**Change to Innovate – Recommending changes to Board Compensation**

**For a Technology Firm to Remain Innovative**

As he looked out his Boston Seaport office window, Evan Winchester, reminisced about the ups and downs he saw after he co-founded his company, VocalStream, while he was a Professor at MIT. His breakthrough AI technology enabled him to create a powerful voice activation technology tool which was being licensed by major companies with any voice activated feature in their products.

His company had endured the difficult cycles of funding with bootstrapped dollars, then from angel and venture capital investors. The IPO process itself was an uneasy one, having happened pretty close to the beginning of the last recession, but the company managed to make a successful offering nevertheless.

Now, three years after the IPO, the company was still growing fast, but the mindset changed to one of a mature business with a stable growth trajectory. However, Winchester understood the need to keep innovating in spite of its size. The lack of innovation in large companies had been a killer, and academic studies have shown that the growth of companies that continue to innovate is much stronger than those that do not.[[1]](#footnote-1) However, innovation is not an easy process in established companies, and needs to be driven by the top leadership.

Winchester was getting concerned that the company was getting complacent and too comfortable in its position, particularly in a space that demanded risky innovation to be a player. He needed board buy-in on a variety of new initiatives he had come up with the improve innovation within the firm and to commercialize such innovations into product lines. But, he also believed that there was a need to re-kindle the notion of innovative evolution within the company. This had to start at the very top. While the top quality board members had to be appropriately compensated, they would also need to be incentivized to undertake innovative risk-taking given the cutting-edge industry they operated in.

Winchester is the chairman of the board along with his CEO title, and owns about 34% of the shareholder votes in the company. To ensure that the company keeps innovating, he needed to provide his management team and board members a compensation structure to ensure such innovation. Studies have shown that option compensation can help increase incentives to take risk.[[2]](#footnote-2)

He also knew that the board, which had been evolving to bring on more veteran industry experts and long-time CEOs from other firms, may have a problem with this idea. Not only would he be proposing increasing option compensation, Evan was considering a shift away from cash/stock to option compensation. After all, if he kept the cash and stock components fixed, any risk-taking effect of options would be diluted. Another change he wanted to incorporate was to have a certain extent of options repricing when options became significantly out of the money. This would allow the risk-taking effect of options to remain active in spite of short term failures.

A complicating factor was that his board had two different kinds of members. One was a group that came from large companies, which were not used to a startup model of thinking, and the other group was prior entrepreneurs who themselves had exited their prior companies or had a tentative relationship with the operations of the companies they had founded. This latter group was familiar with the technology space and understood the need for continued innovation, but it was also in the minority.

He needed to get 3 out of the 5 members of board that were not from a startup culture to get his recommendation accepted. One these members could be easily convinced and one other would come in if others were convinced. The key potential dissenter could be Albus Whitmore, who had the backing of other groups of shareholders needed to ratify the director compensation change.[[3]](#footnote-3) Albus did not like the notions of increasing option compensation or repricing.

The Board has to consider the decision to implement changes to its compensation structure:

Increasing the proportion of options in compensation and setting up a repricing plan that reprices options if the stock price decreases below a threshold value.

**Issues**

a. Address the question of whether changing board compensation to create incentives to innovate make sense, and why such an incentive is important to create shareholder value?

b. Understanding the pros and cons with such a modification in the compensation plan, including what concerns may be voiced by shareholders?

**Existing Board Compensation Structure**

All board members get $60,000 in compensation per year, 70% of which is in restricted stock currently.

1. [Growth through Heterogeneous Innovation, 2016, Ufuk Akcigit and William Kerr, Working paper](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2877265). [↑](#footnote-ref-1)
2. This is driven by the idea that options provide upside if projects do well, but protect from the downside if they don’t. As a result, riskier projects that have both large upsides and downsides are more valuable. [CEO compensation and corporate risk: Evidence from a natural experiment. 2013, Todd A. Gormley, David A. Matsa , Todd Milbourn, *Journal of Accounting and Economics.*](https://www.sciencedirect.com/science/article/pii/S0165410113000505) [↑](#footnote-ref-2)
3. This is now important because of recent court decisions. See, e.g., <http://clsbluesky.law.columbia.edu/2018/03/15/gibson-dunn-discusses-delaware-supreme-court-ruling-on-stockholder-ratification-of-director-compensation/> [↑](#footnote-ref-3)