H.S. Grace & Company, Inc.

Corporate Governance: Macro vs. Micro
Part I – Executive Compensation

The macro elements of corporate governance such as the Sarbanes-Oxley Act have received continuous media attention, and properly so. Organizations such as the National Association of Corporate Directors (NACD) and Financial Executives International (FEI) stand ready to speak for business and industry on such matters, and stress the need for proper consideration of the associated costs and the benefits that flow from this and other various legislative and regulatory pronouncements. These macro elements contribute to the conceptual framework for corporate governance. They represent issues of critical importance to Boards and Senior Management.

Most securities law based litigation, however, focuses on the micro elements of corporate governance. Legal challenges question the appropriateness or inappropriateness of certain actions, taken or not taken. To answer them effectively, there must be an examination of the roles and responsibilities of the various parties involved in the specific situation at that point in time. Customary and ordinary guidelines must be formulated for the particular situation and a determination made of whether these guidelines were observed.

The experience of H.S. Grace & Company, Inc. (HSG) and its team members has made clear that the division of labor is specific to that firm at a given point in time. Our writings have continued to emphasize this in connection with the structuring of corporate governance processes and the evaluation of actual or alleged breakdowns in corporate governance, either inside of or outside of a litigation proceeding.

Two recent assignments of HSG highlight the importance of examining the micro elements of corporate governance.

- Decisions of a Compensation Committee – Plaintiffs alleged that a Compensation Committee failed to properly address its duties in the hiring of a high-profile individual. Plaintiffs pointed to the fact that the meeting to approve the hiring of the individual was very brief, and much of the time was spent discussing a bonus for the Chairman of the Compensation Committee in connection with the hiring. Plaintiffs complained that, after this short and deficient meeting, the Compensation Committee recommended the hiring of the executive at the Board meeting which immediately followed. HSG assisted Counsel in examining the manner in which the Compensation Committee was structured, and the process the Committee had employed in connection with the hiring of this executive. It was determined that the employment agreement with the executive was negotiated by the Chairman of the Compensation Committee and another Senior Member of the Compensation Committee (who had formerly been the Chairman of the Firm), both of whom understood the Firm's compensation structure and were experienced in the negotiation of executive employment agreements. Further, it was determined that these two individuals had employed an outstanding compensation consultant who provided input and assistance throughout the negotiations. The negotiation process was rigorous and thorough, and through the involvement of these two Board Members in the negotiations, both the Compensation Committee and the Board were represented in and informed of the negotiations on a timely basis. The Court's ruling in favor of the Defendants confirmed the appropriateness of the actions of the Compensation Committee.

- No Fault Termination Compensation – Plaintiffs alleged that the Defendant firm grossly overpaid a Senior Executive who had been terminated a short time after joining the firm. The Plaintiffs reported the compensation paid to the executive in connection with the termination, and the reported dollar amount received considerable media attention. HSG, in examining the Plaintiffs' calculations, demonstrated that the Plaintiffs had incorrectly failed to monetize the value of the executive's options after they had vested at the time of termination. Instead, the Plaintiffs used an option pricing type model which produced a value over twice as large as the actual monetized value. As HSG pointed out, once the executive's options had vested, the executive had an amount of cash which could be invested in vehicles from treasury bills to a Brazilian goldmine. The vesting of the executive's options provided the opportunity, but not the requirement, that the executive continue to hold the options in the company. Subsequently the options turned out to be worthless. The Court ruled for the Defendants, and the Ruling noted the excessiveness of the Plaintiffs' estimate.

While the macro elements of corporate governance set the framework for Boards and Senior Management, the micro elements of corporate governance are crucial in evaluating the appropriateness of corporate governance processes and actions.

H.S. Grace & Company, Inc. is a team of senior executives who diagnose and resolve critical corporate problems in business governance, operations, finance and control. With more than 1,000 years of experience, our goal is to help companies enhance shareholder value, protect reputation and their long-term ability to succeed, avoid and manage litigation, and navigate major changes such as mergers and acquisitions or bankruptcies. We often serve as consulting and testifying experts, identifying and analyzing critical business issues.

Houston: 4615 Southwest Freeway, Suite 625, Houston, TX 77027
(713) 572-6800 • FAX (713) 572-6806

New York: 300 E. 57th Street, #18A, New York, NY 10022
(212) 644-8620 • FAX (212) 813-1779

Email: hsgraceco@hsgraceco.com
Visit us at: http://www.hsgraceco.com