



A Joint Publication of Jaeckle Fleischmann & Mugel, LLP and Kei Advisors LLC

Board Member Best Practices

was developed for directors of publicly held companies to assist them in facing the dramatic changes resulting from the new regulations being adopted by the SEC and the stock exchanges. In this time of change, board members tell us they need practical guidance on how to effectively comply with the new regulations. In addition to this newsletter, our Corporate Governance group has also created a Corporate Governance Resource Center. Visit us at www.jaeckle.com for information on the status of new regulations, articles, links to useful resources, frequently asked questions and other practical information for corporate boards.

Jaeckle Fleischmann & Mugel, LLP is a corporate securities law firm with offices in Buffalo, Amherst and Rochester, New York. Teaming with Kei Advisors LLC, our investor relations affiliate, we provide corporate governance counsel to public companies and their boards of directors. For more information on our corporate governance services, please contact James J. Tanous, Esq. at 716.843.3905.

DIRECTOR COMPENSATION: ISSUES AND TRENDS

As a direct result of the numerous corporate financial scandals that have come to light in the past few years, new laws and regulations have been adopted that impose many additional responsibilities on directors. More than ever, directors are being held accountable for their company’s performance. As directors attempt to meet their new obligations, they find that the demands on their time are measurably increasing. This is especially true for directors who also hold positions on the audit committee or compensation committee. Directors are faced not only with additional demands for their time; they simultaneously face exposure to added liability in this environment. As a result, directors are evaluating whether the risk and effort of being a board member are worth the reward.

Companies, therefore, face the challenge of determining exactly what amount and form their directors’

compensation should take. This is an essential matter for a company’s recruitment and retention of qualified and experienced board members.

The following table reflects the 2002-2003 results from the National Association of Corporate Directors’ survey. Director compensation information is provided for smaller companies (revenue of 50 to 200 million dollars), small companies (revenue of 200 to 600 million dollars), and medium companies (revenue of 600 million to 1.7 billion dollars).

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Compensation	Smaller Companies	Small Companies	Medium Companies
Cash compensation	\$20,926	\$29,681	\$39,485
Stock award	\$26,560	\$34,342	\$48,743
Total compensation	\$47,486	\$64,023	\$88,228

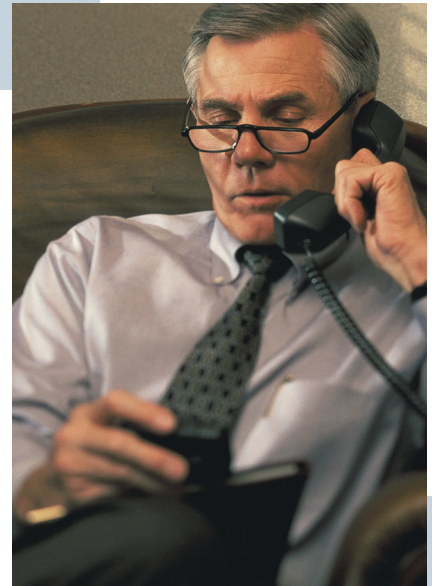
According to the survey results, total compensation for smaller companies, small companies and medium companies changed by one percent, seven percent and nine percent, respectively, from the prior year. Although the increase for these years may seem less than dramatic, the expectation is for dramatic changes in directors' compensation to address the more punitive and demanding legislation, greater levels of litigation involving directors and the increased incidence of the mishandling of corporate affairs. According to a report by Mercer in February 2003, approximately half of the firms they surveyed already had made changes to their directors' compensation and slightly more than another quarter of the remaining firms were contemplating making changes. The definitive trend is a rise in the total amount of a director's compensation.

Another very clear trend has been to change the form of the compensation received by directors. Companies are *moving away from* granting stock options. Stock options are often viewed by investors as providing directors with a short-term view of the company. With options, there is simply an expectation of a gain in the near term.

This is a change that is viewed by some analysts and investors as further aligning the directors with paid management and not providing a focus on the long-term interests of the company. However, many investors are not supportive of simply increasing directors' pay in such a straightforward manner, as this overrides the long-time effort by investors to better align management and the board with the investor's interests.

Interestingly, other forms of compensation appear to have gained some favor with companies. These new forms of director remuneration are a result of the continued attempts on the part of the companies offering them to try to instill investor confidence in their board leadership. Companies are now offering long-term stock that cannot be sold until some date in the future that is dependent on the directors leaving the company or in the event of special circumstances, such as health related reasons. The argument is that the long-term stock will provide the directors an added incentive to focus on the long-term value of the company, a view that is in line with that of the stockholders. Also, by offering long-term stock to directors, in lieu of stock options or additional cash,

Instead, some companies are providing directors with a greater amount of cash compensation.



the interests of investors are served by not increasing the total compensation to directors, but merely changing the form to one with an extended focus.

In addition, companies are imposing ownership requirements on directors. Directors are expected to purchase (and subsequently hold) a certain amount of company stock with the director's own funds within a certain amount of time. The ownership requirement is expected to further align the directors' interests with that of the stockholders. Directors will have more of a personal stake in the company.

Another trend has been to pay additional compensation to members of certain committees. Members of audit committees and compensation committees face greater responsibilities as a result of the passage of numerous new regulations and requirements, including the Sarbanes-Oxley Act. As the roles of these committee members

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One of the biggest challenges facing boards today is composition. While the functions of the audit committee and executive compensation issues have garnered a great deal of attention as of late, a board's corporate governance structure will be shaped through the new director and board committee nomination process. Independence is the ultimate goal. The New York Stock Exchange has proposed new listing standards that would require a board to consist of a majority of independent directors. Likewise, the board's major committees, including audit, compensation and nominating must be composed *entirely* of independent directors.

Companies will need time to recruit qualified independent directors in order to meet the challenging standards of independence. All NYSE listed companies will be required to comply with these new independence standards no later than eighteen months following the SEC's approval of the proposed rules. If a company has a classified board and a change would be required for a director who would not normally stand for election within the eighteen-month period, the company will have an additional year, or a total of thirty months to effect the change in that director position.

How does a company find qualified individuals to serve on the board? It has been estimated that the historic annual turnover of directors of U.S. public companies is approximately 12,000 seats. While this number is likely to increase, the traditional pool

of board candidates, namely CEOs of other public companies, is likely to decrease as more prospective board candidates are declining to consider serving on additional boards due to the increasing time commitments. In addition, many companies are limiting the number of boards on which its executives may serve *and* boards themselves are restricting the numbers of boards on which their members may serve. The intensified demands for genuine independence will cause many companies to consider director search firms to help fill these positions. The NYSE has already indicated that the nominating committee should be given the sole authority to retain and terminate any search firm to be used to identify director candidates, including sole authority to approve the search firm's fees and other retention terms.

What do we need? vs. Who do we know?

In the past, board members were generally insiders, friends and associates of other sitting directors. Board positions were filled on the golf course or by flipping through the CEO's rolodex. Too often, this led to a lack of proactive involvement and missing skill sets in industry expertise. Boards today are being held more accountable. It is no longer possible for a company to ask "Who do we know?"; but rather the company should be asking itself "What do we need?"

A search firm can help a board look at its collective skill sets and perform a gap analysis to shore up the areas of

'In the past, board members were generally insiders, friends and associates of other sitting directors.'

weakness where the directors lack experience to meet the challenges facing the company in the future. While good business judgment is a must, companies are looking for people with very strong, specific functional expertise. The most obvious of these is the audit committee financial expert requirement; however, companies are also looking for individuals with an understanding of the growing number of government regulations. They are looking for individuals with strong operating experience, diversity, stature in their industry, and varied life experiences, as well as individuals who have faced the very issues that CEOs typically face, and who are not afraid to ask difficult, testing questions.

A search firm can help a company look at previously untapped markets to narrow the field of potential candidates or fill a specific niche on the board. The need for financial experts obviously has created an increase in the number of CFOs and retired audit partners who are being actively considered for board roles. Additionally, increased scrutiny of executive compensation has many companies looking to heads of human resource departments. In the long run, the right process may take a little more time, but it assures the fastest route to improved shareholder value and better corporate governance.

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expand and their workload increases, resulting in more meetings, companies are offering to pay these members additional amounts. Some argue that this is unnecessary because they are just fulfilling their duty as committee members and directors. However, if a director is working harder and dedicating more time to the committee work, others argue that it is only fair to pay that director for his or her time. The following table shows the average board and committee fees based on the results of the 2002-2003 survey of the National Association of Corporate Directors.

	Smaller Companies	Small Companies	Medium Companies
Board and Committee Fees	\$10,113	\$12,078	\$15,828


The challenge for companies is to find the right balance. Companies need to identify the amount of remuneration that will adequately provide the incentive for the director to assume the role and its responsibilities and devote the time necessary to the company. This must be balanced against not providing so much compensation that investors feel betrayed and directors have an incentive to

sacrifice their integrity simply to remain a board member. To this end, many companies may benefit from the advice of outside advisors who can assist with determining the correct balance for their company.

When making the director compensation evaluation, it is important to remember that for most directors, board compensation is a small fraction of their total income. Most board members are motivated to participate on the board for reasons other than compensation. Still, in an atmosphere marked with added responsibilities and greater


exposure to liabilities, companies must try to analyze their

needs, based on their size and complexity, and offer a director compensation package that reflects these needs and attracts the type of board members they require.

If you have questions on director compensation or would like additional information, please contact Joseph P. Kubarek at 716.843.3862 or jkubarek@jaeckle.com, or Kayla E. Klos at 716.843.3858 or kklos@jaeckle.com. 

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For more information on getting the right mix, or addressing the challenges of the nominating committee, contact James J. Tanous, Esq. at 716.843.3905 or jtalous@jaeckle.com, or Michael C. Donlon, Esq. at 716.843.3881 or mdonlon@jaeckle.com. 

List of Director Search Firms

In light of the environment of increased regulation facing public companies, many executive search firms, including those listed below, have expanded their services to include assisting public companies to find individuals to fill vital roles on the board of directors.

- A.T. Kearney (www.executivesearch.atkearney.com)
- Boardroom Consultants (www.board-search.com)
- BoardSeat (www.boardseat.com)
- Career Consulting International (www.dunhillmiami.com)
- Christian & Timbers (www.ctnet.com)
- Cornerstone International Group (www.cornerstone-group.com)
- Heidrick & Struggles (www.heidrick.com)
- Korn/Ferry International (www.kornferry.com)
- Ray & Berndtson (www.rayberndtson.com)
- Russell Reynolds Associates (www.russreyn.com)
- Rutherford International Executive Search Group, Inc. (www.rutherfordinternational.com)
- Selker Leadership (www.selkerlead.net)
- Spencer Stuart & Associates (www.spencerstuart.com)
- Stanton Chase International (www.stantonchase.com)
- Stybel Peabody & Associates, Inc. (www.boardoptions.com)
- TMP/Highland Partners (www.tmpsearch.com)



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