The Role of Director Compensation

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WITH MORE **SCRUTINY** THAN EVER ON **BOARDS OF DIRECTORS,** IT PAYS TO UNDERSTAND THE PART **COMPENSATION** PLAYS.

The continuing spotlight on corporate governance is profoundly affecting the roles and accountabilities of board members. Consider the facts:

- Expectations have increased regarding directors' level of responsibility, and the more demanding roles for directors will require stringent qualifications and credentials.
- To meet raised expectations, directors can anticipate devoting more time to their board commitments.
- The risks involved have become more apparent as courts continue to hold board members accountable for corporate wrongdoings and failures.

Given these increased skill and time commitments, combined with greater personal risk, conventional wisdom suggests that it makes sense to increase director pay. But, on the flip side, it is assumed that individuals rarely take on directorships because of compensation.

"Directorship, like all professional endeavors, is predicated on a sense of responsibility that transcends any material rewards," according to the National Association of Corporate Directors' 1995 Blue Ribbon Commission report on corporate governance.

So, if it's not the primary tool to attract and retain directors, then what role *does* compensation play?

Historical Perspective

Historically, compensation has played a very minor role. In the early 1900s, corporate directorships generally were paid very little or nothing at all. *Prevailing Practices Regarding Corporate Directors*, a 1939 survey conducted by The National Industrial Conference Board, reported that, in 1938, 19 out of 505 companies started the practice of "annual payments" to their directors. The annual compensation of those directors was $285 per year, and meeting fees averaged $20 per meeting (in 1938 dollars). These represent fairly meager earnings even in today's dollars. (See Figure 1 on page 34.) The 1939 study goes on to say, "It is not surprising, then, that few highly qualified men feel free to devote all their time to their duties as directors, and that many find the liabilities attached to the service too great for the modest emolument."

Over time, compensation levels began to rise, perhaps in an attempt to narrow

QUICK LOOK

- Given the increased skill and time commitments it takes to serve on a board, combined with personal risk, it makes sense to increase director pay.
- In the good old days, directors were paid very little. But, over time, compensation levels began rising.
- Director compensation should reflect a new reality and reward the directors who provide the greatest value to the board and company.

this gap between the "liabilities and emolument." Companies began providing directors with a cash stipend to acknowledge the time and effort required for travel and board meetings. Many companies added benefits and some perquisites. Because many directors were at or near retirement from their primary careers, health and life insurance benefits held significant value. (See Figure 2.)

In the past 20 years, director benefits have come under fire for compensating complacency and not sufficiently linking the interests of directors and shareholders. As a result, director pay has moved away from fixed pay (cash and benefits) to a more risk-based mix (cash and stock) as companies dramatically increased the use of stock in director pay.

Recent Role of Compensation

Directors ranked compensation as the No. 5 reason for serving on a board, according to *Pawns or Potencies — The Reality of America's Corporate Boards*, a 1989 study of 1,000 directors of the S&P 400. From this study, published by the Harvard Business Press, it was determined that the first four personal benefits derived from board membership were (in order of importance):

- Opportunity to learn
- Seeing new businesses
- Establishing contacts to enhance other business relationships
- Opportunity to contribute to society.

Ideally, intrinsic rewards will continue to outweigh the financial rewards. Recent interviews conducted by Spencer Stuart, a privately-owned global executive search firm, of more than a dozen directors found that 70 percent accepted directorships to learn and gain a fresh perspective; 60 percent felt that developing connections and associations was important; nearly half indicated that they were fulfilled in their directorship by their ability to contribute. While these directors did not cite compensation as a determinant for taking on a directorship, companies may find that compensation arrangements need to be refocused to address changes to director roles.

FIGURE 1: SUMMARY OF HISTORICAL DIRECTOR COMPENSATION LEVELS

Cash compensation for directors has increased over time, especially since the addition of stock grants (not included in the figures reflected here).

Compensation in 2002 Dollars*						
	Board Service		Committee Service			
			Executive Committee		Other Committees	
Year	Median Retainer	Median per Meeting Fee	Median Retainer	Median per Meeting Fee	Median Retainer	Median per Meeting Fee
1938	--	$137	--	$137	--	$137
1972	$12,571	$573	$5,625	$438	$4,251	$438
1981	$16,169	$931	$5,571	$815	$4,316	$777
1991	$22,215	$1,192	$4,277	$1,004	$4,432	$1,192
2002	$27,190	$1,075	$3,760	$1,030	$3,667	$1,031

*Based on a 3-percent annualized growth rate.

Source: The Conference Board.

FIGURE 2: SUMMARY OF HISTORICAL BENEFITS LEVELS

The use of benefits (especially life, health and pension) peaked in the early 1990s and has since declined significantly. The use of stock grants (including options and restricted stock) has evolved into a common practice over the past decade.

	1972	1981	1990	2002
Total Number of Companies in the Survey	824	1,064	949	662
Insurance Benefits				
Travel Insurance	23%	24%	36%	23%
Life Insurance	10	14	16	8
Accidental death and dismemberment	2	15	17	10
Medial and hospitalization	4	7	9	3
Other Benefits				
Matching Donations	10	23	33	24
Pension	Less than 1%	4	31	4
Product or Service Purchase Discount	Less than 1%	5	10	7
Stock Grants	Not discussed in this survey	Not discussed in this survey	33	84

Source: The Conference Board.

Future Role of Compensation

As mentioned, companies are beginning to expect directors to add more time, expertise and leadership as governance practices continue to evolve. Conversely, director compensation systems must reflect that new reality and reward those directors who provide the greatest value to the board and company. While individuals may have taken on directorships for the prestige, opportunity to contribute and to enhance learning, today it may take some well-designed compensation packages to lure the necessary talent to the boardroom.

Compensate Those with the Greatest Burden of Demands

To deliver value-based director compensation, companies will consider matching compensation with the burden of demands. This includes increased retainers for specific committees (e.g., audit, compensation) and chairmen, as well as more compensation for attendance at scheduled meetings to compensate for preparation time.

In an article published in the *Atlanta Journal-Constitution,* Nell Minnow, editor of The Corporate Library LLC, estimated that, in the post-Enron world, directors will have to allot at least one to two days of preparation for every day spent in a board or committee meeting. Based on preliminary findings, companies already appear to be planning for these changes.

A survey of 69 companies conducted by Sibson Consulting found that:

- Fifty-five percent are changing audit committee pay.
- Thirty-two percent are changing compensation committee pay.
- Twenty-five percent are increasing committee chair retainers.
- Thirteen percent are increasing committee retainers.
- Thirteen percent are increasing committee fees.

Encourage a Long-term Focus

Companies may want to consider continuing to encourage stock ownership by developing programs to increase the personal investment holdings of directors in the company's stock. In an October 2002 speech, Hardwick Simmons, head of Nasdaq, speculated that "if every one of us being a director had 5 percent 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."

Directors' holdings can be encouraged and increased by developing written guidelines that either indicate expectations for personal stock holdings of directors, or discourage/limit (through deferral or restrictions) the sale of stock grants. These guidelines can be combined with opportunities to accumulate stock through:

- Retainers paid in a combination of cash and stock
- Stock grants, including restricted stock or outright grants
- Deferred compensation in shares of company stock.

Interestingly, in a recent Sibson study, only 24 of 385 companies clearly disclosed stock ownership guidelines for outside directors in their proxies.

Conversely, companies should avoid performance-based plans that could create the appearance of a conflict between short-term gains for the director and the long-term health of the organization. The 2003 Conference Board Commission on Public Trust and Private Enterprise says that "managing for short-term earnings and stock price results has led to many of the behaviors and manipulations that have resulted in the recent corporate crises and loss of investor confidence."

In the next few years, companies will continue to explore ways to increase directors' stock ownership. However, the method of delivery likely will shift away from stock options to restricted stock or outright grants. This offers several benefits by:

- Eliminating associated transactions (exercise or sale of stock from options), which the market may misinterpret and/or perceive negatively
- Avoiding the need for cash to exercise options, which is an important consideration if directors are expected to hold stock
- Avoiding the high leverage inherent in stock options, which may not be appropriate for board members.

Provide Business-based Perquisites

Companies also need to align perquisites with business needs by focusing on items such as subscriptions to industry- or governance-related periodicals, expense reimbursement for relevant training/seminars or other continuing education, and board retreats that focus on team building and discussions about key business issues.

While compensation should not be the main reason directors join boards, it remains an important lever that companies may adjust within the overall rewards mix. Over the years, compensation levels have been rising, and a continued upward trend is expected. 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. They also need to fill these needs from a shrinking pool of director candidates. While these pressures may warrant both an increase in director pay and changes to the form of pay, it is important to remember that pay needs to work in concert with effective governance practices. WS

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