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DIRECTOR COMPENSATION IN TURBULENT TIMES

To Our Clients and Friends:

Recent turmoil in the mortgage and credit markets, and the resultant difficulties at a number of large financial institutions, have once again led some to ask the question: "Where was the board of directors?" Those raising this question have inquired about the nature and extent of the board's involvement in overseeing the risks associated with sub-prime lending and other activities at these institutions. It is generally understood that the appropriate role of the board of directors is one of diligent oversight, and that directors cannot, and *should not*, be involved in the day-to-day operation of a company's business. Recent events, however, have underscored that serving on a public company board of directors in the 21st century involves more than simply attending meetings. More than ever before, being a director involves a substantial commitment of time and effort, a commitment for which directors are increasingly receiving significant compensation.

In the nearly six years since the passage of the Sarbanes-Oxley Act of 2002, boards of directors have become more active and engaged, with directors taking on increased workloads and facing heightened exposure to liability. Moreover, there is no question that, today, directors are operating in a more precarious environment that presents greater risks of litigation than in the past. Director compensation necessarily should reward directors not only for their time, but also for the risks attendant to board service in the current environment.

With greater responsibility and increased exposure to litigation has come a significant increase in the compensation paid to non-management directors for board service. (Members of management generally do not receive compensation for serving as a director.) In addition, there is greater transparency relating to director compensation as a result of the comprehensive amendments to the Securities and Exchange Commission's executive and director compensation disclosure rules, which took effect with the 2007 proxy season. At the same time, attracting and retaining qualified directors has become more difficult. While some have cautioned that "excessive" compensation may compromise independence, competitive compensation can be an important recruiting tool.

Cash Compensation -- Meeting Fees and Annual Retainers

Historically, meeting fees have been the most common form of director compensation. Meeting fees remain a majority practice today, but in the past several years, there has been a movement away from them in favor of annual retainers.

The trend away from meeting fees is attributable in part to an impetus for simplification in the structure of director compensation programs. However, it also has deeper roots in good governance practices. The increased emphasis on the importance of an engaged, diligent board has contributed to the growing view that attendance is a core requirement of board membership, and, therefore, that directors should not be paid simply for coming to meetings. Moreover, directors are devoting more time to board activities outside the context of meetings -- studying materials for meetings, counseling the CEO and senior management, keeping abreast of relevant company developments and attending educational programs. Finally, there has been a recognition that the work of directors, and the value they bring to the table, goes well beyond attendance at meetings. Accordingly, as an alternative to or in conjunction with meeting fees, companies have begun to rely more heavily on annual retainers.

There also has been a pronounced trend toward differential compensation, or paying more for roles that place additional demands on directors. These roles typically include serving on, or chairing, particular committees -- usually the three "key" committees (audit, compensation, and nominating/governance), with increased compensation most frequent for the audit committee. Other roles that typically command extra compensation include serving as a presiding/lead director or independent chair.

With directors devoting more time to board service outside of meetings, a compensation structure that includes meeting fees may no longer be suited to the realities of public company board service. Meeting fees may encourage individuals to view board service as a succession of discrete, intermittent activities -- periodic meetings -- rather than an ongoing service that entails the performance of an oversight function. An annual retainer may be a more effective tool for encouraging directors to view board service this way and fostering a long-term focus. In addition, not using meeting fees avoids the definitional question of what constitutes a meeting, as well as practical issues such as whether to pay differential compensation for in-person versus telephone meetings and how to compensate directors for attending a portion of a meeting.

Equity Compensation

Most governance commentators recommend that director compensation consist of a mix of cash and equity. Equity serves the important function of aligning directors' interests with those of a company's stockholders, ensuring that directors have "skin in the game."

In recent years, as the emphasis on aligning director and stockholder interests has grown, companies have begun to pay a larger proportion of total director compensation as equity. There is no "one size fits all" approach when it comes to the appropriate mix of cash and equity, but to align director and stockholder interests effectively, equity should constitute a meaningful portion of total director compensation. Similarly, the types of equity awards granted to directors vary from one company to the next. The popularity of stock options as a form of equity compensation for directors surged during the technology boom, but options have since fallen out of favor. Critics of stock options argue that options do not require directors to accept any economic risk and that options may encourage a short-term focus on a company's stock price. Instead of options, in the past few years companies have begun using restricted stock and other "full-value" equity awards (a term generally used to refer to awards other than stock options and stock appreciation rights).

In evaluating director compensation, boards should consider the appropriate mix between cash and equity compensation and the reasons for their selected approach. In deciding what forms of equity to provide, consideration should be given to whether full-value awards rather than stock options may be a more effective tool for aligning the interests of directors with those of stockholders.

Stock Ownership Guidelines and Requirements

Stock ownership guidelines typically encourage -- and in the case of stock ownership requirements, mandate -- that directors attain a specified level of ownership in a company's stock. Some companies also have a retention requirement mandating that directors hold an established amount of stock for a specified period of time. Like equity compensation, stock ownership and retention policies align directors' interests with those of stockholders.

Typically, stock ownership guidelines or requirements take the form of a multiple of the annual retainer, and directors must achieve the threshold ownership level within a specified period of time after joining the board. The most common multiples are three to five times the annual retainer, and directors typically are given five years to meet the threshold. Stock ownership requirements obviously have more "teeth" than guidelines and therefore, a company's stockholders make look on them more favorably and its directors may take them more seriously. Whether a company adopts requirements or guidelines, the ownership targets and the associated time frames for reaching the targets should be reasonable in light of directors' current stockholdings and financial circumstances, while at the same time providing for the attainment of a meaningful equity stake. Company policies in this area should make it clear whether provisions relating to stock ownership are "requirements" or "guidelines."

A growing number of companies also have adopted stock retention requirements mandating that directors hold an established amount of stock for a specified period of time. Typically, this time period extends until a director meets the company's stock ownership guidelines or requirements or until a director retires from the board. Some companies require directors to retain a percentage of shares acquired through option exercises and the vesting of equity awards for specified periods. Stock retention requirements have not yet become a majority practice, but are looked upon favorably as a way of aligning director and stockholder interests. Boards that are considering adopting stock ownership guidelines or requirements, or that are reviewing existing policies in this area, should consider including as part of their policies a requirement that directors retain a specified amount of stock for the full term of their board service.

Perquisites and Other Benefits

The SEC's recent compensation disclosure rule changes also have led to greater transparency about directors' perquisites. Companies must report directors' perquisites and other personal benefits that equal or exceed $10,000 in the aggregate in the "All Other Compensation" column in the Director Compensation Table in their annual proxy statements. The proxy statement must identify each perquisite or personal benefit by type, and separately quantify in a footnote to the table any perquisite or personal benefit that exceeds the greater of $25,000 or 10% of the total amount of perquisites.

In recent years, there has been a trend away from providing perquisites to directors, which has been accelerated by the SEC's new requirements. Perquisites have been criticized on the grounds that, among other things, they have no relation to corporate performance or the quality of director service. In addition, critics have argued that some overly generous perquisites may compromise independence. Because they result in directors being treated more like highly salaried employees than fiduciaries and representatives of a company's stockholders, perquisites -- so the argument goes -- align the interests of directors with those of management rather than stockholders. One perquisite that has all but disappeared from today's landscape is director retirement programs. Retirement programs have been criticized, among other reasons, for suggesting that directors have tenure, a notion that now seems outdated in an environment where renomination to the board is no longer viewed as automatic.

Many companies offer deferred compensation plans to provide flexibility for directors who may not wish to receive their cash compensation on a current basis. Some deferred compensation plans provide benefits to directors for deferring compensation into company stock, a practice that some organizations have frowned upon. Companies should avoid paying above-market interest on deferred compensation, and any above-market or preferential earnings on nonqualified deferred compensation must be disclosed in the Director Compensation Table.

In 2007, matching and charitable gifts were the most common board perquisite, according to a report published by the National Association of Corporate Directors. A matching gift program generally should not raise issues if it is offered to directors on the same terms available to all company employees. On the other hand, charitable award programs raise more issues. These programs permit directors to designate one or more charitable organizations to receive a donation of company funds -- often as large as $1 million -- upon a director's departure from the board or death. In addition to the criticisms applicable to perquisites generally, charitable award programs have come under fire on the grounds that the amounts paid under the programs are excessive. When the SEC most recently amended its compensation disclosure rules, it specifically listed charitable award programs among the perquisites that companies must disclose. Charitable award programs are not as commonplace as they once were, due in part to the potential impact of charitable contributions on director independence.

Disclosure issues aside, in the current environment, boards should reconsider the continued appropriateness of including perquisites as part of director compensation. It is questionable whether many perquisites are consistent with the director's role. In addition, perquisites are a "hot button" issue for stockholders and an easy target for criticism. In light of these considerations, and because the amounts involved are relatively minimal, boards may well decide that it is preferable to avoid most perquisites absent a compelling justification. If perquisites are part of a company's director compensation, the board should evaluate whether specific perquisites are appropriate and reasonable, and the impact that perquisites may have on director independence.

Setting Director Compensation

The board of directors should periodically review the company's director compensation in light of developments in the marketplace and the board's needs. In determining director compensation, boards should focus on creating total director compensation that is reasonable relative to directors' responsibilities and compensation at comparable companies. Boards should consider why they are paying each element of compensation and how the elements, individually and collectively, further the goal of aligning directors' interests with those of stockholders. Boards should also be comfortable that director compensation adequately rewards directors for the risks associated with board service, as well as their time and efforts.

In setting their own compensation, directors face an inherent conflict of interest. The corporate laws of Delaware and other states outline procedures for boards to follow in approving any so-called "interested transactions." These procedures are designed to safeguard board decisions on interested transactions from challenges based on conflict-of-interest grounds and generally require that a majority of the disinterested directors approve an interested transaction. Although director compensation is the classic example of an interested transaction, a board has no disinterested directors when it comes to director compensation. This suggests that boards should pay particular attention to the process of setting their own compensation and seek to arrive at compensation that is fair and reasonable under the circumstances. Decisions on director compensation should be made at the full board level, and the board should review and consider all relevant information, including data on market trends and compensation paid by comparable companies. Some boards may find it useful to engage an independent compensation consultant for the purpose of collecting and analyzing this information, and a consultant can also advise on specific compensation-related issues that may arise from time to time.

The processes that boards follow for reviewing and approving director compensation vary. Typically, a committee of independent directors -- either compensation or nominating/governance -- assists the board in this endeavor and recommends proposed changes in compensation to the full board for approval. Delegating responsibility for director compensation to the compensation committee may make sense because this committee is accustomed to working on compensation issues and is likely to have a relationship with a compensation consultant who can provide market data. On the other hand, some companies determine that the nominating/governance committee is the appropriate committee to handle director compensation because this committee focuses on the recruitment of directors, director qualifications and governance matters more generally. Whichever committee is selected, SEC rules require that companies include a narrative description in their annual proxy statements of their processes for considering and determining director compensation. In addition, a company's governance guidelines should address the substance of and process for determining director compensation.

What Companies Should Do Now

Almost six years after the passage of the Sarbanes-Oxley Act, a number of director compensation practices that were once considered "emerging" have become mainstream at large companies. This is true, for example, of stock ownership guidelines and requirements. Over the next several years, we can expect to see the practices that have now firmly taken hold at these companies "trickle down" to mid-sized and smaller companies.

As boards review their director compensation programs, the board or responsible committee should:

1. *Consider the forms of cash compensation that directors receive*. In particular, boards that pay meeting fees should consider whether this continues to be appropriate and whether some or all of directors' cash compensation should be paid in the form of an annual retainer.

2. *Consider whether the mix between the cash and equity portions of directors' compensation is appropriate and the rationale for the mix selected*. In particular, boards should focus on paying a meaningful portion of total director compensation in the form of equity in order to align directors' interests with those of stockholders.

3. *Consider the forms of equity compensation that directors receive*. In particular, boards still using stock options should evaluate whether full-value awards are a more effective tool for aligning director and stockholder interests.

4. *Consider adopting stock ownership and retention policies*. Boards that already have stock ownership requirements or guidelines should consider whether their policies in this area promote meaningful equity ownership. In addition, boards should consider adopting retention requirements mandating that directors hold a specified amount of stock for the full term of their board service.

5. *Consider the continued appropriateness of including perquisites as part of director compensation*. In addition, boards should evaluate whether specific perquisites are appropriate and reasonable, and the impact that perquisites may have on director independence.

6. *Consider the board's process for evaluating director compensation*. Decisions on director compensation should be made at the full board level after review and consideration of all relevant information, including data on market trends and compensation paid by comparable companies. Some boards may find it useful to engage an independent compensation consultant to assist in this process.

There is no question that trends in compensation practices are important in structuring a director compensation program, as are so-called "best practices" like director stock ownership. It is equally important, however, for a company's board to consider the company's individual circumstances. The result should be a compensation program that appropriately compensates highly qualified board members and aligns their interests with those of the company's stockholders.

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Gibson, Dunn & Crutcher's Securities Regulation and Corporate Governance Practice Group and its Executive Compensation and Employee Benefits Practice Group are available to assist in addressing any questions you may have regarding these issues.

Please contact the Gibson Dunn attorney with whom you work, or John F. Olson (202-955-8522, jolson@gibsondunn.com), Brian J. Lane (202-887-3646, blane@gibsondunn.com), Ronald O. Mueller (202-955-8671, rmueller@gibsondunn.com), Amy L. Goodman (202-955-8653, agoodman@gibsondunn.com), Stephen W. Fackler (650-849-5385, sfackler@gibsondunn.com), or Gillian McPhee (202-955-8230, gmcphee@gibsondunn.com).