A roadmap for director pay: GE leads again

Stung by scandal, companies should now be aiming for a better balance in board compensation.

BY DENNIS CAREY AND MICHAEL USEEM

GENERAL ELECTRIC Co. has done it again. It set the benchmark for management performance in the 1990s. Now it's setting the standard for director pay: 60% of its directors' compensation will come in stock units that pay out only when the directors leave the board.

Other companies are also revisiting their directors' compensation, for good reason: Boards have become too closely aligned with investors. That is ironic but true: Directors are shareholder emissaries, but their shareholder-like compensation has overfocused them on investor drumbeat and underconcerned them with company policy or ethical transgression.

Years ago, companies placed directors' paychecks under their plate: When the lunchtime board meeting adjourned, directors folded their napkins and pocketed the check. Pressed by the rise of investor sovereignty, companies then pitched the pendulum the other way, transforming fixed retainers into stock options. The result: too much concern for quarterly results, too little for the fundamentals.

Stung by scandal, companies should now be reaching, like GE, for a better balance in director pay: both dollars and shares, and about the same of each. That will remind directors that they must assiduously heed the concerns of investors but also autonomously guide the decisions of managers.

Director pay must also be structured to avoid even the hint of insider advantage. That has become an insidious underside of directors' stock packages. When directors sell, outsiders can never be sure they are acting without privileged information. Giving directors shares that can only be sold once they've left the board, as GE has done, eliminates even the appearance of impropriety.

Companies should ask directors to put their own skin in the game by acquiring a significant number of shares within several years of joining the board.

At the same time, the compensation for directors must also address the far harder job of recruiting directors in the wake of the past year's corporate disgrace and public reform. Four factors are conspiring to make it so.

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First, to ensure effective oversight, the New York Stock Exchange now requires that boards be dominated by independent directors and that their key committees consist of purely independent directors.

Second, to ensure time for that oversight, some companies are restricting the number of outside boards on which their executives and even their directors can serve. Consider GE's policy: CEO Jeffrey Immelt may sit on no other boards. The outside CEOs who serve on GE's board may serve on no more than two.

Third, to exercise their oversight, some boards are meeting more often. Consider Tyco International: Since Dennis Kozlowski resigned last June, the directors have held dozens of meetings to pick a successor, revise their policies, and recruit their own replacements.

Fourth, directors are assuming greater risk. Their personal time, reputation, and assets all face more peril. If disaster strikes, even if from a rogue trader or secretive CFO, they have far more to lose.

With corporate directors now facing longer hours, greater demands, and larger risks, and given the heightened need for great directors but lessened availability of suitable talent, companies will inevitably have to raise their directors' remuneration.

The key player in this evolving compensation story is the board's nominations or governance committee. The NYSE requires annual evaluation of the board's own performance, and this is the committee to do that and then set directors' pay. The potential for abuse is obvious. Academic research reveals that when compensation committee members are highly paid in their outside roles, they pay the CEO exceptionally well too, regardless of actual performance. No wonder that a prominent former chief executive recently advised a group of new CEOs to put only wealthy directors on their own compensation committee. The new CEOs chortled at the suggestion, but the former chief executive retorted that he was dead serious.

Director pay should be approached with the same confidence that justifiably characterizes any pay-for-performance scheme. It works better than all known alternatives.

A commitment to continuous improvement is essential. GE's new pay for director performance is sure to be revised yet again. But for the moment it is pointing in the right direction: some cash, some stock, and some time before stock can be cashed.