, except that it expands upon the Business Corporation Law’s “degree of care” phrase by substituting the phrase “degree of diligence, care, and skill.” This difference led a trial court to conclude that the N-PCL’s “formulation . . . is an ‘expansion’ of the comparable section of the Business Corporation Law which does not contain the words ‘[diligence]’ and ‘skill.’ ” Another difference is that the Business Corporation Law “§ 402(b) enables corporations to exculpate directors for duty of care violations such as negligence,” while the N-PCL has no such analogous provision. These differences show that the N-PCL is stricter with regard to duty of care violations. But, regardless of these differences, both the N-PCL and the business corporation statute adopt an ordinary negligence standard.

Although these statutes appear to require ordinary negligence, the business judgment rule creates a grossly negligent or reckless standard by establishing a “safe harbor” for directors’ decisions. The business judgment rule “bars judicial inquiry into the actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes.” For that reason,

Where the business judgment rule is in effect, plaintiffs will have a much higher burden to meet than the statutory standard may suggest.

151. N.Y. BUS. CORP. LAW § 717(a) (McKinney 2003).
152. N.Y. NOT-FOR-PROFIT CORP. LAW § 717(a).
155. N.Y. NOT-FOR-PROFIT CORP. LAW § 402.
156. See Lee, supra note 19, at 940 (explaining that “[t]raditionally, the reasonable person standard has implicated an ordinary negligence review by the courts”).
157. Id. at 939.
159. Lee, supra note 19, at 940. Because New York common law recognizes the business judgment rule and its duty of care statute uses an ordinary negligence standard, the same problem of judicial non-review would occur in New York.
In New York, the business judgment rule seems to apply to the directors of nonprofit corporations. According to one scholar, "[a]lthough the N-PCL does not expressly refer to the business judgment rule, courts nonetheless apply the business judgment rule to the decisions of not-for-profit corporation officers and directors." At least one opinion noted that a trial court in New York found that the business judgment rule applied in nonprofit cases. Another commentator found that "while there is no case definitively deciding this question, it appears that the business judgment rule would apply to decisions of not-for-profit directors." While the law is not entirely clear, there is a strong argument that the business judgment rule applies to nonprofit directors and officers.

Due to this confusion, it was not surprising that the Board of Regents in the Adelphi case was unclear as to which negligence standard it was applying. Some language suggested that it was employing the business judgment rule, with its gross negligence standard, while other language indicated application of a true ordinary negligence standard. At one point, while paying lip service to the business judgment rule, it also seemed to hold the trustees to the higher, ordinary negligence standard. This inconsistency may have been because, under either standard, the Board of Regents easily concluded that the Adelphi trustees breached their duty of care for two reasons: (1) the Board failed to make informed decisions, and (2) the Board did not award compensation commensurate with performance, as required by § 202(a)(12). First, the Board's lack of informed decisionmaking was

160. Caudill, supra note 68, at 459.
162. Pamela A. Mann, Nonprofit Governance in ADVISING NONPROFIT ORGANIZATIONS 37, 42 (Practicing Law Institute ed., 2003) (stating that "while there is no case definitively deciding this question, it appears that the business judgment rule would apply to decisions of not-for-profit directors.").
164. Id. § II.D.2. ("It is simply no defense where, as here, trustees have wholly failed to exercise any judgment whatsoever... [and when directors act blindly, recklessly and heedlessly . . . ]").
165. Id. § II.D.1-2. (writing that "the trustees failed to exercise the degree of care and skill that ordinarily prudent persons would have exercised in like circumstances" and that "the trustees [cannot invoke the rule's protections when they have failed to exercise the degree of care and diligence which ordinary persons in their positions would exercise").
166. Id.
167. Id.
particularly egregious. In the eight years that Diamandopoulos served as President, the Board “never fixed or approved Diamandopoulos’ compensation,” as his salary was set by an ad hoc committee of the board.\textsuperscript{168} In addition, the trustees who served on the ad hoc committee “made no reasonable effort to learn about presidential compensation packages at comparable universities,” nor did they have “in place a formal or structured evaluation process...[or] articulate expectations or goals against which Diamandopoulos’ performance [could be] measured.”\textsuperscript{169} Likewise, the trial court reviewing the University’s purchase of a Manhattan apartment for Diamandopoulos criticized Adelphi’s board for “fail[ing] to evaluate any other less costly alternatives to achieving the objective of a ‘Manhattan presence,’ or to investigate how the apartment they had previously rented had been used, or whether Adelphi had benefited from the rental of the prior apartment in New York City.”\textsuperscript{170} Both the Board of Regents and the state court found a breach of the Board’s duty of care using the N-PCL standards articulated in § 717.

The Board of Regents used a second ground to support its conclusion that the Board of Trustees violated their duty of care: N-PCL § 202(a)(12).\textsuperscript{171} Using “objective factors” like comparable pay and performance measures, the Board of Regents found that the trustees should not have paid Diamandopoulos as they did.\textsuperscript{172} Despite extensive discussion of these “objective” factors, the court noted that the § 202(a)(12) analysis “is, to some extent, subjective.”\textsuperscript{173}

Similar to the Committee’s charge against the Adelphi trustees for breach of their duty of care, Spitzer charges Langone, former Chairman of the Compensation Committee, with breaching his duty of care\textsuperscript{174} “by misleading the NYSE Board of Directors... about the amount of the annual compensation the Compensation Committee was recommending be approved by the Board.”\textsuperscript{175} The complaint alleges that, during Langone’s tenure as Chairman of the Compensation Committee, the benchmark set for Grasso’s

\textsuperscript{168} Id. § II.D.1.a.
\textsuperscript{169} Id. § II.D.1.b-c.
\textsuperscript{171} N.Y. NOT-FOR-PROFIT CORP. LAw § 202(a)(12) (McKinney 2003); see also discussion of § 202(a)(12), supra Part II.C.
\textsuperscript{173} Id.
\textsuperscript{174} Complaint, supra note 3, at 50.
\textsuperscript{175} Id.
compensation “was wholly disregarded.” Spitzer also accuses Langone of failing to advise the full Exchange Board “of the details of Grasso’s proposed compensation” in 2000 and 2001, pointing out that Langone did not mention Grasso’s CAP awards, worth $6.8 million and $8.05 million, respectively, at either annual meeting.

There are two ways in which a court could find that Langone breached his duty of care. First, like the trustees in the Adelphi case, who failed to make an informed decision, Langone allegedly did not stick to the (albeit inflated) benchmark set for Grasso’s salary and failed to give complete information to the full Board as required. Yet, unlike the trustees, Langone and the Compensation Committee hired consultants, employed some analysis, and made reports (although partially inaccurate) to the full Board. For this reason, using the corporate standard of grossly negligent, it would probably be difficult to show that Langone breached his duty of care. But under N-PCL § 717(a), which may be read as more expansive than the Business Corporation’s duty of care provision, which requires a “degree of diligence, care and skill,” a court may be more likely to find that Langone violated his duty of care.

On the other hand, as the Board of Regents did in its opinion, a court could use § 202(a)(12) and conclude that failure to award “reasonable compensation” in and of itself results in a breach of the duty of care, thereby employing Coffee’s second interpretation of § 202(a)(12). Although Spitzer does not make this argument with

176. Id. at 20. Furthermore, the benchmark that was used was allegedly inflated because Grasso’s salary was compared against that of executives from “enormously large and complex financial services conglomerates” and mistakenly included the value of stock options and other forms of pay that should not have been factors. Id. at 18.

177. “CAP” stands for Capital Accumulation Plan, which “entitled [Grasso] to a deferred award equal to fifty percent of his [Incentive Compensation Plan].” Id. at 13.

178. Id. at 22-23.

179. See supra notes 168-169 and 174-178 and accompanying text.

180. See Complaint, supra note 3, at 17 (noting that “[e]ach year, Hewitt [the Exchange’s consultant] provided the NYSE with data concerning the compensation of chief executives and other senior executives . . . ”).

181. See supra notes 158-157 and accompanying text.


183. N.Y. NOT-FOR-PROFIT CORP. LAW § 717(a) (McKinney 2003).

184. See supra notes 137-145 and accompanying text.


186. See supra note 132-136.
respect to Langone, he does make the allegation against Grasso.\(^{188}\)

Spitzer bases this claim on the mere fact that Grasso accepted an allegedly "unlawful" payment; therefore, a court may find, as in the Adelphi cases, that the mere award or acceptance of compensation in violation of § 202(a)(12) violated Langone's fiduciary duty of care.\(^{189}\)

2. Waste

Section 720(a)(1) of both the Business Corporation Law and the N-PCL is New York's statutory version of the common law waste claim.\(^{190}\) The provision in both codes provides that an action may be brought against an officer or director of a corporation to compel the defendant to account for his official conduct in 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.

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.\(^{191}\)

New York courts use two different waste standards: first, New York's traditional common law understanding of waste as employed in Marx v. Akers;\(^ {192}\) and second, a reasonable test as employed in Baker v. Cohn.\(^ {193}\)

The first approach, under New York's common law, requires that a successful waste claim allege one of three corporate abuses:

[one], compensation rates excessive on their face or other facts which call into question whether the compensation was fair to the corporation when approved, [two], the good faith of the directors setting those rates, or [three], that the decision to set the compensation could not have been a product of valid business judgment.\(^ {194}\)

The latter two abuses implicate the fiduciary duties of loyalty and care and are discussed elsewhere in this Note.\(^ {195}\)

The first abuse, which "call[s] into question" the fairness of the compensation, is known as the "classic waste" claim. It presents a

\(^{188}\) Complaint, *supra* note 3, at 46.

\(^{189}\) *Id.*

\(^{190}\) Cornell Mfg. Co. v. Mushlin, 420 N.Y.S.2d 231, 236 (N.Y. App. Div. 1979) (noting that the purpose of § 720 is to "provid[e] redress to corporations whose assets have been wrongfully wasted by its officers and directors.").

\(^{191}\) N.Y. NOT-FOR-PROFIT CORP. LAW § 720(a)(1) (McKinney 2003); N.Y. BUS. CORP. LAW § 720(a)(1) (McKinney 2003).


\(^{194}\) Marx, 666 N.E.2d at 1043.

\(^{195}\) See *infra* Part III.D.3. (duty of loyalty), Part III.D.2 (duty of care).
fairly high standard for plaintiffs to meet: "Under the classical waste standard, a court asks whether the consideration the corporation received 'is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid.'"\textsuperscript{196} For that reason, "[w]aste is often considered a difficult claim to make because a plaintiff must demonstrate that the company failed to receive even minimal consideration for the compensation awarded."\textsuperscript{197}

Courts typically employ multifactored tests to determine whether the compensation was fair on its face or whether the corporation received adequate consideration for its expense. A leading Delaware case involving waste examined the following factors in determining whether there was adequate consideration: "what executives of similar corporations were making, whether the company's financial condition had improved during the period of the executive's employment, and how much the executive was required to do in order to receive the base compensation and bonuses."\textsuperscript{198} In addition, a New York case used a multifactor test to assess whether the compensation of directors and officers of a bank was excessive.\textsuperscript{199}

Although New York courts have cited this case with approval,\textsuperscript{200} there are few recent cases applying such analysis. In Marx v. Akers, the Court of Appeals in New York dismissed a claim challenging the "excessiveness of director compensation."\textsuperscript{201} The court held that the complaint did not show compensation excessive on its face even though the directors of the company had given themselves raises while their services and responsibility to the company and its profitability had remained unchanged.\textsuperscript{202} The high standard for


\textsuperscript{197} Thomas & Martin, \textsuperscript{supra}, note 36, at 582-83.

\textsuperscript{198} Johnson, \textsuperscript{supra} note 196, at 156-57 (citing Saxe v. Brady, 184 A.2d 602, 610-17 (Del. Ch. 1962)).

\textsuperscript{199} Gallin v. Nat'l City Bank, 273 N.Y.S. 87, 114 (N.Y. Sup. Ct. 1934):

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.

\textsuperscript{200} See, \textit{e.g.}, Blake v. Blake Agency, Inc., 486 N.Y.S.2d 341, 349 (N.Y. App. Div. 1985) (explaining that the lower court "referee was fully justified in finding that [a director's] compensation was not excessive in light of his abilities and duties" (citing Gallin, 273 N.Y.S. 87)); \textit{see also} Serbaroli, \textsuperscript{supra} note 111, at 3 \& n. 6.


\textsuperscript{202} Id. at 1042-43.
proving waste prevented the complaint from moving past the pleading stage. As noted above, making a successful waste claim can prove to be "difficult."\(^{203}\)

A second approach to waste claims is used in cases involving closely-held corporations. New York courts use a less stringent reasonableness standard in these types of cases.\(^{204}\) In *Baker v. Cohn*, a case in which the compensation of directors in a closely-held corporation was at issue, a New York court held that “[i]t is common knowledge and experience that salaries of officers in an efficiently managed corporation must bear a reasonable relation not only to the services rendered but to the income of the business, both gross and net.”\(^{205}\) Under this approach, a court should use the amount of consideration, i.e., what services the director rendered in return for his salary as well as its proportion to the company's income to determine reasonableness.

In the complaint, Spitzer alleges that both Langone and Grasso breached their fiduciary duties under § 720(a)(1).\(^{206}\) Marx suggests that Spitzer could encounter difficulty in showing this particular type of breach, especially if a court stresses factors that focus on "whether the company's financial condition had improved during the period of the executive's employment"\(^{207}\) or whether even minimal consideration was given to the corporation.\(^{208}\) Under these standards, Grasso could argue successfully that there was, at the very least, minimal consideration received by the Exchange from his service as CEO. A letter from his attorney "argues that the NYSE's success during the 1990s—including the rise in total market capitalization—could be linked to Mr. Grasso's leadership and policies."\(^{209}\) In a letter in the *Wall Street Journal*, Ken Langone also asserted that Grasso provided

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203. See * supra* note 197 and accompanying text.

204. See *Baker v. Cohn*, 42 N.Y.S.2d 159, 165 (N.Y. Sup. Ct. 1942) (indicating that salaries of officers need to bear some reasonable relation to the services provided and the income generated); Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV 937, 962-963 (“Courts regularly pass on salary fairness, or lack thereof, in this area.” (citing *Baker*, 42 N.Y.S.2d 159)).


206. Complaint, * supra* note 3, at 47 (claiming that “Grasso’s receipt of unlawful, ultra vires payments” constituted waste under § 720(a)(1)); at 51 (claiming that “Langone’s misrepresentation to the NYSE Board of Director about the amount of compensation being paid to Grasso” constituted waste under § 720(a)(1)).

207. See * supra* note 198 and accompanying text.


209. Gary Silverman & Andrei Postelnicu, *Grasso Fights for $190M NYSE Pay*, FIN. TIMES, Feb. 27, 2004, at 1; see also Der Hovanesian & Elgin, * supra* note 71, at 78 (crediting Grasso with maintaining the market share of the NYSE during his term of office.).
more than minimal consideration: "Under his leadership, the value of seats on the exchange increased several-fold, new companies joined the exchange in droves and healthy revenue stayed consistent even through rough economic waters." 210 Focusing on these factors, Grasso has a strong case that there was no corporate waste.

But, if a court were to examine "what executives of similar corporations were making," Spitzer's case is stronger. 211 Spitzer could show that Grasso's total compensation was completely out of line with executives at other stock exchanges. According to the Exchange's press release, his base salary and bonus totaled approximately $2.4 million. 212 This salary and bonus are not entirely out of line with those offered by other exchanges. For example, the CEO of the National Association of Securities Dealers (NASD) received $2.1 million in salary and bonus payments, 213 while the CEO of the American Stock Exchange (AMEX) received $4.4 million. 214 The CEO of the Chicago Board Options Exchange received a base salary of $1.25 million. 215 No other disclosures, however, suggest that any stock exchange executive had a deferred compensation package in the range of Grasso's. The CEO of Chicago Mercantile Exchange Holdings Inc., did have options worth $65 to $70 million; however, the Mercantile Exchange is a public company and these options were still much lower than Grasso's compensation package. 216 Comparing his salary to these groups, even under the strict Marx v. Akers standard, suggests that Grasso may have a more difficult time proving waste.

Instead of using the Marx v. Akers standard, Spitzer could argue for application of the reasonableness standard. Although courts use the stricter Marx standard in cases involving public corporations, Spitzer could argue that the court should apply the more lenient, reasonableness standard because nonprofit corporations require greater protection of their resources in the same way that closely-held corporations do. 217 The Adelphi case did not discuss the claim of waste.

211. See supra note 198 and accompanying text.
212. Press Release, supra note 2.
216. Id. (deriving these numbers from Merc share prices at the time the article was published).
217. See Lee, supra note 19, at 946 (arguing the same).
nor have any other cases addressed it with regard to a nonprofit corporation. Spitzer may, therefore, have a viable argument for use of the reasonableness standard. Second, under his view of § 202(a)(12), Spitzer could argue that the legislature has indicated its intention to require all compensation paid to directors of nonprofit organizations be both “reasonable” and “commensurate with services performed” and thus any failure to do so is a waste of corporate assets.

If Spitzer succeeds in using the reasonableness standard, he can readily show that Grasso’s salary did not bear a reasonable relation to the income of the Exchange. In setting Grasso’s salary, the Compensation Committee used a “Comparator Group,” which “was comprised of enormously large and complex financial services conglomerates.” These companies were chosen based “not [on] comparability in size, revenue, or complexity, but rather [on] a subjective sense that these companies and the NYSE might ‘compete’ for executive talent.” The Wall Street Journal created the table below because “Dick Grasso has argued that his NYSE compensation was in line with executives at major financial firms.” As the table demonstrates, his compensation was not in line with these firms, and furthermore, it bore no relation to the Exchange’s income, as the reasonableness test requires. The table below includes the value of stock options in all cases except Grasso’s because “the exchange ha[s] no stock options.” More importantly, “the pay for the comparator group CEOs came in the form of options, which meant there was at least some risk. But Grasso’s money was never at risk,” making Grasso’s pay seem even more out of line.

218. Complaint, supra note 3, at 18.
219. Id. at 17.
221. Id.; see supra note 205.
222. Elkind, supra note 11, at 298.
223. Id..
<table>
<thead>
<tr>
<th>Executive (Company)</th>
<th>CEO's Compensation (in millions)</th>
<th>Firm's Income (in millions)</th>
<th>CEO's Compensation as a % of his Company's Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dick Grasso (NYSE)</td>
<td>$38</td>
<td>$54.6</td>
<td>$37.6</td>
</tr>
<tr>
<td>Henry Paulson (Goldman Sachs)</td>
<td>$22.49</td>
<td>$18.97</td>
<td>$9.51</td>
</tr>
<tr>
<td>James Cayne (Bear Stearn Cos.)</td>
<td>$19.73</td>
<td>$7.75</td>
<td>$22.89</td>
</tr>
<tr>
<td>David Komansky (Merrill Lynch &amp; Co.)</td>
<td>$32.61</td>
<td>$16.13</td>
<td>$14.44</td>
</tr>
<tr>
<td>Richard Fuld (Lehman Bros. Holdings, Inc.)</td>
<td>$28.30</td>
<td>$16.05</td>
<td>$12.48</td>
</tr>
</tbody>
</table>


The table demonstrates that not only was Grasso making more than executives that were arguably his counterparts, but unlike those executives, his compensation was virtually equal to, if not more than, the Exchange’s net income. “Common knowledge and experience” therefore suggests that Grasso’s compensation does not “bear a reasonable relation . . . to the income of the business.”224 In addition, the table above suggests that Grasso’s compensation was not “reasonable” and “commensurate with services performed” under § 202(a)(12).

Ultimately, if the court uses the higher standard in Marx v. Akers and focuses on factors that look at the benefit received by the Exchange, Grasso and Langone are more likely to be successful in showing that there was no waste.225 But, if the court uses either a reasonableness standard or compares Grasso’s salary to his peers at other Exchanges, or, even those in his “Comparator Group,” Spitzer is more likely to prove waste.226

3. Duty of Loyalty

“The ‘business judgment rule’ . . . yields to the rule of undivided loyalty. This great rule of law is designed ‘to avoid the possibility of fraud and to avoid the temptation of self-interest.’ ”227 The common law “requires directors to act in the best interests of the corporation

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225. See supra notes 206-210 and accompanying text.
226. See supra notes 218-216 and accompanying text.
and to refrain from conduct that might injure the company and its shareholders." But the duty of loyalty does not make any contract or transaction in which a director has divided loyalty "void or voidable for this reason alone." Rather, both codes—Business Corporation Law § 713 and N-PCL § 715—provide three protections for a self-interested transaction. First, a director can make a good faith disclosure of the material facts of his or her conflict to the board of directors, who may approve it by a majority vote of the disinterested parties. Second, following full disclosure, the shareholders or members, depending on whether it is a for-profit or nonprofit corporation, may approve the transaction. Lastly, the director or officers could "establish affirmatively that the contract or transaction was fair and reasonable as to the corporation at the time it was authorized [or approved] by the board, a committee or the members [or shareholders]."

These two code sections, only pronouncing the circumstances under which interested transactions will not be voided, do not provide for liability or, for that matter, indemnity for directors who engage in such transactions. The Board of Regents in Adelphi explained this loophole in the statute:

Section 715 speaks only to the circumstances under which a corporation may take legal action to void a contract where a conflict of interest exists. It does not absolve the interested trustee of any wrongdoing if the contract is ultimately found to be fair. To the contrary, while fairness to the corporation may somewhat relax the conflict of interest constraints, the director's conduct must, at all times, further the organization's goals and not his or her own interests.

In the Adelphi case, a conflict of interest arose when the board hired an insurance company of which one of the trustees was an owner. Because the trustee failed to disclose the material terms of the relationship between the insurance company and the school, the transaction was voidable unless the trustees could show it was fair and reasonable under § 715(b). While the defendants argued that the transaction was fair, the Board of Regents disregarded the fairness issue altogether. It found that the trustee with the conflict of interest

228. Thomas & Martin, supra note 36, at 584.
229. N.Y. NOT-FOR-PROFIT CORP. LAW § 715(a) (McKinney 2003); N.Y. BUS. CORP. LAW § 713(a) (McKinney 2003).
230. N.Y. NOT-FOR-PROFIT CORP. LAW § 715(a)(1); N.Y. BUS. CORP. LAW § 713(a)(1).
231. N.Y. NOT-FOR-PROFIT CORP. LAW § 715(a)(2); N.Y. BUS. CORP. LAW § 713(a)(2).
232. N.Y. NOT-FOR-PROFIT CORP. LAW § 715(b); N.Y. BUS. CORP. LAW § 713(b).
234. Id.
and Diamandopoulos both neglected their duty of loyalty and recommended their removal. Under the Board of Regents' reasoning, any conflict of interest that hinders an organization's goals while advancing those of the directors or trustees, regardless of fairness, can result in liability. Notably, this transaction was only one of many conflicts of interest involving the trustees of Adelphi.

In the attorney general suit in the Adelphi case, the court noted allegations that "Diamandopoulos exerted undue influence over the Board in order to cause it to purchase [an] apartment [for the University which he used as a personal residence] and there are allegations that [he] was responsible for appointing the members of the Finance Committee, which could possibly have tainted their recommendation." Diamandopoulos' self-interest in the transaction and use of his position to influence others suggested that he violated his duty of undivided loyalty, leading the court to deny the defendants' motions to dismiss.

Similarly, Spitzer alleges that both Grasso and Langone violated their duties of loyalty to the NYSE. Spitzer's complaint is peppered with instances of Grasso's conflicts of interest and undue influence over the other directors of the Board. The complaint stresses that "Grasso had the authority unilaterally to select those who served on the Compensation Committee. He also regulated most of them. This conflict allowed Grasso to influence directors who might have wanted to pay him less, and to reward directors who would pay him more." In addition, the fact that Ken Langone, Home Depot co-founder and director, "headed the NYSE compensation committee when it approved Grasso's lucrative pay package" while Grasso simultaneously served on Home Depot's board of directors, suggests that Langone also had a significant conflict of interest.

Under N-PCL § 715, Grasso's compensation transactions could be ratified by a majority of the members or disinterested directors upon full disclosure or by a showing of fairness. The members of the Exchange did not vote on Grasso's compensation, and it seems

235. Id.
236. Id.
238. Id. at 270.
239. Complaint, supra note 3, at 46, 50.
240. Id. at 7-10, 16, 38.
241. Id. at 7.
unlikely from the analysis above that fairness could be shown unless a *Marx v. Akers* approach is used.\textsuperscript{244} This leaves disinterested director approval as the only way to prevent voiding Grasso’s compensation awards. Because a majority of the NYSE Board approved all of the awards, Spitzer may not be able to succeed in voiding the transactions.\textsuperscript{245}

In order to void them, Spitzer would have to prove, as the complaint alleges, that the directors on the Board, not just Langone, were “interested” directors\textsuperscript{246} or that there was not a full disclosure of the facts. Proving directors’ interest may be difficult because it is based on an abstract notion of Grasso’s ability to influence and pressure other directors. Moreover, there appears to be little concrete evidence of this influence.\textsuperscript{247} Proving lack of full disclosure is equally difficult: “Some directors insist they knew every penny Grasso got. Others say they were confused. And still others now believe they were misled.”\textsuperscript{248} If Spitzer fails to show interest or lack of full disclosure, Grasso would be able to keep the entire compensation package.

Even if Grasso’s compensation awards are not voided, under the Board of Regents analysis,\textsuperscript{249} Grasso and Langone would not be absolved of liability for violating their duty of loyalty. In the Board of Regents proceeding, this distinction was important because the fairness of the transactions was irrelevant to the issue of whether the trustees should be removed.\textsuperscript{250} In this case, there would be few practical implications, as Grasso and Langone are no longer directors and Spitzer’s main concern is voiding the compensation transaction.

\begin{footnotesize}
\begin{enumerate}
\item 244. See infra Part III.D.2.
\item 245. See generally Complaint, supra note 3.
\item 246. See Complaint, supra note 3, at 7 (alleging that Grasso regulated those who served on the Compensation Committee, which allowed him to influence the directors); see also Elkind, supra note 11, at 298 (“Many directors came from the securities industry, which, of course, Grasso regulated . . . . Grasso’s status as a regulator made it difficult for Wall Street board members to confront him and gave them strong incentives to make him happy.”).
\item 247. In his own words, Langone illustrates the difficulty in showing Grasso’s improper influence:
\begin{quote}
Having been there, I know the records will prove it was all above-board, well-vetted and fair. It is absurd to suggest that the brightest minds and keenest thinkers on Wall Street were befuddled by the complexity of Richard Grasso’s compensation package – especially one composed just like their own. Might as well say NASA couldn’t launch a Goodyear blimp.
\end{quote}
\end{quote}
\item 248. Id. at X.
\item 249. See text accompanying note 233.
\end{enumerate}
\end{footnotesize}
Finally, similar to the duty of care analysis, Spitzer can rely on § 202(a)(12) in arguing that Grasso and Langone breached their duties of loyalty.\textsuperscript{251} Under this analysis, Grasso's mere acceptance of the compensation arguably is a violation of his duty of loyalty.\textsuperscript{252} While Spitzer does not cite § 202(a)(12) in his claim against Langone, there seems no reason why a similar argument could not be made against Langone.

To summarize, Spitzer may be successful in proving that Grasso and Langone breached their duties of loyalty, but it will probably be much more difficult to argue that the transactions should be voided because a majority of the board approved his compensation. Additionally, the lack of concrete evidence will make it difficult to prove an improper influence over these directors.

IV. PROPOSALS

Commercial nonprofit organizations like the NYSE have much in common with typical business corporations. For that reason, the business corporation law serves as a good framework for large commercial nonprofits. In addition, N-PCL § 202(a)(12), which requires nonprofit corporations to set reasonable compensation for officers and directors, provides a strong weapon in any action involving excessive compensation at a nonprofit corporation, provided Coffee's second interpretation is accepted. The filing of Spitzer's complaint alleging breaches of the duties of care and loyalty, as well as corporate waste, further suggests that the law provides a sufficient outlet to bring suits alleging excessive director compensation at nonprofit corporations.

Yet it is not certain that Spitzer will prevail, nor is it certain that the N-PCL will provide adequate relief in all cases of excessive compensation at nonprofit organizations. Because the NYSE serves an important public regulatory function, members lack financial incentive to sue, and disclosure requirements of nonprofit corporations are less rigorous than those applicable to for-profit corporations, this Note proposes modifications to certain aspects of the N-PCL when applied to the Exchange and other nonprofit corporations that serve an important public role. This Note proposes: (1) liberalizing the current standing and demand requirements to permit members and other beneficiaries to initiate derivative suits more easily; (2) maintaining the duty of care and business judgment rule; (3)

\textsuperscript{251} See text accompanying notes 137-145.
\textsuperscript{252} Id.
broadening the duty of loyalty and waste claims that can be brought; and (4) subjecting the Exchange to stricter disclosure requirements.

A. Standing and Demand

Member suits and attorney general actions provide effective vehicles for bringing suit against nonprofit corporations in cases of excessive compensation. Due to the limited resources in the attorney general's office, however, the attorney general cannot pursue every possible action against every nonprofit organization.\(^{253}\) The publicity surrounding Grasso's compensation probably increased the chances of the attorney general's involvement in this case, but this may not hold true in all cases of executive compensation. While member standing provides a good alternative to the attorney general, members may choose not to sue, either because they fear retaliation, as was the case with the Exchange, or, more likely, because they lack a financial incentive.\(^{254}\) Furthermore, many public nonprofit organizations do not have members and therefore are left to rely solely on the attorney general to take action.

This Note proposes that any party with a "sufficient special interest" have standing to file a derivative suit against a nonprofit corporation for excessive executive compensation.\(^{255}\) While New York law specifically prohibits standing by anyone other than those listed by statute, some courts have given standing to parties with a "sufficient special interest" in a charitable institution.\(^{256}\) These actions would be similar to derivative suits in that the corporation, "except in the most unusual circumstances, ... should be the recipient of any monetary recovery."\(^{257}\) In the instant case, companies listed on the Exchange would have a "sufficient special interest," thereby adding a third category of potential plaintiffs. In cases involving charities, this type of standing could give large donors an opportunity to sue; or in cases like Adelphi, students, alumni, faculty,

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253. Lee, supra note 19, at 933.
254. See supra note 102 and accompanying text.
256. See, e.g., Holt v. College of Osteopathic Physicians & Surgeons, 394 P.2d 932, 934 (Cal. 1964) ("The prevailing view of other jurisdictions is that the Attorney General does not have exclusive power to enforce a charitable trust and that a trustee or other person having a sufficient special interest may also bring an action for this purpose."); RESTATEMENT (SECOND) OF TRUSTS § 391 cmt. c (1959).
257. Goldschmid, supra note 255, at 652.
and donors could directly sue the university for monetary damages to be paid back to the university.

In each of these cases, the plaintiffs, whether a listed company suing the Exchange, a donor suing a charity, or a student suing a university, have both a financial stake and vested interest in seeing that its respective nonprofit corporation is properly run. In the case of the listed companies, the Exchange trades the member-plaintiffs' stocks, meaning that their profitability depends on the Exchange's proper functioning. Furthermore, listed companies would want to assure that the NYSE remains a viable institution so that there is a large marketplace for its securities. Likewise, a donor does not want to see his or her donations go to a CEO's private use, and a student wants his or her tuition money to provide educational services and to improve the reputation of the school. In each of these circumstances, the proposed plaintiffs would have a "sufficient special interest" to confer standing.

Although "[1]ess stringent standing rules would undoubtedly open the nonprofit sector to the danger of weak (but lawyer driven) or spiteful litigation," this danger could be curbed in three ways. First, statute or judicial mandate could narrow the interpretation of "sufficient special interest," thereby limiting parties who would have standing. Second, requiring parties with this "sufficient special interest" to meet the 5 percent rule would diminish the risk of frivolous suits. Third, "statutory provisions or court decisions providing that legal costs and fees will be awarded against plaintiffs and their lawyers if an action is unreasonably brought or litigated could moderate some of the danger." Under current practice, the attorney general is often the only party capable of bringing a suit against a nonprofit organization. Adding a third category of possible plaintiffs may increase the number of suits against nonprofit corporations and result in better policing of breaches of a fiduciary duties.

This Note further recommends eliminating the demand requirement for members and waiving demand in the proposed "sufficient special interest" cases. As noted above, if a member is required to show demand futility, the member will be faced with a fairly high burden. While proving demand futility would not be necessary in Grasso's case, it may be necessary in other executive

258. Id.
259. Id.
260. See supra note 119 and accompanying text.
261. See supra note 120 and accompanying text.
compensation cases that do not create as much publicity and the resultant change in board of directors. In addition, due to the Exchange’s important public function and its status as both an SRO and a nonprofit corporation, the members, unlike shareholders, should not be faced with a hurdle to a suit, especially in a case involving breaches of fiduciary duties. For the same reason, other parties with a “sufficient special interest” should not be faced with the same hurdle that shareholders face.

B. Fiduciary Duties

1. Duty of Care

Courts may use three possible standards to measure a nonprofit board of directors’ duty of care: (1) the corporate standard, (2) the trustee standard, or (3) an ordinary negligence standard. The corporate standard, as discussed above, is a grossly negligent or reckless standard. The trustee standard, traditionally used for charitable corporations, “is generally regarded as even more stringent than the ordinary negligence standard . . . [because it] is measured against the level of care exercised by a trustee managing his own property . . . [and] entails an affirmative duty of caution.” Although this standard would make it easier to hold directors liable for a breach of their duty of care, its stringency could deter directors from serving on the boards of nonprofit corporations for fear that they would routinely be sued for any decision that they make.

One commentator has recommended a true ordinary negligence standard for nonprofit directors based on the belief that the business judgment rule should not apply to nonprofit corporations due to the numerous differences between nonprofit corporations and for-profit corporations. “The primary argument articulated in defense of the business judgment rule is the need to encourage risk-taking . . . . Without the rule, many fear that directors and officers would become excessively cautious.” But, unlike for-profit corporations, “[n]onprofit organizations should be more cautious in preserving their resources because their obligation to donors and patrons is not to
maximize profits, but rather . . . to provide services to its members or the general public."267 Thus, an ordinary negligence standard is not needed with nonprofit corporations because they do not need to take risks in order to make a profit.

This Note recommends maintaining the current corporate standard duty of care as modified by the N-PCL's more expansive statutory duty of care and § 202(a)(12).268 Three reasons support this proposal.

First, while nonprofits must be cautious with their resources, risk-taking is still critical in the nonprofit context. As one commentator explained, "[t]here is wisdom in protecting nonprofit directors from hindsight review of their unsuccessful decisions and encouraging them to change the configuration of their nonprofit enterprises (e.g., expand a nonprofit museum, produce a new education or health care product . . .)." Public-serving nonprofit organizations, especially large commercial ones like the NYSE, need to be able to take risks in order to better serve the public. In order to maintain a stable market force, the NYSE necessarily will need to take risks.269 The members of the NYSE, as well as the public shareholders of the listed companies, presumably want the Exchange to be able to act without the fear that a court will review every decision under a pure ordinary negligence standard.

Second, the Adelphi case suggests that where the board has acted particularly egregiously, courts will find that such board decisions violated the business judgment rule and the board's duty of care.270 The business judgment rule thus does not act as a per se prohibition on review of board decision-making. In addition, an expansive reading of N-PCL § 717(a) adds a further protection by suggesting a slightly higher duty of care for nonprofit directions.271

Finally, if courts interpret § 202(a)(12) as the Board of Regents in the Adelphi case and Spitzer have, it will serve as an effective curb on awards of excessive compensation. This interpretation will ensure that any award or acceptance of unreasonable compensation to a nonprofit executive or director will result in a breach of the duty of care.272

267. Lee, supra note 19, at 946.

268. See supra notes 152-155 (discussing the more expansive statutory duty of care), Part III.C (discussing § 202(a)(12)).

269. Der Hovanesian & Elgin, supra note 71, at 78-79.


272. See supra notes 185-189 and accompanying text.
The Exchange does serve an important public regulatory function, as do many other nonprofits that serve the public. These nonprofits should be cautious in preserving their resources; however, the protection provided through the other proposals in this Note should adequately address this concern.

2. Waste

Courts have used three different standards to define waste. The first, known as the "classic standard," is nearly identical to the New York waste standard used in *Marx v. Akers*. It examines whether "the consideration the corporation receives 'is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid.'" As noted above, satisfying this classic standard of waste can be difficult. A second, higher standard is the reasonableness standard used in cases involving closely-held corporations, also discussed above. A third approach is even stricter than the reasonableness standard and Delaware courts have used it to assess the fairness of stock options. This standard, known as the "proportionality standard," has two prongs. The benefit prong requires that all compensation "contain conditions, or that surrounding circumstances are such that the corporation may reasonably expect to receive the contemplated benefit from the grant of options." The value prong requires "a reasonable relationship between the value of the benefits passing to the corporation and the value of the options granted." While the classic standard only examines "the value of the benefit and whether a person of reasonable business judgment would call the benefit a waste," the proportionality standard analyzes whether the corporation is actually receiving a benefit from the compensation.

This Note proposes application of the reasonableness standard. This standard is consistent with N-PCL § 202(a)(12), which requires reasonable compensation to be paid and would further enforce the use of a reasonableness test for compensation awards. The stricter

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273. See supra Part II.A.2.
274. Lee, supra note 19, at 946.
276. Johnson, supra note 196, at 155.
277. Thomas & Martin, supra, note 36, at 582-83.
278. See supra text accompanying notes 204-210.
280. Id. at 157-60.
281. Id. at 161-62.
proportionality standard is unnecessary because reasonableness, as demonstrated above in the Grasso case, seems likely to curb excessive awards of compensation. Moreover, courts accustomed to applying a reasonableness analysis may have difficulty with the subjective elements of the proportionality standard.

The less stringent classic standard provides inadequate protection to the NYSE members and investors. As discussed above, Grasso may be more likely to prevail under this standard. This example reinforces the theory that waste is very difficult to prove.

Protection against corporate waste is especially important with respect to nonprofit corporations because resources typically are limited and should be completely devoted to serving the public. While the NYSE's resources are not limited to the extent that it can continue to require fees from its members, its resources, like that of all public nonprofit corporations, should not be wasted, but rather spent in ways that better serve the public or its members.

3. Duty of Loyalty

Four approaches have been advanced to hold nonprofit directors and officers liable for duty of loyalty violations. First, the corporate standard, exemplified by § 715 of New York's N-PCL and § 713 of the Business Corporation Law, provides three methods for protecting transactions voidable due to a conflict of interest. This standard permits self-dealing transactions to be ratified easily by a majority vote of disinterested directors or members and does not adequately protect against conflicts of interest. In discussing its application in the for-profit setting, one commentator found that the corporate standard does not provide effective deterrence of director misconduct for two reasons. First, the approval is rarely disinterested. As discussed above, Grasso allegedly influenced other directors whose companies were listed on the Exchange. Yet, proving this influence may be difficult due to the abstractness of

282. See supra notes 209-226 and accompanying text.
283. See supra notes 206-210 and accompanying text.
284. Thomas & Martin, supra, note 36, at 582-83.
286. Id.
287. See J. Robert Brown, Jr., Speaking With Complete Candor: Shareholder Ratification and the Elimination of the Duty of Loyalty, 54 HASTINGS L.J. 641, 654 (2003) ("[D]isinterested shareholders will be influenced by the board of directors" through its proxy statements and by its ability to use "the corporate treasury...to spend conspicuous sums to obtain approval of the interested transaction.").
influence or pressure. Second, "[d]isinterested approval presupposes full disclosure of all material information." Because directors may not always make full disclosure and because courts differ on their interpretation of materiality, "[i]nadequate information raises the risk that shareholders will approve an unfair transaction." Similarly, members or directors may not possess all material information relevant to a possible conflict of interest and could, like shareholders, be easily swayed by statements and "campaigning" from the CEO. This occurred at the NYSE, where directors were not given full information about Grasso's pay package, and at Adelphi, where the trustees were not fully informed of other trustees' conflicts of interest.

A second approach to duty of loyalty violations is an absolute prohibition on any self-dealing transactions; however, this type of prohibition could deter instances of self-dealing that may be useful to the board. For instance, if a member of the board of directors could get the Exchange a cheaper rate on an electronic system that would speed the processing of sales on the Exchange floor because his company owned the machine, members and companies would most likely want to ratify this transaction. With a blanket prohibition against self-dealing, though, ratification would be impossible. A third proposal would "require advance administrative approval of all self-dealing transactions" by an appropriate state agency. New York probably would not "have the budget resources to develop the requisite administrative expertise," making this option unworkable.

The final approach, and the one which this Note endorses, would consider any "self-dealing transaction...voidable unless the transaction's proponents can affirmatively establish its fairness to the corporation at the time of the transaction." Courts currently use this standard for transactions entered into by controlling shareholders. Because it would result in judicial review of the

288. See supra notes 246-247 and accompanying text.
289. Brown, supra note 287, at 659 (emphasis added).
290. Id. (finding that "Delaware courts consistently refuse to require disclosure of material information in at least two critical circumstances").
291. See, e.g. Complaint, supra note 3, at 21; see also note 248 and accompanying text.
293. Hansmann, supra note 18, at 569-72.
294. DeMott, supra note 68, at 144.
295. Id.
296. Id. at 143; Goldschmid, supra note 255, at 648 (arguing for a fairness test).
297. DeMott, supra note 68, at 144.
merits of any self-dealing transaction, this standard should effectively
deter potential abuses by directors and officers. In addition to
deterring abuses, a higher standard for nonprofit corporations is the
fairest approach considering that "[t]hese corporations... receive
everseous tax benefits." "[I]f commercial nonprofits are dissatisfied
with this arrangement, they can easily convert to for-profit status if
they feel the benefits... outweigh the tax and public subsidies." "Business and financial relationships, familial relationships, and 'taints' to the process, for example, which might be considered of
marginal concern in the for-profit context, should be resolved in favor
of review under loyalty standards... when nonprofit institutions are
involved." This principle is especially true for public nonprofits like
the Exchange, which serve an important regulatory or public-type
function. It undermines the power and prestige of the Exchange as a
market-regulator when it fails to regulate its own directors.

C. Disclosure

"In the for-profit sector, easier-to-read disclosures about details
of executive compensation arrangements are an integral part of the
SEC regulation of reports to shareholders." It is logical that
"disclosure of financial... information about nonprofit entities would
make them easier to monitor and would enhance accountability." New York Law requires nonprofit corporations to disclose certain
financial information annually. In November 2004, the SEC
"unanimously proposed rules... that would require... the nation's
stock exchanges... to disclose how much they pay their five top
executives." The SEC's director of market regulation also stated, "It
is my belief that SROs should comply with substantially all of the
transparency and disclosure requirements of public, listed

298. Id.
299. Lee, supra note 19, at 948 (arguing for an ordinary negligence standard for duty of
care).
300. Id. at 948-49.
301. Goldschmid, supra note 255, at 651.
302. Consuelo Lauda Kertz, Executive Compensation Dilemmas in Tax-Exempt
303. Id. at 857-58.
304. N.Y. NOT-FOR-PROFIT CORP. LAW § 519 (McKinney 2003).
Independent Board Majorities, WASH. POST, Nov. 10, 2004, at E03. These rules have not been
officially adopted yet.
Because the exchanges serve such an important regulatory function and indirectly serve the investing public, they should also be subject to the same reporting requirements as the companies that trade on their floors. This Note recommends that the extensive disclosure requirements regarding executive compensation, currently imposed on the listed companies, be extended to other large nonprofit corporations that serve the public. Their financial information should be as public as that of large for-profit corporations.

V. Conclusion

The New York Stock Exchange is an important and unique institution. Each day it serves a wide variety of investors by providing a place to trade securities and, hopefully, make money. Because the Exchange is structured as a Type A nonprofit corporation, New York nonprofit corporation law governs its operation. The N-PCL, which is largely based on for-profit corporation law, provides a solid framework for reviewing charges of excessive executive compensation by nonprofit corporations. The Grasso case demonstrates, however, that the N-PCL may not provide sufficient relief.

For these reasons, this Note proposes five changes to the N-PCL when applied to the Exchange and similar nonprofit corporations that serve important public roles. First, standing should be expanded to permit parties with a "sufficient special interest" to bring derivative-type actions. Second, demand should be abolished. Third, a reasonableness standard for waste should be used. Fourth, a duty of loyalty standard that examines the fairness of any self-interested or conflicted transaction is recommended. Finally, the state should impose greater disclosure requirements so that executive compensation is reported clearly in the same way that SEC guidelines require public companies to report compensation.

Although the ultimate outcome of the Grasso case may result in the curbing of excessive compensation at the Exchange and in substantial internal reforms, not every case of compensation or violation of fiduciary duties will receive this type of publicity and its consequent internal reactions. For these important but less publicized cases, stricter standards are necessary to assure the full protection of the public who rely on the efficient functioning of nonprofit corporations that serve them. The proposed changes should create a fairer balance between potential plaintiffs and the corporations so that
cases alleging serious fiduciary duty violations can be heard without imposing excessive costs on the corporations in defending such litigation.

Rachel Penski

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Duties to Subjects in Clinical Research


Clinical trials pose a fundamental conflict between physicians' commitment to protecting the medical best interests of current patients and the goal of producing scientific knowledge for the potential benefit of patients in the future. While this conflict has long been of interest to physicians and bioethicists, it has largely escaped the attention of legal scholars. That is likely to change, however, as a growing wave of litigation brought by individuals injured in clinical trials will force courts to determine the nature of researchers' legal obligations to subjects. In making these determinations, this Article argues, courts must recognize that medical research is fundamentally different from ordinary clinical treatment, in terms of both its underlying purposes and its methodology. In light of these differences, requiring researchers to adhere to the same therapeutic obligations as treating physicians, as some commentators have advocated, would be tantamount to a virtual prohibition of clinical trials, an outcome that courts should reject. At the same time, it would be a mistake to hold that researchers have no duty whatsoever to protect the medical best interests of individual subjects. This Article therefore develops an alternative framework for conceptualizing researchers' duties to subjects, using principles governing conflicts of interests in fiduciary relationships a starting point for analysis. These principles demonstrate that it is possible to protect vulnerable individuals in dependent relationships without absolutely precluding the pursuit of goals that potentially conflict with those individuals’ overall welfare. Importantly, however, consent is generally insufficient to justify deviations from the pursuit of the best interests of the beneficiary in a fiduciary relationship; instead, the law imposes additional requirements to ensure that such deviations are objectively fair. After explaining why a similar approach makes sense in the context of clinical trials, this Article provides a specific framework for using those principles to resolve conflicts between the pursuit of scientific knowledge and subjects' medical needs.