What should we pay board members for?

Oversight responsibility? Performance of the company? Or both? This is one of the most basic issues of compensating directors … and it is one that is rarely addressed.

By Jack Dolmat-Connell and Gerry Miller

Over the last decade, board service has changed dramatically, with much more time being spent on board and board committee matters and significantly more real, or perceived, risk associated with board service. These factors altered the supply and demand equation relative to board members, and, correspondingly, board pay levels have risen substantially. While the "how much" board members are paid is interesting, little is said about how this changing environment has altered "how" board members are paid. This critical piece of the board compensation equation needs rethinking.

Today, other than determining magnitude of pay, the strategy for board compensation can be developed by answering two important questions: Should we pay for oversight responsibility, or performance of the company, or both? And, should we compensate on the basis of an individual's board membership alone (i.e., an overall retainer), or be emphasizing the requirement to attend meetings?

Pay for oversight responsibilities or pay for performance?

This is one of the most basic questions of compensating members of a board of directors. The question is rarely asked. How a board answers this question determines its fundamental philosophy about board service and, thus, board pay. Not surprisingly, developing an answer or, at least, some insight as to what the answer might be, is not straightforward. For most companies, the answer is most likely to be found on a spectrum of possibilities.

At one end of the spectrum is pure oversight responsibility. That is, based upon regulatory requirements and an intense scrutiny by the media and other pressures, a board's focus is solely on corporate governance. As a result, remuneration for oversight may be only in the form of cash.

At the other end of the spectrum is a focus only on the long-term performance of the company. That is, based upon being elected by the shareholders, a board's focus is purely on the performance of the company so that over a longer-term horizon shareholder value is increased. Remuneration for performance may be only in equity compensation — in particular, stock options, whereby the stock price must increase for directors to receive any remuneration.

The changing role of boards — resulting in

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greater time commitment and real or perceived risk — indicates a movement to more cash compensation. In fact, most surveys and analyses of board compensation practices show a rapid rise in cash compensation, even in smaller public companies.

For most companies, we expect that the answer is not at either end of the spectrum. Neither would we expect the answer to be in the middle. The dynamics by industry segment, stage of development, financial strength, and company image would dictate a workable balance, and not merely following broader market norms.

One area that is changing in the board compensation arena is how the equity compensation component is structured. Many boards are now moving away from stock options to restricted shares as the oversight role becomes increasingly important. Restricted shares serve to provide remuneration to directors even if the stock price does not increase, but members receive more compensation if the stock price does in fact increase, thereby balancing the pay for oversight and pay for performance perspectives.

Membership or attendance?

Over 25 years ago, board pay was almost exclusively a retainer only arrangement. Then, conventional wisdom changed to a combination of retainer and meeting fees so that shareholders could determine which directors were *earning their keep* (as many board members missed several meetings a year). Proxy statements required reporting on directors who did not attend at least 75% of the meetings, thereby facilitating shareholder judgment about the matter.

For the most part, the increased liability and openness created by the Sarbanes-Oxley Act and the new proxy disclosure rules have changed that notion. Rising retainers reflect the need for companies to attract and retain qualified board members in this new more difficult environment. Rising meeting fees recognize the increased time demands of the job of board members. One way to again balance both perspectives is to pay a retainer that covers a given number of meetings per year and then pay a meeting fee for any meetings above that number.

The changes in the role of the board have also led to the recent surge in lead director and non-executive chairman positions. There has been, and will continue to be, increases in compensation for these positions reflecting significantly increased time commitments and responsibilities.

In addition to determining magnitude of compensation and the mix of pay elements, there are a number of secondary compensation practices that need to be addressed by boards as they rethink their pay (see sidebar).

There is no doubt that total remuneration for directors will continue to rise. Setting pay levels for them is much more than just trying to be competitive at a given percentile relative to the marketplace. While the "how much" board members are paid has been on the rise and is well documented, it is now critical to re-examine how this new environment has impacted "how" boards are paid. ■

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Practices ripe for rethinking

Compensation practices for directors continue to evolve.There are a number of secondary compensation practices that need to be addressed as boards rethink their pay:

• **Pay Deferrals May Make Bad Disclosures**: While pay deferrals may sometimes provide good tax and estate planning vehicles for a board member, generally they do not make for good proxy statement disclosures. In a post corporate scandal era, shareholders may not appreciate a tax *scheme* for a relatively small amount of a director's income and wealth associated with a deferral. Alone, it may be inconsequential. In conjunction with other practices, pay deferrals may not be in line with the image that the board wants to convey to its shareholders.

• **Stock Ownership Requirements**: Stock ownership requirements, whereby directors need to own shares (other than unexercised stock options), have grown in usage. To some shareholders, board members having *skin in the game* is important and that the formal disclosure of the requirements and status adds another positive component to a proxy CD&A. We strongly support this notion, particularly as board equity compensation evolves away from options and toward restricted shares.

• **Pensions Have Almost Disappeared**: At one time, pensions for directors were commonplace. Most were an additional year of retainer for every year of service as a board member. Pensions reinforced long-term service more than any other aspect. They still exist in some more mature and larger-cap companies. Simply, pensions for directors are contrary to the intents of typical contemporary pay practices and the continuing evolution of the role of a board.

• **Equity Grants to Audit Committee Members:** The audit committee is the embodiment of oversight responsibility. As such, it is important that the members not be aligned with executive management. A novel idea, therefore, is that during the years that board members serve on the audit committee they do not receive equity grants — e.g., stock options or restricted stock — as part of their pay packages. Instead, they would receive additional cash compensation. While not universally appropriate, this pay practice may fit well into certain board pay strategies. For example, not only may it be appropriate for companies that have experienced regulatory scrutiny, it may also be appropriate in companies wishing to emphasize further the independence of the audit committee.

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