

## **Point of View: Is This the Time To Change Board Compensation?®**

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Boards of directors, regardless of the company size or industry, are facing increasing pressures to exercise more independent governance over the companies they serve. They have always had the accountability for strategic decisions and ethical practices. They have always sought to support shareholder interests and challenge executive decisions or policies if they felt the direction was inappropriate. But, what has changed is the increased scrutiny to operate independent of executive management and assure decisions and actions of management support the long-term interests of stockholders.

This change means that the demands on the director's time are increasing. Their decisions are often examined by shareholder interests groups and regulatory agencies. Their risks and liability are increasing. The job of a director has become more serious and they have been placed into the position of having accountability for people they do not manage—the top executives.

Naturally this situation leads many members of boards to question whether or not to continue serving and many boards to consider whether they have the right mix of expertise. These questions of commitment, work requirement, liability and expertise mean that the job of the director is, for better or worse, changing.

Therefore, it is indeed time to review the compensation for directors. While the boards of most companies will wait and see what others do before taking action, the thoughtful, strategic or troubled directors will not take a passive, wait and see posture. Dynamic, committed directors know that now, not later, is the time for appropriate action.

The decisions regarding board compensation need to be taken in light of the company's current situation. And you need to be honest with yourself. Is the company in trouble financially or organizationally? Do you sense the shareholder's are confident in the strategy and leadership of the company? Or, is there dissention with regard to board or management decisions? Does the board need to change the membership composition by adding or replacing certain members? This is a time for hone and direct action.

While there are many elements of change emerging with boards, the Point of View you are now reading will address one key topic—the emerging issues and recommended actions for board compensation.

The following actions should be considered in light of your company's own circumstances. The important message here is to examine how to address the specific issues of the company, and how to make the necessary changes if they are needed.

***Action #1: Cash compensation for the directors should be made as a retainer.***

Typically Companies make cash payments to their directors for attending meetings and/or as a retainer. Some companies forget that the director's job is to oversee the management and direction of the company, not simply attend meetings. Here at the Wilson Group we feel they should be paid for their responsibilities not their activities. Therefore, pay them with a retainer. If they don't do their job—attend meetings, review the materials prior to meetings, engage in meaningful dialogue, make decisions in a thoughtful and strategic manner, in short perform like a director—*then remove them from the board.*

***Action #2: Pay the leaders of the Board significantly more than the standard directors.***

The job of the committee chair is growing in both importance and time demands. They can contract with their own external advisors as well as thoughtfully review the information provided by management. They should direct the agenda and decisions of their respective committees. Further, the boards are charged with the responsibility of selecting a lead director who should supplement or replace the activities of the chairman when it comes to the board's decisions. Therefore, the organization needs to pay these people commensurate with their responsibilities. So, how much more? At the Wilson Group we feel...

- The Lead director should receive 2x to 4x the average director cash retainer.
- The Committee chairs should receive 1½x to 2x the average director cash retainer.

Finally, these payments should be made in cash, not stock. (See the next issue for our rationale).

**Action #3: *In addition to cash compensation, provide equity participation for all directors.***

As yourself this question: When the directors receive stock options or awards for being a member of the board, does this align their interests with those of management and the shareholders? Or, does the stock encourage them to collude with management in taking actions that “look good to the market” in the short-term, but fundamentally undermine the future of the company? The purpose of equity participation is to provide the individual with a stake in the future of the company. Therefore, each organization will need to develop their ownership philosophy, guidelines and mechanisms for the stock ownership. Here are several important recommendations we suggest you closely consider:

- **Pay all your directors the same amount when they are elected and more on annual basis.** Consider if it is appropriate to provide higher stock awards to those with board management responsibilities, but in most cases **do not** differentiate with regard to the stock. This reinforces the principal that the board members share common corporate performance responsibilities and the Lead Director and Committee Chairs are paid more cash compensation for their additional duties and responsibilities.
- **Use restricted stock awards (not options) for the directors.** Options have no value when they are initially granted and if the stock price goes below the exercise price. Stock grants, however, have immediate value and a fewer number of them are needed to realized a comparable gain. (Be sure to develop an individualized response to the tax implications for these grants to the board directors.)
- **Provide grants on an initial election and annual basis.** The initial grants should be approximately 2x the number the board member receives on an annual basis. The annual grants provide a “dollar-cost-averaging” effect to stock awards.
- **Use cliff vesting for all stock awards.** The purpose of vesting for directors is not to retain them, but to encourage decisions that reflect both short and long-term impact. Graduated vesting can cause a focus on annual results over long-term performance. Over time the number of shares a director owns should reflect an “appropriate” stake in the company without encouraging decisions focused more on short-term gains. The primary shareholders should be able to define what is “appropriate.” This also looks good to shareholders and potential shareholders.

**Action #4: Consider eliminating “simulated employment” provisions.**

These include board members participating in the company’s health benefits, retirement and deferred compensation programs as well as perquisites like cars, cell phones, employee services, etc. The board needs to remain independent of the corporation while understanding and serving the interests of all of its stakeholders. *This means the board members should not be dependent on any programs the company offers to its employees.* Obviously they should be compensated for any expenses incurred in fulfilling their responsibilities including travel costs, telephone charges, special mailings, and similar costs.

**Action #5: Consider carefully if the board of directors should receive performance-based compensation.**

When a company’s executives, managers and employees participate in performance-based compensation programs, there is a set of objectives or measures that link to the organization’s strategy. The performance is evaluated on the basis of results and judgment of one’s superiors. These conditions do not exist for the board members, unless lead investors serve this role. Consequently, performance-based compensation plans for the board, that link either additional cash or equity awards to the achievement of specified outcomes, could be challenged for their integrity. However, the consequences for board decisions and actions need to extend beyond just the “threat” of losing one’s position at the table. The issue of performance-based pay should be frankly discussed as it will likely become an important focus for future dialogue and development.

## Summary

It is imperative that boards of directors reexamine their compensation arrangements, and use these programs to reflect new roles and responsibilities. To best represent their constituencies—the shareholders, the board needs to become independent of executive management, while demonstrating confidence (if appropriate) in the firm’s leadership.

What is needed now is a strategic framework and set of guidelines for the compensation of the board of directors that is appropriate for the industry and the company. The actions highlighted in this Point of View should serve to stimulate discussion and better decision-making. Reactive or ad hoc decisions will likely add conflict and confusion to many board members and undermine their crucial ability to operate as a cogent, highly effective team.

In these times of fundamental change to the mind-set and working style of the board, compensation plans communicate and reinforce the important tenants of governance. The tasks of developing an effective compensation plan for directors can serve to clarify and facilitate how the board addresses core issues in structure and operational practices. It can also clarify and support actions related to defining responsibilities and staffing requirements. These decisions become the core elements of effective corporate governance. And, this is the time when these issues need to be addressed.

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