Director pay: The 'why' behind the 'what'

Establishing principles to address specific pay program amounts and components will help the board to ensure that decisions regarding director pay are made thoughtfully, holistically, and accurately. **By Blair Jones and Jesse Purewal**

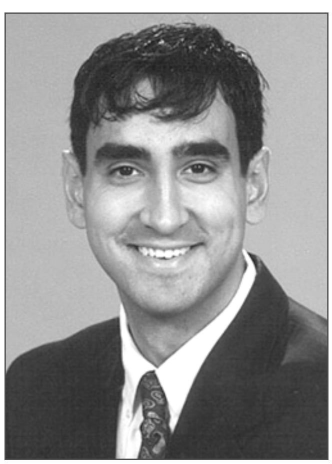
As we exit an era of shallow confidence and enter one of cautious optimism, shareholders will be looking to the stewards of America's corporations — its directors — to help guide the way. In order to bestow such a high level of expectation upon this cadre of leaders, the question first must be answered: Is there a well-defined set of rewards in place that makes it worth their while to lead the charge?

Though historically very few directors have cited pay as a key factor in their own attraction and retention, an imprudent compensation plan design may — all else equal — convince a director that his or her scarce time is better spent on a board whose pay for services more fairly reflects that director's perception of personal value. And, given the significant investor scrutiny on directors and their workloads, directors must use more discretion than ever before when considering where to focus their energies.

In much of our recent work with boards and governance committees, Sibson has found that establishing a set of coherent, well-defined guiding principles is an excellent foundation for designing and implementing director compensation programs, and for communicating the intent of these programs to external constituencies. At first blush, this should be a somewhat intuitive step in determining compensation. After all, boards and compensation committees have been establishing executive pay in the context of guiding principles for many years. However, just because directors are not paid to actively manage a company does not mean their pay should not be governed by a set of principles shared by each member of the board.

In one instance, Sibson worked with the governance committee of a Fortune 500 board, whose organization was enduring a number of strategic challenges, to revise its director pay program. Because of these strategic challenges, the focus and intensity of its directors' efforts was changing — yet in many ways, the types of duties for which they remained responsible were fairly constant. Before submitting plan design recommendations to the committee, we worked with the committee chair and board chair to create and refine the guiding principles that would become the foundation of the revised plan design.

It is important to note that, although the management of this organization was driving a number of significant changes, the rationale for developing guiding principles was based on the board's desire to create a director pay program that was aligned with the company's business needs, appropriately consistent with the organization's existing executive com-



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pensation principles, and sufficiently attractive to existing and prospective directors. As such, though the guiding principles were certainly created to be flexible as business situations and needs changed over time, they were not installed as a one-time or temporary "fix-it" solution for the company and its directors. Rather, they were designed to inject a further degree of transparency into the director pay program — making clear to shareholders and investors the business reasons for each element in the plan design.

EXHIBIT 1: Step 1 — Questions to Consider

Pay Prominence
- How important is pay in attracting and retaining the talent we need on this board (compared to other benefits of directorship)?
- Do the other benefits of directorship buttress pay strongly enough?

Market Considerations
- To what extent should peer practices and pay levels be used to make decisions about director pay?
- What is the appropriate set of comparators to consider when evaluating "competitive" pay levels?

Ownership/Pay Mix
- How important is director equity ownership? Why?
- How satisfied are directors with the relative mix of cash and equity compensation?

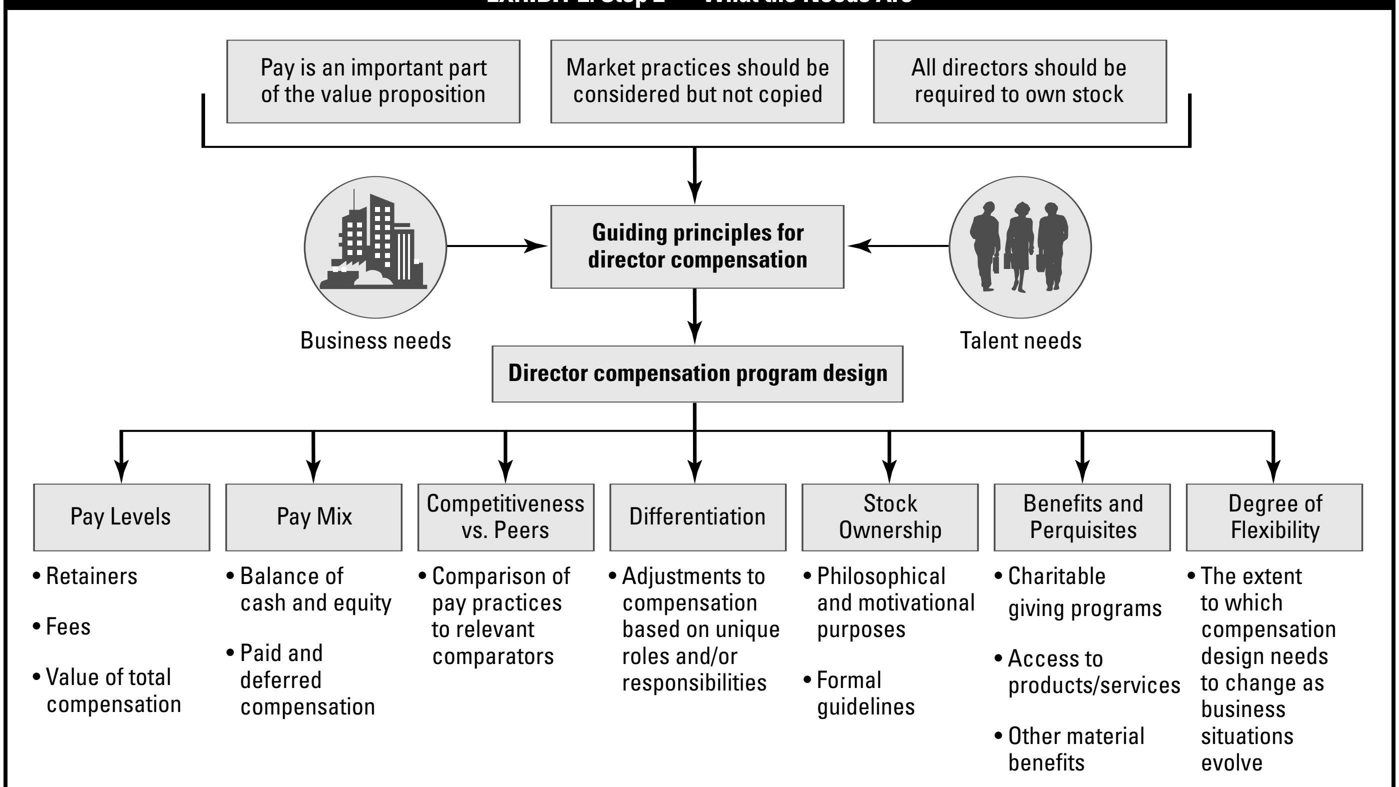
Other Considerations
- Do the demands of any director's role, the time commitments associated with certain duties, or the risks inherent in any position on the board suggest the need to differentiate pay among directors?
- Are there certain executive compensation principles that should be paralleled — or contrasted — by the design of a director compensation program?
- How flexible or static should the program remain over time? Why?

Guiding Principles: Design

The principles underlying a director pay program will vary, usually based on the company's business situation and the board's talent needs. To begin creating the principles that will act as a foundation for a thoughtfully designed director compensation program, the committee responsible for approving director pay should sit down with the chairman and/or lead director and reflect on answers to the types of questions posed in Exhibit 1.

Though this list of questions is not exhaustive, the answers — the board's *statements of belief* — are a necessary step toward developing a foundation for director pay. However, this is only the first step. These answers must be considered in the context of the company's *business needs* and the board's *talent*

EXHIBIT 2: Step 2 — What the Needs Are



needs before they can be transformed into principles that will inform the design of the director compensation program (see Exhibit 2).

For instance, consider the first question under "Other Considerations" in Exhibit 1 regarding pay differentiation. The increased demands on directors' time and the heightened exposure of certain roles (e.g., lead directors and audit chairs), coupled with the paucity of extremely well-qualified individuals willing to take on directorships, has led many boards to increase compensation levels for certain roles in order to attract and retain needed resources. At the same time, most boards view their members as players on a team. Many boards are unwilling to differentiate pay to such a degree as to create disharmony or feelings of ill will among directors.

Consider this example: The board of a diversified products company wanted to determine the most prudent mix of cash and equity compensation for its directors. The board had decided to install a stock ownership guideline to evidence long-term shareholder alignment between shareholders and directors, and to parallel the existing executive stock ownership guideline. In order to create this alignment and allow directors to achieve the guideline, the board needed to ensure that equity compensation comprised an appreciable portion of total pay. However, while a number of the board's directors are executives still drawing salaries as employees of other corporations, some directors — namely, academic and nonprofit leaders who need more ready access to liquidity — consider cash an attractive and critical ingredient of the program.

Because the types of situations described above can be quite complex, and because the types of questions considered in Exhibit 1 typically do not have simple or single answers, it is often helpful to consider a spectrum of design possibilities. Doing so can help a group of individuals with different contributions, opinions, and biases more easily bring the board to consensus on a given issue.

Exhibit 3 presents illustrative spectra of possibilities for addressing two guiding principle categories raised above (differentiation and pay mix), and presents a hypothetical board's rationale — based on business and talent needs — for positioning themselves at given points on the spectra.

When relevant *statements of belief* (Exhibit 1) are

EXHIBIT 3: Spectra of Relevant Considerations

DIFFERENTIATION

NONE ◄———————————————— X ————► SIGNIFICANT

- Stress value of internal equity
- Pay directors primarily as members of a unit
- Assume that all directors will contribute equally over time

- Reflect need for specific expertise and/or experience
- Acknowledge differences in expected/required levels of contributions from different positions
- Adjust for heightened exposure of certain roles

Rationale for Positioning ("X")

- Chairs, particularly the audit chair, have more demands on their time and leadership, and may be subject to scrutiny (+)
- Market practices suggest increasing pay to directors with increased workloads, especially audit and compensation committee chairs (+)
- Internal equity among directors needs to be considered (-)

PAY MIX/STOCK OWNERSHIP

CASH ◄——————————— X ———————————► EQUITY

- Emphasize the view that directors should primarily be compensated for skill set
- Provide for liquity in compensation
- Invoke less dilution

- Focus on long-term results
- Strengthen allingment with shareholders
- Encourage long-term view with ownership guidelines and/or holding requirements
- Create more potential dilution

Rationale for Positioning ("X")

- Directors support the philosophical and motivational importance of ownership, and want to implement ownership guidelines consistent with executive pay practices (+)
- Directors depend to varying degrees on income from cash compensation (-)

EXHIBIT 4: Illustrative Guiding Principles

DIFFERENTIATION

Definition

- The degree to which directors are paid special compensation for increased or additional responsibilities, roles and expected contribution

Board's Prinicple

Though all directors are expected to contribute equally over time, total pay is slightly differentiated based on the time demands associated with certain roles.

PAY MIX/STOCK OWNERSHIP

Definition

- The relative weights put on cash and equity compensation
- Whether directors should be required to hold/own company stock

Board's Prinicple

The program will focus on stock ownership by weighing the pay mix towards equity and introducing an ownership guideline, yet will include cash element that allows appropriate flexibility.

put into the context of *business and talent needs* (Exhibit 2), and the board has agreed to a given *positioning* on the spectra of relevant considerations (Exhibit 3), a guiding principle is ready to be defined. Based on the positioning depicted in Exhibit 3, guiding principles such as those drafted in Exhibit 4 could be put into effect for a director compensation program.

Guiding principles: Application

Boards should take care to define a set of guiding principles that addresses the set of considerations presented in Exhibit 1. Establishing principles to address specific pay program components (e.g., total compensation, reliance on the market, pay mix, differentiation, etc.) will help the board to ensure that decisions made with regard to director pay are made thoughtfully, holistically, and accurately. Principles, and their definitions, should be articulated clearly so that their specific implications will be well understood.

Many boards are unwilling to differentiate pay to such a degree as to create disharmony among directors.

For instance, given the guiding principle regarding differentiation presented in Exhibit 4, a board may choose to pay more to certain directors whose responsibilities demand more time (compared to historical levels as well as other directors). It may also decide to determine a premium compensation level for its non-CEO chairman or lead director. This additional "demand-based" pay could consist of cash, equity compensation, or both. Several boards with whom we have worked have chosen to pay a premium to all committee chairs, offering a slightly higher premium to certain chairs whose time demands have increased more significantly than others. One manufacturing company's board chose as a further step to invoke a mandatory rotation for committee chairs, so that directors could be given the opportunity to contribute additional leadership and time to the board over the course of several years.

In regard to the pay mix principle in Exhibit 4, the board of one technology company decided to compose half of its annual retainer in cash and half in stock. In addition, it moved from granting stock options to granting a mix of options and restricted shares, in order to create the alignment it was seeking and to allow directors to satisfy the newly erected ownership guideline within a reasonable number of years. Retainers for committee service were also made subject to the 50/50 cash/equity mix.

Looking ahead

Corporate boards can do a great service to their directors, companies, and shareholders by having in place a thoughtfully designed "director value proposition" — the spectrum of benefits and costs that directors must consider when deciding whether to join, or stay on, a board (for a fuller analysis of the director value proposition, see "Board Tenure: How Long Is Too Long?," DIRECTORS & BOARDS, Winter 2004). Because this value proposition will include compensation, it makes sense for boards to think through and articulate exactly what directors will be paid for, how they will be paid, and why they will be paid in such a way.

Designing, effecting, and following a set of guiding principles is a reliable and concrete way to ensure that pay decisions are considered in light of the corporation's business needs, the board's talent needs, and the board's comprehensive set of beliefs about the design of a director compensation program. ■

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