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The Design of Incentive Compensation for Directors

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Abstract

Today, most firms provide equity-based incentive compensation to their non-executive directors. We summarize viewpoints supportive and critical of this development. We argue that the effectiveness of incentive compensation is related to the structure of the incentive pay contract. We discuss the use of options and shares as well as the issue of whether incentive pay should be geared toward current rewards or future incentives. We also discuss the critical issue of maintaining the ownership exposure of directors by providing sufficient levels of equity as well as placing restrictions on cashing out. Using our arguments above, we suggest guidelines for constructing an optimal contract. We compare 289 incentive plans offered by public companies in the US during 1988-1998 and find that plans deviate significantly from the optimum.

The Design of Incentive Compensation for Directors

In 1989, the board of General Electric Corporation (GE) voted to offer stock options to its non-executive directors (hereafter, simply directors). For the first time, GE directors would have their annual compensation directly tied to their shareholders' fortunes. Directors were given an annual option grant of up to 1,500 shares with an exercise price equal to the prevailing share price. The options were exercisable in four equal annual installments and expired in 10 years. Interestingly, the annual option grant was designed as an addition to an already competitive compensation package containing an annual retainer of \$25,000 and a fee of \$1,200 per meeting.

GE was in the vanguard of the move to offer stock options to directors. In a 1992 Conference Board survey of large corporations in the United States, only 45% of the companies surveyed reported to have included some stocks in annual compensation for directors. In contrast, in a similar survey in 1997, more than 80% of the firms offered some form of equity-based compensation to their directors. What is behind this phenomenon? Why are so many US firms jumping on this bandwagon? What issues should firms consider when offering incentive pay to their directors?

Our paper has the following objectives. We summarize the prevailing arguments and anecdotal evidence on director incentive pay using both academic and business sources. We then identify practical implementation issues concerning the design of director incentive compensation arrangements and provide evidence on the current state of such practices by reporting on 289 plans adopted by US firms during the period 1988-1998.

Why Use Incentive Compensation for Non-Executive Directors?

We define director incentive compensation as the use of stocks, stock options, and other equity-based compensation as an integral part of the director's compensation package. Providing financial incentives to directors can encourage desirable behavior such as active monitoring of

managerial decisions. Michael Jensen states the following in his Presidential Address to the American Financial Association in 1993 (Jensen, 1993):

Boards should have an implicit understanding or explicit requirement that new members must invest in the stock of the company. While the initial investment could vary, it should seldom be less than \$100,000 from the new board member's personal funds; this investment would force new board members to recognize from the outset that their decisions affect their own wealth as well as that of remote shareholders. Over the long term the investment can be made much larger by options or stock-based compensation. The recent trend to pay some board member fees in stock or options is a move in the right direction. Discouraging board members from selling this equity is important so that holdings will accumulate to a significant size over time.

The main element of the director pay plan advocated by Jensen is that a substantial amount of a director's wealth is put at risk. Jensen argues that newly appointed directors should invest a minimum of \$100,000 in equity *using personal funds*. In addition, companies should enable directors to build on this initial equity investment by compensating them with equity-based instruments *in lieu of* the usual annual cash retainer. These sequential actions will encourage directors to accumulate significant equity over time and generate 'ownership exposure.' However, directors can counteract and reduce ownership exposure by liquidating their equity positions. Directors can also use financial derivatives such as (put) options as risk management tools to reduce their ownership exposure. Therefore, a key design feature of an effective director incentive plan is the imposition of restrictions on sale of the equity instruments awarded. Furthermore, directors should also be constrained from using financial derivatives to reduce their ownership exposure.

With these sequential and complementary steps, director compensation can be an effective tool to align the interests of directors and shareholders. The National Association of Corporate Directors (NACD, 1995) supports this position. In the 1995 *Blue Ribbon Commission Report on Director Compensation*, the NACD proposes "boards should pay directors solely in the form of stock and cash --- with equity representing a substantial portion of the total up to

100%.” While Jensen defines an initial level holding of at least \$100,000, the NACD suggests an eventual target of \$600,000 for directors of large companies.

The idea of providing directors with equity-based incentives so that they can attain a meaningful level of ownership exposure has gained widespread acceptance in the US. Shareholder interest groups in particular tend to concur with this prescription. Two influential pension funds, TIAA-CREF and California Public Employees’ Retirement System (CALPERS), support the idea that directors should maintain a minimum ownership level in the company’s stock (Koppes, 1996). For instance, CALPERS advocates that at least 50% of the director’s total compensation should be in company stock.

Caveat Emptor: Does Incentive Pay for Directors Provide Incentives? Or Is It Payoff?

Director pay contains incentives if the amount of the compensation is strongly linked to firm performance and if there is a substantial penalty for poor firm performance. If this were the case, directors are motivated to increase firm value. The downside or penalty is a critical feature of an incentive contract. This is the reason why Jensen and others stress that plans should put director wealth at risk and generate ownership exposure.

On the other hand, director pay can provide considerable compensation to directors even if firm performance is weak. A payoff plan can arise when sufficient penalties for poor performance do not exist and/or when a director is not required to maintain ownership exposure. An example of a plan with an insufficient penalty is one where stock options with an exercise price close to zero are given to directors. In this case, the compensation obtained from stock options will almost always be positive, and the directors will be exposed to no downside. Thus, there are substantial rewards even for poor performance. Payoff plans can also be plans that provide directors substantial flexibility to reduce their ownership exposure. For instance, when shares with very short vesting periods (i.e., the period in which shares cannot be sold) are given to directors, the directors can quickly cash out of their positions. Such plans are counter-

productive because once directors have cashed out the incentives no longer exist. It is questionable whether a payoff plan can benefit shareholders.

Graef S. Crystal, a noted author on CEO compensation, weighed in on this subject. In a 1991 Fortune article (Crystal, 1991), Crystal questions: "Do directors earn their keep?" Analyzing a sample of 104 largest Fortune 500 and Service 500 companies, Crystal found that firms do not use stock option grants to overcome an under-competitive level of compensation for their directors. Rather, they added these stock-based components on top of already competitive levels of compensation resulting in an increase in total director compensation. While this observation may be dated, it is consistent with the more recent trend reported by Investor Responsibility Research Center (Bertsch, 1998). Studying the Standard & Poor's Super 500 firms in 1997, the IRRC report suggests that directors' annual cash compensation has been essentially stable for the last several years. The number and size of supplemental stock and option awards, however, have skyrocketed, leading to substantial increases in the aggregate level of director compensation. Are these increases in director compensation justified? Or are they merely additional "perks" to directors?

Opposition to incentive pay for directors, while sporadic in the US, appears to be widespread in other jurisdictions, especially in the United Kingdom. In a report commissioned by the Secretary of State for Trade and Industry and the Chancellor of the Exchequer of the United Kingdom, Derek Higgs advocates the use of fees and discourages the use of shares and options (Higgs, 2003). In particular, Higgs recommends that in addition to specifying the conditions for exercise, the shares thus obtained should be held until one year after the non-executive director leaves the board. This recommendation is based on information obtained from a survey of UK directors and chairmen.

Implementation Issues: Designing an Effective Package

Once a firm decides to offer incentive pay to its directors, it has to design an effective package that offers incentives. How can firms best implement incentive pay for directors? In the following discussion, we identify key implementation issues concerning the parameters of the compensation package. In general, these issues pertain to the form of the award, the pre-conditions for the award and the restrictions imposed on the awardees.

Issue #1: Options or Stocks?

The key to offering incentives is to increase a director's ownership exposure by including equity-based components in the compensation package. Two main ways in which firms offer incentives are awards of shares and stock options. In both cases, firms should try to restrict the cash out process. In the case of restricted shares, directors can be prohibited from selling the shares before a certain date, which may or may not be related to the director's tenure. In the case of stock options, firm can restrict resale and constrain option exercise by stipulating a long vesting period.

Options and restricted shares differ in their sensitivity to firm performance and hence in their risk levels. Restricted shares offer a lower risk and reward profile than options. While option values can reach zero, shares are rarely worthless. Thus, restricted shares often provide greater value to directors than options when firm performance declines. In this context, restricted shares are less risky and provide greater reward to the directors.

Stock options are more commonly used in incentive contracts. Their attractiveness lies in their leverage and the ability to select their exercise price. First, options are leveraged instruments. Option values can increase dramatically in percentage terms when the underlying asset increases in value. Thus directors are given the opportunity to increase their wealth dramatically by working to increase share prices. Second, since options are granted with a fixed exercise price, they offer the advantage of downside risk if firm value does not achieve a certain threshold. If the share price is below the exercise price, the option is not valuable. Consider a

firm that offers its directors options in lieu of a portion of the retainer. Here, the consequence of poor performance would be a lower than usual remuneration. Thus, by setting appropriate levels of the exercise price, firms can provide their directors with powerful incentives.

Issue #2: To Give Incentives as a Bonus or Not?

Warren Buffett, in his 1994 annual letter to shareholders of Berkshire Hathaway Inc., writes “Ironically, the rhetoric about options frequently describes them as desirable because they put managers and owners in the same financial boat. In reality, the boats are far different. No owner has ever escaped the burden of capital costs, whereas a holder of a fixed-price option bears no capital costs at all. An owner must weigh upside potential against downside risk; an option holder has no downside (Cunningham, 2001).” Implicit in Buffet’s criticism is the fact that managers do not bear capital costs because they are given options (or shares) without requiring a monetary sacrifice. The same criticism also applies to providing directors with shares or options. To alleviate this concern, firms should impose capital costs by requiring directors to purchase these instruments with their personal funds. Alternatively, firms can also encourage directors to “buy” equity-based incentives by giving up a portion of their cash retainer. That is, firms can pay directors with incentives in lieu of the annual cash retainer. By taking these actions firms can prevent their director incentive compensation from assuming a bonus-like form.

However, there is another consideration that argues for a bonus-like structure for director incentive compensation. Like managerial compensation, director compensation can simultaneously contain both incentive and reward components. While incentive components compensate directors for future performance, reward components compensate directors for past performance. The blanket provision of options and restricted shares, irrespective of past performance provide incentives to improve future performance but do not reward director for past performance achievement. Arguably, a reward component in the compensation package may provide equally important alignment of director incentives for two reasons. First, the

reward may serve as a periodic signaling or feedback mechanism to reinforce desirable performance behavior and thus elicit higher levels of such behavior leading to improved future performance (Luthans, 1999). Second, by providing additional shares or options for past performance, the level of incentives also rises. Thus, there is an implicit correlation between the reward and incentive components.

Reward components can be built into the compensation package by varying the condition in which incentive awards are granted. For instance, the awards of options or shares could be contingent on metrics that relate to past performance such as (a) Prior year stock price performance (b) Prior year Earnings per Share (EPS) (c) Prior year Return on Equity (ROE) and (d) Prior year cash flow metrics such as Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). Since a reward component pays directors for past performance, such a component would generally not require a tradeoff in the cash retainer. In this context, director compensation can take the flavor of a 'bonus.'

Issue #3: Set a Clear Objective of Attaining a Significant Level of Ownership

Incentive compensation for directors is structurally different from that for managers. Management compensation is set at high levels in the absolute as well as relative sense. Annual income for a manager is typically a significant fraction of his wealth. In contrast, director compensation is relatively modest. Most directors are either retired or retiring senior executives from large public companies (Ferris, forthcoming). Because of their work history, these directors are likely to have accumulated a significant level of wealth. Also, corporate directors can diversify their income stream by serving on multiple boards. Thus, a director's compensation from a particular firm is neither a large portion of his overall wealth nor is it a large fraction of his overall income.

For these reasons, it is especially important to pay heed to the recommendations of Jensen and the NACD and design contracts that will serve to accumulate significant equity

positions over time. Consequently, vesting periods and restrictions on the sale of equity are important components of the compensation plan.

“Best Practices” for Designing Director Incentive Pay

Based on the above discussion, we can summarize the best practices governing the design of an incentive contract for directors as follows:

1. An effective plan should provide a majority of the pay with equity-based instruments such as stocks and stock options. But incentive compensation to directors should not be used as an excuse to increase total compensation substantially and unconditionally. At least some portion of the incentive pay should be in lieu of the cash retainer.
2. The goal of providing stock related compensation should be to accumulate substantial equity exposure. While this can be achieved simply by requiring directors to invest their existing wealth in company shares, a more practical alternative is to ensure that (a) annual awards of shares or options are substantial and (b) directors are prohibited from reducing their exposure by selling their shares.
3. Incentive compensation should create incentives for future performance enhancement as well as provide reinforcement for past performance achievement. To achieve these purposes, firms should vary the amount of the grant based on current or past performance so as to link incentive awards to past performance achievement.

Are “Best Practices” Followed?

We now report on 289 director incentive contracts adopted during 1988 -1998. Our data are derived from Gerety (2001), who study stock price reactions to the adoption of director incentive plans. The sample covers 11 years and represents the initial experience of firms that provide incentive pay for directors. We focus on two important aspects of these plans: the nature

of the equity-based instrument used and whether the incentive is gravy-like in that it does not require tradeoff of an existing retainer. We identify plans that solely use options, restricted shares or (unrestricted) stock awards and find that the majority of the plans (152 of 289) use solely options for the incentive component. The typical option plan entails an annual grant of options on 1,000 shares with an exercise price equal to the prevailing share price; the vesting period is typically 0-4 years; the maturity is typically 10 years. The number of restricted shares and stock award plans are 49 and 31 respectively.

TAKE IN TABLE I

We also report on the number of gravy plans. We find that most plans (222 out of 289) provide incentive awards as “gravy” in addition to existing cash compensation. In these plans, the directors are not required to give up any of their current pay to receive the incentive awards. As we have discussed previously, director compensation can take on a “bonus” flavor if incentive awards are contingent on achievement of past performance goals. However, we find that almost none of these plans link the awards to past firm performance. Thus, we call these gravy plans. Earlier, we had noted that the level of director compensation has risen in recent times. Clearly, these gravy plans have contributed to this increase.

The above issues are best highlighted by two examples: GE and Handy & Harman. The 1989 GE plan only satisfies some of the requirements for an effective package. The shortcomings of the GE plan are as follows. First, the stock option component covering 1,500 shares does not dominate the annual cash retainer and meeting fees. In fact, the option grant is made without any reduction in the existing director compensation. Thus, even if the options are worthless, directors would benefit substantially from the other cash components of the compensation package. Second, the vesting schedule for the options is inadequate in that it fails to create a long-term exposure to corporate equity holding. The GE plan allows directors to exercise option grants in four equal annual installments and once the options are exercised, there

are no further restrictions on the sale of stock. A director who wishes to minimize his exposure to GE equity can exercise whenever possible and immediately sell the shares obtained. We calculate that, at the minimum, this strategy will expose the director to no more than 3,750 shares in the option contract.

The 1990 Handy & Harman plan is particularly egregious and laden with gravy. This plan offers options with a notional value of \$12,000 while maintaining the director's cash retainer of \$24,000. The plan therefore increases director compensation by 50%. Further, the options carry a low exercise price of \$1 compared to the stock price of \$13.50. Thus, these options have an intrinsic value (i.e., the value if exercised today) of approximately 50% of the annual retainer. The fact that these options are valuable in almost all circumstances, unless the stock price drops to below a dollar, should be a poor signal to shareholders and institutional investors.

In light of this evidence, a valid question is whether director effort and performance has correspondingly increased in recent years. Given that the vast majority of firms use incentive compensation as an addition to director cash compensation, one would hope to observe that director performance has increased. Otherwise, the label 'gravy' remains descriptive and accurate. One positive development is that the number of gravy plans is decreasing in recent years. For example, if one considers the most recent 4 years, 1995-1998, one observes a slightly lower incidence of gravy plans (72.4% or 89 of 123) than in the first 4 year period, 1988-1991 (85.7% or 72 of 84).

What does the future hold?

The move to offering incentive pay to directors is well under way and irreversible. All the important constituents---academicians, business leaders, managers, investors and portfolio managers---are supportive of this movement. We note that the first part of this revolution is now

complete with a vast majority of US firms now having an incentive plan in place. The pace of incentive plan adoptions has been quite rapid, with most of the adoptions occurring in the 1990s.

Our study of the first generation incentive plans for directors indicates that most plans are flawed. They are excessively bonus-like and provide rewards even for poor performance. They have served to increase director compensation significantly. An impartial observer is left wondering whether the object of the exercise is to increase director pay or to increase incentive alignment between directors and shareholders. Influential critics of managerial compensation, such as Graef Crystal, have now started paying attention to the equally important issue of director compensation.

We do, however, note some positive trends in the design of these contracts. We note a small but noteworthy convergence toward the ideal contract. More and more firms are requiring directors to make monetary sacrifices to receive valuable equity-based instruments such as options. Some firms are even making awards conditional on prior performance. Also, there is an increasing sensitivity toward the need to increase share ownership of directors over time by imposing constraints on the liquidation of the equity instruments. Finally, in a direct response to Jensen's call, we are seeing firms dramatically increase the proportion of equity-based compensation to overall director compensation; this is especially true for technology firms such as Dell and Yahoo where the proportion is close to 100%. Our assessment is that the second part of the revolution is under way but has quite a way to go before its completion.

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Table I
Plan Characteristics By Year of Proposal, 1988-1998

Characteristics for 289 equity-based compensation plans for non-executive directors. Deferred compensation plans are not considered to be incentive compensation plans. A gravy plan is a plan that provides directors with additional equity-based compensation without requiring tradeoff in annual retainer. Option plans are plans that involve the use of options. A majority (143) of the 152 option plans provides directors with periodic annual awards of stock options rather than a one-time award. A restricted share plan indicates either a formal restricted stock plan or an incentive plan involving the use of resale-restricted shares. Stock award plans are plans that involve the use of common stocks. Mixed plans have both option and share components.

		Distribution by Types of Incentive Award				Distribution of Gravy Plans	
<i>Year of Proposal</i>	<i>Total Number</i>	<i>Option Plan</i>	<i>Restricted Share Plan</i>	<i>Stock Award Plan</i>	<i>Mixed Plan</i>	<i>Gravy Plan</i>	<i>Non-Gravy Plan</i>
1988-1991	84	58	13	4	9	72	12
1992-1994	82	42	20	9	11	61	21
1995-1998	123	52	16	18	37	89	34
<i>Overall</i>	289	152	49	31	57	222	67

The Design of Incentive Compensation for Directors

Executive Summary

In 1989, the board of General Electric Corporation (GE) voted to offer stock options to its non-executive directors. GE was in the vanguard of the move to offer equity-based incentive compensation to directors. Today, we find that most large US firms have followed GE's lead. We explain this phenomenon by summarizing arguments from academicians and practitioners.

The most eloquent proponent for incentive pay is Michael Jensen who argues for substantial (>\$100,000) ownership exposure by directors and for such ownership to rise over time. Additionally, Jensen calls for at least part of this ownership to be paid using the personal funds of directors. Such a conceptual framework for director pay also finds supports from the National Association of Corporate Directors (NACD).

Although the prevailing conventional wisdom is strongly supportive, there is a valid concern that firms too often design these compensation arrangements ineffectively, providing 'payoffs' to the directors that would increase their compensation regardless of firm performance. This has led noted critics of executive compensation such as Graef Crystal to focus on director compensation and question whether directors are earning their 'keep'.

We identify three important issues regarding the design of director incentive compensation arrangements. First, firms need to decide on whether to use options or shares. We show that the risk-reward profile differs for these two alternatives and that options offer a more sensitive profile. Options also allow design flexibility in that the exercise price can be tailored to create an optimal amount of incentives. Second, firms need to determine the proportion of the compensation attributable to past performance (bonus component) and the proportion attributable to future performance (incentive component). Superficially it might appear as though the latter must dominate, but there is a case to be made for a bonus component; for example, firms may vary the number of shares or options to reflect past performance. Third, and perhaps most

importantly, firms should constrain and prevent directors from reducing their ownership exposure. This can be achieved by using longer vesting periods or by specifying minimum levels of exposure; additionally, firms should prohibit directors from using financial derivatives to decrease their ownership exposure.

Finally, we analyze 289 instances of firms offering incentive pay to directors to understand whether actual practice conforms to the general principles identified above. We focus on three important aspects of these plans: the use of options vs. shares, whether the equity award requires giving up a part of the existing retainer and whether the amount of the award depends on past performance. We find that the majority of the plans (152 of 289) use only options. We also report on the number of gravy plans where incentive awards are ladled on top of the usual retainer. We find that a super-majority of the plans (222 out of 289) fit this category. Finally, we find that almost none of these plans link the awards to past firm performance.

List of Keywords

1. board of directors
2. director pay
3. incentive compensation
4. corporate governance

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