The director's 'wealth leverage' is insufficient

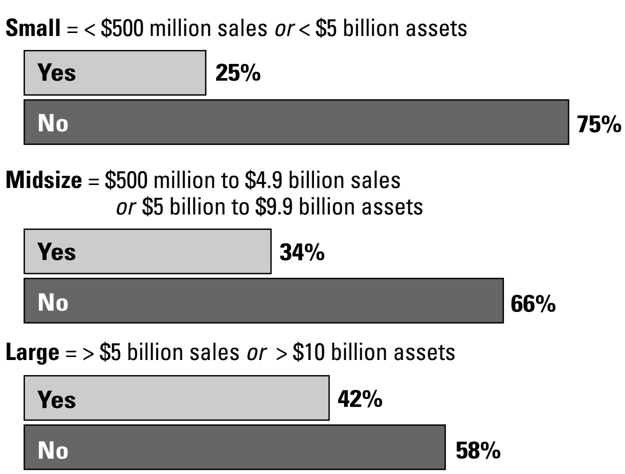
BY STEPHEN F. O'BYRNE

DIRECTORS SHOULD HAVE strong financial incentives to monitor corporate performance and take actions that increase shareholder value. Most outside directors have weak financial incentives because their company-related wealth is a small percentage of their total wealth. A prohibition on director stock sales can make a contribution to strong financial incentives for directors, but it will not make a significant contribution until companies dramatically increase the stock and option compensation of their directors.

A director's financial incentive to monitor and take action depends on the sensitivity of the director's wealth to changes in shareholder wealth. If a 50% drop in shareholder wealth causes a 50% drop in director wealth, the director has a strong incentive to monitor. If a 50% drop in shareholder wealth only causes a 2% drop in director wealth, the director has very little financial incentive to monitor. The ratio of the percentage change in director wealth to the percentage change in shareholder wealth is called "wealth leverage."

A "pure" entrepreneur, whose entire wealth is held in company stock, has wealth leverage of 1.0 because any change in shareholder wealth causes an equal percentage change in the entrepreneur's wealth. For a director or executive who receives annual compensation for services, wealth includes the present value of expected future compensation. When future compensation is denominated on a "fixed share" basis, e.g., an annual stock grant of 10,000 shares, the present value of expected future compensation is highly sensitive to changes in shareholder wealth, but when future compensation is denominated in dollars, e.g., an annual stock grant of $150,000, the present value of expected future compensation has no sensitivity to changes in shareholder wealth.

Stock ownership guidelines for directors



Source: American Society of Corporate Secretaries

'Given the high cost, companies may be forced to limit strong financial incentives to a few key directors.'

— Stephen O'Byrne

The dramatic growth in stock and option compensation for directors over the past 10 years and the widespread use of fixed share grant guidelines has raised the median leverage of directors' company-related wealth to 0.9, or 90% of entrepreneurial wealth leverage (based on data for the 1,700-plus companies in Standard & Poor's Execucomp database). This would provide a very strong financial incentive to monitor if the director had little unrelated wealth, but most directors have very substantial unrelated wealth. For the average company, director company-related wealth is only 1.5% of the CEO's company-related wealth and only 5% of the No. 3 executive's company-related wealth.

A prohibition on directors' stock sales will increase their total wealth leverage, but the increase will not be significant unless companies dramatically increase director stock and option compensation. Assume that directors currently hold their stock and option grants for four years and that a prohibition on stock sales will increase their holding period from four to eight years. At current grant levels, the impact of the longer holding period on total wealth leverage is tiny. Total wealth leverage increases from .038 to .056 for a director who is the No. 3 executive in a similarly sized company, and from .012 to .018 for a director who is the CEO of a similarly sized company. To raise director total wealth leverage to .25 (only a quarter of entrepreneurial wealth leverage), the director's annual stock and option compensation needs to be increased dramatically: by five times if the director holds grants for eight years and by eight times if the director holds grants for only four years.

Given the high cost of creating strong financial incentives for directors, companies may be forced to limit strong financial incentives to a few key directors — for instance, a lead director and the chairman of the audit committee. ■

Stephen F. O'Byrne is president of Shareholder Value Advisors Inc., Larchmont, N.Y. He co-founded the firm in 1998 after having served in senior positions with Stern Stewart & Co. and Towers Perrin. He has 25 years of consulting expertise in the areas of valuation, performance measurement, and incentive compensation.