The New Director Compensation Paradigm

Daniel J. Ryterband and Eric Winikoff, Frederic W. Cook & Co. Inc., with Practical Law Employee Benefits & Executive Compensation

A discussion of the catalysts for recent changes in director compensation programs and a review of current trends and best practices.

Compensation practices for senior executives have evolved substantially over the past decade in response to many factors, including:

- Government regulation.
- Accounting changes.
- The global financial crisis.
- The recent focus on enterprise risk management (ERM).
- Pressure from investors to create a stronger link between pay and sustained performance over time.

A similar but less noticeable shift has occurred with regard to the philosophy, design and administration of compensation programs for non-employee directors.

This article addresses:

- The catalysts underlying the evolution of director compensation programs.
- Resulting trends and recognized best practices.

FACTORS INFLUENCING EXECUTIVE AND NON-EMPLOYEE DIRECTOR COMPENSATION PRACTICES

Over the past several years, a variety of corporate governance developments have:

- Empowered shareholders.
- Promoted the ability of directors to govern independently and objectively.
- Driven increased transparency and heightened accountability for board level decisions related to compensation policy and practices.

These developments include:

- Enhanced compensation disclosure requirements.
- Increased prevalence of annual majority voting for director elections.
- Say-on-Pay and other provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).
- The increasing influence of proxy advisory firms.

For a discussion of the issues that companies should consider when establishing or evaluating their corporate governance practices, see *Practice Note, Corporate Governance Practices: Commentary (http://us.practicallaw.com/0-383-5234)*.

FUNDAMENTAL TENETS OF DIRECTOR COMPENSATION PROGRAMS

The above developments have contributed to the following fundamental tenets with regard to director compensation programs:

- **Strong Corporate Governance.** The design and structure of director compensation programs can demonstrate to shareholders the board's commitment to strong corporate governance principles and practices. In other words, the philosophy underlying director compensation reflects fundamentally on the board's overall views regarding corporate governance.
- **Promotion of Best Practices.** A shareholder-friendly approach to director compensation sets an example that the board can reference when promoting best practices with regard to executive compensation by creating a foundation of trust, balance and fairness with management.
- **Objectives Supporting Director Independence.** The objectives of executive and director compensation programs should be different. Whereas executive compensation programs focus on encouraging retention and continuity of service, director compensation programs should support independence and objectivity among directors. While it is important for director compensation programs to create alignment with shareholders and foster high levels of engagement and commitment, it is essential to avoid policies that could entrench directors or affect their willingness to challenge the management team with regard to a company's operational and strategic initiatives. Striking the right balance between interest alignment and independence is a major objective in director compensation design.

These three factors have been the principal drivers behind the evolution of director compensation programs over the last several years, resulting in the primary design trends and best practices presented below.

DESIGN TRENDS AND BEST PRACTICES FOR DIRECTOR COMPENSATION

Benchmarking and Philosophy

Director compensation should be benchmarked and managed in a manner similar to the company's executive compensation program. For example:

- Benchmarking studies should generally use the same comparator group as that used for the company's executive compensation program and should avoid aspirational peer groups or peer groups comprised of other companies where directors may sit on the board. For more information on benchmarking and peer groups, see *Practice Note, Designing, Determining and Disclosing Executive Compensation: A Consulting Perspective (http://us.practicallaw.com/6-507-0928)*.
- The targeted competitive posture for the director compensation program (for example, the market median or the 75th percentile of peer companies) should be the same as that used for executives. This is particularly critical for companies where long-term incentive program costs and share usage are constrained due to:
  - profit and loss affordability issues;
  - high overhang levels (that is, the sum of the number of shares authorized for grant under awards and any shares subject to outstanding awards are a significant percentage of the company's total outstanding stock); or
  - pressure on equity plan share reserves.
- Directors should hold themselves accountable to:
  - owning a minimum level of company stock similar to that required to be owned by executives, which is often required by director stock ownership guidelines, with required ownership levels generally ranging from three times to five times the annual cash retainer; and
  - strict compliance with company policies regarding stock sales by insiders.

Form of Equity Compensation

While once viewed as creating appropriate alignment between director and shareholder interests as well as parity with the management team, stock options and other leveraged equity compensation vehicles are no longer considered an appropriate form of compensation for directors at most large, mature companies. This is because the asymmetry in payout outcomes could create a perverse incentive for directors to support high-risk, high-reward business strategies.

Once underwater (that is, the exercise price exceeds the fair market value of a share), the practical value of an option is not affected by further declines in share price, but high-risk business strategies may enable a payout if they result in sizable appreciation. Because of this potential for encouraging risk, the prevalence of stock option grants to directors, with the exception of certain industries (for example, high-tech and biotech companies), has dramatically decreased over the past several years.

More prevalent are restricted or deferred stock or unit awards that are less highly leveraged and have symmetry in upside and downside payout opportunity. For an overview of different types of equity compensation, see *Practice Note, Stock Options and Other Equity Compensation (http://us.practicallaw.com/0-501-9297)*.

Short Vesting Schedules

A fundamental principle in director compensation programs is to avoid policies that may entrench directors or otherwise discourage their willingness to proactively challenge management or other board members. Long vesting schedules combined with annual elections create the risk of lost compensation if a dissident director is asked not to stand for reelection. As a result, there has been widespread movement towards immediate or annual vesting of director equity awards.

No Entitlements

Director compensation programs should avoid material benefits and perquisites or other entitlements that can compromise independence and make board members beholden to management. As a result, many once common director benefits and perquisites have become virtually extinct, such as:

- Health and welfare benefits.
- Automobile allowances.
- Country club dues.
- Charitable matching benefits.

No Performance-based Compensation

To promote independence and the willingness of board members to challenge management with regard to the setting of short- and long-term financial goals, cash and equity compensation for directors should not:

- Be earned based on operating performance.
- Fluctuate up or down based on prior year results.

These types of programs may:

- Impair a director's ability to govern in an objective way.
- Compromise the goal-setting process for executive annual and long-term incentive programs.

Rather, the performance-based nature of director compensation should be more organic, through the combination of:

- Full-value equity awards such as restricted or deferred stock or units.
- Stock ownership requirements. Generally, directors should be required to hold a minimum level of company stock for the duration of their service on the board, or, alternatively, until six months following termination of service.

Differentiation in Compensation

Changes in the regulatory and corporate governance environment over the past several years have placed increasing time demands on directors and many companies have structured programs to deliver differentiated compensation based on the time commitment and responsibility of each role. This has manifested itself through:

- The use of committee meeting fees to account for differences in workload by committee.
- Enhanced compensation for committee chairs.
- Incremental compensation for Lead Directors or non-executive chairs. For information on different board leadership structures, see *Article, Implementing Independent Board Leadership Structures (http://us.practicallaw.com/9-505-3423)*.

The degree to which companies differentiate varies, however, with some paying *per diem* fees for participation in board and committee meetings and others building compensation for meetings into the annual board retainer to promote the message that full attendance is obligatory and expected.

Tax Efficiency

Because many corporate directors are current or retired executives that do not rely on their board compensation to cover their day-to-day expenses, directors should be afforded the opportunity to defer cash or equity compensation to avoid immediate taxation and provide flexibility in managing their personal financial situation. This is especially important for certain equity awards because, due to non-employee directors' status as independent contractors, companies are not permitted to withhold shares to cover taxes associated with vesting, which creates an unintended incentive for directors to sell shares. Given the recent tax rate increases, the attractiveness of deferral opportunities for directors is likely to grow.

Any director deferral program must be structured to comply with Section 409A of the Internal Revenue Code. For more information on Section 409A, see *Practice Note: Section 409A: Deferred Compensation Tax Rules: Overview (http://us.practicallaw.com/6-501-2009)*.

IMPORTANCE OF MAINTAINING A SOUND DIRECTOR COMPENSATION PROGRAM

Maintaining a sound director compensation philosophy and program structure is critically important to:

- Attract and promote a high-functioning, independent board.
- Demonstrate the board's commitment to high standards of corporate governance.

It is therefore important for companies to regularly review their director compensation programs. Most compensation committees or nominating and governance committees (whichever committee has oversight responsibility for the company's director compensation program) review their director compensation program structure and pay levels annually, although it may be reasonable to review the program every other year during periods:

- Of low stock market volatility.
- With few regulatory or corporate governance developments.

When reviewing director compensation programs and contemplating changes, the program's philosophy and structure should be considered for alignment with both:

- Peer group practice.
- Current corporate governance principles and corresponding market trends.

For the links to the documents referenced in this note, please visit our online version at http://us.practicallaw.com/2-538-5845