CURRENT ISSUES WITH OUTSIDE DIRECTOR COMPENSATION

By Bob Romanchek and Adam Hearn

THE TOPIC OF OUTSIDE director compensation has been relatively static over the last few years, becoming greatly simplified over time (i.e., no more health insurance or country club perks). However, there are important issues boards are currently dealing with when it comes to their own compensation and related policies. The following information identifies issues currently in play when it comes to outside director pay.

Although director compensation has become simplified over the years, dynamic pay and related policy issues remain important ongoing considerations.

■ **A Simplified Pay Package:** Historically, some director pay packages included retirement benefits, medical and life insurance and numerous perquisites. Today, primarily due to public scrutiny, the perks and benefits are gone. Total pay packages now consist of an equity grant, cash retainers and possibly meeting fees. The primary question is now how large the equity grant should be, relative to the cash retainer.

■ **RSU Equity Grants are the Norm:** In the equity grant category, performance-based grants are almost never appropriate for outside directors. Stock options have dramatically decreased in prevalence. Full-value equity grants that vest based upon the passage of time, particularly restricted stock units, are now the norm. Unlike restricted stock, RSUs provide a deferral opportunity and also solve most tax and securities law issues, if granted outside the U.S.

■ **One-Year (or less) Vesting:** As director terms have decreased from three years down to one, equity grant vesting lengths have followed suit and are now predominantly one year. However, a growing number of companies are making outright stock grants that are immediately vested, but subject to stock ownership "holding" guidelines.

■ **Stock Ownership Guidelines:** Company policies that require executives to own a certain amount of stock also commonly pertain to directors. These non-statutory "stock ownership guidelines" require each director to own stock of around five times the value of their cash retainer. RSUs almost always count as ownership.

■ **Committee Meeting Fees vs. Annual Retainers:** The issue of continuing to pay a fee for each meeting has lingered for years. Most companies now pay a cash retainer instead of meeting fees, as the job has changed considerably. With a material increase in the number of calls and virtual sessions, paying by the meeting has become impractical, just as it would be to pay your CEO by the meeting.

■ **Smaller Annual Pay Changes vs. Large Changes Every Three Years:** As director elected terms decreased from three years down to one, the timing for implementing pay changes has also decreased. When three-year terms prevailed, many companies changed director pay only once every three years—which meant fewer, but larger, pay increases. Now that most directors are elected annually, it has become common to make smaller annual increases.

■ **Everything Can be Deferred (in the U.S.):** If a company has moved to RSUs, these values can be voluntarily deferred. In contrast, restricted stock cannot be deferred as stock is considered to be "property" under the U.S. tax code. And with all other pay components being cash, everything can be voluntarily deferred. However, be sure to keep the statutory-required deferral timing, payout and other related rules in mind if voluntary deferrals will be allowed.

■ **Special Committee Pay:** Inevitably, special circumstances will arise that require a unique committee to address the issue. Participation on a special committee should result in fair pay for the services rendered. Some companies compensate by the required number of meetings; others identify an "after the fact" one-time cash retainer that is fair in comparison to the time required.

■ **The Lead Director vs. Independent Chair:** The lead director position emerged upon the implementation of the statutory requirement that boards were required to hold executive sessions while management was not present. If the chairman was also the CEO, they were part of management and thereby not allowed to participate in the executive session. The lead director was initially appointed to run these executive sessions, but quickly gained duties and responsibilities similar to an outside/independent chairman. That said, lead director pay remains considerably below that of an independent and/or executive chairman. However, over time this pay gap is slowly closing.

Although director compensation has become simplified over the years, dynamic pay and related policy issues remain important ongoing considerations. As annual meetings approach, along with director elections, this is an appropriate time to take a step back and consider the application of these director pay issues.

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