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ADVISER

Helping Public Companies

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Directors' Compensation: A Delicate Balancing Act

After passage of the Sarbanes-Oxley Act of 2002, the director's role took on greater responsibility and heightened exposure to liability. It's no surprise, then, that directors' compensation has grown steadily over the last seven years. Companies, however, need to regularly review directors' compensation to ensure it remains reasonable.

Not enough or too much?

Directors' compensation isn't a private matter between your company and its board members. In today's tumultuous economic environment, shareholders, the media and other interested parties are paying close attention to the compensation paid to both officers and directors. What's more, SEC rules now require detailed disclosures about directors' compensation and your company's process for determining it.

All public companies, therefore, need to evaluate their directors' compensation programs periodically, focusing in particular on non-management directors. The pay should be enough to compensate directors for the responsibilities and risks they assume, but not be so much that it jeopardizes their independence or attracts public censure.

Questions you should ask

Consider the following as you review your directors' compensation program:

Compensation amount. There's nothing wrong with paying healthy fees or retainers to directors, so long as these amounts are reasonable in light of their duties, the risks they assume and directors' fees at comparable companies.

It generally makes sense to pay higher compensation to directors whose roles involve greater responsibility, such as

chairing a committee or serving on audit, compensation or nominating/governance committees. Because there's an inherent conflict of interest when the board determines its own compensation, directors must document the process thoroughly with market data and detailed descriptions of roles.

Form of cash. Many companies are moving away from traditional meeting fees to paying annual retainers. This helps reinforce the idea that a director's oversight responsibilities extend beyond meeting attendance. It also helps companies avoid confusion over issues such as what constitutes a "meeting" (for example, do phone meetings count?) and how to compensate a director for partial attendance.

Mix of cash and equity. Most companies pay a portion of directors' compensation in equity to ensure that their interests are aligned with the shareholders'. There's no magic percentage that companies should use, provided the equity portion is large enough to be "meaningful."

Form of equity. Traditionally, companies have used stock options, but options have become less popular in recent years for a couple of reasons. First, the recent backdating scandal has made many people suspicious of option programs. And second, many view options as less effective motivators because they have no downside risk and may encourage a short-term approach that focuses on the company's stock price.

Restricted stock may be a better alternative because it encourages directors to take a long-term view that better aligns their interests with those of shareholders. To ensure this alignment, many companies require directors to maintain a certain level of stock ownership for as long as they serve on the board.

Additional perks. If your directors' compensation includes benefits, such as cars or country club memberships, consider whether they send the wrong message about director independence. Most perks have no relationship to a director's performance.

Review your program

You have some flexibility in evaluating your current compensation program and determining whether it's reasonable. The important thing is that you work to make pay commensurate with directors' levels of responsibility and risk, and that you be sure your program aligns the interests of directors and shareholders. Just make sure you thoroughly document the process of setting directors' compensation, and your program is more likely to withstand shareholder and government regulator scrutiny. h

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