How Should Companies Compensate Board Members?

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Amid today's heightened competition for directors, it's essential to create a comprehensive plan for paying them.

Every organization must consider how and when to compensate board members. For almost all public companies, the question is not whether to compensate board members, but how much to compensate them. For private companies, both questions might apply. As the conversation over board members' role and expectations intensifies, public and private companies — and even nonprofits — face new board compensation challenges. Here are some factors to consider in making compensation decisions.

Board Members' Intensified Expectations

The role of independent board members has expanded and intensified over the last 20 years. Organizations have experienced unanticipated hardships, corporate/executive malfeasance, industry disruption, hostile takeovers, pressure from activist investors, increased regulatory compliance demands and, in some cases, outright financial failure and dissolution. Board members are in the crosshairs of targeted attacks.

Board service used to be viewed by many as a cushy, soft landing for retiring CEOs as they continued their professional lives in the lower-pressure environment of a boardroom. But board service now requires much more homework, due diligence, and focused time and energy to execute board fiduciary roles.

Most organizations have six to eight (or more) scheduled board meetings per year. These meetings — and the meetings of standing and special committees — take more time and require more advanced preparation than ever before. As a result, few board members are able to take on more than two or three board

ctively employed executives.

Talent Challenges for

Populating Boards

Organizations of all types face the need to add or replace board members.

- Boards' growing demands sometimes cause board members to reduce the number of board appointments they accept.
- New priorities around ESG, cybersecurity, increased disclosures, executive compensation and pay equity create the need for more specialized skill sets and experience.
- Most organizations realize they must increase board diversity.

With increased demand for new board members — and heavier demands on their time — it is not surprising that there is additional pressure on how they will be rewarded.

The Board Compensation Decision

For most companies, decisions around compensation involve "how much" and "in what form." The typical board member at a public company can expect to receive a cash retainer, an additional retainer or meeting fees for committee service, regular grants of company equity and reimbursement for travel expenses. An independent chair, a lead director and committee chairs often receive additional compensation for taking on more responsibility.

The compensation committee or the nominating and governance committee typically makes decisions about board compensation. These committees often rely on advice from outside advisors who share how board members in comparable organizations are paid.

This process offers three assurances:

- Compensation decisions are as independent as possible.
- Compensation is grounded in information that allows the company to attract needed members.
- Board members receive competitive compensation for board service.

While compensation for a company’s executives can change annually, compensation for external board members is reviewed and adjusted less frequently — typically once every two to four years.

In large U.S. public companies, the median level of individual board member total compensation approximates $300,000, with 60% or more provided through an annual equity grant. In private companies, the total is much lower, with a much heavier weight toward cash retainers.

Growing expectations for board members and the need for new and specialized expertise has led more companies to revisit and to increase the compensation paid to outside directors.

The Complex Case for Board Compensation

Before companies consider compensation issues of “how much” and “in what form,” they must address other questions. Here is a road map to guide deliberations.

Messaging. Compensating board members for their service reinforces the message that their input and guidance is valued; their role is taken seriously; and they are expected to deliver time, energy and wisdom in exchange for their compensation.

Accountability. Competitive compensation reinforces expectations around accountability. Compensation sends the message that board members are expected to uphold their fiduciary responsibilities and align with the organization’s purpose, vision and values over personal interests.

Expertise. Competitive compensation enables companies to recruit members to take on top board strategic challenges, shareholder and investor activism, ESG, human capital, economic uncertainty and cybersecurity.

Attracting the Right Board Members

Once executives and board chairs embrace the business case for competitive board compensation, they can evaluate the impact of board compensation by asking questions in five areas:

Expertise. How will competitive board compensation attract members with specialized expertise? Evaluate board strength in these areas:

- Strategy and risk assessment
- ESG and sustainability, including climate risk
- Shareholder, stakeholder and activist engagement
- Talent, human capital management and CEO succession
- Data governance, including cybersecurity and data privacy
- Crisis prevention and response
- Culture monitoring and analysis
- Talent and diversity within the boardroom

Diversity. How will board compensation enhance board DEI and complement the organization's DEI strategy?

Board mindset. Will competitive compensation promote an executive mindset among board members? An executive mindset drives leaders to "think up, down, horizontally and through time." Board members blessed with an executive mindset focus on the following:

- **Action.** They question what the board needs to achieve.
- **Purpose.** They analyze alignment with company purpose, vision and values.
- **Execution.** They critique plans featuring goals, objectives, strategies, tactics and anticipated outcomes.
- **Accountability.** They take responsibility for decision-making and communication.
- **Vision.** They nudge board conversations away from problems and toward opportunities.
- **Community.** They refer to the board and company as "we" instead of focusing on "I."

Risk-taking. Will competitive compensation motivate board members to engage in disciplined risk assessment — identification of hazards and harm, evaluation of risks, implementation of precautions and review of risk mitigation measures?

Engagement. Will competitive board compensation promote board engagement and participation? Compensation makes it more likely that board members will participate in every meeting, prepare ahead, volunteer for committees and learn about the company and industry.

As executives and board chairs evaluate the benefits of competitive board compensation, they should also assess the risks to company image and reputation. To what extent will competitive board compensation:

- Pose risks to the company’s image and reputation?
- Drive pushback from investors and stakeholders?
- Generate conflict among employees, managers and executives?
- Raise questions about the board’s ability to fulfill its fiduciary responsibilities?

Build a Board Compensation Review Process

Who’s in charge of board compensation? Most companies entrust this responsibility to the compensation committee or the nom/gov committee. Either can make decisions that set and review board compensation.

By scheduling regular board compensation reviews, companies can verify the competitiveness and reasonableness of their practices and levels. Consider these guidelines:

- Establish a timetable for board compensation review.
- Compare your board compensation program with programs of other peer organizations.
- Choose companies for comparison by size, reputation, growth, products and services, financial performance, employees, customers and investors.
- Develop a rationale or justification for the mix of cash and equity offered to board members.
- Engage an external compensation consultant to review your board compensation program for alignment with company goals, shareholder expectations, public perceptions and regulations.

Develop a Board Compensation Policy and Plan

The first step in setting competitive board compensation is creating a market peer group similar to that used for evaluating CEO compensation. The peer group should reflect organizations of similar size in the same or related industries.

Be sure to supplement group feedback with data from published surveys. Then develop a market comparison through answers to these questions:

- Does board compensation include annual retainers and meeting fees?
- What's the mix of cash and equity compensation? Does the equity award specify vesting and number of shares vs. dollar value?
- Does board compensation allow for deferred compensation?
- Are there guidelines for stock ownership and retention?
- Is compensation provided for board and committee meetings?
- How does compensation relate to the number of board and committee meetings and board and committee chair roles?
- How is board performance evaluated?
- How are individual directors evaluated?

Get Ready to Navigate Legal Landmines

Boards can protect against lawsuits over director compensation by implementing these precautions:

Be prepared. Expect attorneys to review pay disclosure in your proxy statements. Work to prevent claims of excessive board compensation.

Design with limits in mind. Insist on annual board compensation limits, especially in equity compensation. Even though you can amend your equity incentive plan without stockholder approval, seek stockholder ratification as soon as possible.

Put it in writing. Include limits on board member retainers in board and committee minutes.

Review and amend. Check out your company's stock incentive plan and other documents on board member compensation.

Get outside help. Retain a qualified compensation consultant to review and compare board member compensation with programs in the same or related industries.

Expand content. Clarify and expand the discussion of board compensation in your proxy statement.

Call legal. Seek legal counsel to pinpoint steps to avoid litigation risks.

Look ahead. Anticipate how stockholders will respond to board compensation decisions. Be prepared to address litigation risks and back up arguments with board compensation data.

Forward to the Future

Board members have a fiduciary responsibility to establish policies and plans for competitive board compensation. As boards develop or update compensation programs, they should plan for periodic reviews of competitive compensation practices, evaluating every element of pay and total pay levels. Reviewing the structure, design and level of board compensation puts you in a better position to attract and retain board talent and address shareholder concerns, institutional investor guidelines and legal challenges.

Once boards assess the advantages and risks of competitive board compensation, they are ready to develop and implement a policy and plan with shareholder-approved limits on board compensation. Attracting and retaining the right skills, experiences and capabilities is front and center for board leadership given the complexities and nuances public companies are facing in today’s economic climate.

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