How to strengthen director incentives

Want a board to make decisions that increase shareholder wealth? Then let's increase the directors' wealth leverage. **By Stephen F. O'Byrne**

Governance experts are sharply divided about the impact of compensation on director decision making and effort. Some experts argue that directors serve on boards primarily to learn and that compensation has little impact on director performance. Others argue that the prospect of personal financial gain makes directors work harder and make better decisions. And both sides of the debate struggle to find a meaningful analytical framework for thinking about director pay. Some see more mystery than science, with directors in some industries getting much higher pay but putting in no more effort than directors in other industries. The NACD Blue Ribbon Commission on Director Compensation, for one, has lamented the lack of an "accepted philosophical framework" for director pay, particularly for director incentives.

I share the view that compensation affects director decision making and effort. I present an analytical framework for thinking about and measuring director incentives, and outline nine ways to strengthen director incentives to make decisions that increase shareholder wealth.

Director compensation, like management compensation, has three basic objectives: 1) provide strong incentives to increase shareholder value, 2) provide sufficient compensation to attract and retain qualified directors, and 3) limit shareholder cost to levels that maximize the wealth of current shareholders.

Director incentives to increase shareholder value have two components: 1) the incentive for effort, that is, motivating directors to invest sufficient time to fully understand issues, to participate in board deliberations, and to monitor company and management performance; and 2) the incentive to make value-maximizing decisions.

Managers and directors, like investors, seek to maximize their wealth, not their current year pay. A manager or director's wealth includes the present value of expected future compensation as well as stock and option holdings. A useful measure of incentive strength is "wealth leverage" — that is, the ratio of percent change in manager or director wealth to the percent change in shareholder wealth. A "pure entrepreneur," who has 100 percent of his wealth in company stock, has wealth leverage of 1.0 because any percent change in shareholder wealth results in an equal percent change in manager wealth. A manager who has 50 percent of his wealth in company stock and 50 percent in the present value of expected future salary has wealth leverage of 0.5 because a change in shareholder wealth has no effect on the present value of expected future salary. Our research shows that top management at the median S&P 1500 company has wealth leverage of 0.4.

For a full-time CEO, wealth leverage provides a good measure of the CEO's decision incentive and an adequate measure of the CEO's effort incentive. It is an adequate measure of effort incentive because positive incremental effort (e.g., hours above 40 per week) is likely to have a significant impact on the CEO's company-related wealth — typically a large portion of the CEO's total wealth —and low levels of effort are limited by organization demands and the expectation of a full-time commitment.

For a director, wealth leverage provides a good measure of the director's incentive to make decisions that increase

Stephen F. O'Byrne is president of Shareholder Value Advisors Inc. (www.valueadvisors.com). He has more than 25 years of experience as a consultant to companies on compensation, performance measurement, and valuation issues. He has done extensive research to measure the strength and cost-efficiency of top management incentives.

shareholder wealth, but a poor measure of the director's effort incentive. That's because incremental effort (particularly low effort) is unlikely to have a significant impact on the director's company-related wealth, and the director's company-related wealth is typically a small portion of the director's total wealth. Better measures of effort incentive are the ratio of the director's incremental director compensation per hour to the director's incremental primary employment compensation per hour and the probability of termination (i.e., being dropped as a candidate for re-election) for low effort.

Boards must provide strong effort incentives and strong decision incentives. Strong effort incentives for directors require significant compensation tied directly to incremental effort — e.g., meeting fees, or a significant probability of termination for low effort. Given that meeting fees are less than 10 percent of director total compensation at almost two-thirds of the S&P 1500 companies, most companies do not have significant effort incentives from incremental compensation. In my view, a director evaluation process that creates a significant threat of termination for low effort is the most cost-efficient way to create strong effort incentives.

To understand how to create strong decision incentives, we must understand how director pay practices affect wealth leverage.

Wealth leverage computed

In 2005, a director at the median S&P 1500 company received $42,000 in cash compensation and $72,000 in equity compensation. If we assume that the director was just elected to the board and anticipates eight years of future service, the director's company-related wealth consists of $72,000 in stock or options and $912,000 in the present value of expected future compensation. (We assume, for simplicity, that the compensation growth rate and the discount rate are both 5 percent.)

If the directors' equity compensation is in stock (with wealth leverage of 1.0), the director's wealth leverage is 0.07 = 1.0 x 7% + 0 x 93%. If the directors' equity compensation is in options (which typically have wealth leverage of 1.5), the director's wealth leverage increases by 50% to 0.11 = 1.5 x 7% + 0 x 93%. If the director receives three years of option compensation up front, the director's company-related wealth will consist of $216,000 in options and $768,000 in the present value of expected future compensation. This gives the director wealth leverage of 0.33 = 1.5 x 22% + 0 x 78%. If the director has an annual stock grant that is denominated in shares — e.g., an annual grant of 5,000 shares — the director's company-related wealth will consist of $72,000 in stock, $576,000 in the present value of expected future fixed share stock compensation, and $336,000 in the present value of expected future cash compensation. This gives the director wealth leverage of 0.66 = 1.0 x 7% + 1.0 x 59% + 0 x 34%.

The accompanying exhibit lists nine ways to increase director wealth leverage.

There are some tough questions to answer in designing director compensation: Should incremental compensation be used to provide strong effort incentives? Will strong financial incentives affect director decision making? Should directors have stronger wealth leverage than top management? Should all directors have similar wealth leverage regardless of years of service? What is the most cost-efficient way to provide strong wealth leverage with limited retention risk?

Two critical tools to help address these tough questions are a meaningful measure of incentive strength — wealth leverage — and an understanding of the ways in which compensation design can increase director wealth leverage. ■

The author can be contacted at sobyrne@valueadvisors.com.

Nine ways to increase director wealth leverage

1. Increase the percent of target annual compensation provided by equity compensation.

2. Increase the required holding period for equity compensation — e.g., use deferred stock units paid out on retirement from the board, or require directors to retain 75 percent of the after-tax value of option exercise or stock vesting.

3. Increase the leverage of the security used for equity compensation — e.g., use at (or in) the money options instead of stock.

4. Provide term limits for directors.

5. Denominate annual compensation in shares.

6. Adjust the dollar target for a director's annual equity compensation by the company's excess shareholder return since the director's initial election.

7. Front load equity compensation — e.g., grant three years of annual equity compensation up front.

8. Use a lagged stock price to determine the translation of dollar compensation targets into equity compensation shares — e.g., use a trailing three-year average stock price to calculate equity compensation shares.

9. Encourage voluntary deferral of cash compensation in equity — e.g., provide a matching equity grant for every $1 of cash compensation deferred in equity.

— Stephen F. O'Byrne