Scrutiny And Standardization Of Director Pay

by Alec Lentz and Ken Sparling

With more attention on board pay, programs are becoming more standardized and equity pay is usually in stock awards targeted at specific dollar values. Lawsuits are causing director-specific pay limits to become an emerging best practice.

Evolving director pay practices reflect the challenges facing public companies today, including market volatility, increased shareholder scrutiny and activism. The result is normalizing practices, narrowing pay ranges and more frequent (but smaller) adjustments.

Director pay levels remained fairly steady in 2015, with more uniformity in how pay is delivered. Share ownership guidelines are nearly universal, and an emerging practice among large-cap companies is a requirement to hold all equity for a defined period or until retirement.

Top accounting firms have indicated that these "mandatory hold" policies may allow for a discount in the accounting value of directors' stock pay. Such a discount allows a company to grant the same number of shares at a reduced reported value and with less compensation expense, or to grant a greater number of shares for the same grant value.

Looking ahead, litigation promises to make director pay a higher-priority topic in the boardroom. There were a handful of lawsuits in the last few years claiming that directors were paid too much. Companies are responding by asking their shareholders to approve specific director compensation limits.

☐ ***Director pay levels.*** Our firm studied non-employee director pay programs at 300 companies of various sizes and industries in 2014 and 2015, and found a four percent year-over-year increase in total pay at the median. The 100 large-cap companies in our sample (market cap greater than $5 billion) pay directors $260,000 at the median, with few crossing the $300,000 level.

At mid-caps (market cap $1-$5 billion), the median director pay is just shy of $200,000, and is $136,000 in the sample of small-cap companies (market cap less than $1 billion). Technology companies pay the most if results are broken out by sectors, and financial services companies pay the least. Amounts exclude additional compensation for serving as lead director, non-executive chair, or for chairing a committee.

Board pay is now more dynamic, with greater standardization and compression of pay levels between companies of similar size and industry.

Companies are also reviewing their director programs more frequently now, with most large-cap companies reviewing annually to allow smaller adjustments, replacing the larger, once-in-awhile increases of the past. There is now a great deal of standardization and compression of pay levels between companies of similar size and industry. To illustrate, there is only about a 35 percent difference between the 75th percentile and 25th percentile in total board pay in the large-cap group.

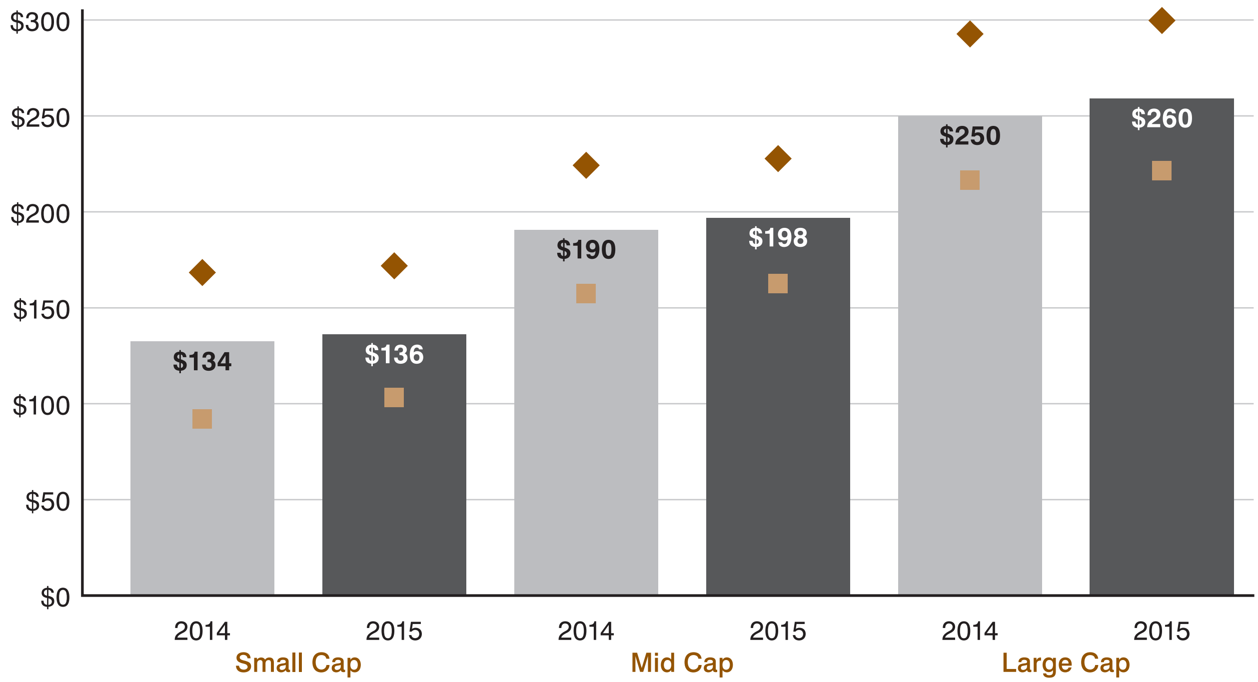
Equity grants generally make up more than half of total director compensation at companies of all sizes. Large-caps provide the greatest portion of pay in equity (65 percent equity and 35 percent cash, on average).

☐ ***Pay structure.*** Board pay programs have become simpler, with practices first seen at large-cap companies now common throughout the market. Cash is increasingly paid in the form of an annual retainer, without additional fees provided for attending board meetings. Eighty percent of large-cap

Alec Lentz *and* **Ken Sparling** *are consultants in the Los Angeles office of F.W. Cook & Co. [www.fwcook.com]*

Pay Correlates With Size

Total Director Compensation By Size ($000)



2015:	Small Cap	Mid Cap	Large Cap
◆ 75th percentile	$172	$227	$300
Median	**$136**	**$198**	**$260**
■ 25th percentile	$102	$162	$220

companies use retainers only, which is an increase over the 73 percent retainer-only rate in our study one year ago. The large-cap companies led the shift to retainer-only arrangements, but now the majority of mid-cap and small-cap companies have followed suit.

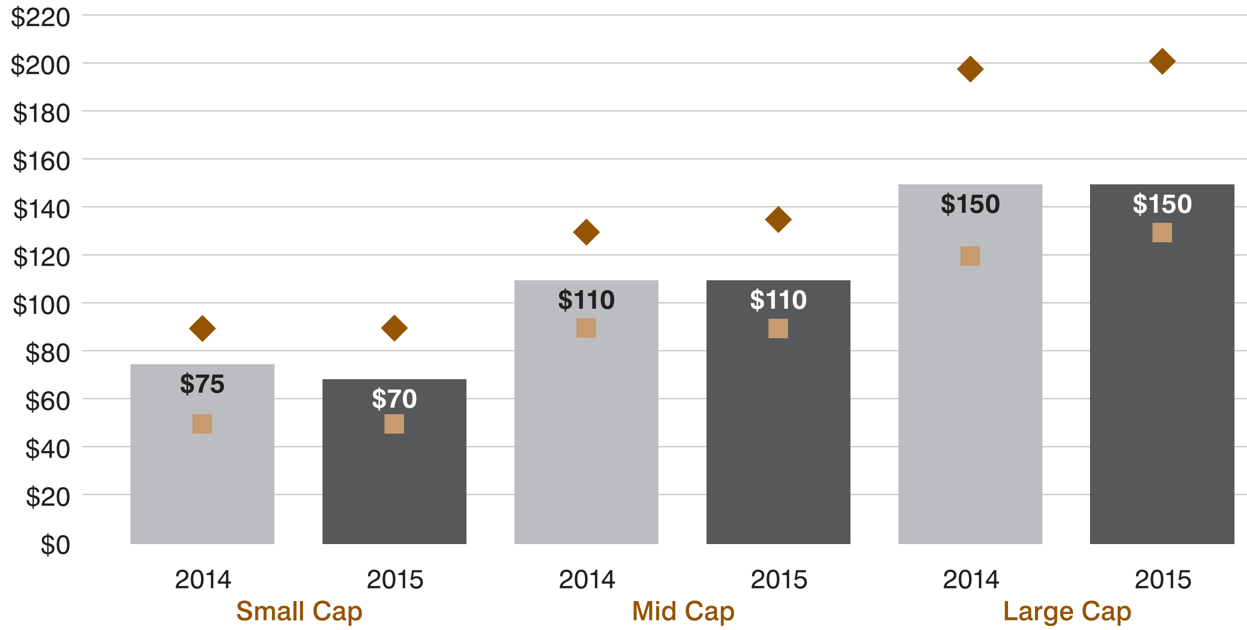
A small portion of companies (about five percent) are scaling back meeting fees instead of eliminating them completely. They pay meeting fees once the number of board meetings exceeds a set minimum per year (typically six to ten, if such feature is in place). This conditional fee structure automatically adjusts pay in a year of higher than expected board workload, such as a year with a great deal of M&A activity.

About two-thirds of companies provide directors with additional compensation for serving on a board committee, either through committee retainers and/or committee meeting fees. This is the first year more companies in the survey paid committee member retainers than paid committee meeting fees. The prevalence and value of committee retainers are typically highest for the audit committee.

Nearly all companies pay additional compensation to committee chairs to recognize the substantial time required to lead the committee. Of those that pay both the audit and compensation committee chairs, roughly a quarter provide the same value to both of these chairs, emphasizing the growing requirements of the compensation committee.

Equity—A Vital Pay Tool

Equity Compensation Value By Size ($000)



2015:	Small Cap	Mid Cap	Large Cap
◆ 75th percentile	$100	$135	$201
Median	**$70**	**$110**	**$150**
■ 25th percentile	$50	$90	$130

Sectors that provide the highest board equity pay are also those that provide the highest total board pay, underscoring equity's prominent role in director compensation.

☐ ***Equity awards.*** Median equity pay remained flat year-over-year in each size group. The difference in total compensation between size groups is primarily due to differences in equity values. For instance, median equity value at small-cap companies ($70,000) is less than half of the median value of $150,000 at large-cap companies.

Equity pay continues to be highest among technology companies and lowest among financial services firms. The sectors that provide the highest equity pay are also the sectors that provide the highest total board pay, underscoring equity's prominent role in director compensation programs.

Stock awards (such as restricted stock/units, deferred stock units, or fully-vested stock) are the most prevalent equity grant type in director compensation programs across all company sizes and sectors. This is led by the large-cap segment, where 90 percent of companies grant stock awards. The use of stock-only equity programs increased compared to the prior year in each size category. Stock options are more prevalent at small-cap companies than at large-caps, although still found at only about 15 percent of the small-cap sample group.

Ninety percent of companies that grant stock awards start with a targeted grant value, then determine the number of shares based on the stock price at grant (a "fixed-dollar value" grant strategy). Dollar-denominated awards provide the same grant value and consistent proxy disclosure of equity compensation each year, regardless of fluctuations in stock price.

The median board equity ownership requirement is now five times the annual cash board retainer, a preferred level for some shareholder advisors and institutional investors.

☐ ***Stock ownership guidelines and retention requirements.*** Director stock ownership guidelines are in place at nearly every large-cap company, and continue to grow in prevalence among smaller companies. Ninety-six percent of large caps in this study have some form of stock ownership guideline and/or retention requirement in place (up from 91 percent last year), while over 60 percent of the small caps have ownership guidelines and/or a retention requirement (up from just over 50 percent last year). The increase in these mandates reflects the ongoing focus on corporate governance best practices that seek to align the interests of directors and long-term shareholders.

In general, directors are given a specified timeframe within which to comply with the guideline, or must retain shares for a specified time period (e.g., until the ownership guideline is met) after vesting of grants. The median ownership requirement is now five times the annual cash board retainer, which aligns with the preferred level of some shareholder advisory firms and institutional investors. Meanwhile, 10 percent of companies have a mandatory hold-until-retirement policy (although this is rare at small-cap companies).

☐ ***Compensation deferrals.*** The 2013 increase in the marginal tax rate contributed to wider adoption of deferral programs for directors. Thirty percent of companies in our study allow directors to voluntarily defer cash compensation into alternative investments, commonly the same as those provided in a company's employee 401(k) plan. A similar proportion allows directors to defer cash into a company stock unit account.

These are not mutually exclusive groups—many companies provide directors opportunities to defer into both diversified investments and their own stock units. Of the large caps, over 60 percent allow deferral of cash pay. Deferrals are most often distributed upon a director's separation from the board.

Deferral of equity compensation beyond the vesting period is a little less prevalent than programs allowing deferral of cash. Twenty-six percent of large-cap companies allow equity deferral, and an additional 23 percent mandatorily defer settlement beyond vesting. Therefore, nearly 50 percent of the sample large-cap companies now allow or require deferral of equity pay. Equity deferral programs are mostly seen at large-cap companies, and are fairly rare at smaller companies, with the feature included by only 10 percent of the small-cap sample.

☐ ***Discounted grant values.*** Mandatory post-vesting holding periods for director equity may increase in the coming years due to new attention toward the accounting treatment of equity grants with this feature. Emerging guidance from the national offices of the big four accounting firms indicates that the expense for grants with a post-vesting holding requirement could be discounted due to the lack of liquidity during the holding period. This allows companies to either grant more shares and recognize the same expense, or keep the number of shares granted constant and disclose a lower grant value and expense.

With nearly one quarter of large-cap companies already having mandatory deferral policies in place for directors, these companies may reevaluate the cost and proxy-disclosed value of director equity grants. There is not yet universal agreement from accountants on how to properly value the discount for a hold-until-retirement policy. The effective holding period could range from zero to over ten years. The practice has only been disclosed in a handful of proxy statements to date, so shareholder reaction and companies' response is not yet known. As a result, many companies are taking a wait-and-see approach.

A middle ground for applying a grant discount is to adopt a fixed minimum holding period (such as one year). This means that instead of simply requiring deferral until termination of board service (which could occur at any time), the company would require directors to hold their vested grants for a fixed number of years, irrespective of when they retire from the board. The size of the discount is directly related to the length of the mandatory hold period (e.g., a larger discount would be applied for a three year hold requirement than a one-year hold requirement).

☐ ***Director compensation litigation and shareholder-approved pay limits.*** A series of shareholder lawsuits have challenged the magnitude of director pay. While the courts have yet to issue a final decision in favor of shareholders, multiple cases have proceeded beyond initial motions to dismiss, and, recently (in litigation involving the pay of Facebook directors), a settlement. These developments may spur similar lawsuits at other companies, or cause boards to implement meaningful shareholder limits on director pay.

Under Delaware law, director decisions are generally provided broad protection under the business judgment rule. However, this protection does *not* extend to director compensation, because directors set their own pay (they are not disinterested).

Absent application of some other doctrine, defeating a shareholder lawsuit at trial would require a company to demonstrate that its director pay was not excessive based on a higher standard of review than the business judgment rule. Even though a company may prevail, the discovery process and trials are costly, and companies may settle to avoid further expenditure of time and money.

However, when the shareholder-approved equity compensation plan includes a limit on director pay, the courts have indicated that the doctrine of "shareholder ratification" may protect the boards' decisions. Recent cases suggest that this shareholder ratification defense will only apply if the director pay limits in shareholder-approved plans are "meaningful."

In other words, the limit of total shares authorized in an equity plan or individual award limits for IRC Section 162(m) deductibility are *not* treated as blanket shareholder approval of director pay. There are no specific guidelines for what constitutes a "meaningful" limit, but emerging practice is two to three times a company's current director pay value. Since the case law does not appear to distinguish between equity and cash pay (though the latest cases have focused on equity compensation), the more prudent approach is to have a meaningful limit on total compensation, both cash and equity.

Another way to discourage such lawsuits might be to set director pay at a level that would not be considered excessive by outsiders (a "median" of comparable companies) and enhance proxy disclosure to include a description of the approach used to benchmark director compensation.

How should boards respond to this litigation trend? Unless you believe your proxy statements make clear cases that director compensation is at or below the median of comparable companies, consider adding "meaningful" annual limits on director cash and equity pay into the stock plan the next time the plan goes to shareholders for approval. Some companies may also find reason to move up shareholder approval of an amended stock plan into 2016 or 2017 for the sake of adding director compensation limits sooner rather than later. ■

Reprinted by THE CORPORATE BOARD
4440 Hagadorn Road
Okemos, MI 48864-2414, (517) 336-1700
www.corporateboard.com