

NOTES

NEW DEMANDS, BETTER BOARDS: RETHINKING DIRECTOR COMPENSATION IN AN ERA OF HEIGHTENED CORPORATE GOVERNANCE

KATHERINE M. BROWN*

Sarbanes-Oxley and the accompanying era of heightened corporate governance dramatically changed the composition, role, and responsibilities of corporate boards. As a result of these changes, many of the justifications for traditional director compensation plans no longer apply. As directors struggle with their new responsibilities as independent corporate monitors, the manner in which they are compensated must reflect these changes. A director compensation plan in which directors receive compensation primarily in the form of cash, coupled with finely tailored equityholding requirements, strikes the right balance of director independence and director accountability. It also facilitates the creation of corporate boards drawn from a more diverse pool of talent.

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INTRODUCTION

In April 2006, the board of directors of Coca-Cola adopted a bold new compensation plan—“unlike any other at a major company”¹—for its members. Effective 2006, as their sole form of compensation, directors will receive “equity share units” each year.² These units, which are essentially hypothetical shares of stock in the company, are equal to a valuation of \$175,000, payable in cash at the end of the initial three-year performance period.³ The unique feature of this compensation plan is that the units are entirely forfeitable.⁴ Directors are paid nothing if the corporation does not meet the performance target of eight percent compounded annual growth in earnings per share during the performance period.⁵ Neville Isdell, the Chairman and CEO of the company, stated that the “all-or-nothing approach to

¹ Chad Terhune & Joann S. Lublin, *Coke Directors Agree To Give Up Pay if Company Misses Earnings Goals*, WALL ST. J., Apr. 6, 2006, at A1; see also Press Release, Coca-Cola Company, The Coca-Cola Company Announces New Compensation Plan for Directors (Apr. 5, 2006), available at http://www2.coca-cola.com/presscenter/nr_20060405_corporate_new_compensation_plan.html (announcing new compensation plan); Graef Crystal, *Things Won't Go Better with Coke Board Pay Plan*, BLOOMBERG.COM, Apr. 12, 2006, http://www.bloomberg.com/apps/news?pid=10000039&sid=a9KgEIsOU9YQ&refer=columnist_crystal (discussing new plan).

² Press Release, Coca-Cola Company, *supra* note 1; Stephen Taub, *Coke Ties Board Pay to Performance*, CFO.COM, Apr. 5, 2006, http://www.cfo.com/article.cfm/6768563/c_6771225?f=ThisWeekinFinance040706.

³ Press Release, Coca-Cola Company, *supra* note 1; Taub, *supra* note 2. The value of the units can also change as Coca-Cola's stock price fluctuates. Terhune & Lublin, *supra* note 1.

⁴ Press Release, Coca-Cola Company, *supra* note 1; Taub, *supra* note 2. Another unique feature of the plan is that all directors are paid the same amount, regardless of their role on the board. Press Release, Coca-Cola Company, *supra* note 1.

⁵ Press Release, Coca-Cola Company, *supra* note 1. The eight percent figure represents the “mid-point of the Company's long-term performance target.” *Id.* The baseline for the growth calculation is the 2005 figure for earnings per share, adjusted for items impacting comparability. *Id.* The board can also choose to reset the financial target each year, although a company spokesman indicated that the earnings-per-share goal will likely remain. Terhune & Lublin, *supra* note 1.

Board compensation aligns the interests of . . . [d]irectors with those of shareowners more closely than any other compensation formula”⁶ Warren Buffett, the billionaire investor who has been a long-time member of Coca-Cola’s board, also heartily endorsed the plan.⁷

This type of compensation plan has drawn heavy criticism from corporate governance and compensation experts.⁸ However, Coca-Cola’s dramatic move to this self-proclaimed “all-or-nothing” approach raises the question of how corporate directors should be paid. Director compensation plans represent a delicate balance between the practical responsibilities facing the board and a normative view of the role of the board. Coca-Cola’s striking move was one response to recent corporate governance reforms that upset the previously existing balance by significantly altering the structure and responsibilities of the board.⁹

The related issue of executive compensation has been scrutinized, studied, and criticized by the press, scholars, shareholders, and even the courts.¹⁰ These commentators, however, have paid very little attention to the normative inquiry surrounding the compensation of those charged with setting corporate executives’ pay—the members of the board.¹¹ This is especially surprising given that the board is charged (via its compensation committee, and sometimes with the

⁶ Press Release, Coca-Cola Company, *supra* note 1; Taub, *supra* note 2. James Robinson, the chairman of the company’s Committee on Directors and Corporate Governance added: “Shareowners understand that they are only rewarded when the Company performs The . . . Board will hold itself to the same standard. As the Company performs well, Directors will be appropriately compensated.” Press Release, Coca-Cola Company, *supra* note 1.

⁷ Terhune & Lublin, *supra* note 1 (quoting Buffett as having “never seen a system as good as Coke has now”).

⁸ See *infra* Part II.C.4 (discussing criticisms of “payment-for-performance” plans).

⁹ See *infra* Part I.B.1 for a discussion of the impact of these reforms on the structure and function of corporate boards. Cf. Assaf Hamdani & Reinier H. Kraakman, *Rewarding Outside Directors* 4–5 (Harvard Law Sch. Law & Econ. Research Paper Series, Discussion Paper No. 578, 2007), available at <http://ssrn.com/abstract=959210> (arguing that market, reward-based systems of director compensation are inferior to negligence-based liability regimes and advocating use of “reverse negligence regime” or “leadership regime” to compensate directors).

¹⁰ E.g., *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 35 (Del. 2006). See generally LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004) (arguing that public outrage is main control on excessive executive pay); Symposium, *Management and Control of the Modern Business Corporation: Executive Compensation & Takeovers*, 69 U. CHI. L. REV. 751 (2002); Rik Kirkland, *The Real CEO Pay Problem*, FORTUNE, June 30, 2006, at 78.

¹¹ Most analyses of director compensation have focused on its relationship to the corporation’s value. E.g., Eliezer M. Fich & Anil Shivdasani, *The Impact of Stock-Option Compensation for Outside Directors on Firm Value*, 78 J. BUS. 2229 (2005). In addition, the literature in the field of executive-compensation consulting focuses primarily on the

help of the corporate governance committee) with setting its own pay.¹²

This Note provides a unique view of director compensation, addressing the topic through the lens of the normative role of the board in an era rife with corporate change. As corporate boards struggle to adjust to these changes, they must reconsider how they *should* operate, and this includes how they should be compensated. This Note focuses on how best to compensate corporate directors who are “outsiders.”¹³ With few exceptions, directors who are “insiders” (employees of the corporation) generally do not receive additional compensation for board service.¹⁴ This Note’s analysis of director compensation considers both directors’ personal reasons for board service—altruism, access to valuable business education, financial gain, and the opportunity to build reputation capital—as well as the motivations and challenges facing directors in the current regime of heightened corporate governance.

The inquiry of this Note is twofold: First, what is the normative role of the board? Second, given this role and the board’s responsibilities in the current climate of heightened corporate governance, how should directors be paid?¹⁵ Part I provides an overview of the corporate board—its role, recent changes to board structure and responsibilities, and necessary considerations in designing a director compensation plan. Part II features a critical discussion of director compensation and how it is changing. Part III depicts the optimal director compensation plan given the board’s changing role and responsibilities. In this final Part, building on proposals calling for changes to director compensation given the new role of the board, this Note argues that cash, coupled with a new form of equityholding requirement, should be the primary vehicle for compensating direc-

mechanics and amount of director compensation. *E.g.*, JAMES F. REDA ET AL., COMPENSATION COMMITTEE HANDBOOK 77–88 (2d ed. 2005).

¹² REDA ET AL., *supra* note 11, at 78. The full board almost always approves the compensation recommended by these committees. *Id.* Director compensation is usually reviewed every two or three years. *Id.*

¹³ The term “outside director” is defined as “one who is neither an officer nor an employee of the corporation.” 18B AM. JUR. 2D *Corporations* § 1173 (2004). Outside directors generally have no operational responsibilities within the company. *E.g.*, *Rowen v. Le Mars Mut. Ins. Co. of Iowa*, 282 N.W.2d 639, 652 (Iowa 1979). For purposes of this Note, the term “director” means “outside director.”

¹⁴ Nikos Vafeas, *Determinants of the Adoption of Director Incentive Plans*, 14 J. ACCT., AUDITING & FIN. 453, 455 (1999).

¹⁵ An inflexible approach is not possible for all firms, given the numerous differences between firms of different sizes and those at different stages in the corporate life cycle. This Note focuses on large corporations—the top two hundred firms ranked by annual revenues.

tors for board service. This compensation scheme is unique in that it not only strikes an appropriate balance between director independence and director accountability, but also enables the creation of corporate boards which are drawn from a broad cross-section of talent. This proposal brings director compensation in line with boards' new duties, while also providing a compensation scheme that facilitates the creation of better quality boards.

I

THE CORPORATE BOARD

Understanding the responsibilities and features of the corporate board is essential when designing a director compensation plan. This Part details the corporate board's primary features and duties, how they have changed due to recent corporate governance reforms, and their relationship to the design of a director compensation plan.

A. Role and Responsibilities of the Board

A normative judgment about the board's primary role will factor into any analysis of how its members should be paid. Because a compensation scheme creates incentives for the board to achieve a desired result, the scheme itself reflects value judgments about what a board should do.¹⁶ A corporate board of directors has several main functions: to remain independent from both management and the company, to monitor management, to serve as a source of guidance for management, and to maximize shareholder value.¹⁷ Another important feature of a corporate board is the diversity of its members. This Note contends, as do many corporate governance experts, that a better board will consist of a diverse set of individuals—those drawn not only from the corporate world, but also from government, the nonprofit sector, and academia.

Independence. For the board to monitor and guide management effectively with the goal of maximizing shareholder value, it must remain independent. Today, the typical board of a company among the top two hundred firms has ten members, nine of whom are

¹⁶ See Linda Zong, *Emerging Trends in Board Total Compensation*, COMPENSATION & BENEFITS REV., Mar.–Apr. 2004, at 45, 45 (“A typical board compensation program has included multiple components in varying balances that are dependent on the company’s culture and particular goals.”).

¹⁷ See Scott C. Linn & Daniel Park, *Outside Director Compensation Policy and the Investment Opportunity Set*, 11 J. CORP. FIN. 680, 681 (2005) (“The board of directors has a duty to oversee managers and monitor and approve decision-making all with an eye towards enhancing the interests of shareholders.”).

independent.¹⁸ The importance of director independence can be summarized as follows: “When a shareholder looks at a director, there needs to be a level of confidence that this person doesn’t have any relationships that raise questions.”¹⁹ Problematic relationships normally include those between the board and management, and those between the board and the company (such as side agreements with the company for other services, or directors’ ownership of a sizeable amount of the company’s stock).²⁰ A director compensation plan must not inadvertently undermine the board’s independence and objectivity.²¹

Monitoring Management. Corporate boards devote much of their efforts to monitoring management.²² While management typically runs the day-to-day operations of the company, the board is charged (often by statute) with managing the “business and affairs” of the company on behalf of the shareholders.²³ This task is largely accomplished through the board’s oversight of management, in which the board acts as an agent of the shareholders.²⁴

Today’s corporate governance environment requires that directors provide “intangible, ongoing oversight.”²⁵ Failures of the board to monitor management effectively often stem from a “board culture [that] inhibits constructive criticism,” and from information asymme-

¹⁸ See *Board Watch—Study Shows Variations in Director Pay and Policies*, DIRECTORSHIP, Apr. 2006, at 3, 3 (citing study conducted by Pearl Meyer & Partners on board of directors’ pay and policies). This is largely a function of changes in law brought about by the Sarbanes-Oxley Act of 2002 and related modifications made by self-regulatory organizations (such as the New York Stock Exchange) to the definition of a director’s “independence.” These changes are discussed in detail, *infra* Part I.B.

¹⁹ Michael Barrier, *The Compensation Balance*, INTERNAL AUDITOR, June 2002, at 42, 45 (quoting Todd DeZoort, director of Ph.D. program in accounting at University of Alabama).

²⁰ See *id.* at 47.

²¹ For example, board members should not be influenced by concerns for their own finances when setting corporate policy.

²² Renée B. Adams, *What Do Boards Do? Evidence from Board Committee and Director Compensation Data 4* (Eur. Fin. Ass’n, 2005 Moscow Meetings Paper, 2003), available at <http://ssrn.com/abstract=397401>.

²³ Stephen Bryan et al., *Compensation of Outside Directors: An Empirical Analysis of Economic Determinants 1, 3* (Sept., 2000) (unpublished paper), available at <http://ssrn.com/abstract=244540> (citing DEL. CODE ANN. tit. 8, § 141(a) (2002)).

²⁴ *Id.* at 1 & n.1, 3 (noting that board is responsible for correcting “severe corporate malfunctions”).

²⁵ Alisha Hornsby & Peter Opperman, Mercer Human Res. Consulting, *Director Compensation Trends*, PERSPECTIVE, Aug. 23, 2005, <http://www.mercerhr.com/referencecontent.jhtml?idContent=1189965>. See *infra* Part I.B.1 for a detailed discussion of the corporate governance environment that was ushered in with the passage of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, and 29 U.S.C.).

tries between management and the board.²⁶ In monitoring management, the board fosters a system of “corporate checks and balances.” Management’s objectives may be contrary to the board’s, and a director compensation plan should not erode the board’s ability to check management when such cases arise.

Mentoring Management. While the board (as an agent of the shareholders) is charged with overseeing management, it also collaborates with management.²⁷ Far from being removed overseers, many boards today are directly involved in the design and implementation of corporate policy and programs.²⁸ Although this increased amount of interaction between the board and management²⁹ can sometimes be in tension with the monitoring function of the board, a director compensation plan should facilitate collaboration with management.

Maximizing Shareholder Value. Many scholars and experts assert that the other roles and features of the board merely serve the purpose of maximizing the value of the firm and protecting shareholder interests.³⁰ As one compensation analyst stated, “[t]he only incentive [for directors] should be for them to think and act like shareholders.”³¹ Most experts agree that the board should employ a “long term”³² perspective in discharging its duties to the corporation, thereby counterbalancing market pressure on management to increase the firm’s value in the short run.³³ However, this responsibility actu-

²⁶ Ivan E. Brick et al., *CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?*, 12 J. CORP. FIN. 403, 404 (2006).

²⁷ Adams, *supra* note 22, at 4.

²⁸ Jannice L. Koors, *Director Pay: A Work in Progress*, CORP. GOVERNANCE ADVISOR, Sept.–Oct. 2006, at 25, 25; *see also* Brick et al., *supra* note 26, at 404 (“The general purpose of the board . . . is to advise and monitor top management . . .”).

²⁹ *See* Koors, *supra* note 28, at 25 (noting obligations of management to provide board with “far more detailed information” than previously provided).

³⁰ *See, e.g.*, Brick et al., *supra* note 26, at 404 (describing purpose of board as protection of shareholder interests).

³¹ Barrier, *supra* note 19, at 44 (quoting Diane Posnak, managing director of executive-compensation consulting firm Pearl Meyer & Partners).

³² It is impossible, however, to define the “long term” with any precision. JOHN MAYNARD KEYNES, *A TRACT ON MONETARY REFORM* 80 (1923) (“[The] long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again.”); *see also, e.g.*, Bill Gerrard, *Beyond Rational Expectations: A Constructive Interpretation of Keynes’s Analysis of Behaviour Under Uncertainty*, 104 *ECON. J.* 327, 332 (1994) (“Long term expectations are formed in a situation of ‘uncertainty’ . . . in which agents have a very limited knowledge base with regard to future outcomes.”).

³³ Barrier, *supra* note 19, at 44 (“The board’s role is to critique, evaluate, monitor, and oversee management, and it has to do that from a long-term perspective. There’s a lot of pressure from Wall Street on the short term side, but that’s management’s concern.” (quoting Peter R. Gleason, Chief Operating Officer and Director of Research at the National Association of Corporate Directors)).

ally puts the board in some tension with those shareholders who may not hold their shares for the long term.

Diversity. A corporate board whose members possess a diverse set of skills and leadership experiences will be better equipped to carry out its responsibilities and to create novel solutions to corporate challenges.³⁴ Corporate leaders stand to learn a great deal from their peers in government, academia, and the nonprofit sector.³⁵ Unlike their corporate counterparts,³⁶ these potential board members are not as likely to be independently wealthy. This may create unique obstacles to their ability to serve on a board.³⁷ A successful director compensation plan must take care not to inadvertently preclude this source of valuable talent outside the corporate world from pursuing board service within it.

B. Changes in the Functions and Features of the Board

The passage of the Sarbanes-Oxley Act of 2002 (SOX)³⁸ in response to a wave of corporate scandals³⁹ dramatically started a new era of heightened corporate governance. Corporate boards suddenly faced enormous external pressures and numerous new compliance requirements, forcing them to work not only more than, but also differently from before. This section describes the resulting changes to board structure, the responsibilities and liability exposure facing corporate boards, and the demand for heightened independence in this new corporate governance environment.

³⁴ See Brent M. Longnecker, *Director Compensation Trends*, CORP. BOARD, Mar.–Apr. 2004, at 7, 8 (expressing concern for director compensation plans that may preclude those from government or nonprofit sectors from serving on corporate boards).

³⁵ See Nicholas van der Walt & Coral Ingley, *Board Dynamics and the Influence of Professional Background, Gender and Ethnic Diversity of Directors*, 11 CORP. GOVERNANCE 218, 228 (2003) (noting that boards containing members who are “almost always cut from the same cloth . . . lack the diverse perspective needed to challenge the thinking of management”). Much of the same reasoning for boardroom diversity across race and gender lines also applies to arguments for diversity of leadership experiences. E.g., Lisa M. Fairfax, *The Bottom Line on Board Diversity: A Cost-Benefit Analysis of the Business Rationales for Diversity on Corporate Boards*, 2005 WIS. L. REV. 795, 810–37 (surveying business rationales invoked to assert that diversity has positive impact on corporation’s profitability).

³⁶ See *infra* text accompanying notes 82–84.

³⁷ For example, some equity-based compensation packages may impose significant tax burdens for directors of moderate means. See *infra* notes 161–63 and accompanying text.

³⁸ Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, and 29 U.S.C.).

³⁹ H.R. REP. NO. 108-63, pt. 1, at 11 (2003) (“[T]he Sarbanes-Oxley Act [was] enacted in 2002 in response to a series of large-scale corporate scandals at companies like Enron, WorldCom, Tyco, Global Crossing, Adelphia, and Rite Aid.”).

1. *Changes to Board Structure, Responsibility, and Liability*

Five main legal and cultural consequences of the recent corporate governance reforms have changed board structure. First, in order to remain listed, the board of directors of each New York Stock Exchange- and NASDAQ-listed firm must have a majority of independent directors.⁴⁰ Second, each independent director must meet a refined standard of independence that requires the board to determine, and to disclose its basis for determining, that the director has “no material relationship” with the company.⁴¹ The new definition of independence excludes auditors, members of interlocking directorates,⁴² and some former employees (as well as their immediate family members).⁴³ Third, the board’s compensation and nominating/governance committees must consist entirely of independent directors.⁴⁴ Fourth, the board’s audit committee must have a minimum of three members and must consist entirely of independent directors.⁴⁵ In addition, each member of the audit committee must be financially literate.⁴⁶ One member must be an “audit committee financial expert,” or the company must disclose why it does not have such an expert.⁴⁷ Finally, nonmanagement directors must meet regularly outside the presence of management.⁴⁸

In 2003, nearly eighty percent of companies planning to make changes to director compensation said that their changes resulted from both greater demands for independent directors and a greater workload facing those directors.⁴⁹ Board service is becoming more

⁴⁰ NYSE Listed Company Manual § 303A.01 (2007); NASDAQ Manual § 4350(c)(1) (2007). Controlled companies, limited partnerships, companies in bankruptcy, and some other types of entities are exempted from this requirement. NYSE Listed Company Manual § 303A.00.

⁴¹ NYSE Listed Company Manual § 303A.02(a). The NASDAQ definition of director independence requires that independent directors have no relationships that would “interfere with the[ir] exercise of independent judgment in carrying out the[ir] responsibilities.” NASDAQ Manual § 4200(a)(15); *see also* James S. Linck et al., *The Effects and Unintended Consequences of the Sarbanes-Oxley Act, and Its Era, on the Supply and Demand for Directors 5* (Feb. 14, 2007) (unpublished paper), *available at* <http://ssrn.com/abstract=902665> (summarizing the effects of SOX, the NYSE rules, and the NASDAQ rules on board structure).

⁴² *See infra* note 72 for a definition and discussion of interlocking directorates.

⁴³ NYSE Listed Company Manual § 303A.02(b); Linck et al., *supra* note 41, at 5.

⁴⁴ NYSE Listed Company Manual § 303A.04(a), .05(a); Linck et al., *supra* note 41, at 5.

⁴⁵ NYSE Listed Company Manual § 303A.07(a)–(b); Linck et al., *supra* note 41, at 5.

⁴⁶ NYSE Listed Company Manual § 303A.07(a) cmt.; Linck et al., *supra* note 41, at 5.

⁴⁷ SEC Reg. S-K, Item 407(d)(5), 17 C.F.R. § 229.407(d)(5) (2007); Linck et al., *supra* note 41, at 5.

⁴⁸ NYSE Listed Company Manual § 303A.03.

⁴⁹ *Board Independence Will Cost Companies*, INVESTOR REL. BUS., Feb. 24, 2003, at 4, 4 (citing survey by Hewitt Associates). The following fake want ad for a board member parodies some of the changes to the demands and nature of board service:

demanding and less rewarding,⁵⁰ as directors “work harder, longer, and . . . more carefully than ever before.”⁵¹ Before the shift to this era of heightened corporate governance, directors would typically spend approximately one hundred hours per year on board service.⁵² In contrast, one expert estimates that directors of public companies now devote between two hundred and three hundred hours per year to a single board.⁵³ The direct effect of SOX on board workload is largely due to Section 404 of the Act, which requires companies to report on the effectiveness of their internal controls.⁵⁴ This task is left to the members of the board’s audit committee, which is responsible for internal control and disclosure procedures.⁵⁵

The demands imposed by SOX and accompanying changes in “corporate culture,” as evinced by an increase in shareholder activism, have also left directors more vulnerable to legal liability.⁵⁶ For

Wanted: High-profile senior executive for extremely challenging part-time position. Proven track record as a risk-taker is essential, although position’s objectives primarily involve risk management and risk avoidance. Must be willing to challenge senior management despite limited access to information. May face loss of reputation due to ridicule by media. High probability of being named in shareholder litigation at least once during tenure, with limited personal asset protection provided by the company. While service is part-time, must be on call for emergency meetings at any time. Cash compensation is about 50 percent of the per diem rate of full-time employment. Value of performance-based compensation is largely outside the candidate’s control.

Carl R. Weinberg, *What’s Wrong with Director Pay—and How to Fix It*, DIRECTORSHIP, Dec. 2004, at 10, 10.

⁵⁰ *Roles Central to Directors’ Pay*, FIN. EXECUTIVE, July–Aug. 2003, at 10, 10 (2003) (“The rewards and costs of directorship . . . are in flux, driven by the ongoing upheaval in corporate governance. The demands and risks of board membership are rising, while non-financial rewards of directorship are declining.”). The workload of directors has certainly increased. As a result, outside directors are precluded—whether formally by the company, or functionally by the amount of time board service now entails—from sitting on the boards of more than four public companies, with the typical number being two or three. REDA ET AL., *supra* note 11, at 77–78; Zong, *supra* note 16, at 49. The Institutional Shareholder Services (ISS) takes this one step further, recommending that voters withhold votes for “directors who are members of more than six public company boards or are CEOs of public companies and serve on more than two public boards other than their own.” Hornsby & Opperman, *supra* note 25.

⁵¹ REDA ET AL., *supra* note 11, at 77.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ Pub. L. No. 107-204, § 404, 116 Stat. 745, 789 (codified at 15 U.S.C. § 7262); Linck et al., *supra* note 41, at 8 n.8.

⁵⁵ Pub. L. No. 107-204, § 404, 116 Stat. 745, 789 (codified at 15 U.S.C. § 7262); SEC Reg. S-K, Item 407(d), 17 C.F.R. § 229.407(d) (2007); Management’s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release Nos. 33-8238, 34-47986, 68 Fed. Reg. 36,636 (June 18, 2003).

⁵⁶ Koors, *supra* note 28, at 25 (describing atmosphere of increased pressure for majority voting, public criticism of boards, and changes in accounting and disclosure requirements);

example, effective 2007, compensation committees are required to disclose in detail an explanation of, and rationale for, executive and director compensation plans.⁵⁷ These disclosures qualify as documents filed with the Securities and Exchange Commission (SEC), therefore exposing the committee members to liability under the securities laws.⁵⁸ Directors also face the increased threat of shareholder lawsuits, which may force them to pay damages out of their own pockets.⁵⁹

All of these circumstances are changing the structure and the role of the board, as directors redefine their role in the face of “growing demands . . . placed on them from all fronts.”⁶⁰ Director compensation is increasing as a result of “growing competition for director talent in light of heavy new regulatory requirements, more time spent on board service and a perception of increased liability.”⁶¹ These changes provide a timely opportunity to reexamine *how*—as opposed to simply *how much*—directors are paid.

2. *The Need for Independence*

Boards today spend the majority of their time monitoring management.⁶² As a result, the board's independence is of primary importance. A recent study that investigated “cronyism” between the board and the CEO illustrates the connection between independence and effective monitoring.⁶³ The study found that director and CEO compensation are strongly positively related, and that when the CEO and

cf. Zong, *supra* note 16, at 45 (remarking that “outside directors will be held to a higher degree of accountability than in the past”).

⁵⁷ 17 C.F.R. §§ 228.402, 229.402 (2006); Executive Compensation Disclosure, Exchange Act Release Nos. 33-8765, 34-55009, 71 Fed. Reg. 78,338 (Dec. 29, 2006); Executive Compensation and Related Person Disclosure, Exchange Act Release Nos. 33-8732A, 34-54302A, IC-27444A, 71 Fed. Reg. 53,158 (Aug. 29, 2006).

⁵⁸ Koors, *supra* note 28, at 30. The fact that director compensation must now be disclosed highlights that the SEC, the market, governance watchdogs, and shareholders are paying attention to this largely overlooked aspect of the corporate board.

⁵⁹ *E.g.*, Rebecca Smith & Jonathan Weil, *Ex-Enron Directors Reach Settlement*, WALL ST. J., Jan. 10, 2005, at C3 (remarking that ten former Enron directors agreed to pay \$13 million personally toward \$168 million settlement); Jonathan Weil & Shawn Young, *Tracking the Numbers/Outside Audit: WorldCom's Steep Price—Outside Directors' Failures Send Expensive Lessons on the Cost of Inattention*, WALL ST. J., Jan. 7, 2005, at C1 (noting that ten outside directors of WorldCom agreed to pay \$18 million of their own money to settle shareholder lawsuits).

⁶⁰ Longnecker, *supra* note 34, at 11.

⁶¹ *Director Pay on the Rise*, DIRECTORSHIP, Mar. 2003, at 18, 18.

⁶² *E.g.*, Adams, *supra* note 22, at 24. However, boards of larger firms and firms that face more uncertainty spend relatively less time monitoring, and growing firms spend relatively more time focused on business strategy. *Id.*

⁶³ See Brick et al., *supra* note 26, at 404 (hypothesizing that high director compensation is associated with culture that fails to produce constructive criticism).

the directors receive compensation that is deemed “excessive,”⁶⁴ firm performance suffers.⁶⁵ This suggests that excessive board and CEO compensation is one symptom of a corporate environment rife with “mutual back scratching,” in which the board fails to monitor management with shareholders’ interests in mind.⁶⁶ The result is a board culture that lacks one of the primary features of “corporate separation of powers”—the ability to serve as an independent check on management.⁶⁷ In short, “when the CEO is entrenched and the board loses independence,” significant agency problems arise and wealth maximization of the firm becomes less likely.⁶⁸

As boards become more independent, the board relationship has shifted from one of “CEO domination” to one of “CEO accountability,” as companies move to separate CEO and board chairperson positions.⁶⁹ Historically, the CEO played a significant and often decisive role in the selection and retention of directors.⁷⁰ Directors who displeased a CEO often found it difficult to keep their seats on the board, which made it hard for the directors to maintain independence from the CEO.⁷¹ The shift toward board independence and heightened monitoring of the CEO has alleviated this problem and changed boardroom dynamics.⁷²

⁶⁴ *Id.* (defining “excessive” as exceeding compensation related to variables that proxy need for monitoring directors).

⁶⁵ *Id.* at 404, 417, 419. The study found that a ten percent increase in director excess compensation corresponds to a one percent decrease in firm returns. *Id.* at 419.

⁶⁶ *Id.* at 404.

⁶⁷ *Id.* (“The board may not effectively monitor executive performance because board culture inhibits constructive criticism . . .”).

⁶⁸ Harley E. Ryan Jr. & Roy A. Wiggins III, *Who Is in Whose Pocket? Director Compensation, Board Independence, and Barriers to Effective Monitoring*, 73 J. FIN. ECON. 497, 523–24 (2004).

⁶⁹ Zong, *supra* note 16, at 49 (citing study conducted by Hewitt Associates finding that ten to twelve percent of companies have separate roles for CEO and chairman positions); see also Vafeas, *supra* note 14, at 457 (citing study showing that presence of outsiders on boards increases likelihood of replacing poorly performing CEOs).

⁷⁰ Melvin A. Eisenberg, *The Compensation of the Chief Executive Officer and Directors of Publicly Held Corporations*, 39 CORP. GOVERNANCE INST. 103, 130 (1999).

⁷¹ *Id.* at 130–31.

⁷² Related to board independence from the CEO and management is the phenomenon of interlocking directorates—when the same individuals sit on the boards of different companies. See Matt Krantz, *Web of Board Members Ties Together Corporate America*, USA TODAY, Nov. 24, 2002, at B1. Recent studies have found that these “cozy” board relationships limit effective monitoring by the board. Stuart L. Gillan, *Recent Developments in Corporate Governance: An Overview*, 12 J. CORP. FIN. 381, 386 (2006) (citing M.J. Conyon & M.R. Muldoon, *The Small World Network Structure of Boards of Directors* (Univ. of Pa., Working Paper, 2004) and D.F. Larcker et al., *Back Door Links between Executives and Executive Compensation* (Univ. of Pa., Working Paper, 2005)). For instance, when CEOs serve as outside directors on other boards, they might endorse certain compensation packages that would be desirable to them as CEOs, rather than as board members. See Dan R.

Board independence enhances shareholder welfare since independence results in director compensation contracts that provide greater incentives to monitor management.⁷³ Director compensation plans should reduce the agency costs arising from the separation of management oversight and ownership's ultimate control.⁷⁴ Setting the amount of a director's compensation thus involves giving "responsible persons an incentive to serve as directors" and rewarding service in an appropriate way, while not choosing an amount so large as to compromise directorial independence.⁷⁵

C. *The Directors' Perspective: Characteristics and Motivations*

Given the heightened role of the board as a corporate monitor and the increased demand for board independence, how should board members be paid? This section examines two factors that should be considered when designing a director compensation plan: the reasons directors engage in board service, and the message sent by the director compensation plan.

1. *Reasons for Board Service*

In examining a director compensation plan, one needs to consider the underlying reasons that individuals choose to serve on corporate boards. Several factors, other than compensation, drive the decision to serve as a director.

First, board members, like elected politicians, are generally trusted to serve altruistically, with an eye focused on what is best for the company. One scholar asserted that "[t]he strongest incentive for directors to 'do the right thing,' . . . is not so much independence as it is their expertise, diligence, and inherent curiosity."⁷⁶ Board members themselves recognize that they do not consider compensation to be a

Dalton & Catherine M. Daily, *Directors and Shareholders as Equity Partners? Handle with Care!*, 31 COMPENSATION & BENEFITS REV. 73, 77 (1999) (noting that "[t]he most common occupation of an outside director is that of CEO of another firm" and that CEOs are predisposed to favor stock option plans). Interlocking directorates also have the negative effect of reducing diversity both among and within corporate boards.

⁷³ Ryan & Wiggins, *supra* note 68, at 500, 523 (finding that "shareholders' economic interests are best served when the board remains independent" and that "[t]o the degree that the board remains independent, director compensation provides incentives more closely aligned with those of the shareholders").

⁷⁴ See Bryan et al., *supra* note 23, at 2–3. Agency costs are the "social and private costs of an agent's actions due to incomplete alignment of the agent's and owner's interests." James S. Ang et al., *Agency Costs and Ownership Structure*, 55 J. FIN. 81, 81 (2000).

⁷⁵ Eisenberg, *supra* note 70, at 131–32.

⁷⁶ Barrier, *supra* note 19, at 47 (quoting Todd DeZoort, director of Ph.D. program in accounting at University of Alabama).

strong motivator when it comes to board service.⁷⁷ Rather, directors feel a sense of duty to guide the corporation responsibly.⁷⁸ Even in the twenty-first-century world of corporate governance, directors are not frightened away from board service by an increase in the level of risk associated with it, so long as they believe they can help remedy looming problems.⁷⁹

A second motivating factor is the business education provided by serving on a board. Directors have “the opportunity to learn, the intellectual challenges of serving, the ability to observe a business up close, and the chance to work with their peers.”⁸⁰ One director even posited that “directors ought to pay to serve on boards because you learn so much about situations that you, in turn, become faced with.”⁸¹

Third, financial compensation may also influence the decision to serve on a board, though only minimally for wealthy members. The amount received as compensation for board service is generally very small relative to the director’s other income and overall net worth.⁸² Most directors are “successful professionals who have built significant wealth,”⁸³ and do not serve on boards for the monetary rewards.⁸⁴

⁷⁷ One survey of directors found that “compensation and major stock ownership ranked least among all the possible reasons for joining a board and that compensation ranked least among all the potential personal benefits derived from board membership.” Jay W. Lorsch, *The Fuss Over Director’s Pay and Pensions—Is Stock Ownership Really the Answer?*, DIRECTORSHIP, June 1996.

⁷⁸ Claudia Zeitz Poster & Mark R. Ullman, *Director Pay: What Makes Sense Today*, DIRECTORS & BOARDS, 3d Quarter 2006, at 42, 44 (quoting one director as remarking, “At the end of the day I am driven by my sense of duty and responsibility to be genuinely helpful”).

⁷⁹ See *id.* (listing responses from directors that generally indicate understanding of seriousness of their role and desire to help management achieve its goals).

⁸⁰ Lorsch, *supra* note 77.

⁸¹ *Id.* The director went on to state that he had been better able to handle many situations at his own company because of similar experiences he had encountered as an outside board member. *Id.* The educational benefit that board service confers on directors who serve as managers of other companies is not the same as the phenomenon of interlocking directorates, discussed *supra* note 72.

A recent survey of directors of over twenty companies in the *Fortune* 500 provided additional insights into the self-identified role of the board, as well as board members’ motives for board service. See Poster & Ullman, *supra* note 78. The directors indicated that they take their position as mentors to management quite seriously, as their decision to join a board is based “at least as much on whether they believe they can add value [to management] as on their assessment of the risk and time demands.” *Id.* at 44.

⁸² See Fich & Shivdasani, *supra* note 11, at 2231–32 (discussing CEOs who serve as outside directors on other firms’ boards).

⁸³ Lorsch, *supra* note 77.

⁸⁴ Poster & Ullman, *supra* note 78, at 44–45.

Rather, “[t]hey are there because their expertise adds value.”⁸⁵ Nevertheless, even though the prospect of remuneration does not strongly affect wealthy individuals’ initial decisions to serve on corporate boards, the compensation they ultimately receive can affect the manner in which they execute their boardroom responsibilities.⁸⁶

Despite the fact that personal financial gain is not the primary motivator for board service, directors still want to be paid fairly for their time.⁸⁷ While their pay may be a small percentage of their net worth, directors want their compensation to be fair relative to that paid by competitors and the responsibilities they face.⁸⁸ In addition, not all directors are independently wealthy. For these individuals, the form of compensation may be of some importance. For example, if it is entirely illiquid, e.g., comprised entirely of stock with restrictions on resale, these directors may find that board service is not a viable financial option.⁸⁹ Furthermore, compensation may motivate all board members, including wealthy ones, to perform better if it establishes a psychological link to the corporation.⁹⁰

Finally, a director’s “reputation capital” is a key external motivator of director behavior.⁹¹ When the company performs poorly, the reputation capital of the board members—as leaders of the company—suffers.⁹² Several studies support the conclusion that “there are beneficial employment opportunities as directors for individuals who have been or are directors of high performance firms.”⁹³ Studies have also confirmed that outside directors with more valuable reputation capital tend to protect shareholder interests better.⁹⁴

⁸⁵ *Shareholders, NACD Want Directors To Be Paid in Stock*, INVESTOR REL. BUS., Apr. 3, 2000, at 8, 9 (quoting Roger Raber, President of National Association of Corporate Directors (NACD)). Raber continued: “Boards shy away from an individual who wants to join because . . . the company pays quite well. Getting greedy about compensation is a definite red flag in the recruitment process. Companies that chase potential directors with money are making a mistake.” *Id.*

⁸⁶ See *infra* Part II.C.2.a for a discussion of the psychological effects of compensation on board members, regardless of their level of personal wealth.

⁸⁷ Poster & Ullman, *supra* note 78, at 44–45.

⁸⁸ *Id.*

⁸⁹ See *infra* text accompanying notes 161–63.

⁹⁰ See *infra* Part II.C.2.a.

⁹¹ “Reputation capital” is the term given to signify that reputation is an intangible asset that can enhance an individual’s or firm’s profitability and marketability. CHARLES S. FOMBRUN, REPUTATION: REALIZING VALUE FROM THE CORPORATE IMAGE 81 (1996).

⁹² *Cf.* Fich & Shivdasani, *supra* note 11, at 2231–32 (discussing under-diversification of risk as cost of stock option plans, due to risks to reputation capital inherent in board service).

⁹³ Linn & Park, *supra* note 17, at 682 (citing studies).

⁹⁴ Vafeas, *supra* note 14, at 458 (citing studies).

Despite the fact that compensation does not necessarily strongly influence directors' decisions, the subject is important for several reasons. First, the manner and amount of director compensation is a "proxy for good corporate practices."⁹⁵ Good director compensation practices send a signal that the company is well-run, able to attract valuable talent, and is overseen by a board that is committed to the company.⁹⁶ Second, despite its weakness as a motivator for director behavior, director compensation should not inadvertently encourage director behavior that is contrary to the health of the company. In other words, director compensation should not hamper directors from serving free of conflicts of interest. Finally, as the role and responsibilities of boards change due to external factors such as SOX, shareholder activism, and other changes to corporate culture, board members' compensation ought to be brought in line with the altered reality facing the board.

2. *Appearances Matter*

Given the relatively small amount that many directors are paid compared to their overall net worth, no particular scheme of compensation will dictate the way in which every director carries out her responsibilities.⁹⁷ A director compensation plan should therefore be concerned with not only the incentive effects created by compensation, but also with the message that it sends to the public.⁹⁸ Directors "should be independent in fact and in appearance,"⁹⁹ since appearances matter when it comes to an evaluation of a director's independence and ability to effectuate her duties. The fact that the board sets its own compensation compounds the heightened concern for appearances.¹⁰⁰

While the actual effect of compensation on a director's behavior is unclear, the perceived incentive effects of director compensation are a critical piece of this analysis. By recently requiring additional disclosures of both the elements of director compensation and the reasons for their adoption, the SEC signaled that it believes that investors

⁹⁵ Telephone interview with Frederic W. Cook, Founding Director, Frederic W. Cook & Co., in New York, N.Y. (May 14, 2007).

⁹⁶ *Id.*

⁹⁷ *Cf.* Barrier, *supra* note 19, at 45 (noting it is unlikely that particular compensation system will encourage directors to cheat).

⁹⁸ *Id.* (citing Todd DeZoort, director of Ph.D. program in accounting at University of Alabama).

⁹⁹ *Id.* (quoting Todd DeZoort, director of Ph.D. program in accounting at University of Alabama).

¹⁰⁰ *See* Dalton & Daily, *supra* note 72, at 76 (noting that stock options awarded by boards to themselves pose "public relations problems").

should be allowed to evaluate director compensation themselves.¹⁰¹ Boards are well-aware that public perceptions of their compensation do matter. One compensation expert urges boards to ask the following questions when setting their compensation:

Are we certain that our programs are defensible, from both a legal and public relations standpoint? What is likely to be the first impression that potential institutional investors will have of our programs? How will employees perceive our . . . board compensation programs? Will they inspire or hinder productivity? How do they impact shareholder value in this regard?¹⁰²

Boards know that the market, the SEC, shareholders, and stakeholders are paying attention to the message sent by the amount and manner of director compensation. Compensation plans provide one metric that shareholders and others use to measure the “health” of the corporation and the board’s performance. Shareholders are looking for cues that the board is serving as their agent,¹⁰³ and the market is looking for signs that the corporation is on a value-maximizing trajectory. Director compensation is one of the many factors employed in this analysis.¹⁰⁴

Director compensation, though not the primary motivator of director behavior, is thus important for two reasons. First, compensation has the capacity to reduce the independence of individual board members, which may in turn compromise the board’s ability to monitor management effectively. Second, shareholders, the market, and directors themselves are paying attention to the message sent by the amount and method of director compensation. Corporations must work to ensure that this message conveys a commitment to the health of the company and the value of its stock.

¹⁰¹ See 17 C.F.R. §§ 228.10, 229.10 (2006); Executive Compensation Disclosure, Exchange Act Release Nos. 33-8765, 34-55009, 71 Fed. Reg. 78,338 (Dec. 22, 2006); Executive Compensation and Related Person Disclosure, Exchange Act Release No. 33-8732A, 71 Fed. Reg. 53,158 (Aug. 29, 2006); Nikos Vafeas, *Operating Performance Around the Adoption of Director Incentive Plans*, 68 ECON. LETTERS 185, 190 (2000).

¹⁰² Longnecker, *supra* note 34, at 11.

¹⁰³ Cf. Longnecker, *supra* note 34, at 8–9 (noting that both market and directors view equity ownership as impetus for active involvement by board members).

¹⁰⁴ See generally CMA CANADA, MEASURING AND IMPROVING THE PERFORMANCE OF CORPORATE BOARDS 18–30 (2002), available at <http://www.aicpa.org/audcommctr/download/measuring%20and%20improving%20performance%20of%20corporate%20boards.pdf> (listing factors used to assess corporate success).

II

DIRECTOR COMPENSATION AND HOW IT IS CHANGING:
A CRITICAL ANALYSIS

This Part describes the components of board pay and details recent trends in director compensation. It then discusses and critiques the different ways in which directors could be compensated: cash, equity, stock options, and payment-for-performance.

A. *Components of Board Pay*

The director compensation plan that Coca-Cola recently adopted—in which directors are paid nothing if the company does not meet its performance target¹⁰⁵—replaced a plan that is far more typical among corporate boards today. Under this former compensation plan, directors of Coca-Cola received an annual retainer fee of \$125,000.¹⁰⁶ Of this retainer, \$50,000 was paid in cash and \$75,000 was paid in accrued share units.¹⁰⁷ In addition, directors received fees for tasks such as chairing committees and attending board and committee meetings.¹⁰⁸ Directors received this compensation regardless of the company's performance.¹⁰⁹ These elements of compensation—a fixed annual retainer¹¹⁰ consisting of cash and equity, meeting fees,¹¹¹ and fees for chairing committees¹¹²—are the common components of a

¹⁰⁵ See *supra* notes 1–6 and accompanying text.

¹⁰⁶ Press Release, Coca-Cola Company, *supra* note 1; Taub, *supra* note 2.

¹⁰⁷ Press Release, Coca-Cola Company, *supra* note 1; Taub, *supra* note 2.

¹⁰⁸ Press Release, Coca-Cola Company, *supra* note 1.

¹⁰⁹ Terhune & Lublin, *supra* note 1.

¹¹⁰ Annual retainers are used almost universally as a form of compensation. Zong, *supra* note 16, at 49 (citing survey conducted by Hay Group). These retainers are usually paid in cash, equity, or some combination thereof. REDA ET AL., *supra* note 11, at 78. In 2002, the median annual retainer paid by a *Fortune* 50 company was \$50,000. Zong, *supra* note 16, at 49–50.

¹¹¹ Board members are paid (usually in cash) for attending board meetings as well as committee meetings, regardless of whether they attend in person or by telephone. REDA ET AL., *supra* note 11, at 79. If the telephone meeting is short and informal, sometimes the fees associated with the meeting will be ignored. *Id.* In 2002, the median board meeting fee paid by *Fortune* 50 companies was \$1200, and the median committee meeting fee was \$1000. Zong, *supra* note 16, at 49 (citing survey conducted by Hay Group).

¹¹² As a result of their “increased time commitment and additional responsibility,” board committee chairpersons are usually compensated for their services, either on a per meeting or (more commonly) a fixed retainer basis. Hornsby & Opperman, *supra* note 25. Chair retainers are generally about twenty percent of the value of the annual retainer, and they range between twenty and 150 percent more than committee retainers. Zong, *supra* note 16, at 46 (citing study conducted by Pearl Meyer & Partners). An “evolving rule of thumb” is that the audit committee chair fee should be roughly three times the committee fee received by the regular audit committee member, and that the compensation committee chair fee should be double that of the committee fee received by the regular compensation committee member. *Id.* (citing recommendation of Frederic W. Cook & Co.).

typical board member's pay package.¹¹³ Generally, just under half of total compensation is in the form of cash, with the remainder in equity.¹¹⁴

B. Trends in Board Compensation

There are several recent developments in the means of and basis for board member compensation.¹¹⁵ In general, compensation amounts have increased.¹¹⁶ The members of the most "demanding" board committees (the audit, compensation, and governance/nominating committees) have seen the most significant increase in compensation, largely as a function of longer and more frequent meetings.¹¹⁷ Equity compensation now more commonly consists of full-value shares, as opposed to stock options,¹¹⁸ and most companies have increased the amount of the company's stock that directors are

¹¹³ Historically, many companies also provided their directors with retirement plans. NAT'L ASS'N OF CORPORATE DIRS. BLUE RIBBON COMM'N, DIRECTOR COMPENSATION: PURPOSES, PRINCIPLES, AND BEST PRACTICES, at ix (2001). Director retirement plans are nearly obsolete today. *Shareholders, NACD Want Directors To Be Paid in Stock*, *supra* note 85, at 8.

¹¹⁴ *E.g.*, Koors, *supra* note 28, at 28; *Shareholders, NACD Want Directors To Be Paid in Stock*, *supra* note 85, at 8.

¹¹⁵ In this section, trend analysis is based on a comparison of director compensation in 2004 with director compensation in 2005. *See generally* Koors, *supra* note 28 (compiling analyses of changes in director compensation from 2004 to 2005 and discussing longer term trends in director compensation).

¹¹⁶ In 2005, the average total director compensation for a firm in the top two hundred was approximately \$195,000. Koors, *supra* note 28, at 26–27. Within the top two hundred firms, the total amount of director compensation varied between \$36,250 and \$931,337. *Board Watch—Study Shows Variations in Director Pay and Policies*, *supra* note 18, at 3 (citing study by Pearl Meyer & Partners). The latter figure (belonging to UnitedHealth Group) was "something of an anomaly," as it was more than twice that of the next highest paying company and was the result of stock option awards. *Id.* (citing study by Pearl Meyer & Partners). The company is now under formal investigation by the SEC for options backdating. Robert Simison, *SEC Investigates UnitedHealth over Stock-Options Practices*, SUN-SENTINEL (Fort Lauderdale, Fla.), Dec. 27, 2006, at 1D. The wide variation in total director compensation is entirely due to differences in the value of the equity granted to board members. *Board Watch—Study Shows Variations in Director Pay and Policies*, *supra* note 18, at 3.

¹¹⁷ *See* Koors, *supra* note 28, at 25, 28.

¹¹⁸ This change may result from new accounting rules mandating options expensing, i.e., treating options as a corporate expense on the income statement, *see* REDA ET AL., *supra* note 11, at 80, and "longtime governance concerns that stock option awards tend to promote a focus on short term price growth," Koors, *supra* note 28, at 29. An additional (and more cynical) explanation for this trend stems from the fact that the recent dive in the market had a negative effect on directors' option holdings, *see* Zong, *supra* note 16, at 47 (noting market slump's impact on option values), putting some of these options "out-of-the-money," meaning that the strike price is greater than the current market price of the stock, *see* Hannah Clark, *Stock-Option Stashes Grow for CEOs*, FORBES.COM, Feb. 28, 2007, http://www.forbes.com/corporategovernance/2007/02/27/ceo-stock-options-lead-govern-cx_hc_0228options.html.

required to hold.¹¹⁹ These trends are the result of the higher demands now imposed on board members, the increased threat of director liability, and a perceived need for heightened board independence.¹²⁰

The phenomenon of increasing director compensation, however, can also be explained by simple economics. As the demand for financially literate, sophisticated, independent directors increases—assuming the pool of candidates for these positions remains fixed—the amount of compensation paid to directors will necessarily increase.¹²¹ Furthermore, the supply of qualified candidates may have shrunk, as CEOs can no longer sit on other companies' boards due to the increased time demands and exposure to liability that now come with board service.¹²² Moreover, the size of the board has increased since the implementation of SOX,¹²³ which only serves to exacerbate this problem of supply and demand.

C. Form of Compensation

This section analyzes the benefits and drawbacks of the two primary forms of director compensation: cash and equity. It also addresses the use of stock options as a unique form of equity compensation. The section then critiques payment-for-performance plans.

1. Cash Compensation

The main benefit of cash compensation is that it maintains directors' independence from both management and the company.¹²⁴ Directors do not realize additional income (in the form of increases in the company's share price) as a result of management's efforts and the company's performance. Cash compensation enables directors to perform their duties objectively and free of any conflict of interest—

¹¹⁹ Although not required by the SEC, nearly three-quarters of the top two hundred companies employ director stock ownership guidelines. Koors, *supra* note 28, at 31. Share ownership requirements are endorsed by a number of governance proponents, and therefore the newfound prevalence of such guidelines may be a response to the heightened governance environment. *See id.* (noting support for share ownership programs by NACD and other corporate governance proponents and increase in public disclosure of existence of share ownership guidelines).

¹²⁰ *See supra* Part I.B.

¹²¹ *See* Linck et al., *supra* note 41, at 1 (analyzing supply and demand effects on director compensation); Zong, *supra* note 16, at 50 (noting how high demand for outside directors will increase their compensation).

¹²² *See* Zong, *supra* note 16, at 50 (noting that “fewer CEOs will be available for directorships as companies seek to avoid exposing their top executives to the new time demands and potential risk of reputation derived from board service”).

¹²³ *E.g.*, Gillan, *supra* note 72, at 385.

¹²⁴ Barrier, *supra* note 19, at 45–47 (citing Todd DeZoort, director of Ph.D. program in accounting at University of Alabama). *But see id.* at 47 (citing Charles M. Elson's position that cash payment creates alignment between directors and those paying out cash).

because they are paid regardless of the firm's performance, they do not consider possible effects on their personal finances when setting corporate policy.¹²⁵

The main drawback of cash compensation is also its main virtue: It keeps directors independent from the company and does not encourage directors to think like owners.¹²⁶ In today's riskier market environment, many directors prefer to be paid in cash, perhaps in order to insulate them from the risks inherent in equity ownership.¹²⁷

2. *Equity-Based Compensation*

Nearly all of the largest companies in the United States use equity in the company as some part of their directors' compensation package.¹²⁸ Providing directors with an equity stake in the company can take several forms. Grants of full-value shares of stock give directors "an immediate, real ownership stake" in the company.¹²⁹ These stock grants can be deferred or restricted.¹³⁰

¹²⁵ Because it is not dependent on the company's performance, cash compensation best enables director independence. However, excessive director compensation in any form (cash or otherwise) may indicate that a board is not performing as an effective corporate monitor on behalf of the shareholders. *See supra* notes 62–68 and accompanying text.

¹²⁶ Sterling Baldwin & Leonard I. Wilson, *Beyond Stock-Related Compensation for Directors*, CORP. BOARD, Nov.–Dec. 1998, at 15.

¹²⁷ *See Board Games*, ENTREPRENEUR, July 2006, at 66, 66 (remarking that "[t]he turbulent IPO market" has spurred potential directors "to require a portion of their compensation in cash instead of just equity").

¹²⁸ NAT'L ASS'N OF CORPORATE DIRS. BLUE RIBBON COMM'N, *supra* note 113, at vii; *see also* Barrier, *supra* note 19, at 44 (noting that most common form of payment for directors is both cash and stock).

¹²⁹ Zong, *supra* note 16, at 47.

¹³⁰ Restricted stock compensation plans normally provide for an annual grant of a pre-specified number of shares, or an amount of shares equal to a pre-specified amount of money. Vafeas, *supra* note 14, at 455. Board members are prohibited from selling the shares so long as they remain on the board, *see* Barrier, *supra* note 19, at 44 (quoting Charles M. Elson, Director of Center for Corporate Governance at University of Delaware), or until a specific restriction period lapses, Vafeas, *supra* note 14, at 455. Directors receive dividends and can vote the stock during the restriction period. *Id.*

Similar to restricted stock, deferred stock is delivered at the end of a board member's service on the board. *See, e.g.*, Michael Rothfeld, *Review of Decisions*, NEWSDAY, Feb. 25, 2007, at A6 (noting that director would have access to deferred stock after tenure on board); Client Alert, Frederic W. Cook & Co., Inc., Heads-Up on Deferred Compensation Guidance: IRS Guidance on Provisions of American Jobs Creation Act of 2004—Stock-Settled SARs of Public Companies Permissible; Transition Rules Provided 2 (Dec. 22, 2004), available at http://www.fwcook.com/alert_letters/12-22-04%20Heads-Up%20on%20Deferred%20Compensation%20Guidance.pdf (noting that grant of deferred stock gives recipient right to receive shares in future). The deferred stock units allow the director to participate fully in the growth (or decline) in the stock price throughout her tenure on the board. Weinberg, *supra* note 49, at 11. Generally, the director can earn dividend equivalents (through the deferred stock units) that she may convert into additional deferred stock units. *Id.*

Many companies also use stock options as equity compensation for directors (as for executives¹³¹). Stock options are granted to directors, often annually and with an exercise price equal to the fair market value of the stock on the date of the grant.¹³² The options typically become exercisable in annual installments and expire ten years from the issue date.¹³³ In addition to providing the director with an equity stake in the company, stock options are used with the hope of motivating directors to focus on the company's long term performance.¹³⁴

Stockholding requirements are used in conjunction with equity compensation, in order to focus directors on the long term health of the company. For example, some plans may require directors to hold the shares received as compensation or to delay the exercise of stock options for a given period of time—such as a minimum of one year, until the director retires from the board, or until stock ownership guidelines are met.¹³⁵

Directors are encouraged, and sometimes required, to hold a minimum specified amount of the company's stock.¹³⁶ Where formal stock ownership guidelines exist, they most commonly mandate that within five (but sometimes as few as two or as many as ten) years of board appointment, a director must hold stock that either is between roughly three- and five-times the value of the annual retainer or, alternatively, meets a minimum dollar value requirement.¹³⁷

a. Advantages of Equity Compensation

Regardless of their level of personal wealth, directors feel that equity compensation carries symbolic value, providing them with psychological incentives to improve the performance of the corpora-

¹³¹ See, e.g., David S. Hilzenwrath & Derek Willis, *2005 Compensation for Top-Earning Executives Grew with Stock Option Awards*, WASH. POST, July 10, 2006, at D1 (discussing executive compensation using stock options).

¹³² Vafeas, *supra* note 14, at 455.

¹³³ *Id.*

¹³⁴ Barrier, *supra* note 19, at 44 (citing Charles M. Elson, director of Center for Corporate Governance at University of Delaware).

¹³⁵ Hornsby & Opperman, *supra* note 25.

¹³⁶ NAT'L ASS'N OF CORPORATE DIRS. BLUE RIBBON COMM'N, *supra* note 113, at ix.

¹³⁷ *Id.* at x; Zong, *supra* note 16, at 48; see also Weinberg, *supra* note 49, at 11 (remarking that roughly one-fifth of major U.S. companies disclose ownership guidelines for outside directors, and that most common approach is to require directors to own shares equal to about five-times their annual board retainer within five years).

tion.¹³⁸ They find that the psychological benefits of stock ownership are powerful motivators to influence the stock's price.¹³⁹

The market also agrees with the "intuitive correlation between director ownership and overall corporate performance."¹⁴⁰ For example, in 1994, when the Scott Paper Company announced that all director pay would be in the form of stock, the company's stock price rose by more than three percent.¹⁴¹ Corporate performance, according to some studies, is generally better when director equity ownership is high.¹⁴²

The conventional view is that compensating board members with an equity stake in the company decreases agency costs by bringing directors' incentives in line with those of shareholders.¹⁴³ According to this view, regardless of whether or not compensation from board service constitutes a large or small percentage of a director's personal wealth, directors do not want this level of wealth to decrease as the result of a drop in the value of the company.¹⁴⁴ Equity is seen as the primary vehicle for inducing directors to monitor management¹⁴⁵ and to think and act in a way that is representative of shareholders.¹⁴⁶ When "a director's personal capital is potentially affected by inept or corrupt management, that director is much less likely to acquiesce passively to such a group."¹⁴⁷ Anecdotally, directors say that significant ownership "fosters vigorous debate among [board] members on important issues, encourages involvement in the scope of management and also promotes engagement during difficult times. In short, ownership makes boards work harder."¹⁴⁸ Equity ownership is one of the

¹³⁸ See Poster & Ullman, *supra* note 78, at 45 (noting that equity ownership "works to reinforce engagement" among directors).

¹³⁹ See *id.* at 47 ("Stock provides [directors with a] psychological link between [their] efforts and the building of enduring shareholder value.").

¹⁴⁰ Longnecker, *supra* note 34, at 8.

¹⁴¹ *Id.*

¹⁴² *Id.* at 9; Lorsch, *supra* note 77.

¹⁴³ *E.g.*, Vafeas, *supra* note 14, at 454.

¹⁴⁴ See, *e.g.*, Dalton & Daily, *supra* note 72, at 75 (remarking that "equity holdings presumably would sharpen directors' interest in the value of their stock").

¹⁴⁵ Vafeas, *supra* note 14, at 454 (asserting that director incentive plans are "ultimately intended to promote shareholder wealth maximization by reducing agency costs").

¹⁴⁶ See, *e.g.*, Dalton & Daily, *supra* note 72, at 75; *Shareholders, NACD Want Directors To Be Paid in Stock*, *supra* note 85, at 8 (explaining how equity compensation aligns directors' and shareholders' interests); Vafeas, *supra* note 14, at 455 (noting that "many firms are [using equity compensation] to guide directors towards developing shareholder-like interests").

¹⁴⁷ Eisenberg, *supra* note 70, at 138 (quoting Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649 (1995)).

¹⁴⁸ Longnecker, *supra* note 34, at 9.

ways in which boards are induced to “work harder” on behalf of shareholders.

Equity compensation, especially in the form of full-value shares and deferred stock, is cited approvingly for promoting long term value creation by the board. Full value grants are said to motivate directors to “drive stock price over the long term,”¹⁴⁹ because “[when] directors are paid in shares and [the] stock price drops, they lose hard-earned money just like shareholders.”¹⁵⁰ Deferred stock is also touted not only for its ability to align director and shareholder interests, but also for its ability to focus directors’ attention on the creation of long term value.¹⁵¹

The use of equity to motivate directors to monitor management may no longer be as relevant today. As motivations to monitor (SOX, institutional investor activism, shareholder lawsuits, threats to reputational capital)¹⁵² have greatly increased, there may no longer be a need for powerful personal motivations to monitor (such as the lucrative payout potential offered by equity compensation).

b. Disadvantages of Equity Compensation

The effect of equity compensation on directors’ abilities to monitor management is not without contention. One empirical study found that equity compensation (whether in full-value shares or options) motivates directors to tailor incentives for effort-averse managers.¹⁵³ The study found that the composition of directors’ compensation affects both their design of management contracts as well as the flexibility of the company’s accounting (which determines how earnings are computed by management).¹⁵⁴ The study also found that equity compensation induces directors to collude tacitly with man-

¹⁴⁹ *Shareholders, NACD Want Directors To Be Paid in Stock*, *supra* note 85, at 8.

¹⁵⁰ *Id.* (quoting Ed Archer, Vice President of executive-compensation research firm Pearl Meyer & Partners); *see also* Barrier, *supra* note 19, at 45 (“With straight stock, [directors] actually suffer a wealth diminution if the [share price] falls. If the value goes down, [directors] feel the pinch of the decline in value.” (quoting Charles M. Elson, Director of Center for Corporate Governance at University of Delaware) (second alteration in original)).

¹⁵¹ Weinberg, *supra* note 49, at 11. *See supra* note 32 and accompanying text for a discussion of the difficulty of defining the “long term.”

¹⁵² *See supra* notes 56–59, 91–94 and accompanying text.

¹⁵³ Joshua Ronen et al., *The Effect of Directors’ Equity Incentives on Earnings Management*, 25 J. ACCT. & PUB. POL’Y 359, 380 (2006).

¹⁵⁴ *Id.* at 362.

agers in the manipulation of earnings (or “earnings management”) and to engage in insider trading.¹⁵⁵

Moreover, equity compensation does not necessarily promote long term thinking by directors. Unlike stock options, full-value grants of stock retain value even when the company as a whole declines in value.¹⁵⁶ Equity compensation does not automatically induce directors to manage the firm wisely for the undefined “long term.”¹⁵⁷ The board actions best for the company’s long term health are extremely uncertain and by no means clear *ex ante*; they may be a matter of serious debate among reasonable, informed directors. Demonstrating that long term value maximization necessarily follows from equity ownership is extremely difficult.¹⁵⁸ Equity compensation may simply be an insufficient motivator of director behavior.¹⁵⁹

There are several additional drawbacks to compensation in the form of stock. First, payment in stock may deter certain types of individuals from pursuing board service, thus diminishing the diversity of board membership.¹⁶⁰ Directors need cash on hand in order to pay taxes on their equity compensation. Therefore, payment in stock may have the effect of excluding qualified talent, such as academics and small businesspeople.¹⁶¹ If equity compensation comes with restrictions on resale, these individuals may not be able to afford both to lock up their wealth in the company’s equity and to pay income taxes

¹⁵⁵ *Id.* at 362, 380. Earnings management distorts the information available to the market and decreases the firm’s value (by shifting management’s efforts away from other areas onto earnings management). *See id.* at 380.

¹⁵⁶ Barrier, *supra* note 19, at 45 (quoting Michael J. Halloran, partner in Mercer Human Resource Consulting). Some experts argue that full-value stock provides no “motivation to ensure that there’s a solid, long-term plan in place.” *Id.* (quoting Michael J. Halloran).

¹⁵⁷ *Id.*

¹⁵⁸ Indeed, one study found that the adoption of an equity ownership plan for outside directors had no effect on a firm’s operating performance (measured alternatively by return on assets, asset efficiency, and return on sales). Vafeas, *supra* note 101, at 187–88. However, the study noted that equity ownership plans may be adopted “offensively” rather than “defensively.” *See id.* at 189 (hypothesizing that adoption of incentive plans may “pre-empt performance problems”).

¹⁵⁹ *Id.* at 189–90. However, equity compensation may have its place. For instance, the value of equity ownership may change throughout the company’s life cycle, which is why a one-size-fits-all approach to director compensation is not possible. As an example, the appeal of equity compensation to directors of start-up and high-growth companies is that it keeps fixed-cost expenditures low and provides significant upside potential. Longnecker, *supra* note 34, at 9.

¹⁶⁰ Barrier, *supra* note 19, at 44 (citing Barbara H. Franklin, former U.S. Secretary of Commerce). *See supra* notes 34–35 and accompanying text for a discussion of the benefits of a diverse board.

¹⁶¹ Barrier, *supra* note 19, at 44 (quoting Barbara H. Franklin, former U.S. Secretary of Commerce).

on this illiquid form of compensation.¹⁶² Second, when a substantial amount of the director's compensation or net worth is tied up in the company's stock, she may become too risk-averse, shying away from potentially profitable strategies that seem too personally risky.¹⁶³

The baseline assumption that equity compensation aligns directors' interests with those of shareholders has also been criticized as too simplistic. Although equity compensation may focus directors' views on share price, directors and shareholders are still differently situated: "The fundamental difference [between directors and shareholders] . . . is that most shareholders are not in a position to take actions that influence the stock price, and most directors are"¹⁶⁴ The board should also not be constrained to behave solely as a shareholder would: "[T]he fulfillment of a board's overall responsibilities, including proper corporate governance, ethical business standards, and planning for the long-term well-being of the company may be more important for shareholders than the share price on any given day."¹⁶⁵ While a shareholder may decide to sell her shares when the company takes a downward turn, the board is obliged to act with a more long term perspective in mind. Additionally, certain tasks under the board's guidance, e.g., leading the corporation to act as a good "corporate citizen," improving employee morale, and serving as an

¹⁶² Compensation in the form of equity is still "income" for tax purposes. Regardless of whether directors hold or sell any stock received as compensation, they must pay income tax on it upon receipt. See I.R.C. § 61(a) (2000) ("[G]ross income means all income from whatever source derived"); Treas. Reg. § 1.61-1(a) (1960) ("Gross income includes income *realized in any form*, whether in money, property, or services. Income may be realized . . . in the form of services, meals, accommodations, *stock*, or other property, as well as in cash." (emphasis added)).

¹⁶³ Longnecker, *supra* note 34, at 8–9. This also puts the director at odds with the typical diversified shareholder. See *infra* notes 232–34 and accompanying text.

¹⁶⁴ Barrier, *supra* note 19, at 45 (quoting Todd DeZoort, director of Ph.D. program in accounting at University of Alabama). For example, when the board decides to undertake a stock buyback, this can increase the price of the company's common stock, therefore enhancing the directors' wealth if they have an equity stake in the company. Because the board controls the timing of stock buybacks, they have the power to do so in a number of ways that could maximize their personal benefit, such as immediately after any restrictions on resale by directors lapse, or in order to put any stock options they possess "in the money" (i.e., the increase in share price will make it profitable for directors to exercise their options, given the strike price). Dalton & Daily, *supra* note 72, at 76. This would put the board on both sides of the transaction—and therefore may subject them to liability for breaching their duty of loyalty to the shareholders—if they stood to benefit in a way not shared by all of the corporation's shareholders. See *Feldman v. Cutaia*, No. 1656-N, 2006 Del. Ch. LEXIS 70, at *22–26 (Apr. 5, 2006) (denying motion to dismiss plaintiff's claim that directors who undertook stock repurchase plan which significantly benefited them personally breached duty of loyalty).

¹⁶⁵ Baldwin & Wilson, *supra* note 126.

active member of the community, may have little if any direct relation to the tangible share increases on which shareholders are focused.

Even though the objectives of “aligning directors’ interests with those of shareholders” and “maximizing the long-term value of the corporation” are both touted as two of the primary benefits of equity ownership by directors, a subtle tension exists between the two objectives.¹⁶⁶ This is most observable in the context of a potential merger or acquisition of the company. Normally, shareholders receive a premium for their shares in a merger.¹⁶⁷ When directors have a significant equity stake in the company, their decision to allow the company to be acquired “may not be perceived as independent.”¹⁶⁸ For instance, directors may be influenced by the share premium they personally will receive in a particular merger, when in fact it would be better for the company to wait for another bidder or remain independent.

The use of equity as a form of director compensation also highlights the ambiguity inherent in the definition of “independence” when it comes to analyzing various relationships within the company.¹⁶⁹ For example, while outside auditors cannot own any stock in the company, audit committee members may own (and may be compensated with) as much stock as they want.¹⁷⁰ British and Continental European corporate systems present yet another conception of independence. Companies expect their directors to be “disinterested,” serving the interests of *all* of the company’s stakeholder groups.¹⁷¹ These companies thus frown on equity compensation because they believe it compromises the director’s “disinterested” status.

¹⁶⁶ See *supra* note 33 and accompanying text.

¹⁶⁷ E.g., Dalton & Daily, *supra* note 72, at 77.

¹⁶⁸ *Id.* at 77–78. Restricted stock also threatens director independence and is criticized as creating a subtle conflict of interest. If a company requires that restricted stock be forfeited once the director is not renominated for board membership, there is a danger that directors may avoid taking actions that may displease management. Longnecker, *supra* note 34, at 9.

¹⁶⁹ Barrier, *supra* note 19, at 45.

¹⁷⁰ *Id.* (quoting Dana R. Hermanson, Director of Research of Corporate Governance Center at Kennesaw State University). Some scholars argue that because one would never pay outside auditors in stock, audit committee members (at the very least) should not be paid in stock either. *Id.* (quoting Todd DeZoort, director of Ph.D. program in accounting at University of Alabama).

¹⁷¹ See Weinberg, *supra* note 49, at 11 (noting that British and European directors are expected “to serve the interests of all the company’s stakeholder groups”). See generally John Armour, Simon Deakin & Suzanne J. Konzelmann, *Shareholder Primacy and the Trajectory of UK Corporate Governance* (ESRC Centre for Bus. Research, Univ. of Cambridge, Working Paper No. 266, June 2003), available at <http://www.cbr.cam.ac.uk/pdf/WP266.pdf> (discussing stakeholder model as applied to British and Continental European companies).

In sum, although equityholding by directors signals to shareholders and the market that the board has a stake in the long term value of the company, equity compensation is an inferior mechanism for sending this message.¹⁷² In the current era of heightened corporate governance, not only do the drawbacks outweigh the benefits of equity compensation, but these benefits can be captured by alternative means.

3. *Unique Issues Posed by Stock Options*

Although stock options are a type of equity, they present unique challenges for compensation schemes. Proponents of stock options assert that they effectively induce the board to manage the business with the long run in mind, as they are valueless unless the company's stock price goes up.¹⁷³ Like all forms of equity compensation, stock options are praised for their ability to align directors' incentives with those of shareholders.¹⁷⁴

One study of over seven hundred firms came to several positive conclusions about stock options.¹⁷⁵ First, firms are more likely to compensate outside directors with stock options when the firms possess "strong corporate governance characteristics,"¹⁷⁶ such as domination by independent directors.¹⁷⁷ Moreover, the study found a positive correlation between a company's market-to-book ratio¹⁷⁸ and the presence of a stock option plan for outside directors.¹⁷⁹ A similar positive correlation exists between the use of stock options for outside

¹⁷² See *infra* notes 211–13 and accompanying text (advocating more refined, mandatory equityholding requirements for corporate directors).

¹⁷³ Barrier, *supra* note 19, at 44–45 (quoting Michael J. Halloran, partner in Mercer Human Resource Consulting). Options are also an attractive form of compensation currency, particularly for small companies facing higher levels of risk and lower availability of cash. See *Greater Use of Cash Compensation for Technology Directors Is Predicted*, CORP. BOARD, Jan.–Feb. 2003, at 28, 29; *Shareholders, NACD Want Directors To Be Paid in Stock*, *supra* note 85, at 8 (equating giving full-value grants to giving cash, which only large companies can afford).

¹⁷⁴ One study found that this is particularly true when a firm has an abundance of investment opportunities and faces a high likelihood of takeover. Bryan et al., *supra* note 23, at 22–23. In these situations, stock options have a greater potential for payout compared to straight stock grants. *Id.* at 23.

¹⁷⁵ Fich & Shivdasani, *supra* note 11, at 2230, 2233.

¹⁷⁶ *Id.* at 2230.

¹⁷⁷ *Id.*

¹⁷⁸ *Id.* Market-to-book ratio measures how much a company is presently worth, as compared to the amount of capital invested into it by current and past shareholders. See *id.* at 2239 (calculating market-to-book ratio as "market value of the firm's equity at [year's end] plus the difference between the book value of the firm's assets and the book value of the firm's equity at [year's end], divided by the book value of the firm's assets at [year's end]").

¹⁷⁹ *Id.* at 2230.

directors and metrics of accounting performance,¹⁸⁰ such as cumulative abnormal stock returns. Finally, the researchers found that such compensation plans were well-received by the market, as evidenced by investors' favorable response to the adoption of these plans.¹⁸¹ These findings led the authors of the study to conclude that stock options provide strong incentives for board members to monitor management with the goal of maximizing shareholder value.¹⁸²

Critics of using stock options as director compensation argue that options do not in fact properly align the interests of directors and shareholders.¹⁸³ Unlike holders of "straight" equity, option holders "share in the creation of shareholder value but not in its erosion" because options asymmetrically reward only stock price appreciation.¹⁸⁴ This asymmetry can make directors too risk-inclined.¹⁸⁵

Other concerns about compensating directors with options include a risk that the board will encourage management to manipulate the financials of the company.¹⁸⁶ Options are also contrary to the long term perspective considered appropriate for boards,¹⁸⁷ because the directors have a personal interest in not "hav[ing] any bad news that would cause the stock price to go down." Stock-option plans also pose the threat of equity dilution if all options owned by directors are exercised within a short period of time.¹⁸⁸ In many ways, the use of options as director compensation undermines the board's ability to execute its duties to shareholders and erodes the system of corporate checks and balances.

4. *Payment-for-Performance Plans*

While noteworthy in some respects, Coca-Cola's payment-for-performance plan—which ties compensation to certain performance

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² *Id.* at 2230, 2252.

¹⁸³ *Shareholders, NACD Want Directors To Be Paid in Stock*, *supra* note 85, at 8.

¹⁸⁴ Weinberg, *supra* note 49, at 11.

¹⁸⁵ See *Shareholders, NACD Want Directors To Be Paid in Stock*, *supra* note 85, at 8 ("When directors receive a large number of options, their interests may mirror other options holders—namely management. This can develop a profile of a company that is too willing to take on risks that may not be justified." (quoting Ken Bertsch, then-current TIAA/CREF Director of Corporate Governance)). Option grants may "inadvertently encourage directors to support risky strategies in the hope of significant payoffs, instead of properly balancing upside opportunity with downside risk." Weinberg, *supra* note 49, at 11.

¹⁸⁶ Barrier, *supra* note 19, at 45 (quoting David Hoare, Executive Chairman of Virgin Express Holdings PLC).

¹⁸⁷ Zong, *supra* note 16, at 47.

¹⁸⁸ Baldwin & Wilson, *supra* note 126.

targets—presents some troubling questions. As an initial matter, payment-for-performance plans do not bode well under the “appearances matter” concern¹⁸⁹ because they seem to compromise the board’s independence. Since the board sets its own performance targets in a payment-for-performance plan, it can set low targets that would increase the board’s likelihood of being compensated.¹⁹⁰

Additionally, payment tied to any type of performance benchmark conflicts with the board’s role as an independent, supervisory body. Making both the board and management accountable for the same goals (achieving specific performance targets) undermines the board’s ability to serve as a corporate monitor.¹⁹¹ Payment-for-performance induces the board to act too much like management, thus undercutting its ability to monitor and mentor management.¹⁹² This “blurs the line between management accountability and board accountability”¹⁹³ and erodes the system of corporate checks and balances. In a balanced corporate system, directors serve as an objective sounding board for management, act as a check on overly aggressive or overly conservative management, and generally operate “above the fray.”¹⁹⁴ Most companies avoid payment-for-performance plans due to the imbalance that these plans produce.¹⁹⁵ The consensus is that payment-for-performance is best suited for management.¹⁹⁶

Payment-for-performance is even riskier than payment in equity, as equity ownership links directors with the long term health of the company, while performance bonuses focus the board on specific,

¹⁸⁹ See *supra* Part I.C.2.

¹⁹⁰ See Dalton & Daily, *supra* note 72, at 76 (“At the board of director level, the directors are setting their own performance goals. This could create the appearance of a conflict of interest.” (quoting Ira Kay of Watson Wyatt Worldwide)); Stephen Taub, *Coke Director Pay Plan Raises Eyebrows*, COMPLIANCE WEEK, Apr. 18, 2006 (“If compensation is based on goals [that the board itself is] setting, you can ultimately say they are not disinterested. They can set the goals low.” (quoting Pearl Meyer, executive-compensation consultant, Steven Hall & Partners)).

¹⁹¹ Poster & Ullman, *supra* note 78, at 46.

¹⁹² Taub, *supra* note 190.

¹⁹³ Poster & Ullman, *supra* note 78, at 42.

¹⁹⁴ Taub, *supra* note 190.

¹⁹⁵ See REDA ET AL., *supra* note 11, at 81 (asserting that such type of compensation is avoided due to “inherent conflicts it engenders”).

¹⁹⁶ *Id.* (noting that payment-for-performance is appropriate for management, given that they “run the day-to-day business of the company and, therefore, have more direct effect on the attainment of particular financial performance measures”). In contrast, the view regarding director compensation is that “long-term stock price movements [should] be the primary performance measure.” *Id.*; see also Barrier, *supra* note 19, at 47 (“We all want the companies we work for to do well, but I don’t think you can link my work to that performance so directly and then expect me to be tough when it comes to making decisions and saying what needs to be said.” (quoting Todd DeZoort, director of Ph.D. program in accounting at University of Alabama)).

short term targets.¹⁹⁷ Linking payment-for-performance to objective and explicit criteria (such as earnings per share or stock price) may have the effect of emphasizing short term profitability at the expense of long term company viability.¹⁹⁸ Furthermore, figures such as earnings per share are easy to manipulate.¹⁹⁹

Another problem is that measuring a director's performance is inherently difficult. The role of the board is perhaps not to set and achieve specific targets, but to oversee management and *management's* setting and achievement of specific performance targets; this suggests director pay should not be linked to the achievement of specific targets.²⁰⁰ If measurement of a director's performance is based on her "engagement, focus, participation, preparation, insights, and constructive challenging,"²⁰¹ then neither specific performance targets nor equity compensation are capable of adequately encouraging and capturing such performance. In addition, the causal relationship between compensation and firm performance in the area of executive compensation is far from clear, despite the fact that it is the focus of much study.²⁰² Given this uncertainty, the expansion of payment-for-performance plans into the director arena is puzzling.

Payment-for-performance plans may decrease diversity on corporate boards. For example, academics, heads of nonprofits, former government officials, and others with limited financial resources may be averse to an all-or-nothing system of pay based solely on performance.²⁰³ These problems with payment-for-performance plans suggest that in order to maintain objectivity (both in fact and in appearance), directors should be paid for their time, rather than for the achievement of specific performance targets.²⁰⁴

¹⁹⁷ Barrier, *supra* note 19, at 47 (quoting Charles M. Elson, director of Center for Corporate Governance at University of Delaware).

¹⁹⁸ Dalton & Daily, *supra* note 72, at 78. The fundamental problem with this type of payment-for-performance scheme is that what you measure is what you get; i.e., whenever a specific benchmark is used to measure "performance," directors will focus on achieving that particular benchmark. *E.g.*, Business Success: You Get What You Measure, <http://www.kpmg.ca/en/services/enterprise/issuesResultsBusinessSuccess.html> (last visited Feb. 18, 2007).

¹⁹⁹ Taub, *supra* note 190.

²⁰⁰ Poster & Ullman, *supra* note 78, at 46.

²⁰¹ *Id.*

²⁰² *See, e.g.*, Dalton & Daily, *supra* note 72, at 75 (citing results of three hundred empirical studies and concluding that linkage between executive pay and corporate financial performance is "relatively trivial, when it exists at all").

²⁰³ Heather Brewer, *Snap Judgments*, BUS. L. TODAY, July–Aug. 2006, at 10, 10 (discussing Coca-Cola's compensation plan).

²⁰⁴ *See* Taub, *supra* note 2 ("It's hard to be objective if you are continuously rewarded for blessing the recommendations of the management teams Directors are then put in the same shoes as management." (quoting David Swinford, Senior Managing Director of

While Coca-Cola's payment-for-performance plan possesses many drawbacks, it does have some positive aspects. For instance, paying directors entirely in cash—with the value of the cash compensation linked to the value of the company's stock (including the payment of hypothetical dividends)²⁰⁵—is a novel attempt to combine the benefits of cash and equity compensation. The Coca-Cola plan should be commended for recognizing the current need for an overhaul of director compensation. However, the solution it offers falls short.

III

TOWARD A BETTER COMPENSATION PLAN

Building on the observations about the nature and role of the board, as well as the strengths and shortcomings of different forms of board compensation, this Part offers a formulation of best corporate practice when it comes to director compensation in today's corporate governance environment. As a starting point, the practice of giving directors an equity stake in the company does have its place: "Stock provides the psychological link between directors' efforts and the building of enduring shareholder value."²⁰⁶ Furthermore, the positive effect on appearances that flows from providing directors with an equity stake in the company highlights that some form of equity ownership by directors is—on balance—a good thing.²⁰⁷ Rather than simply paying directors in stock, or deferred stock, in order to achieve this end, this Note proposes a more nuanced solution.

Setting the appropriate level of equity compensation has been described as a "delicate balancing act" aimed at promoting ownership interest without compromising objectivity for the long term good of the company.²⁰⁸ Equity-heavy compensation may also undermine the ability of the board to attract directors from the noncorporate sector.²⁰⁹ The use of equity as compensation should not foreclose the opportunity to create a more diverse board.

In line with many compensation experts, this Note contends that the practice of paying directors differently depending on their role in

Pearl Meyer & Partners)). One set of commentators made the following remark on this point: "If we think stock options will buy management, then Coke's plan will buy directors." Poster & Ullman, *supra* note 78, at 44.

²⁰⁵ Coca-Cola Co., Current Report (Form 8-K), at 3–4 (Apr. 5, 2006).

²⁰⁶ Poster & Ullman, *supra* note 78, at 47.

²⁰⁷ *Id.*

²⁰⁸ Longnecker, *supra* note 34, at 8.

²⁰⁹ *Id.*; see also *supra* notes 34–35 and accompanying text (discussing merits of board composed of members from both corporate and noncorporate sectors); *supra* notes 161–62 and accompanying text (discussing tax obstacles to accepting stock as income).

the boardroom is a more refined manner of compensating them.²¹⁰ The plan proposed in this Note responds to the salient features of board responsibilities in the current corporate governance environment. This plan captures the benefits of equity ownership²¹¹ without the attendant drawbacks. It also captures the benefits of cash compensation and enables the creation of corporate boards comprised of individuals possessing a broad array of leadership experiences and abilities.

The elements of the proposed plan are as follows. First, directors should have the option to be paid entirely in cash. Cash preserves the positive elements of a director's independence from both management and the company. It also affords her flexibility (and, arguably, neutrality).²¹² Second, the plan should require directors to meet specific equity ownership guidelines, similar to those in effect at many companies today.²¹³ However, equity ownership by directors must strike a delicate balance between signaling to directors, shareholders, and others that directors have a symbolic stake in the company²¹⁴ and not becoming so large as to undermine directors' independence and monitoring abilities.²¹⁵ The effect of this proposal is that directors who opt to be paid entirely in cash would be required to purchase the company's shares on the open market in order to meet the mandated equity ownership guidelines.

Director equity ownership guidelines should be closely tailored for each individual board member. Equity ownership guidelines should be a function not only of the annual retainer and length of board service, as they are now,²¹⁶ but also of the board member's net worth, total income, and amount and composition of income from board service.²¹⁷

Refined stockholding requirements would make board members' equity stake in the companies more proportional to their net worth.

²¹⁰ See REDA ET AL., *supra* note 11, at 83 (noting that drawback of one-size-fits-all approach is that it "presumes that all directors provide equal service to the company, which in many circumstances is not the case").

²¹¹ See Vafeas, *supra* note 14, at 458 (noting benefits of equity ownership by directors, such as increased incentives to monitor management).

²¹² Longnecker, *supra* note 34, at 8 ("Offering directors a paycheck gives them some latitude in determining their own cash flow needs balanced against stock ownership requirements.").

²¹³ See *supra* text accompanying notes 135-37 (discussing director equity-holding requirements).

²¹⁴ See *supra* Part II.C.2.a.

²¹⁵ See *supra* Part II.C.2.b.

²¹⁶ See *supra* notes 135-37 and accompanying text.

²¹⁷ Cf. Weinberg, *supra* note 49, at 11, 15 (discussing limitations of inflexible approach to director share-ownership requirements).

This in turn would allow more diversity within the composition of the board, as onerous ownership requirements would not preclude individuals with lower net worth from serving on boards. Given the intangible reasons for board service,²¹⁸ the strong presence of noncompensatory motivating factors to improve shareholder value,²¹⁹ and the generally symbolic nature of compensation, directors' equity stake in the company need not be large. Shareholders would see that directors have a stake in the long term outlook of the company, and directors would be reminded of this fact as well. This Note recommends that (although not required by the SEC or the listing exchanges) director equityholding requirements be fully disclosed to shareholders and the markets, which goes hand-in-hand with the "appearances matter" element of compensation.

Within this compensation framework, in order to increase the tax efficiency and decrease the transaction costs of paying board members, directors should have the option of receiving full-value shares of the company's stock in lieu of cash.²²⁰ They should fix ex ante what percentage (if any) of their compensation they would like to receive in the form of stock. This way, each "paycheck" would be a combination of cash and full-value stock, with the cash component varying as the share price varies. The ex ante determination of the equity component of compensation greatly mitigates conflicts of interest posed by board decisions influencing share price.

This compensation scheme is desirable for a number of reasons. It gives directors the psychological benefits of equity ownership,²²¹ while also allowing for more diversity in board composition. It maintains board independence by not tying payment (directly or indirectly) to any performance target, yet the equityholding requirement lets board members and others know that board members are committed to the long term value of the company. Clear, nuanced stock ownership guidelines facilitate this symbolic and psychological stake in the company.²²²

Given the changing role of the board and the affirmative duties it now faces in a post-SOX corporate governance regime, the problem

²¹⁸ See *supra* notes 76–85 and accompanying text (discussing nonmonetary reasons for board service).

²¹⁹ See *supra* notes 56–59 and accompanying text (noting changes in external incentives to monitor).

²²⁰ An analysis of the various tax issues presented by board member compensation is beyond the scope of this Note.

²²¹ See *supra* text accompanying notes 138–39.

²²² Poster & Ullman, *supra* note 78, at 44. One director summarized the role of equity ownership as follows: "Stock encourages engagement; even though it's not a lot of money, it is a medium that I think I can influence." *Id.* at 44.

of board passivity and acquiescence to management is less pronounced than it once was. Therefore, using equity to combat board inaction is less relevant today.²²³ As noted, new external forces exist to induce the board to monitor management. The balance has shifted such that the drawbacks of equity (especially stock options) as director compensation now often outweigh its benefits.²²⁴ Maintaining director stock ownership in the manner advanced by this Note preserves the last remaining benefit of director equityholding: its symbolic effect on both shareholders and directors.²²⁵

The prominence of the cash component of this proposed plan reduces directors' incentives to exit board service solely for the purpose of selling their stock.²²⁶ This plan also mitigates the problem posed by onerous equity ownership standards, which could create a scenario in which directors who are not independently wealthy are "forced to resign if they need to have full access to their equity gains."²²⁷ This plan also finds support in the Breeden report,²²⁸ which was issued by the court-appointed monitor for the WorldCom/MCI SEC enforcement proceedings. The report provides several ideas on emerging best practices of corporate governance in the post-SOX era,²²⁹ including that directors be paid entirely in cash, a portion of which they must use to purchase and hold company stock.²³⁰

This proposal is not without potential drawbacks. Board members facing a crisis (e.g., scandal, insolvency, or change of control scenario) will face a conflict of interest as equityholders. That is why the relevant equityholding requirements should not be too large. However, some may respond that the equityholding requirements are too low. The National Association of Corporate Directors (NACD) maintains that in order for a director to have a "substantial" stake in the company, such that the equity ownership is effective, the director

²²³ Cf. Eisenberg, *supra* note 70, at 137–38 (describing pre-SOX need to align directors' thinking with shareholder interests).

²²⁴ See *supra* Part II.C.2.a–b for a discussion of the benefits and drawbacks of equity compensation.

²²⁵ See *supra* text accompanying notes 138–42.

²²⁶ See Longnecker, *supra* note 34, at 8.

²²⁷ Zong, *supra* note 16, at 48. When directors are all required to hold the same amount of the company's stock, those directors who rely on the income from board service (as opposed to independently wealthy directors) may face situations in which they feel compelled to resign in order to liquidate the wealth they hold in the form of the company's stock. Put differently, one-size-fits-all equityholding requirements impose a differential burden on directors of limited financial means.

²²⁸ RICHARD C. BREEDEN, RESTORING TRUST, REPORT TO THE HON. JED S. RAKOFF, THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK, ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, INC. 77–81 (2003).

²²⁹ Zong, *supra* note 16, at 52.

²³⁰ *Id.* at 52–53 (noting Breeden report's recommendations for MCI).

should have an equity stake in the company equal to about ten times the amount of her total annual compensation.²³¹

However, in requiring directors to hold a “substantial” equity stake in the company, the NACD fails to recognize that this does not actually align directors’ interests with those of the typical shareholder, who has a diversified portfolio.²³² Modern portfolio theory posits that risk-averse, rational investors will diversify their holdings to prevent holding a “substantial” stake in any one company.²³³ The “fictional undiversified shareholder” to whom the board holds itself accountable does not reflect the actual shareholder whose interests the board is charged with protecting.²³⁴ The plan advanced in this Note better protects actual shareholders by compensating board members in a way that preserves their independence and objectivity while maintaining their psychological and symbolic stake in the company.

CONCLUSION

This Note has portrayed the current need to reconsider director compensation in the face of changes to the composition, role, and responsibilities of the board of directors in the post-SOX corporate governance environment. The external incentives for directors (as agents of the shareholders) to monitor management continue to increase, in the form of heightened legal duties, shareholder activism, and calls for more transparency in the boardroom. Based on these structural and functional changes to the board, this Note concludes that the role of compensation as an incentive for directors to monitor has changed as well. As the noncompensation-related reasons to monitor gain strength, the role of director compensation has shifted toward that of maintaining the board’s independence.

The form of director compensation should adjust to both the declining importance of internal incentives and the increased role of

²³¹ Dalton & Daily, *supra* note 72, at 77.

²³² See, e.g., Christopher T. Pickens, Note, *Of Bookies and Brokers: Are Sports Futures Gambling or Investing, and Does It Even Matter?*, 14 GEO. MASON L. REV. 227, 244 (2006) (noting that investors diversify their portfolios in order to reduce variance on their investment returns).

²³³ See generally Edwin J. Elton & Martin J. Gruber, *Modern Portfolio Theory, 1950 to Date*, 21 J. BANKING & FIN. 1743 (1997).

²³⁴ See Gregory Scott Crespi, *Maximizing the Wealth of Fictional Shareholders: Which Fiction Should Directors Embrace?*, 32 J. CORP. L. 381, 426 (2006) (calling for rejection of “fictional undiversified shareholder”); Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. (forthcoming Oct. 2007) (manuscript at 32), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=977582 (noting that “modern financial theory tells us that, as a first approximation, management does not have to ascertain or consider the diverse risk and time preference of the company’s shareholders”).

external incentives to monitor, as well as to the recent emphasis on board independence. In the current era of heightened corporate governance, director compensation should not be viewed as the primary mechanism for motivating the board to monitor management and act as agents of the shareholders. However, director compensation should not hinder the board as it undertakes these tasks and should send a message that the board is doing so faithfully.

A fresh form of director compensation is needed, as evidenced by Coca-Cola's attempt at a new approach. Compensation primarily in the form of cash, coupled with more refined equityholding requirements, preserves the board's independence and its ability to monitor (and mentor) management effectively. This will create more diverse boards and better long term returns for shareholders.