Performance-Based Director Pay

The flap over pensions misses the real issue: A new model is needed to more appropriately reward the time, productivity, and accountability of directors.
by Dennis C. Carey

The 1995 proxy season has witnessed over 30 challenges to outside director pension plans. These initiatives will not get far this year, but will help to sharpen the debate on the role of directors and how compensation plans might affect their behavior. The most direct outcome of these challenges may likely be to further accelerate the movement to stock compensation schemes that might ultimately replace director pensions based on the value of cash-based retainers. However, it also provides an excellent opportunity to reevaluate how directors are compensated and to bring pay–for–performance and market pricing principles into the corporate boardroom.

The issue of director retirement plans is a relatively new one. According to our Spencer Stuart Board Index (SSBI), which is an annual survey of board trends and issues at America's 100 leading corporations, less than 20% of the largest U.S. corporations provided outside director retirement plans in 1980. This figure rose to 64% in 1990 and 79% in 1994. Among the Standard & Poor's 500, such retirement plans were virtually non–existent 10 years ago, but had risen to almost 50% by 1994, according to the Investor Responsibility Research Center.

The rise of such plans coincides with relatively modest increases in retainers over the same period, and as such were justified as "necessary" for maintaining director compensation competitiveness. In addition, it was "fashionable" during the 1980s to establish deferred income vehicles for all employees, and retirement plans for directors fit this approach. The tide of acceptance for director pensions rose rapidly as a few of America's leading corporations adopted them in the late 1970s and the rest simply followed their lead.

The issue of pensions has fueled discussion among shareholders in ways not dissimilar to the debate on whether to pay directors in stock in lieu of cash. From opposite ends of the spectrum, both find root in the belief that director compensation should be tied directly to the fortunes of the company. Over the past several years, there has been considerable debate, yet no consensus or proof, that such compensation schemes change the behavior of directors or produce better company stock performance. Nevertheless, the growth of stock compensation programs are proliferating. By last year, 22% of companies in the SSBI paid part of their annual retainer

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in stock or provided that option. This was up from 10% in 1990. Three boards introduced this option in 1994, and several more have programs in development for implementation this year.

Mix of Approaches

Stock plans range from Amoco's program to pay one–fourth of its $50,000 retainer in shares of common stock, to United Technologies, where 60% of the retainer will be paid, at election, either in shares of common stock or in deferred stock, converted to shares of common stock upon termination of service. Several companies, including Hewlett–Packard, Unocal, and Wells Fargo, have provided options to directors to receive all their retainers in the form of common stock or restricted stock. Also, over 50% of SSBI companies are now providing stock grants and/or options for outside directors in addition to their annual retainers.

Most director compensation plans have developed in ways that bear little relationship to the performance of boards or of individual directors.

The number of companies providing such plans has doubled over the last three years. Six companies now provide for both retainer payments in stock and additional stock grants/options. Companies ranging from Allied Signal (one time grant of 1,500 shares of restricted common stock), to Colgate-Palmolive (stock grant of 275 shares per year), to Compaq (newly elected directors granted option to purchase 10,000 shares of common stock and, upon re–election, granted option to acquire 4,000 shares), are included in this mix of approaches.

A few companies, notably Scott Paper and Travellers Insurance, have adopted plans which pay directors exclusively in stock. Such programs are advocated by some shareholder activists as the ultimate device to tie director decision making to shareholder value. These programs are likely to be challenged by the need for board "diversity," which often requires boards to pursue director candidates who may lack the financial means to make the service meaningful to them in the short term without immediate cash benefit. The emphasis to pay more in stock and less in cash will likely accelerate nevertheless.

As this momentum continues to build, the issue of pension programs will receive increasing attention. They seem, according to some shareholders, to be out of sync with new thinking. Regardless of company performance, or for that matter, director performance, such plans guarantee significant financial opportunity which can be more attractive than the cumulative effect of retainers themselves. Further, the impetus behind stock compensation may fuel consideration to build pension programs that are tied to stock appreciation rather than the value of the retainer. Last year, for example, Alexander & Alexander Services Inc. gave stock to directors in lieu of pension payments.

Shareholder Challenges

Several proxy challenges have asserted that pension plans serve only to reinforce the bond between management and the Board and may diminish director independence in fulfilling their obligations to shareholders. In the Philip Morris challenge, for example, it is asserted that such plans are "management's way to ensure their (directors) unquestioning loyalty and acquiescence to whatever policy management initiates." It goes on to say, "Accordingly, when viewed from this perspective, these types of retirement benefits become yet another device to enhance and entrench management's control over corporate policy while being accountable only to themselves, and not to the company's owners." The McGraw-Hill proposal uses the term "cronyism" to define the impact of such programs on director–management relationships. Several proposals point out that pensions have the "pernicious effect of compromising director impartiality." Similar language is found in proposals to US Air, B.F. Goodrich, Borden, Dow Jones, Champion, Bell Atlantic, Avon Products, W.R. Grace, and others.

Several resolutions cited the "excessive" compensation provided by such plans which simply mirror that which most directors already have in their principal place of employment. In the case of Phillip Morris, the resolution is critical of the company's retirement plan which pertains to directors with five or more years of service. They enjoy an annual retirement benefit for life equal to the annual board cash retainer plus 25% of attendance fees earned for up to 24 board meetings during the two years before retirement. The retainer is "now a generous $26,000," plus $1,000 for attending each board meeting ($2,000 for committee chair-

Director Retirement: 5 Sample Pension Plans

Company	Minimum years service for vesting	Minimum age for payment of benefits	Amount of retainer paid annually at retirement	Length of payments	Survivor benefit
Bell Atlantic	5	65	10% for each year of service up to 10 years	10 years	No
B.F. Goodrich	10	55	100% of retainer at retirement	10 years	No
Merck & Co.	5	70	50% of retainer at retirement	Life	No
Philip Morris	5	60	100% of retainer plus 25% of attendance fees for up to 24 meetings before retirement	Life	No
Time Warner	3	60	50% of retainer (cash/restricted stock)	Number of years of service	Yes — Lump Sum

man). The resolution goes on to say that "because of our strong concern for maximizing the ability of Boards of Directors to act in shareholder's interest, we feel that the long–term best interests of the companies are not well served by such retirement policies. The vast preponderance of directors at various corporations are undoubtedly covered by generous retirement policies at their principal places of employment, and they need not be 'double–dipping' at this company or any others." The implication is that directors should not be treated as yet another employee of the company and that this tie to pension plans comes too close.

The Johnson & Johnson proposal goes even further by arguing that the spirit of pension systems is violated through these director plans, especially with short vesting periods. It points out that "traditionally, pensions have been granted in both the private and public sectors for long–term service... the practice of offering pensions for consultants is a rarity... outside directors' service could logically fit the definition of consultants and pensions for this type of service is an abuse of the term." (Examples of this include Time Warner and W.R. Grace, which provide for three-year vesting programs.)

Other shareholder proposal language focuses on the relationship between director compensation and the company's bottom line, and does so sarcastically. In the Merck resolution, among others, a rebuttal is launched to the board's contention that retirement plans are needed to attract qualified directors by pointing out that "since there are also companies that do not offer their outside directors pensions, can management demonstrate that those companies that offer pensions have a better performance record than their non–pensioned peers? In addition, do we have any evidence of a significant improvement in corporate profitability with the advent of pensions for outside directors?"

No companies made mention of why a pension, as opposed to some other form of compensation, is necessary to make its program 'competitive.'

The Board View

In every case, the board's of these companies recommended against the proposals to abolish pension programs. They do so by arguing that their director compensation programs must remain competitive and assert that director motivation and actions will not be compromised in any way by providing retirement plans. Further, most recommendations included strong language citing the high demands on directors and the need to do whatever possible not only to recruit but also retain and motivate people to serve. Some companies even went so far as to provide mar-

ket data to make their cases. For example, B.F. Goodrich pointed out that "the Conference Board indicates that more than 65% of manufacturing companies with sales in excess of $1 billion provide pension benefits to directors. The company believes that the Director's compensation, including pension benefits, is within the middle range of compensation for other large manufacturing companies."

Every company response included some mention of the need to ensure total compensation "competitiveness," but none made mention of why a pension, as opposed to some other form of compensation, is necessary to make its program "competitive." However, the GTE case was impressive in arguing that the mix of compensation elements included in its package was consistent with shareholder solidarity. The GTE plan includes three elements—the cash retainer, the value of certain shares awarded under a profit-sharing plan, and the value of certain shares awarded under a long–term incentive program. Two of the three components of compensation are stock–based, and accordingly, the retirement benefit is closely tied to GTE's stock and reinforces the mutual interest of GTE directors and shareholders. Moreover, the design of this plan ensures that this commonality of interest is long–term and continues beyond a director's retirement date.

We recognize that there is no single best answer to the question of how to remunerate directors.

Boards argued as well that the insinuation was outrageous that director independence was compromised by retirement plans. At Phillip Morris, the company said that "claims that directors will act purely out of self interests, violating not only their duties under corporate law, but also the principles pursuant to which the company conduct it's business" essentially "impugns the character and integrity of the men and women the shareholders have chosen to direct the affairs of the company."

Unaddressed Issues

The arguments advanced in 1995 shareholder challenges rely heavily on the concern that pension programs serve to diminish director independence from management. Ironically, they seem to miss the argument that such plans are not tied to director or company performance and may serve to motivate certain directors to stay beyond their "value-added years" simply to qualify for vesting or to cushion their retirement income. On the other side, board recommendations against such proposals rely on the argument that director recruitment and "competitiveness" will be adversely affected. Our firm recruits over 100 directors a year, ranging from the Fortune 10 to start–ups, and we know of no specific case where a director retirement plan affected the decision of a candidate to accept a board seat. The argument of boards should have been that pension plans are a valid approach, but could be more effective if tied to stock rather than retainers.

The difficulty with both sides of this debate is that the fundamental issue has been to a large extent ignored. The real issue is whether the mix of compensation for directors is appropriate given what is expected of boards today and whether that mix is likely to motivate directors to be accountable to shareholders.

Why Directors Serve

The problem with getting answers to these important questions is that many directors do not serve on boards for financial reasons, and most probably do not respond to important questions posed to them on the basis of their own personal financial circumstances. There are exceptions, but as a rule, we believe this is generally the case. Directors serve on boards for a variety of reasons: 1) real or perceived power, 2) the chance to establish relationships with other industry leaders, 3) the chance to address problems of consequence, 4) the importance of links between the board assignments and their own companies, and 5) compensation. They do not seem overly concerned about the benefits plan.

If it is true that normal "market" principles do not totally pertain in the board context, the next best thing is to construct compensation models which at least intuitively appear to incent behavior in the right way and reward time invested by directors. We should bear in mind that recent independent studies by Charles Elson, a Heritage Foundation Fellow, and Harvard Business School Professor Robert Stobaugh both found relationships between the amount of stock held by a director and the company's performance. In Stobaugh's study, he found the median amount of stock held by a direc-