Director pay: Overhaul in progress

A 'premium' for board leadership: Changes in board governance — in terms of time, effort, role, and responsibility — are beginning to be matched by changes in board compensation.

By Judy Canavan and Donald Gallo

UNTIL THIS YEAR, director compensation practices tended to be generic. Differentiation in pay levels was historically driven by company size and industry rather than individual director contribution. A new factor is now influencing board pay — the role a director is required to play.

As described in the accompanying sidebar (see page 50), there is a growing imbalance between the new demands and traditional rewards of directorship. There is now heightened scrutiny, more stringent governance requirements, and greater intellectual and time requirements placed on directors; and, for certain roles, these demands are even magnified. In response, companies are considering very explicit changes to board pay — changes that reflect the contributions and role of the individual director.

There are two key categories of directors whose pay will be most affected:

• Leadership roles such as board chair, committee chair, and lead independent directors.

• Those in roles in which directors bear the greatest "burden of effort," generally translating into the greatest expertise and time. The primary focus is on the members of the audit committee, but we expect that this will broaden as other committees (e.g., compensation, governance) increase demands on directors.

A premium for board leadership

The CEO currently chairs most companies' boards. According to the Conference Board, in 66% of the companies surveyed, the CEO is also the chair of the board, while only 22% reported having an independent outside chair. Only 6% acknowledged having a lead director.

However, this will likely change. Institutional Shareholder Services (ISS) recommends voting for shareholder proposals requiring that the position of chairman be filled by an independent director, unless there are "compelling reasons" to recommend against the proposal. The Conference Board also asserts that if a company chooses to have its CEO serve as the chair, then a "lead independent director" should be an appointed position. The National Association of Corporate Directors and others also have similar recommendations.

To respond to these demands, more companies are considering the creation of roles such as lead independent director and independent board chairs. Additionally, boards are seeking directors who bring new expertise. This could have a dramatic impact on compensation for these positions as the demand for these roles outpaces the potential supply.

Judy Canavan is a senior consultant with Sibson Consulting (www.sibson.com), a division of The Segal Co., and leads the firm's work in governance research. **Donald Gallo** is a principal of Sibson and heads the firm's corporate governance practice.

Even now, companies that have non-CEO chairs or lead independent directors are taking steps to acknowledge the additional time, effort, and responsibility through additional pay for these roles.

To shed light on the degree to which companies are paying a premium for these roles, we reviewed the compensation levels for three leadership roles:

1. The chair of the board, who is the company's former CEO.
2. The chair of the board, who is fully independent (i.e., was never an employee, is not the founder, and has no other material associations with the company).
3. The lead independent director.

In the accompanying table, the pay levels for these positions are compared with the overall director pay levels for the company. For instance, the chair retainer is calculated as a percent of the regular board member retainer. These data reveal some interesting findings:

• Companies pay their former executive chairs handsomely relative to other board members. Median total compensation levels are:

— Three times more than regular board members, and

— Almost twice that of their fully independent chair counterparts.

Often these pay levels are designed as part of a transition package and are meant to recognize the level of knowledge and insight that these former executives bring to the table.

• Independent chairs earn, on average, 36% more than regular board members.

• Most companies pay lead independent directors a premium, but a few do not:

— Companies that pay a premium are providing 16% more than regular directors. Interestingly, this premium is about half as large as that for independent chairs.

Directorship has its rewards ... or does it?

With nearly daily revelations of failed board oversight fueling a crisis of confidence in American corporate governance, why would anyone want to be a director? Because, for many, the rewards of directorship have outweighed the demands. This formula, however, has been strained by recent developments:

• *Time demands are greater,* with more frequent meetings (e.g., of the audit committee) and greater meeting preparation time. Our experience suggests that increased time demands will stabilize, but not decrease to past levels anytime soon.

• *Risks — real and perceived — have increased.* These include legal risks from heightened regulation and litigation, as well as more generalized concerns about governance transparency and effectiveness at companies on whose boards directors serve.

• *Increased need for specific expertise* such as finance and accounting, and for independent directors who can fill such roles as board/committee chair and lead independent director. In fact, we have seen many companies considering ways to enhance board expertise beyond that required by Sarbanes-Oxley.

While demands are escalating — in some cases, dramatically — rewards are changing, too, and may not be keeping pace with demands:

• *Nonfinancial rewards are essentially unchanged.* Most directors join boards for nonfinancial rewards, such as new business perspectives, relationship development, and the ability to make a contribution. While these continue to be important, they may not be enough.

• *Collateral business benefits are becoming almost nonexistent* as regulatory developments and the push for board independence have made these benefits inappropriate. In the past, these included business contracts, consulting arrangements, transaction finder's fees, and the like.

• Although many companies have added stock to the board compensation mix, this has, in many cases, *replaced lucrative perquisites* like retirement income plans, insurance, and use of company property.

• *Cash compensation remains in flux.* Many directors believe that retainers and meeting fees are *de minimis,* while critics contend that board compensation is lucrative relative to the demands.

The result is a potentially widening shortfall between the personal rewards of directorship and the demands of board service. If unchecked, this could exacerbate the difficulties that companies are facing in attracting and retaining necessary board talent.

To attract and retain qualified directors, companies will need to ensure that the rewards of directorship continue to outweigh the demands. And, while companies can take steps to decrease certain demands associated with risk, the net effect is that companies can do little to reduce the overall demands of directorship. For this reason, companies are exploring ways to enhance the rewards, while holding to a high standard of propriety.

While some directors will earn greater satisfaction from more rigorous board oversight and engagement, and some companies will embrace greater director education, there is little else companies can do to improve nonfinancial rewards of directorship. Regulations and demands for greater director independence will continue to sharply curtail the use of collateral business benefits, leaving companies the latitude to change only the financial rewards of directorship — including cash, stock, and benefits.

— Judy Canavan and Donald Gallo

— However, 20% of companies with lead independent directors are not paying any premium. As more companies create these positions and the role gets further defined, we anticipate that a greater number of companies will pay a premium.

Pay for leadership role as a percent of overall director pay

	Non-CEO Chairs		Lead Independent Directors	
Element of compensation	**Previous CEOs**	**Fully independent**	**All combined**	**Companies that pay a premium**
Board Retainers	565%	173%	125%	143%
Board Per Meeting Fees	100	100	100	100
Total Compensation (including stock)	302	136	105	116
Number of Companies	13	34	15	12

Source: Sibson Consulting

Adjustments to committee compensation

Committee members typically have been paid a combination of retainer and meeting fees. Historically, there has been little variation in these pay levels. Rarely did a company pay members of one committee differently than another committee, and most companies pay the same retainer and per-meeting fees. In addition, until recently, many companies had considered eliminating this differentiation for committee membership altogether.

Companies are now moving toward greater pay differentiation in recognition of the added time and effort that is now placed on members of certain committees. Based on a survey conducted recently by Sibson Consulting, we found that:

— 55% are changing audit committee pay,

— 32% are changing compensation committee pay,

— 25% are increasing committee chair retainers,

— 13% are increasing committee retainers, and

— 13% are increasing committee fees.

For those companies that are making changes, they are substantial:

• The median committee chair retainer is undergoing the most substantial changes:

— Among companies that are implementing committee chair retainers for the first time, these retainers are twice the size of historical levels ($10,000 versus $5,000).

— Among companies that already have committee chair retainers, the median increase is 77% (or $5,000).

• Overall committee retainers are also increasing:

— Companies that are implementing retainers for the first time are setting them 25% higher than historically typical levels ($5,000 versus $4,000).

— Those companies that already have committee retainers are planning increases of 38% on average.

• Among companies changing committee meeting fees, the median increase is 33%.

Revisions to equity compensation

We found that companies also are examining their use of equity for compensating directors. In our survey, 23% of the companies indicated that they plan to change the mix of stock and cash for directors. Currently, companies are predominantly using stock options as their grant vehicle. Of the 78% of companies that provide some form of equity to their directors (with several companies offering more than one stock plan):

— 66% provide annual stock option grants,

— 8% provide annual restricted stock grants,

— 12% provide annual outright grants of shares of stock, and

— 31% provide initial grants of some form of stock upon election to the board.

Although many companies adopted stock option plans for directors during the 1990s to increase the "alignment" of board pay with shareholder value, companies will continue to encourage stock ownership by developing programs to increase the personal investment holdings of directors in the company's stock. As Hardwick Simmons said shortly before stepping down as head of the Nasdaq stock market: "If every one of us being a director had 5% of our net worth tied up in the companies of which we were a director — I don't mean stock options, I mean really tied up — what we find is that the company tends, over time, to outperform all others in its industry."

The search for directors who bring new expertise could have a dramatic impact on compensation.

In light of this emerging trend, we anticipate that companies will shift away from stock options to re-

Summary of plan design alternatives

Alternative	Pros	Cons	Other Considerations
Higher retainers for board chairs	• Reflects workload, extra time spent outside of meetings, and unique qualifications required • Consistent with competitive practice	• Does not consider time spent for special projects or during time of transition	• Will become a more pressing issue as more companies fill the chair position with fully independent directors • Consider paying retainers using a blend of cash and stock
Higher meeting fees for board chairs	• Addresses issues described above • Acknowledges effort required for preparation and management of meetings • Especially important for companies that anticipate having higher-than-typical number of meetings	• Increased pressure to determine what constitutes a meeting • Does not compensate directors for informal phone meetings or other between-meeting demands	• Will become a more pressing issue as more companies fill the chair position with fully independent directors
Higher retainers for lead directors	• Reflects potential workload, extra time spent outside of meetings, and unique qualifications required	• May not be appropriate if lead's role is not materially defined	• Will become a more pressing issue as more companies create a lead independent director position
Higher committee retainers for more demanding committees	• Reflects considerable work done outside the context of meetings • Reflects unique qualifications and time demands associated with committee membership	• Does not address high-volume and low-volume years, as key issues arise	• While there is general agreement that the audit committee may require additional compensation, other committees (compensation, governance) may also warrant it
Higher per-meeting fees for more demanding committees	• Reflects that considerable work is done to prepare for meetings • Automatically adjusts for high-volume and low-volume years	• Increased pressure to determine what constitutes a meeting • Does not compensate directors for informal phone meetings or other between-meeting demands	• While there is general agreement that the audit committee may require additional compensation, other committees (compensation, governance) may also warrant it
Same retainers and per-meeting fees for all committees, but allow differentiation to occur through different number of meetings	• More consistency across committees	• Does not respond to additional between-meeting workload	• May be impractical as market dynamics reduce the supply and increase the demand for directors with specific skills
Develop stock ownership guidelines	• Provides a greater sense of ownership by directors • Sends an appropriate message to investors	• Not all directors may feel they can afford to purchase company stock • May need to implement programs for directors to acquire stock	• May want to consider setting ownership guidelines based on shares rather than dollar value, especially for companies that have a volatile stock price
Restrict transactions	• Avoids sending the "wrong" message to the market	• Directors may feel that they are not receiving sufficiently liquid compensation for their effort	• Consider restricted stock or restricted stock units instead of options • Consider longer holding periods for restricted stock — potentially to retirement from the board

stricted stock or outright grants. This offers several benefits:

• Eliminates associated transactions (exercise or sale of stock from options), which the market may misinterpret and/or perceive negatively.

• Avoids the need for cash to exercise options, which is an important consideration if directors are expected to hold stock.

• Avoids the high leverage inherent in stock options, which may not be appropriate for board members.

Some companies are taking this one step further and encouraging their directors to hold company stock. The Conference Board found that 26% of companies surveyed have stock ownership guidelines for outside directors. In our research of 385 companies, 24 disclosed specific stock ownership guidelines for non-employee directors, using either a multiple of retainer or some share number or share value guide.

The same study found that directors are given five years, on average, to achieve these goals, and companies use one of several methods to get stock in the hands of their directors:

— 29% offer a deferral plan tied to company stock,

— 29% offer restricted stock or stock units,

— 29% provide stock options,

— 25% make outright grants of stock,

— 12% have other methods such as a stock purchase plan or retainer paid in stock.

Other benefits

The use of other benefits for compensating directors peaked in the late ’80s and early ’90s and has dropped off precipitously since then. For instance, the practice of providing retirement income plans to outside directors has dropped from 31% of companies in 1990 to 4% of companies in 2002. We do not anticipate any change in this trend; however, companies should consider the use of “business-based perquisites” such as:

• Expense reimbursement for relevant training/seminars or other continuing education.

• Board retreats that focus on board development and discussions of strategic business issues.

• Subscriptions to industry- or governance-related periodicals.

Remaining competitive

While financial rewards are not the main reasons directors join boards, they remain a significant “degree of freedom” that companies may adjust within the overall rewards mix. Management must respond to the two major forces encouraging companies to make changes to director compensation. The first is the already recognized imbalance in the growing demands and diminishing traditional rewards of directorship. The second pressure is the *market dynamic.* Companies still need to replace retiring directors, add financial experts, increase diversity and independence, and fill seats vacated by directors who do not stand for re-election. In addition, they need to fill these needs from a shrinking pool of traditional director candidates. For this reason, companies may need to carefully consider changes to compensation — both the amounts and the form — to remain competitive. ■

Restricted stock avoids the high leverage inherent in stock options, which may not be appropriate for board members.

Joys aplenty

In their report on the overhaul underway in director compensation (see page 49), Sibson Consulting's Judy Canavan and Donald Gallo identify what they call a "potentially widening shortfall between the personal rewards of directorship and the demands of board service." Such a gap has serious ramifications: Talented executives may eschew board duty, fearful that there will be *nothing* to be gained (and everything to be lost) by accepting a board invitation. To borrow the phrase of a past Directors & Boards author, it appears that, even with upward monetary adjustments, there is diminishing opportunity to "have fun while you fiduce."

That author was the late, great Robert K. Mueller. This governance guru, a former chairman of Arthur D. Little Inc. who died in 1999, wrote a classic article for Directors & Boards in 1986 entitled "The Joys of Directorship." With all the gloom that has attached itself to the role of corporate director, this article is a perfect antidote — reminding one anew of "directorship's good side."

These are some of the "joys," in his own inimitable terminology, that Bob Mueller identifies and promotes: the Exhilaration of Challenge; the Service Ethic; Eliteness Motivation; the Ethical Algorithm ("the attraction for a director is the role he or she can play in clarifying what constitutes human welfare"); the Celebrity Role; the Ego Factor; the Marching and Chowder Society; Team Play; Networking; and, lastly on Bob's list, Perks and Pay. Here is Bob on this latter item, and indeed this is how he concludes his seminal advisory:

"While such perks may give a hedonic tone to board service, they are actually the least enduring and satisfying of the joys of directorship. The real reward of serving on an effective board is in the service-without-dominance ethic, and the exultant challenge of governing in risky circumstances with a select group of respected peers. Dostoevsky expressed our thinking better on this perspective of corporate governance: 'Man is fond of counting his troubles, but he does not count his joys. If he counted them up as he ought to, he would see that every lot has enough happiness provided for it.'"

Amen to that. I'll be happy to share with you a copy of "The Joys of Directorship." Simply drop me a line at jkristie@directorsandboards.com. You can also look for this classic as an Article of the Week selection on the D&B Web site in the coming weeks.

Speaking of our Web site, we have spent the past few months revamping it for an unveiling to coincide with the release of this summer edition. On it you will find many new features, including a vastly expanded article archive and other content additions that will make the site an even richer source of information. (See the inside back cover, which displays an image of the new home page.) Any Web site is a work in progress, and we will continue to refine and expand our site to be a prime destination, just as the printed journal has been since 1976, for all governance matters.