"World Class" Director Compensation

By Matt Vnuk and Dan Laddin

While global "pay equity" debates rage over the compensation of top executives versus rank and file employees, pay setting for corporate board members has also drawn unwelcome criticism. Though the 2023 court case clawing back $735 million in pay to Tesla directors is an outlier, how well is your board shaping—and communicating—its own pay plan?

Best-in-class outside board members meaningfully contribute to the long-term success of a company. Compensation is one of several factors that contributes to attracting and retaining such talented and experienced people. So, what should world-class directors expect in terms of pay?

In our experience, directors do not want their compensation to be an outlier versus market data, materially higher or materially lower. They want fair (competitive) pay. To support this, directors should expect their board to review competitive market pay data on a regular basis, with most reviewing it at least every other year. It is best practice to have an independent outside expert prepare this market assessment and present it to the board, typically to either the compensation committee or the nominating and governance committee.

For the director pay review and approval process to be viewed as reasonable and credible, getting "what is market" right is essential. We suggest an assessment of pay levels and pay practices be done using one or both of the following:

- The same peer group of companies that is used for benchmarking senior executive compensation.
- A large cross-industry data set of similarly sized companies.

The cross-industry data set broadly aligns with the typically quite diverse backgrounds of the members of a board, and can assist when there are limited direct peers of similar size.

World-class directors should have a good sense of the typical annual time commitment for their board. Simply looking at the number of board or committee meetings is not sufficient.

Another part of best-in-class process is taking into account time commitment. World-class directors should expect decision makers and advisors to all have a good sense of the typical annual time commitment for the directors on their board, and how that time commitment varies for those in board leadership roles, such as the lead director or the various committee chairs.

There are market benchmarks for typical time commitment, for both public and private companies. Simply looking at the number of board or committee meetings is not sufficient. Meeting lengths can vary materially, and more importantly, a significant amount of work happens outside of board meetings.

☐ ***Compensation philosophy.*** World-class directors should expect a documented board "compensation philosophy" to be in place, which is then periodically reviewed and reapproved.

In our experience, having a documented compensation philosophy supports an efficient process and productive discussion related to outside director pay. This should include a description of how "market" is defined, where in the "market" outside director pay is intended to be positioned, as well as a description of what the director compensation program is intended to accomplish. This may be to attract and engage a diverse group of qualified directors, reasonably pay directors for the investment of time they make to support the company, align director pay with stockholder interests, have a compensation structure that is simple, transparent and easy for stockholders to understand, etc.

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☐ ***Frequency of changes.*** It would be unusual to make changes to outside director pay levels and/or outside director pay program design on an annual basis. For example, among the 100 largest U.S. public companies, 17 percent disclosed an increase to their board annual cash retainer, and 34 percent disclosed an increase to their annual board member equity grant during the last year. It is most common to see changes made to outside director pay levels and/or programs every two to three years. Unlike with executive pay, directors typically do not expect annual changes to their pay program (the design or levels) without a compelling rationale.

☐ ***Pay levels.*** Paying above market is not necessary to recruit and retain world-class directors. They are typically very sensitive to the external optics of their compensation, and do not want it to be a distraction or create potential reputational issues. Still, being paid competitively should be an expectation.

Today the competitive market for director pay is narrow. For example, among the 100 largest U.S. public companies, 25th percentile, median and 75th percentile total board member compensation (excluding any premiums for leadership roles) is $300k, $325k and $342k, respectively. In other words, there is only a 14 percent difference between the 25th and 75th percentiles. While this narrow range indicates there are clear competitive norms for pay levels, it also makes it easy to fall outside those norms if the tight range of market data is not considered in decision making. In our experience, board members would often rather be conservative with their own pay than be an outlier.

World-class directors invest considerable time into board leadership roles, and the additional compensation provided for board members serving in leadership roles is typically quite modest relative to the additional time commitment.

For example, among the 100 largest U.S. public companies, total compensation for a lead director is typically only about 15 percent greater than a standard board member not serving in a leadership role. Total pay for the chair of a major board committee (audit, compensation, nominating/governance) is typically less than 10 percent greater than that of a member not serving in a leadership role. Companies should be asking if more differentiation in pay for those in board leadership roles is appropriate given the considerable additional time requirements, responsibilities and reputational risk that comes with these leadership roles.

Given how much work happens outside the boardroom, directors should generally expect to be paid based on an "advisory fee" versus an "attendance fee" model.

☐ ***Pay program design.*** Demands on outside directors vary from year to year, but world-class directors typically serve on a given board for a number of years. This reduces or eliminates the need for activity-based adjustments from one year to the next. In addition, in today's governance environment, it is a general expectation that all directors are active contributing board members. As a result, we have seen a simplification in director pay programs.

For example, meeting fees have declined in prevalence. Among the 100 largest U.S. public companies, less than 10 percent now provide board meeting fees. Additionally, nearly all of these large companies base equity awards on a fixed target value, rather than a fixed number of shares. This effectively eliminates material volatility in grant value from one year to the next.

Given how much work happens outside the boardroom, directors should generally expect to be paid based on an "advisory fee" model versus an "attendance fee" model. The simplification in pay program design noted above aligns with such an "advisory fee" model. An "advisory fee" model typically includes an annual cash retainer (typically paid quarterly), an annual equity award, plus additional cash retainers for serving in a board leadership role.

In terms of pay mix, at public companies it is considered best practice for a majority of annual board member compensation to be delivered in equity (versus cash) to support alignment of the interests of board members with shareholders. Providing a majority of annual board member pay in the form of equity, at public companies, has been the norm for quite a number of years. Among the 100 largest U.S. public companies, on average, 63 percent of annual board member pay is provided in the form of equity.

It is reasonable for world-class board members to have access to some of their equity compensation while still serving on the board.

☐ ***Equity ownership.*** It is considered a best practice to expect board members to reach a minimum level of stock ownership (through annual equity grants) within five years of joining the board, making consistent progress towards that minimum level of ownership during the five-year period. Such stock ownership guidelines are in place at approximately 90 percent of the 100 largest U.S. public companies. Most of these companies set a minimum ownership level guideline for outside board members equal to achieving five times the annual cash retainer.

Another design element of board member equity awards is the vesting period. The vesting period for outside board member equity awards should not exceed the term for such a director. A vesting schedule that exceeds the term for an outside board member's election can have negative external optics, and it would also be quite unusual. Relatively short vesting, or no vesting, is less of a concern for directors than executives because retention is rarely a concern.

Finally, it is a reasonable expectation for world-class board members to have access to some of their net, after-tax equity compensation while still serving on the board, and also to be able to diversify beyond a certain level of ownership if they would like. While some boards require outside directors to retain all equity-based compensation, net of taxes, until their service on the board ends (such as, until termination of board service due to retirement), this is not necessarily an expectation of institutional investors. Even among the 100 largest U.S. public companies, requiring all equity-based pay to be deferred until the end of board service is a clear minority practice.

☐ ***Risk management.*** Board members approve their own pay, and this comes with some inherent risk. There are several simple ways to mitigate the risk of being viewed as not acting in the best interest of shareholders when board members set their own pay. A regular market assessment of the outside board member pay program, presented by an independent expert, is one example. If directors are being paid similar to the market, defined as board members at comparably sized companies, they are less likely to get external push back.

Another example is including a reasonable limit on outside director pay (cash and equity) in a shareholder-approved document. The long-term incentive governing plan document is the most common location for such a provision (or "limit") for outside board member pay.

Currently, approximately 75 percent of the 100 largest U.S. public companies have such limits in place. The prevalence of shareholder-approved limits on director pay has been trending up over the past several years across the public company marketplace. To some degree, having such a limit in place puts an upper bound on what shareholders will view as acceptable.

Best practice is to either have, or work towards, a thoughtfully designed and shareholder-approved limit on director pay.

Shareholder-approved director pay limits began to gain momentum about ten years ago due to litigation in Delaware courts. A shareholder claimed that, because a company's directors were self-interested in their own equity awards under the company's long-term incentive plan, they acted unreasonably, and wasted corporate assets, and therefore the directors should not be presumed to have acted the best interests of the company.

This presumption is called the "business judgment rule," a judicial presumption that directors acted "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." An action protected by the business judgment rule will not be second-guessed by the courts.

In this instance, the Court indicated the directors would have to show that their awards were "entirely fair." When the business judgment rule does not protect directors' awards of compensation to themselves, the awards are subject to heightened scrutiny under the "entire fairness test," under which both the process and the amount of the compensation must be found to be entirely fair to the company.

It is reasonable to either have, or work towards, a thoughtfully designed and shareholder-approved limit on director pay. This helps support board member actions or decisions related to their compensation being protected by the business judgment rule.

So, what is typical in terms of director pay limits? Among the 100 largest U.S. public companies, limits typically range from $600k to $1 million, with a median limit of $800k. The limits are typically much higher than annual equity grants and/or total annual compensation. More than one-third of the limits are equivalent to more than 5x the annual equity grant value.

Among the 100 largest U.S. public companies with a limit in place, 33 percent have a limit of less than 3x the value of the annual equity retainer, 33 percent have a limit of between 3x and 5x the value of the annual equity retainer. Eleven percent have a limit in place of between 5x and 7x the retainer value, and 23 percent set a limit of more than 7x.

Directors and corporations should expect that such limits be thoughtfully developed, and different companies can have different considerations to take in to account. For example, some companies exclude from the limit initial at-election equity awards, committee chair pay, and additional pay for board leadership roles. Having such exclusions is the exception, not the norm. Also, limits that are defined as multiples of current pay levels, as noted above, are intended to address situations such as having to pay higher amounts to a non-executive chair, among other potential situations.

☐ ***Communication and documentation.*** Good governance includes good communication, both internally and externally. If any elements of the outside director pay program design or levels are clearly outside of market, board members should be aware of this. World-class directors should expect to not be surprised by such information.

Another element of good communication is documentation. Not all companies get this aspect of effective director pay programs right. At a minimum, directors should expect a simple summary (or "cheat sheet") of the director pay program. This should not just list the elements of the pay program, but also include the compensation philosophy and rationale behind the program, as well as a defined individual point of contact for questions. Such a thoughtful, concise explanation supports both perceived value and the effectiveness of the program.

☐ ***Looking ahead.*** Recently there has been notable litigation related to director compensation, with an example being Tesla. We do not expect this to lead to an annual say-on-pay vote for director compensation, or other significant new measures. Instead, we foresee even greater expectations from board members for information and communications regarding their pay, and for even more questions from board members if their compensation is clearly an outlier versus similarly sized companies. Again, directors do not want their pay to be a distraction for the company, or result in potential reputational risk for themselves.

Compensation-related expectations are aligned with good governance and should support efficient and productive processes and communications, individuals' perceived value, and alignment of the interests of outside board members and shareholders. These will serve to mitigate some of the reputational risks that come with being an outside board member. The market continues to evolve in terms of director pay levels and practices, and it is important to keep up. ■

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