

# Director Compensation Trends

by Brent M. Longnecker

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**The roles and duties faced by the corporate board have increased sharply over the past few years, and this turmoil is changing how we pay directors as well. Board members are now earning more for doing more, but the tools and methods for delivering that compensation look very different today.**

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It has never been more challenging or important for companies to attract, retain, and motivate quality directors. The “New Economy,” new employment models, and increasing investor and legal accountability stemming from Sarbanes-Oxley are some of the well-known factors driving this trend.

In 2004, however, the bar will be raised even higher. As institutional investors, with trillions of dollars of capital, place higher importance on corporate governance they will make greater demands of transparency and accountability from directors. For example, investors as well as the general public will have many questions for directors as executive compensation data comes public in the early Spring.

With the Dow Jones Industrial Average having notched a total return of 28.28 percent in 2003 and the S&P 500 a corresponding 28.69 percent rise, many executive pay packages will show dramatic gains for 2003. The reason, of course, is that these programs are heavily rooted in equity compensation. At the same time, rank and file employees’ pay increases have been kept to the low-single digits, as companies sought to hold the line on labor costs.

Directors will be on the front lines when it comes to explaining these pay packages. On top of this, directors will face their own conundrum. Board compensation, in many cases, will have risen dramatically for 2003 over 2002, because of the market gains.

What are the trends in director compensation? Where do they appear to be going and why? What are some of the key issues that compensation committee members need to address so that executive and

director compensation programs create optimal shareholder value?

An analysis of the largest industrial and service corporations in the United States reveals some significant changes in the area of director remuneration. These changes appear to be attributable to seven significant trends. Specifically:

- Continued rise in board pay, primarily on the equity element.
- Dominance and growth of equity pay.
- Growing use of share ownership guidelines for directors.
- Introduction of discretionary board stock grants.
- Continued movement away from director pension plans.
- A decline in the use of meeting attendance fees for both board and committee meetings.
- A decline in the multi-year terms for directors.

**Director compensation is a front-line issue today. Pay policies set director performance expectations for both boards and investors.**

Governance in the new millennium dictates a new model where directors, management and investors are not only active, but also where each works cooperatively with the other two. While senior management still holds the reigns on day-to-day company operations, both directors and investors are making their voices heard on mergers and acquisitions, asset sell-offs, employee ownership, management buy-outs and a host of other change issues that have a bearing on business performance.

With the emphasis on more board activism and the overall re-examination of corporate governance, director compensation is among the front-line issues

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in business today. Compensation policies and levels not only affect director behavior, but also set the tone of director performance expectations to the board and investor community alike.

Director pay is on a continued strong uptick. Significantly increasing over the past several years, levels among the top 250 corporations now exceed \$135,000 and continue to rise as a result of enactment of the Sarbanes-Oxley law.

The pay break down includes annual retainers that are paid in cash and stocks, making up 35 percent of the total compensation level. Meeting fees and committee retainers account for 15 percent, followed by committee chair fees and retainers at five percent.

Perhaps the largest sign of growing expectations of directors is the rise of equity pay as a share of total pay. Among the top 250 corporations, equity now accounts for nearly 50 percent of the total package. In fact, large public companies on average now pay directors nearly twice as much in forms of stock as they do in cash.

This is a huge change in compensation policy, as equity accounted for a mere two percent of total board pay makeup in 1985. Because equity accounts for such a large part of base salary, this suggests that compensation is highly leveraged toward incentives and, therefore, company performance.

The impetus behind the rise in equity pay is, in the consensus among the business and investment communities, that all shareholders benefit when directors have “equal risk” with company stockholders. Building on this principle, several companies have also taken the step of requiring directors to own stock in an amount three to five times greater than their annual retainer within a few years of joining the board.

Setting targets on stock ownership effectively ties directors’ personal financial interests with those of shareholders. This approach negates the short-term focus of annual company performance and creates a longer-term incentive in company boardrooms.

However, while equity compensation has skyrocketed, there are a number of considerations involved in setting the appropriate amount of director stock ownership. The delicate balancing act calls for pro-

moting ownership interest without comprising objectivity for the long-term good of the company.

If corporations seek to expand their boardroom talent horizons, overemphasis on equity can be a hindrance in attracting candidates of relatively modest means. This can be important in avoiding the potential pitfall of disqualifying valuable talent, including those from the academic community or those with governmental or not-for-profit experience.

**While cash speaks loudly in attracting talent, equity has the marketplace’s ear for correlating board ownership to corporate performance.**

Another important ingredient in the equity/cash pay mix is giving directors the option of choosing some cash reimbursement. This is important where directors hold a substantial amount of their net worth in company stock rather than a standard shareholder’s diversified portfolio. Offering directors a paycheck gives them some latitude in determining their own cash flow needs balanced against stock ownership requirements.

One other benefit of providing a mix of cash and equity is its value in board retention. Providing some cash flow to directors makes it less likely that there will be an exodus solely for the purpose of selling the stock.

While cash speaks loudly in attracting and retaining talent, equity has the marketplace’s ear as it builds on the intuitive correlation between director ownership and overall corporate performance. This was demonstrated in 1994 when Scott Paper’s stock price rose by more than three percent—\$140 million in market value—on the day the company announced its decision that all director pay would be made in the form of stock.

A couple of other important caveats should be noted in this kind of straight equity compensation. First, as noted, providing no cash to directors limits talent choices to the wealthiest prospects. Secondly, if directors rely too heavily on company stock hold-

ings for their net worth, dividend policy judgments may be affected, possibly through a tendency to shy away from potentially profitable strategies because they seem too personally risky.

While straight equity pay has a strong emotional appeal, the effect of such programs can actually run counter to the *long-term* well-being of a company.

A number of companies have turned to equity compensation to fuel growth. Leading the charge in equity pay are start-up and high-growth companies where the emphasis is on keeping fixed-cost expenditures low by providing significant upside potential through equity incentives.

The emphasis on equity rather than cash has paid off handsomely for some executives, particularly for those in the high-tech industry during the 1990s. However, given the massive jolt these companies took in recent years, the appeal of being paid mostly in stock has been tarnished.

### **Both CEOs and outside directors say substantial stock ownership by board members sets a tone for active involvement.**

CEOs and outside directors themselves say substantial stock ownership by board members sets a tone for active involvement. Anecdotally, they say significant ownership fosters vigorous debate among members on important issues, encourages involvement in the scope of management and also promotes engagement during difficult times. In short, ownership makes boards work harder.

Among large corporations with high levels of director stock ownership, corporate performance is generally better than that of companies where director ownership is low. This correlation takes on even more weight when considering the fact that boards with substantial levels of stock ownership are more likely to tie CEO compensation to company results.

Companies use several stock award methods in the equity pay mix. Among these are restricted and unrestricted stock (which contribute to directors' annual fees), and stock options, which traditionally serve as long-term incentive compensation.

Of these, restricted stock is usually the type used in addition to cash retainers and meeting fees. Restricted stock awards are subject to company-imposed sale or transfer restrictions, and require a specific holding period, usually until the director retires. Most often, these restrictions are defined so that the stock award is not taxable until the restrictions expire.

While grants of restricted stock are an effective means of providing directors with significant stock ownership, the danger here is in the creation of a subtle conflict of interest. This is because some companies impose forfeiture of this form of deferred compensation when directors are not re-nominated for a board position. The concern is that directors could avoid taking actions that management would not like.

Unrestricted stock is stock awarded without any conditions on its sale or transfer. Although the value of these awards is immediately taxable, unrestricted stock is appealing for a couple of reasons. First, by taking out the vesting factor, the concern that directors will make only management-friendly decisions is removed from the picture. Secondly, this method allows directors to sell stock at any time.

Making up a good portion of director bonus pay is stock options. Traditionally, option awards have been used to motivate and reward executives. While grants to directors tend to be smaller than those awarded to executives, the plans themselves operate under similar guidelines.

Still, this form of pay can carry the same hurdle as restricted stock if vesting requirements are excessive. To get around this, many companies are becoming innovative in their vesting practices, going so far as to allow options to vest monthly. Vesting options on a monthly basis gives directors the opportunity to recognize gains sooner than general marketplace practices would indicate.

Several components make up traditional director compensation packages. Under the old model, the largest share of pay consisted of the annual fee (fixed compensation plus some stock) paid to directors on a monthly or quarterly basis for overall board service. Supplemental compensation was paid in chair

and retention fees with some equity pay. Traditional packages were then rounded out with benefit programs such as retirement and life insurance policies.

While some elements of traditional director pay plans are still being used, boards are re-examining all aspects. In doing so, they are keeping and expanding the good, throwing out the bad and fixing those things that are broken.

**Payment of meeting fees to directors is on a downhill slide, but some boards are moving to fold the fees into annual retainers.**

□ *Retainers, meeting and committee fees.* In days gone by, annual board retainers were a straightforward matter of cash (or mostly cash) compensation. The simplicity of the formula was that companies paid directors a set amount for board service, an added amount for committee work and then another fee for chairing a committee. A further pay category was made for meeting fees, which usually came up in special circumstances, when additional director attention was needed.

These annual retainers, paid to directors monthly or quarterly, assured a set income, regardless of company performance. While these elements still make up a good part of how directors are paid, boards have continued to alter the formula. Traditional compensation also makes cash payment for meeting fees. Oddly enough, the meeting fee portion of the formula is on a downward slide. This trend established itself with the emergence of e-business, along with accusations that fees were being abused with excessive scheduling, poor planning and a general lack of substance.

While some boards have moved away from paying any meeting fees at all, others are moving to fold fees into annual retainers. The compromise solution, however, is still being assessed. Situations like mergers, acquisitions, divestitures and turnarounds—special circumstances—require board members to provide substantially more time and expertise. The trend is to pre-establish a dollar amount for board members when they put in additional time and effort.

□ *Deferred compensation.* Another element in director pay is deferred compensation. This refers to compensation “held” in special accounts until a specified date in the future, usually retirement. The clear benefit of deferred compensation is that a director, typically in a high federal and state tax bracket, can set aside compensation and investment gains for future use. Taxes are paid when the funds are received as income, which is usually when the director leaves the board.

With this method, special individual accounts can be set up that involve various investment approaches. Typically among these are: an interest-bearing account that is credited with interest, usually at the prime rate, or a stock account deemed to be invested in company shares. This “phantom stock” account is credited with the company’s actual share dividends and, at the time of pay out, the account reflects any changes in company stock price.

Directors should make sure that the company takes steps to finance these deferral plans, such as through corporate-owned life insurance, and places the assets, in a “rabbi trust.” This ensures that the funds will be paid in the event of a takeover, or should management in the future try to rescind these benefits. Deferral plans, however, have a substantial risk of forfeiture. Thus, in the event of a bankruptcy the deferral amounts could be lost, as directors become general creditors of the corporation.

□ *Post-retirement compensation.* Retirement programs have also traditionally been a substantial part of director compensation packages, particularly among large companies. The conventional thinking in offering these programs has been that they help companies stay competitive in seeking new directors. Besides adding tax-effective value to director pay, reporting requirements of the programs involve only the existence of retirement benefits, not their costs.

Most commonly, director retirement programs are made up of an annual cash retirement fee equal to the board fee at the time of retirement. One common approach is for the fee to be paid out for the number of years the director served on the board, up to a maximum of ten years. When directors serve more

than ten years, the fee may be paid for the life of the director.

The costs of implementing these benefits comes with a hefty price tag, as much as \$15,000 per year of a director's active service, with little evidence of payoff in terms of attracting talent. Because of this, director pension benefits have taken a huge downturn over the past several years, going from more than 500 percent down to the current level of only seven percent.

Still, the notion of board retirement benefits is one that some companies are unwilling to give up on even with the mounting pressure to cut costs. One particularly effective way innovators have found around this dilemma is in stock allocation awards.

There are several ways to approach this alternate plan. Some companies award unrestricted stock, plus a cash amount large enough to offset tax liabilities. Another approach is to credit directors annually with a specified number of stock units payable at retirement. A third approach is to credit directors with actuarially determined amounts of stock units that are designed to provide a capped retirement income.

*Other benefits and perquisites.* Benefits and perquisites represent yet another element of total director compensation packages. These include such things as free or reduced-priced merchandise or services, medical benefits, matching donations to charities, death benefits to heirs and director legacy donations.

This board benefit differs sharply between start-up, high-growth companies and the mature companies on the Fortune 500. For young companies, benefits make up less than 1.5 percent of the value of

total pay packages. On the other hand, established companies pay more attention to these details as such benefits represent more than five percent of the pay package.

Companies have a daunting number of choices and approaches when it comes to director compensation. The task is made even more difficult because few board members have human resources experience. Only one percent of the Fortune 1000 companies have what appear to be qualified human resource compensation committee members.

In any event, compensation committee members in 2004 and beyond need to be ready to address numerous key questions, including the following:

What was the strategy in designing our executive and director compensation programs?

Are we certain that our programs are defensible, from both a legal and public relations standpoint?

Do we have a compensation expert on the board who has been involved in the strategy and formation of programs?

What is likely to be the first impression that potential institutional investors will have of our programs?

How will employees perceive our executive and board compensation programs? Will they inspire or hinder productivity? How do they impact shareholder value in this regard?

As directors redefine and expand their roles in the formation of corporate policies, they must tackle growing demands placed on them from all fronts. In doing so, directors are redefining corporate governance. ■

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