Compensating Outside Directors in the Current Environment

What should they be paid and how?

Increased responsibilities and a shortage of qualified candidates will likely result in substantial increases in compensation for outside directors.

Traditional packages should be re-examined to ensure alignment with new rules, regulations and corporate objectives.

HayGroup®

HAY VIEWPOINT

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The appropriate compensation of outside directors has emerged as a hot topic for many companies. In view of the increased responsibilities, time commitment and scrutiny of directors, as well as a shortage of top-flight candidates who are willing to serve, Hay Group believes that the overall compensation of directors at many public companies needs to be raised substantially. In addition, critical refinements should be made in the equity components of board pay.

The year 2002 is likely to be remembered for the spotlight it focused on corporate governance and executive compensation, triggered by wide-ranging scandals at major corporations. As events unfolded, public companies came under the microscope from seemingly every interest group—the press, shareholders (including institutional investors), stock exchanges, Congress and government regulators. Corporate board members have been called upon to take a more active role and need to devote more time to their important yet part-time board positions. The concern with excessive compensation of executives at many companies also may trigger a review of director pay which, somewhat ironically, should result in increases in such remuneration.

In view of the increased responsibilities, time commitment, and scrutiny, as well as a shortage of top-flight candidates, it is likely that the compensation of directors will increase substantially.

Typical Components of Directors' Pay

To place our views on compensating outside directors in the proper perspective, it is helpful to review how boards have been paid in recent years. A typical board compensation program has included multiple components in varying balances that are dependent on the company's culture and particular goals. The remuneration of non-employee directors of public corporations generally involves a combination of a fixed annual retainer, board and committee meeting fees, a committee chair fee and equity-based awards, such as outright stock grants, restricted stock, stock options and deferred stock. Retainers and meeting fees may be delivered in cash or in stock. While some companies also provide deferred compensation programs, insurance benefits and certain perquisites, these items have not been significant elements of directors' pay during the last few years.

Companies adapt the customary components of directors' compensation to their particular situations. We recently examined a listing of director pay categories tracked by Executive Compensation Advisory Services and noted that almost 100 separate items of compensation were identified. With this panoply of means to compensate a director, a company should consider how to devise a program that addresses today's challenges and helps build a board with the necessary expertise.

With a panoply of means to compensate a director, a company should consider a program that addresses their unique challenges.

Relevant Principles for Compensating Directors

A 1995 report by the National Association of Corporate Directors' Blue Ribbon Commission on Director Compensation ("Commission Report") set out five principles for use in the design of director compensation programs. Two of these standards appear especially relevant in determining the appropriate compensation of a corporation's outside directors in today's climate. The Commission Report contains the principle that directors should be adequately compensated for their time and effort. Although this principle could prove quite expensive if a company seeks to compensate a director commensurately with alternative opportunities, it is useful in viewing the overall context of director remuneration.

Another principle articulated in the Commission Report was that director compensation should be approached on an overall basis rather than as an array of separate elements. The basic concept is that a company can utilize various components in structuring director pay programs without a concern that one particular element is particularly high or low—it is the total package that needs to be examined. For example, if two similar companies provide board retainers but only one of which pays meeting fees, we would expect the retainer to be higher at the corporation without meeting fees.

Issues Arising from Recent Developments

During the last several years the responsibilities and time commitments of directors have increased as corporate governance concerns have grown in importance. The trend sharply accelerated as well-publicized scandals at some prominent

corporations emphasized a need for directors to provide active and informed oversight of company management. In addition, new corporate responsibility and accounting reform legislation enacted this past summer increased the duties and accountabilities of board members (especially those serving on the audit and compensation committees).

Although a directorship is only a part-time position (often while serving as a chief executive officer or other senior official of another company), recent developments have reemphasized the importance of the position. We especially note the new burdens imposed by corporate governance initiatives, legislative and regulatory efforts and increased shareholder activism. Companies must consider how to help assure that high-quality and experienced individuals can be enticed to accept a position that typically provides only a modest supplement to their income and net worth.

Whether due to a company's perceived need or new mandates, the qualifications for a director have become more exacting.

Whether due to a company's perceived need or new mandates, the qualifications for a director are becoming more exacting. Companies may focus even greater attention on the expertise of each director so that the board as a whole has the necessary knowledge and perspective to perform its expanded functions. Also, as some companies place limits on the number of boards on which their senior executives may sit, the pool of talent from which board members are selected is reduced. In addition, the increased obligations, time commitments and potential have caused many candidates to decline an offered board seat.

A likely result is an increase in the effort needed to find appropriate directors, as the competition for high-quality, suitable board members should intensify. Under our economic system, these events likely will prompt increases in board compensation at many companies. Companies should view recent developments as an opportunity to reevaluate director remuneration and make any appropriate changes. Hay Group has examined numerous issues that companies may wish to consider in determining how best to compensate their outside directors:

- Should the annual retainer be significantly raised (i.e., more than the small increases that typically occur every few years)?
- Are board and committee meeting fees still appropriate or should a board retainer cover all such service? Alternatively, does the expected increase in

the number of meetings suggest that compensation increases are most appropriately handled through payments on a per meeting basis?

- If certain committees involve substantially more responsibility and/or time commitment than others, should its members receive greater compensation than other directors or should this be simply handled by committee fees?
- In attempting to recruit certain persons with especially desirable qualifications to serve on the board, is it appropriate for the Company to pay a larger retainer than for sitting board members?
- Should directors have the ability to defer all or a portion of their cash compensation?
- Should a company require that a portion of a director's retainer be paid in the form of company stock?
- Should a director be required to hold, for the duration of his or her board service, any shares of company stock received in payment of a portion of the annual retainer or acquired by stock option?
- Are options even appropriate for directors? Given the risk-free attributes of options, might options cause directors to encourage excessive risk in order to attempt to obtain outsized gains?

The most significant changes that have caused this rethinking of directors' pay are not reflected in 2002 proxy data.

After a short discussion of some relevant data, we outline our views on the most significant of these questions.

Data on Board Pay—a Starting Point in the Analysis

Traditionally, an important part of the process of setting director compensation has been to examine comparative data from companies of similar size and in the same basic industry. A primary source is information reported in annual proxy statements. However, most of the significant changes that have caused this rethinking of directors' pay occurred this year and are not reflected in 2002 proxy data. Companies thus are unable to rely on that source for information on any emerging trends or best practices in board remuneration.

Instead of waiting for other companies to act and then examining the data that becomes available next year, a company can take a position of leadership in compensating its board members. Adequate information is available to guide a company in this process. To start, broad surveys such as those undertaken by The Conference Board have found, not surprisingly, that the total compensation of directors strongly correlates with company size (based on revenues or assets). As to the components of this remuneration, annual retainers have been by far the most prevalent form of compensation with fairly universal usage. However, the amount of a retainer can vary significantly, particularly with the size of the company but also among industries. For example, a 2002 report of The Conference Board found the median retainer ranged from around $10,000 at the smallest companies surveyed up to almost $60,000 at the largest group of companies. Wide variations existed within companies of similar size.

Meeting fees (particularly for regular board service but also for committee service) also have been paid by a majority of the companies. Our experience is that meeting fees most commonly have been set at $1000 per meeting. In addition, many companies make periodic (typically annual) awards of stock options or, to a lesser extent, other forms of equity-based incentives such as restricted stock. The same survey of The Conference Board found that the median total annual remuneration of outside directors ranged from over $41,000 among financial companies to almost $56,000 at manufacturing firms.

A marked increase in board remuneration is vital for demonstrating that a company is serious in its efforts to obtain and retain qualified directors.

Hay's Views on Director Pay Issues

Hay Group believes that many board members will be substantially underpaid in 2003 unless real changes are made in their remuneration programs. The relatively minor adjustments to annual retainers and stock options that occur every few years in many corporations are not, in our view, what the current environment requires. Rather we believe that a marked increase in board remuneration is:

- justified by the duties and responsibilities of the typical director at a publicly held firm, and
- vital for demonstrating that a company is serious in its efforts to obtain and retain knowledgeable and experienced directors.

The current emphasis on accountability of corporate boards, particularly members of the audit and compensation committees, indicates a need for concomitant increases in board compensation. While the changes we suggest may not significantly impact the annual income of a director who is an otherwise highly compensated executive (or retired executive) of another corporation, they provide tangible acknowledgment of a director's crucial role. The ideas outlined below can help staunch the exodus of well-qualified individuals who otherwise might be unwilling to serve, especially at those companies which have been targets of a cacophony of criticism on corporate governance matters.

A company's threshold question should be what is the appropriate overall level and mix of its directors' compensation.

Director pay packages of course need to be designed in the context of the company's unique needs and circumstances. A company's threshold question should be what is the appropriate overall level of its directors' compensation and then how should that pay be delivered. For purposes of this discussion, we focus on annual retainers, meeting fees and some form of equity-based award (such as stock options).

We already have noted that director pay levels traditionally rise with the size of the company. Accordingly, Hay Group does not propose a fixed dollar increase in board pay. Instead, assuming that a company is not at either extreme in its recent compensation of directors, we suggest that it consider increases in board pay of 20%-40%. Thus at a company with revenues of $5 billion where aggregate board compensation might be $50,000, an increase to $60,000 to $70,000 might be appropriate. At such levels the amounts become more meaningful and demonstrate a commitment to fair compensation.

Retainer

A large portion of our proposed upward adjustment in board compensation would be in the annual retainer. If the hypothetical company identified in the preceding paragraph might provide a current retainer of approximately $30,000, we would consider an increase to $35,000 to $45,000. Also Hay Group believes that same annual board retainer amount (aside from any separate retainer for serving as the board chair or a committee chair) should be paid to all directors regardless of special expertise or anticipated time commitment. While this might conflict somewhat with the adequate pay principle of the Commission Report, in our view any

such differentiation among directors could be disruptive to board harmony. In addition, where not already offered, a company might provide its directors with the opportunity to defer all or a portion of their retainers.

Meeting Fees

Although some companies pay retainers but not meeting fees, Hay Group does not support that approach. In fact, by paying directors a fixed amount for each committee meeting (not just board meeting) attended, a company can provide greater compensation to directors who serve on the busiest committees without differentiating among directors based on the committees on which they serve. This approach is consistent with the adequate pay principle of the Commission Report.

Equity Compensation

With respect to equity compensation, Hay Group:

- believes that outside directors should have a strong ownership position in their company and
- suggests that at least one-half of a director's annual retainer should be paid in shares of the company's stock.

In our view stock options are a means through which outside directors can attain the desired equity position. While stock options for non-employee directors are uncommon in many other countries, practices differ considerably in the United States. The level of option grants (whether determined by a fixed number of options or fixed value of options) should be carefully considered in view of the overall level of compensation intended to be delivered. Given the typically modest level of director option grants, we believe that any concern that stock options could promote excessive risk in directors is unwarranted.

However, we do have concerns regarding the disposition of shares while an individual is serving on the company's board. Accordingly, we propose that awards of stock and stock options to a board member contain restrictions on the director's ability to sell or otherwise dispose of such shares. At a minimum, such restrictions should prohibit such sales at least until the effective date of the director's cessation of service on the board.

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Anticipated Reaction

While this year has seen executive compensation come under attack from multiple fronts, the compensation of directors is a quite different matter and the deserved enhancements of their pay should not be controversial. Most institutional investors and other shareholders do not mind paying well for performance; what is troublesome is perceived excessive compensation in face of poor performance.

Also, even raises in board pay at the upper end of our suggested range should have only a modest cost to the typical corporation. We note that median number of outside directors appears to be 8 or 9 individuals, which means that the aggregate increase typically would be well below the base salary of the company's chief executive officer.

Recap

In essence, a larger annual retainer and the provision of a significant portion of director compensation in equity subject to holding requirements are needed to compensate board members adequately and provide a long-term ownership interest. A corporation should reexamine the compensation programs applicable to its non-employee directors, consider the company's specific circumstances and determine how best to implement appropriate increases and other refinements.

About Hay Group

Hay Group is a professional services firm that helps organizations worldwide get the most from their people by creating clarity, capability, and commitment.

A research-driven firm, all Hay Group's work is supported by proven methodologies and global knowledge databases and is based on over 50 years of specific, documented evidence that people, not strategies, drive long-term competitive advantage. Our areas of expertise include:

- Organizational effectiveness, role clarity, and work design
- Managerial and executive assessment, selection, and development
- Compensation, benefits, and performance management
- Executive remuneration and corporate governance
- Employee and customer attitude research

Founded in 1943 in Philadelphia, we now have approximately 1500 consultants and 700 support staff working from 72 offices in 37 countries worldwide. According to Consulting Magazine, we are the 37th largest management-consulting firm in the world, and among the top five consulting firms primarily focused on human resources.

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