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Columbia Business School

The Evolution of Executive Pay Policy at General Motors, 1918-2008

by Stephen F. O'Byrne, Shareholder Value Advisors, and S. David Young, INSEAD

In this article we document the gradual movement of General Motors (GM) away from the partnership concept that dominated U.S. corporate pay policy in the first half of the 20th century to competitive pay concepts in the second half.[1] The partnership concept was achieved by paying managers bonuses in the form of GM shares, with the amounts paid out of a single bonus pool and based on a fixed share of profit. Thanks to this executive pay policy, GM's managers effectively became "partners" with the company's shareholders, sharing the wealth in good times but also the pain in troubled times. Moreover, we show that from the establishment of the program in 1918 through the 1950s, directors engaged in innovative (and often complex) problem-solving to achieve key compensation objectives while maintaining fixed-share bonuses.

But the sharing philosophy eroded from the 1960s onward, driven by both external and internal forces. By the late 1970s, GM had a board of directors with modest shareholdings, in contrast to the board in the early post-war period, whose directors had large stakes. As a consequence, directors began acting less like stewards of capital and more like employees whose financial rewards came not from returns on invested capital but rather from the fees they received for their services. This fundamental change almost certainly contributed to the gradual abandonment of fixed profit sharing. In its place, the board implemented competitive pay policies, an approach that has come to dominate executive pay policy in the U.S. and abroad.

Competitive pay is an executive compensation strategy that defines target pay for senior managers based on what "peers" earn in comparable companies. The primary problem with such a strategy is that managers are rewarded based on market rates of pay, but independently of past performance. Or, as some critics have put it, the competitive pay system has "no memory" and, as a consequence, little accountability.

GM is an archetypical example of a company whose pay policies gradually evolved from "pay for performance" to competitive pay. Consistent with this development, we show that pay for GM's top five executives during the partnership period had strong sensitivity to investor returns and negative sensitivity to revenue growth. But during the competitive pay period, top-five pay was highly correlated with revenue growth and negatively correlated with investor returns. We also show that the board not only abandoned fixed sharing, but it acquiesced in granting managers substantial increases in their share of corporate profit.

How the Two Pay Concepts Relate to Basic Objectives of Executive Pay

Before beginning the GM narrative, it's helpful to review the three basic objectives of executive pay and to understand why achieving all three simultaneously is a complex challenge under both partnership and competitive pay concepts.[2] The three basic objectives are (1) strong incentives to promote value creation, (2) the retention of key management talent, and (3) the limitation of total compensation costs to levels that maximize the wealth of existing shareholders. Strong incentives require pay variation that is aligned with shareholder value and significant in relation to non-performance-related pay such as salary. With partnership concepts, it's easy to achieve the first and third of these objectives, but difficult to achieve the second. Competitive pay concepts easily achieve the second and third objectives, but struggle to deliver on the first and arguably most important.

The fixed sharing element in partnership-based compensation is particularly effective in promoting the alignment of manager and investor interests because executives can increase their pay only by increasing aggregate "economic" profit, which in turn increases shareholder value. And it provides strong incentives as long as the expected bonus is substantial in relation to base salary. Limiting the fixed share to 10%, as GM did, caps the cost of executive pay at levels that are unlikely to undermine shareholder returns. The biggest challenge with fixed sharing is managing retention. The plan needs to build up a reserve in good times in order to provide competitive pay in periods of poor performance caused by market and industry factors.

Competitive pay targets make it easy to retain key talent because expected pay never falls below market. They also

1. Table 1 in the appendix provides a chronology of executive pay changes at GM.
2. A random review of corporate proxy statements for publicly traded companies in the U.S. shows that there is near universal acceptance of these factors as the principal goals of executive compensation.

control costs because expected pay doesn't rise above market. The daunting challenge in such compensation programs is creating strong incentives. Translating dollar pay targets into shares creates a perverse situation in which superior performance is penalized with a reduction in shares, while poor performance is rewarded with an increase in shares. For example, if target pay is $100,000 and the share price is $20, then 5,000 shares are required to provide competitive pay. But if the stock drops to $10, the number of shares will rise to 10,000. In the former case, executives are penalized in the form of lower share grants because of a higher share price; in the latter case, they are rewarded with higher share grants because the share price went down.

The Original GM Bonus Plan: A Partnership between Owners and Managers

In his 1963 memoir, *My Years with General Motors*, long-time president and chairman Alfred Sloan wrote, "Although the General Motors Bonus Plan was first adopted on August 27, 1918, its fundamental principles have never changed—that the interests of the corporation and its stockholders are best served by making key employees partners in the corporation's prosperity, and that each individual should be rewarded in proportion to his contribution to the profit of his own division and of the corporation as a whole." The plan General Motors adopted in 1918 awarded senior management 10% of profit in excess of a 6% return on capital (which was increased to 7% in 1922). It was heavily influenced by a similar plan adopted years earlier by DuPont, a major shareholder in GM. The GM plan covered 5% of all salaried employees in 1922, or 550 persons in all. Strong growth throughout the 1920s led to nearly 3,000 salaried employees receiving bonuses by the end of the decade.[3] The bonuses were paid in stock in equal installments *over five years*. The deferred payout was one of two features intended to strengthen the plan's ability to retain key talent. The other, which we discuss below, is the management of the bonus reserve. From 1922, the plan endured for 25 years without any change in the sharing percentage or threshold return. This approach, as both theorists and (many) practitioners of corporate finance will recognize, was a simple version of the "EVA"- or economic profit-based compensation practices that became popular among U.S. companies in the 1990s.[4]

Because value creation is a function of a company's ability to generate returns above its cost of capital, paying bonuses linked directly to how much profit the company earns above this threshold was viewed as an effective way to align management and shareholder interests. Since EVA is net of a capital charge (for all capital, including debt *and* equity) and the EVA bonus is calculated after salaries have been deducted, pre-bonus EVA represents the value added of the business after adjusting for the main factor inputs (i.e., capital and labor). The plan could thus be seen as a partnership in the value added of the business.

The fixed sharing percentage was a critical factor because it ensured that, while managers enjoyed a windfall in good times, they took a major hit in bad times (for example, during the worst years of the Great Depression). And GM was by no means unusual in taking this approach during that era. Indeed, such formulas were common among large American companies before World War II. In fact, one 1936 study reported that most of the companies analyzed gave management a fixed percentage of profits beyond a stated dollar threshold or a specified return on capital.[5]

Directors in the early decades of GM's history were strongly committed to the partnership concept of fixed sharing. We can see this in two ways: first, through the direct testimony of GM directors, such as that of Alfred Sloan above; and, second, through three extraordinary efforts directors made to achieve their compensation objectives without sacrificing fixed sharing. The first of these efforts began in 1923 with the creation of the Managers Securities Corporation (MSC), a platform designed to promote greater stock ownership among company executives. Second, the General Motors Management Corporation was created in 1930 to achieve the same objective as the MSC but with a new group of managers. The third was the design of a "contingent credits" program in 1957 to realize the tax benefits of qualified stock options without abandoning the fixed sharing philosophy.

In addition to these efforts, directors sought to increase their ability to retain key talent by creating a group bonus reserve that could be carried over to future years. This bonus reserve would allow GM to reward managers in the event of downturns in the economy or other factors beyond management control. However, we will show that some of the board's bonus reserve decisions, as well as their 1967 decision to reduce bonus sharing above a 15% return on capital, weakened its ability to respond when poor performance occurred in the 1970s.

Building Management Ownership without Stealing Share from Other Owners

In November 1923, GM created a separate legal entity, called the Managers Securities Company (MSC), to give executives an opportunity to increase their ownership interest in GM.[6] As we explain the complicated structure of the MSC,

3. Sloan, *My Years with General Motors,* 418. The number of managers covered by the Bonus Plan grew to 14,000 by 1963, the final year surveyed in *My Years with General Motors*.

4. EVA, which stands for Economic Value Added, is a registered trademark of Stern-Stewart & Company. Economic profit is a more generic term for EVA, and is widely used in industry, especially among clients of the consulting firm McKinsey & Company (which features economic profit as the firm's primarily value-based metric).

5. John Calhoun Baker, "Incentive Compensation Plans for Executives," *Harvard Business Review* 15 (Autumn 1936): 44–61.

6. Sloan, *My Years with General Motors,* 410.

it's important to keep in mind that GM had at its disposal several easy ways to increase management ownership: it could have increased the bonus reserve; it could have made stock grants outside of the bonus reserve; and it could have sold stock to employees and let them pay for it out of future dividends, as Andrew Carnegie did with his top executives. The MSC is a testament to GM's commitment to the partnership concept because it shows the lengths to which GM would go to achieve an objective—in this case, greater management stock ownership—without sacrificing investors' share of profit.

Pierre DuPont, who had just stepped down as GM's President, and John Raskob, the vice president for finance at both DuPont and GM, contributed 2.25 million shares of GM stock at a price of $15 per share, the market price at the time. DuPont and Raskob had built up large shareholdings during the takeover of GM in 1920 that was orchestrated by the DuPont Corporation and the House of Morgan.[7] The two men were anxious to monetize their holdings without having to dump a large block of shares on the market, which might have led to a sharp decline in the share price. The MSC served this purpose, while at the same time providing strong value-creating incentives for GM's senior management.[8]

The MSC paid $33.8 million for the 2.25 million shares of GM stock. The purchase price of the shares was financed by issuing $28.8 million of 7% convertible preferred stock to DuPont and Raskob, with the remaining $5 million financed by selling shares to GM, which in turn resold them to 80 GM managers. As part of the transaction, GM agreed to pay half of the bonus pool to MSC for eight years and the managers agreed to forgo their bonuses for that period. In essence, a group of GM managers put up 15% of the purchase price and agreed to forgo their bonuses for eight years to cover the dividend and repayment of the preferred stock. The bonus pool allocated to MSC grew so rapidly in the years after 1923 that MSC was able to retire the preferred stock by April 1927.

Buoyed by the success of the MSC plan, GM embarked on a new program in 1930, shortly after the stock market crash of October 1929. This time, a new entity was created, the General Motors Management Corporation (GMMC), but with 250 managers participating instead of just 80. The structure of the program was broadly similar to its earlier version. GM sold 1.375 million shares of GM stock to the GMMC for $55 million, or $40 per share. To reimburse GM, the GMMC issued $50 million in 6% bonds that would be serviced with future Bonus Plan earnings. The additional $5 million was raised by issuing shares in the GMMC to the 250 participants. The resulting proceeds were then passed on to GM.

In sharp contrast to the MSC, however, the experience of the GMMC made the risk of leveraged stock ownership abundantly clear. As the Great Depression deepened, GM's stock price took a huge hit, at one point falling to $8 (an 80% drop from the $40 price at the time of the GMMC's creation). The stock price would eventually recover, but only years later. Meanwhile, poor operating results led to small Bonus Plan allocations. Simply put, the implied options behind the stock ownership scheme were deeply "underwater." GM was compelled to create a relief program, which effectively bailed out the GMMC for the debts to GM it was unable to pay. Sloan's reasoning was that to do otherwise would crush executive morale. The finance committee of GM's board of directors was reluctant to offer any concessions but eventually acceded to Sloan's request.[9] The managers participating in the GMMC were given the choice of (1) getting $40 in debt relief (i.e., the original purchase price) in exchange for every share turned in to GM, or (2) retaining the shares. In total, about half of the shares were redeemed. By March 1937, when the program was terminated, the share price had risen to more than $65, providing a positive, though modest, return on the half of the GMMC's shares that were kept. This example shows that GM's aggressive efforts to accomplish its objectives without "taking share" from investors sometimes backfired and forced investors to transfer additional value to managers.

The third example of GM's contractual ingenuity was influenced by the Revenue Act of 1950. Options awarded under the Act were subject to capital gains tax only upon disposal of the stock after it had been acquired by exercising options. Until exercise, the granting and holding of the options were non-tax events. In an instant, stock options had become tax-efficient vehicles for offering equity incentives to senior managers.[10] Not surprisingly, the use of options in executive pay plans sharply increased.

While nearly all large, publicly traded companies responded by abandoning the comprehensive, single-pool bonus, GM embarked in 1957 on an extraordinary—indeed, one might even call it "heroic"—effort to save the single-pool sharing system. The instrument used was called the "contingent credit." To illustrate the concept, let us assume that an executive receives a bonus of $56,000, all of which is drawn from a single pool used to pay all eligible managers. Seventy-five percent, or $42,000, is paid in cash installments over five years.[11] The remaining $14,000 is paid in the form of a contingent credit.

7. The takeover's principal aim was to wrest control of GM away from the company's founder, William Durant.

8. In his memoirs, Sloan seems to go out of his way to credit DuPont and Raskob for their generosity in contributing their shares to the leverage stock ownership scheme. While GM and its senior managers certainly derived benefits from it, the scheme was also a convenient vehicle for the two businessmen to cash out.

9. Sloan, *My Years with General Motors,* 417.

10. At the time, the capital gains rate was 25%, while the marginal rate on ordinary income was 75% at $100,000 and 91% at $400,000.

11. This example is adapted from Burton Crane, "GM and DuPont Push Incentives," *The New York Times*, February 2, 1958.

Let's assume that GM stock has an award value for the purpose of the plan of $35 a share (say, the price of the stock at the time of the award), and that the executive is accordingly granted a contingent credit of 400 shares ($14,000 ÷ $35). At the same time, he (there were no women in senior management ranks in that era) receives a stock option for 1,200 shares at market value ($35 a share). As long as the option is not exercised, he is paid cash amounts equal to the dividends that would have been paid on the shares had they been held in his own name. But if the option is exercised, the 400 shares representing the contingent credit revert to the company and no further dividends on those shares will be paid.

On retirement, the executive—if he has not exercised his option—would have a choice of receiving 400 shares at the rate of 80 shares a year or of exercising, in whole or in part, his option for 1,200 shares. Assuming a market value of $50 a share, he pays $42,000 (1,200 shares × the $35 exercise price) for shares worth $60,000 (1,200 × $50) and waits six months. If, at the end of that time, he sells at $50 a share (assuming he still can), he takes his profit of $18,000 and pays a tax of no more than 25% (the capital gains rate in that era), so his after-tax profit is at least $13,500 (75% of $18,000).[12] The effect of this transaction is to defer any tax effects until the exercise of the option (although the executive would have to pay tax on any dividends received from the contingent credit of 400 shares).

The relation between the value of a company's stock and the value of options on that stock is critical to understanding the logic of this unique plan. Based on modern option-pricing theory, a reasonable estimate of option value for a company like General Motors would be about one third of the stock price. For example, if the share price is $30, a typical at-the-money option (i.e., one issued with an exercise price equal to the stock price) will be worth about $10 per share at the time the options are granted. Alternatively, an option grant for 3,000 shares with a $30 strike price would be roughly equivalent in value to a 1,000 share stock grant.

The contingent credits served three critical functions. First, they allowed GM to retain the single-pool bonus concept, thereby continuing the fixed sharing contract between owners and managers. Second, they enhanced the plan's ability to build equity ownership among senior management. And third, they were tax efficient.[13] The use of the 3-to-1 valuation ratio reflected remarkably prescient judgment on the part of GM's directors, especially at a time when the absence of formal option-pricing models made the relationship between the value of actual shares and options on those shares highly speculative. It showed a clear intent by the board to provide options of equal value to the contingent shares. In this way, the board avoided the granting of awards in excess of the bonus formula. The use of the contingent credit, where the corresponding stock shares are forfeited if the option is exercised, reflected a desire on the part of the board to avoid double payment (i.e., payment in stock *and* payment in options) and to limit compensation to the bonus formula amount. Also, given the tax efficient nature of the arrangement, it was hoped that managers would buy and retain more shares of stock.

The 3-to-1 ratio prevailed until 1972, when the board changed to a 6-to-1 ratio. According to that year's proxy statement, the change was "intended to restore to some degree the incentives present when the plan was first adopted in 1957 for executives to acquire General Motors common stock through the exercise of stock options." Simply put, the take-up of shares in the years leading up to 1972 was significantly lower than the board had hoped when the contingent credit plan was first implemented. Perhaps too the directors thought that the option values were lower than they had anticipated and that redress was possible only by increasing the ratio. It is more likely, however, that the change in the ratio simply reflected an effort to get more money to management and, hence, represented one more step in the breakdown of the partnership between management and shareholders.

Changes in Method of Payout, Sharing Percentages and Threshold Return

From the start of the Bonus Plan in 1918 until 1943, bonuses were paid entirely in shares of stock. The board then began awarding both shares and cash. The change was driven by the high marginal tax rates of the period, which compelled participating managers to sell shares to pay their tax bills, thereby defeating the goal of building up management's ownership interests. From 1950, the explicit GM policy was to award enough cash to enable the bonus recipient to pay the tax on the total bonus and retain the portion of the bonus granted in shares. The bonus was paid in five annual installments. Any unpaid portion of the bonus already earned would be forfeited if the recipient chose to leave GM voluntarily. In this way, the Bonus Plan helped GM to achieve the aim of reducing retention risk—that is, the risk of good managers getting poached by competitors.

One important feature of the post-1943 plan was that both elements—cash and share grants—were drawn from a common pool. The gradual abandonment of this single-pool attribute, which started in the 1970s, would play a critical role in the deteriorating alignment between shareholder and management interests. The sharing percentage and minimum return on capital were changed four times before the fateful decision in 1977 to abandon the single-pool concept. In 1947, the sharing percentage was increased to

12. By contrast, his after-tax profit on 400 shares worth $50 per share would have been only $5,000, assuming a 75% tax rate.

13. After an exhaustive search, we have found no evidence of similar programs at other large American companies.

12%, and the minimum return was reduced to 5%. In 1962, the minimum return was raised to 6%. In 1967, the sharing percentage on corporate returns on invested capital (ROIC) above 15% was reduced from 12% to 6%. And in 1972, the sharing percentage was reduced to 8% from 12% for ROICs between 5% and 15% and to 5% for ROICs above 15%.

Just prior to the change in 1947, the board appointed a special committee made up entirely of large shareholders or those who represented large shareholder interests. This committee decided that an increase in the sharing formula was in the interest of investors because it would strengthen employee incentives and pay for itself through the impact of stronger incentives on company performance. At the same time, because of the large increase in corporate tax rates since the start of World War II, an increase in pre-tax earnings of 35% was required just to maintain pre-war net earnings. Without a change in the formula, the bonus pool would be "substantially lower" as a percentage of the aggregate salaries of the bonus plan participants than in the pre-war years, and so provide a much weaker incentive.[14] Hence the board's decision to reduce the minimum return from 7% to 5%.

The GM proxies provide no explanation for the thinking behind the 1962 increase in the minimum return from 5% to 6%. It may have just reflected changing expectations of a competitive rate of return. The long-term government bond yield in April 1962 (when the proxy was published) was 3.84%, notably higher than the 2.3% yield when the 5% minimum return was approved in 1947.

The changes in the formula in 1967 mark the beginning of a serious breakdown in partnership thinking. During the five years from 1962 through 1966, the bonus and salary committee credited only 68% of the formula amount to the bonus reserve. The special review committee appointed by the board in June 1966 proposed a reduction in the bonus share from 12% to 6% on earnings in excess of 15% of capital and argued that the reduced formula was adequate because it would have provided larger amounts than those actually credited to the reserve in the prior five years. In contrast to the board's statement that accompanied the change in 1947, no argument was made that the change in 1967 was really in the long-term best interest of the sacrificing partner. But only ten years later, the bonus and salary committee complained that the bonus plan had failed to adequately build management stock ownership, noting that "only about 3% of the shares optioned since 1964 have been purchased."[15]

The changes in 1972—namely, the reduction of the employee share from 12% to 8% for ROIC of 7% to 15%, and from 6% to 5% for ROIC above 15%, and the increase in the minimum return from 6% to 7%—are more aptly described as reducing the size of the partnership than stealing the share of continuing partners. The board decided to reduce the number of bonus eligible employees, arguing that for lower level managers "relatively little discretion was possible in the determination of the amount of individual awards granted to them because of the need to maintain proper compensation relationships."[16] The proxy doesn't explain why "proper compensation relationships" should trump performance, but does say that the employees dropping out of the bonus plan received "special salary adjustments," and that these adjustments in turn led to salary increases for the remaining bonus plan participants that were intended "to maintain appropriate and meaningful salary differentials." The reduction in the sharing formula was justified as necessary to avoid increasing the total compensation of the employees who remained in the Bonus Plan; but the board in 1972, unlike the board in 1947, provided no discussion of whether future awards will be sufficiently large relative to salary to provide strong incentives to increase economic profit.

The Demise of Fixed Sharing

The board finally put an end to the single-pool bonus plan in 1977. The justification given in that year's proxy statement demonstrates just how far the company had gone in committing itself to competitive pay: "[T]he fact that options could only be granted in relation to bonus awards places GM's Plan at a distinct disadvantage compared to option plans at other firms." Not a single director spoke up to defend the single-pool concept. What's more, there is no indication in that year's proxy, or in future proxies, that any board member was willing to speak up for fixed sharing. In effect, the board was saying that the single-pool, fixed sharing concept was no longer tenable in a world dominated by pay policies based on benchmarking peers. If peers were no longer constrained by single bonus pools or fixed sharing percentages in the granting of executive stock options, GM had little choice but to follow suit if it was to be competitive in the market for executive talent. To drive home the change even further, the proxy went on to say that the disadvantage of single bonus pools "is particularly true in years of minimum, or no, bonuses when added incentive is needed."

In summary, executives were to be paid what their peers at competitor firms were paid even if no bonus had been earned in the previous year. Because option grants were no longer linked to bonuses, pay could always be topped off even in the absence of bonuses simply by giving executives more options. This meant that GM now had two bonus pools—one for cash bonuses and the other for option grants. The partnership between ownership and management was truly over.

One likely contributing factor in the board's decision is that by 1977 board members had a very small (one could even say miniscule) economic interest in GM. As reported in Table 3, the 24-member board that dropped the single

14. GM's 1947 proxy, 9-10.
15. GM's 1977 proxy, 36.
16. GM's 1972 proxy, 22.

pool concept in 1977 had a median shareholding of 500 shares, worth $133,000 in current (2015) dollars; and aggregate stock holdings of 146,000 shares, representing 0.05% of shares outstanding and worth $39 million in current dollars. In 1947, by contrast, as can be seen in Table 2, the 28-member GM board had a median shareholding of 110,000 shares, worth $11.4 million in current dollars and an aggregate stock holding of 73.7 million shares, representing 28% of shares outstanding and worth $7.7 billion in current dollars. And even if we exclude the holdings of the four DuPont representatives on the board, the other 24 board members' aggregate shareholdings amounted to 13.6 million shares, representing 5.2% of shares outstanding and worth $1.4 billion in current dollars.

Perhaps most striking in the comparison of the two boards is that the combined ownership of the 1977 board was only one-eighth the number of shares held by Alfred Sloan alone 30 years earlier. Also noteworthy is the 98.6% decline in median director ownership over that period. The consequences of such a precipitous decline in director ownership can hardly be overstated. One obvious result was the lack of any creative problem-solving in dealing with the challenges of maintaining the incentives and accountability that come from fixed sharing. Simply put, if directors in the 1970s had had ownership stakes similar to their counterparts in the 1940s, they would almost certainly have been less nonchalant about jettisoning the fixed-share, single-pool concept that, decades earlier, had created such strong alignment between shareholders and senior management.

Also, the board could easily have shown more imagination in its management of the bonus reserve. To illustrate how, consider a firm in which executives receive 10% of EVA—that is, 10% of profits earned beyond the cost of capital. For every $10 of EVA, $1 goes to management and $9 to shareholders. The fact that less than 100% of the bonus earned might be paid out means that in some years less than $1 would be granted to managers. The idea is that the unpaid portion is saved for down years, allowing managers to receive bonuses in later years when profits may be low or even negative because of industry or macroeconomic factors beyond their control. In other words, while the partnership agreement stipulates a fixed sharing percentage for managers of 10%, the amount that they receive in a given year may deviate from the number. The sharing percentage is therefore a long-term target, not one that has to be met each year. If the board pays out less than $1 in a given year, the underpayment can be amortized in future years so that the sharing ratio is maintained.

But just as the board might sometimes choose to retain a portion of the bonus earned in a reserve account, it does not take a great leap to imagine the reverse. Here, the board might pay *more* than $1 for every $10 of EVA in low-profit or money-losing years. The overpayment is then amortized over the ensuing years in the form of lower management bonuses.[17] But, again, the 1-to-9 sharing percentage is maintained in the long term. The virtue of this approach is that it would leave a strong incentive in place as management executes the turnaround after a period of low profitability.

The critical point here is that such approaches were not even considered by the board from the 1970s until the company's bankruptcy in 2009. Little or no imagination was applied to the routine problems encountered in executive compensation—balancing the often conflicting goals of alignment, retention, and cost. The result was the absence of any pushback against the competitive pay juggernaut. Under such conditions, the collapse of the single-pool, fixed-sharing system became inevitable. In effect, the directors were giving away other people's money, not their own, as would have been the case in the 1940s.[18]

Meanwhile, in 1982, GM diverged still further from the old Bonus Plan by adding another distinct bonus pool. This time, according to that year's proxy, the General Motors Performance Achievement Plan (GMPAP) was adopted to "motivate executives to achieve specified objectives, such as increased sales and earnings, which require a period of years to accomplish." Moreover, participants in the new incentive plan were to be granted target awards expressed as a percentage of salary, a policy soon extended to target option grants. Because salary was set by competitive benchmarking, targets for both the GMPAP and option grants were now almost completely independent of performance.

In that same year, GM also abandoned economic profit as the instrument for granting cash bonuses. The company switched to a system in which bonuses were paid based on 8% of profit in excess of $1 billion. For the previous 64 years, bonuses had been paid only when a competitive return had already been earned on capital. The board's reasoning, as expressed in the proxy, was that "only 14 companies had total earnings which exceeded $1 billion." The hurdle to be cleared before any bonus could be paid, therefore, was high by the corporate standards of the time. What the board failed to mention, however, is that GM was the *third* largest company,

17. Something very much like this occurred with the leveraged stock purchase programs that became common in corporate America in the 1920s and 1930s, although they were not explicitly described in this way.

18. It is worth noting that some of GM's earlier creativity in executive pay design was recaptured after its recent bankruptcy. For example, as recent proxy statements reveal, a minimum share ownership requirement was imposed on non-executive directors. As of January 1, 2011 each director was required to own equity with a market value of at least $300,000, with each director given up to five years from the beginning of 2011 or the date he or she was first elected to the board to meet the ownership requirement. Deferred Share Units (DSUs) are another important post-bankruptcy innovation. These units involve the deposit of shares into a locked account. The value of these shares fluctuates with the company's share price and cannot be liquidated by directors until they are no longer affiliated with the company. DSUs offer important advantages in terms of alignment over conventional stock options. One problem with options is that the payout functions (with limited downside and a potentially huge upside) can encourage excessive risk taking by directors. Also, as the stock price falls below the exercise price of the option, the correlation (and, therefore, alignment) between option value and stock price declines. Thus, the downside risk for directors holding the options is much less than that of the company's stockholders. However, if directors own DSUs and the firm's stock price falls, both directors and shareholders suffer losses proportional to their share ownership.

Figure 1 **LN Top Five Share of Cumulative EVA**

For General Motors

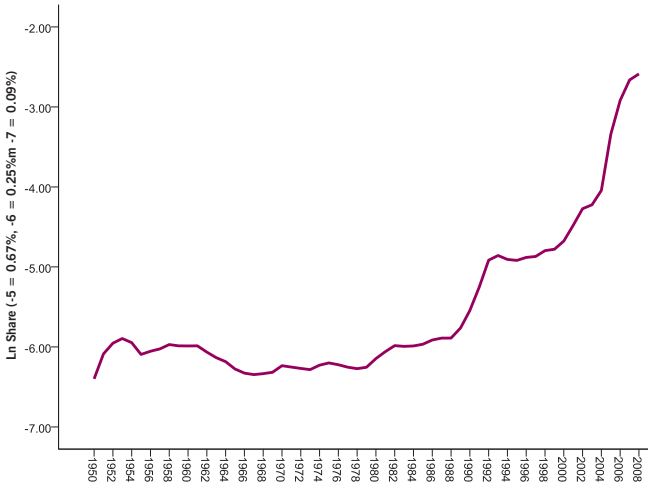
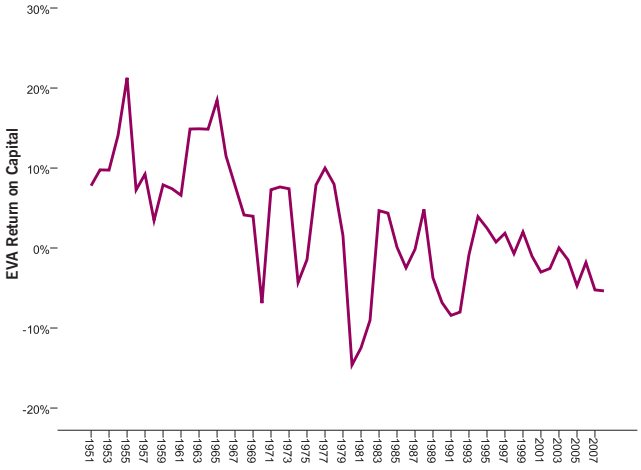


Figure 2 **EVA Return on Capital**

For General Motors



Data sources: Frydman & Saks,[20] Execucomp, Compustat, and CRSP.

by sales, in the U.S. Defining the hurdle this way, instead of in terms of economic profit, simply made it easier for the board to meet competitive pay targets.

Executive Pay before and after the Abandonment of Fixed Sharing

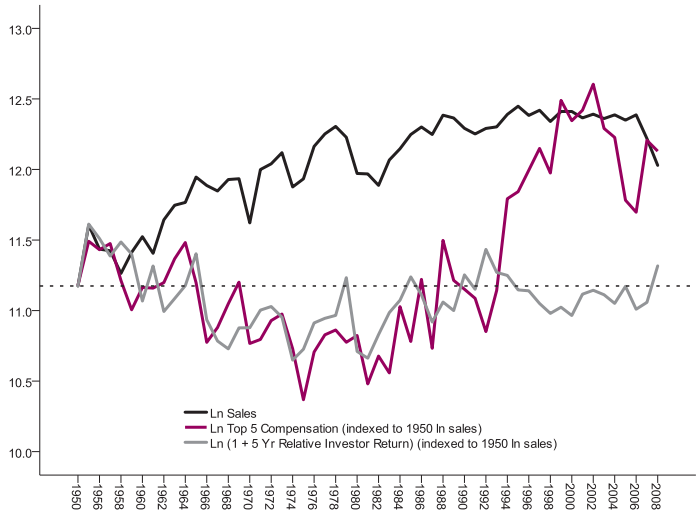
Figure 1 shows the changes in the total pay of GM's five most highly paid executives as a percentage of GM's economic profit from 1950 until 2008. From 1950 until about 1980, the sharing percentage stayed within the narrow range of 0.17% to 0.28%, thus representing a fairly constant cost to shareholders.[19] The figure also shows that the top-five share, after declining modestly from 1953 until the abandonment of the single-pool concept in 1977, increased sharply thereafter. And the slight decline in top-five share prior to 1977 likely resulted from the decisions of the GM board to pay out

19. We use natural logs so that equal distances represent equal percentage changes in the pay percentage of economic profit. Ln sharing percentages of -5, -6 and -7 correspond to percentages of 0.67%, 0.25% and 0.09%.

20. Carola Frydman generously shared the 1936-1991 executive compensation data that she and Raven E. Saks developed for their paper "Executive Compensation: A New View from a Long-Term Perspective, 1936-2005," *Review of Financial Studies* 23, no. 2 (2010): 2099-2138.

Figure 3 **Pay, Sales & Relative Return**

For General Motors top 5; pay and relative return indexed to 1950 sales



Data sources: Frydman & Saks, Execucomp, Compustat, and CRSP.

only two-thirds of the formula amount in 1962-1966 and to reduce the sharing percentages in 1967 and 1972.

Figure 2 shows GM's EVA return on capital over the same period. Together, Figures 1 and 2 show that after 1977 the top 5 took an increasing share of EVA as GM's EVA return on capital declined.

Now let's consider how GM's top-five pay varied with two other performance variables: sales and shareholder returns (specifically, five-year relative total shareholder returns, adjusted for industry effects) during the same 58-year period.[21] As can be seen in Figure 3, GM's top-five real pay declined during the partnership years (1950-1977) even though (real) sales increased substantially. During the same period, moreover, GM's relative shareholder returns were also falling, and the company's top-five real pay roughly tracked its five-year relative return. In the competitive pay period, by contrast, real pay grew rapidly even though GM's five-year relative return was negative in most years.

Moreover, our regression analysis confirms the visual conclusion from Figure 3—namely, that pay was much more sensitive to GM's stock returns during the partnership period and much more sensitive to the company's sales during the competitive pay period. During the partnership period, GM's five-year relative return explains 50% of the variation in log pay (and the coefficient of ln (1 + 5-year relative return) is 0.679 while the coefficient of ln (sales) is –.135). But during the competitive pay period, the company's five-year relative return explains just 1% of the variation in log pay (and the coefficient of ln (1 + 5-year relative return) is –0.201, while the coefficient of ln(sales) is 2.853). This evidence suggests that as competitive pay policy gradually came to dominate, managerial pay became less sensitive (and even inversely related) to the performance of GM shares, and increasingly positively correlated to changes in revenues. Competitive pay had given managers a powerful incentive to grow GM's business independently of whether that growth was adding value or reducing it.

The Causes and Implications of the Rise of Competitive Pay

We have identified three main contributors to the rise of competitive pay: (1) changes in tax laws that encouraged most companies to abandon single-pool sharing; (2) the rise of modern human resource (HR) management, with its focus on "job value" and market rates of pay; and (3) the rise of corporate directors as paid providers of governance labor, and not as stewards of capital.

Tax Preferences for Stock Options. The preferential tax treatment of options resulting from the Revenue Act of 1950 created a strong incentive for companies to grant options. As discussed earlier, the increased use of stock options might have had no impact on the single-pool comprehensive sharing system that was popular before World War II. But this development occurred before the

21. Pay and sales are inflation adjusted and all three variables are shown on a log scale with top-five pay and 5-year relative return indexed to log sales in 1950. The y-axis in Figure 2 is the natural log of inflation-adjusted sales in millions of dollars. For example, 11 is exp (11) = 59,874, or $59,874 million ($59.8 billion). Ln top-5 compensation (in dollars) and ln (1 + relative return) are indexed to ln 1950 sales. Ln 1950 sales is 11.1740 and ln 1950 compensation is 16.6217, which means that adjusted ln top 5 compensation = ln top 5 compensation – (16.6217 – 11.1740). Adjusted ln (1 + relative return) is ln (1 + relative return) - (0 - 11.1740).

advent of option-pricing models such as Black-Scholes. In the absence of a formal model, few companies made any effort to explicitly value the options so that they could charge the option grants directly against the bonus pool. Instead, they created a second pool that consisted only of the stock options. The failure to charge the value of the options to a single bonus pool effectively meant that, for the overwhelming majority of large U.S. companies, the single-pool, fixed-sharing philosophy of the pre-war years became severely compromised. GM's response to these developments was unique among nearly all large, publicly traded American companies.

The rise of modern HR management. The second major factor contributing to the gradual abandonment of the single-pool concept was the shift in focus to "job value" and "competitive pay"—and the reduced attention to an individual manager's contribution to value—that began shortly after World War II. The replacement of sharing formulas by competitive pay practices in corporate America took place gradually from the early 1950s through the 1980s. The HR movement had arrived in full force, fundamentally altering the way everyone in business would be paid, including those at the very top.

The first American Management Association (AMA) survey of executive compensation was conducted in 1950 and the Hay Guide Chart for job evaluation was standardized the following year. The AMA surveys were designed by Arch Patton, a partner at McKinsey & Company and the country's leading compensation authority at the time. As a measure of Patton's influence on the field, between 1950 and 1985 the *Harvard Business Review* published no fewer than 26 of his articles, many of them reporting on the results of the latest AMA survey.[22]

In its initial 1950 survey, the AMA completed what was probably the most comprehensive examination of executive compensation practices ever attempted up to that time, one that elicited responses from 664 companies.[23] The survey found that, after controlling for industry, the level of profits (in dollar terms) was by far the most important determinant of executive pay. This finding suggests that compensation programs in the early post-War period were generally effective in aligning the interests of senior management and shareholders. But while the early compensation surveys used profit as a measure of size, the AMA soon switched to revenue.[24] Henceforth, benchmark pay would be defined in terms of revenue, not profit or value creation. The impact of this seemingly modest change would later prove monumental. As the logic of competitive pay became increasingly dominant in corporate America, the incentives for senior managers would gradually shift from maximizing profit and shareholder value to maximizing revenue.

The near pervasiveness of competitive pay policies explains why even pay systems based on EVA or economic profit usually fail to deliver superior performance. Linking bonuses to EVA (again, profits in excess of a charge for use of investor capital) accomplishes nothing if the targets are recalibrated each year to ensure competitive pay in the following year. Since estimates of market pay are largely unaffected by company performance, annual recalibration to competitive pay levels creates systematic "performance penalties."

What's important to recognize about competitive position targets, then, is that they are designed to provide the same *expected* compensation every year, regardless of a company's past performance. As noted earlier, the system has no memory in the sense that there is no penalty for poor performance—apart from a reduction in the current year's pay—that gets carried forward into future years.[25] The performance penalty helps explain the findings shown in Figure 3. If executives are penalized in good years with lower option grants, while the reverse happens in bad years, it's hardly surprising that the relationship between executive compensation and shareholder returns is negative.

The perverse incentives linked to competitive pay were acknowledged by some critics, including Arch Patton himself. As early as 1966, he noted that the relationship between top management pay and corporate profitability had eroded. Along with the shift from profit to revenue as the defining characteristic of "peers," setting pay targets without regard to performance led to a growing disconnect between performance and pay. In short, compensation programs evolved to the point that senior management was now provided with incentives to invest in growth independently of whether that growth was value creating or value destroying. GM was no exception to this rule.[26]

When Patton died in 1996, his obituary in *The New York Times* noted his regret that managers had "badly abused his survey and that this resulted largely from management assuming that all of its executives were above-average performers."[27] Thanks to the dominance of competitive pay,

22. Stephen F. O'Byrne and Mark Gressle, "How 'Competitive Pay' Undermines Pay for Performance (and What Companies Can Do to Avoid That)," *Journal of Applied Corporate Finance* 25 (Spring 2013): 27.

23. Arch Patton, "Current Practices in Executive Compensation," *Harvard Business Review* 29 (Jan. 1951): 56.

24. Although we have been unable to uncover any specific evidence on this issue, a plausible reason for the change is that revenues tend to be less volatile than profits. Therefore, the use of revenues leads to less volatility in the granting of management bonuses.

25. O'Byrne and Gressle, "How "Competitive Pay" Undermines Pay for Performance," 28.

26. Arch Patton, "Top Executive Pay: New Facts & Figures," *Harvard Business Review* 44, no. 5 (1966): 94-97.

27. Dana Canedy, "Arch Patton, 88; Devised First Survey of Top Executives' Pay," *The New York Times*, November 30, 1996.

everyone would come to enjoy superior rewards.

The rise of the paid director. Throughout the 19th century and well into the 20th, according to corporate governance scholar Charles Elson, "Directors were simply shareholders, and their board service resulted from a desire to protect and enhance the value of their investment. Hence no compensation was necessary or desirable."[28] Moreover, corporate legal doctrine in America was downright hostile to director compensation as late as the 1940s. But as Elson notes, "By the mid-1950s, the legal prohibition against director compensation was crumbling, and directors increasingly were receiving cash compensation for their services."[29]

The primary reason for this development can be traced to the enormous growth in the size of the modern corporation. As companies grew, shareholdings became proportionately smaller, "with no one shareholder or shareholding group possessing enough stock to exercise effective control over the entity." The resulting vacuum was filled by professional managers. Instead of being appointed by the company's largest shareholders, as they had been in in the early 20th century, directors were typically chosen by management, often arriving on the board with little or no equity investment. Elson writes, "Because directors primarily were appointees of management and subject to management approval in relation to retention, the interests of the directors naturally became more aligned with the group that selected and retained them than with the stockholders."[30] Not only was there a profound change in the way directors would come to view their role in corporate governance, but also in the way they were rewarded.

Directors receive two distinct economic benefits from their service on corporate boards. First, their stewardship increases the value of their shares (or should, in theory); and second, their service provides direct compensation in the form of cash and additional shares. As shareholdings among directors declined, the benefit to them from the stewardship function also declined. To make up for the deficiency, companies relied increasingly on direct compensation, a trend that accelerated in the 1960s and beyond. Over time, moreover, this compensation would be subject to peer comparisons just as in the case of competitive pay practices for management.

These trends applied to GM just as they did to other large U.S.-based corporations. For the GM board in 1947, the stewardship benefit far exceeded the direct compensation they received for their labor. For example, Earle Johnson, a retired GM executive, owned 28,524 shares (which, at $57.80 per share, were worth about $1.65 million) while receiving just $900 in director compensation. The large equity stakes of Johnson and his fellow directors gave them strong incentives to monitor the division of value between capital providers and labor providers, and to challenge higher compensation for management that resulted from expropriating share from investors. After all, they were investors, and important ones at that.

In contrast, by 1977 the stewardship benefit for the GM Board was so trivial that they had little financial incentive to challenge the higher management pay that resulted from taking a bigger share of the pie at the expense of shareholders. For example, John Mayer, the former chairman of Mellon Bank, owned just 500 shares of GM stock (worth $68.38 per share, or about $34,000) and received $47,000 in director compensation. At first glance, comparison of Mayer's stock ownership with his annual director pay suggests that Mayer might weight capital about 40% (i.e., 34/(34+47)) and labor about 60% in thinking about his division of value between capital and labor. But because share ownership is a stock while director pay is an annual flow, a better comparison would be between his expected annual stock return, $3,400, assuming a 10% expected return, and director pay. This comparison suggests that Mayer might weight capital about 7% (i.e., 3.4/(3.4+47)) and labor about 93% in thinking about division of value between capital and labor. Having directors, the nominal representatives of capital, giving 93% weight to labor in their decisions about the division of value between capital and labor is hardly an effective way to protect shareholder interests.

Conclusion

The great irony in the evolution of executive pay policy at GM is that just as the shareholder value movement in the U.S. was about to take off, the company experienced a rupture in the partnership between senior managers and shareholders. For decades, GM's bonus system had achieved strong alignment between the two groups. But like most large U.S.-based companies, the advent of the HR movement, with executive pay defined in terms of "job" and not performance, led to the practice of competitive pay. GM's board resisted the trend for several years and, for a while at least, showed great resolve and creativity in dealing with the competing demands of executive pay policy without sacrificing the fixed-sharing philosophy.

But like most companies, GM ended up abandoning

28. Charles M. Elson, "Director Compensation and the Management Captured Board—The History of a Symptom and a Cure," *SMU Law Review* 50, no. 1 (1996): 127-174. Elson writes, "It was not uncommon for directors to receive some kind of 'nominal' payment for their attendance at board meetings—usually a gold double eagle (worth twenty dollars) placed in front of their seats at each board meeting" (138). He also notes that directors sometimes received "unstated" compensation in the form of tips concerning important events such as mergers, proposed stock manipulations, the ability to gain access to stock subscriptions, etc. "Thus," he writes, "the ability to engage in lucrative insider trading was a reward for faithful board service." (139)

29. Ibid., 131-32.

30. Ibid., p. 132.

fixed sharing in favor of competitive pay. An important contributing factor in the demise of fixed sharing was the change in share ownership among GM's directors. The large shareholdings among directors in the early and mid-20th century encouraged a partnership arrangement with managers. But as the board's share ownership diminished, and the stewardship function waned, directors' compensation—much of it in the form of fixed cash fees—increased sharply to compensate them for their time and effort in exercising corporate governance duties for the company's shareholders. Not only did directors acquiesce in succumbing to the competitive pay model for managers, they began to see the advantages of competitive pay for themselves.

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Table 1 **A Chronology of Key Events in General Motors' Compensation Policies**

YEAR	CHANGE IN BONUS PLAN
1918	GM adopts a bonus formula of 10% of profit in excess of 6% of capital
1922	Threshold return is increased to 7%
1923 – 1930	Half of bonus pool allocated to fund leveraged stock purchases through the Managers Securities Corporation
1930 – 1937	Half of bonus pool allocated to fund leveraged stock purchases through the GM Management Corporation
1934	Managers granted relief on 50% of GMMC debt by "paying off" debt with shares valued at 1930 purchase price
1947	Bonus share raised to 12%, and threshold return reduced to 5% of capital
1947 – 1956	Amount credited to bonus reserve is 87% of formula amount
1957	Bonus reserve of $19 million returned to income
1957	"Contingent credits" introduced to integrate option grants into the bonus formula
1962	Threshold return is increased to 6%
1962 – 1966	Amount credited to bonus reserve is 68% of formula amount
1967	Bonus share above 15% return on capital is cut in half (from 12% to 6%)
1972	Threshold return increased to 7%, bonus share reduced to 8% between 7% and 15% ROIC, 5% over 15% ROIC
1972	Option value used for contingent credit reduced from 1/3 to 1/6 of stock price, effectively doubling option grants
1977	Single-pool concept is dropped; option grants no longer determined "in such a formal and rigid manner"
1982	Bonus formula changed to 8% of profit in excess of $1 billion, dropping the economic profit concept
1982	The 5-year option reserve is increased from 2.5 million shares (1977-82) to 7.5 million shares (1982-87)
1982	The General Motors Performance Achievement Plan is adopted
1982	Participants in the new incentive plan "are granted target awards expressed as a percentage of the participant's salary at the beginning of the performance period"
1982 – 1987	Switch is made to target option grants as a percentage of salary
1987	Increase in 5-year option reserve from 7.5 million shares to 35 million shares; drop in individual executive 5-year limit of 50,000 shares
1987	Annual bonus plan is dropped

Source: GM proxy statements.

Table 2 **The 1947 GM board, representing 25 million shares, with median director ownership of nearly 110,000 shares**

Name	Occupation	Director Since	Years Of Director Service	Common Shares Owned By du Pont	Common Shares Owned By Director	Common Shares Owned By Director & duPont	Adjusted For 6-1 Split
Thomas P. Archer	VP, Group Executive, Body & Assembly Divisions Group	1944	3		3,805	3,805	22,830
Albert Bradley	EVP, Chairman of Financial Policy Committee	1933	14		18,776	18,776	112,656
Donaldson Brown	Retired	1920	27		125,636	125,636	753,816
Walter S. Carpenter	President & Director, E.I. du Pont de Nemours & Company	1927	20	10,000,000	0	2,500,000	15,000,000
Lammont du P. Copeland	Assistant Secretary, Member of Finance Committee & Director, E.I. du Pont de Nemours & Company	1944	3	10,000,000	700	2,500,700	15,004,200
Marvin E. Coyle	EVP	1937	10		5,948	5,948	35,688
Harlow H. Curtice	VP, General Manager, Buick Motor Division	1940	7		6,043	6,043	36,258
Frederic G. Donner	VP, in Charge of Finance	1942	5		2,759	2,759	16,554
Lewis W. Douglas	Chairman, Board of Trustees, The Mutual Life Insurance Company of New York	1944	3		0	0	0
Henry B. du Pont	VP & Director, E.I. du Pont de Nemours & Company	1938	9	10,000,000	2,810	2,502,810	15,016,860
Angus B. Echols	VP, Member of Executive Committee, Chairman of Finance Committee & Director, E.I. du Pont de Nemours & Company	1944	3	10,000,000	100	2,500,100	15,000,600
Ronald K. Evans	VP, Group Executive, Engine Group	1946	1		6,010	6,010	36,060
Edward F. Fisher	VP and Director, Fisher & Company, Inc.	1942	5		9,115	9,115	54,690
Lawrence P. Fisher	VP and Director, Fisher & Company, Inc.	1924	23		33,222	33,222	199,332
Louis C. Goad	VP, General Manager, Fisher Body Division	1946	1		3,642	3,642	21,852
Richard H. Grant	Farmer, Chairman, Board of Directors, The Reynolds & Reynolds Co.	1920	27		7,692	7,692	46,152
Ormond E. Hunt	EVP	1934	13		13,507	13,507	81,042
Earle F. Johnson	Retired	1946	1		28,524	28,524	171,144
Charles F. Kettering	VP	1920	27		553,407	553,407	3,320,442
William S. Knudsen	Chairman, Board of Trustees, Hupp Corporation	1924	23		11,850	11,850	71,100
R. Samuel McLaughlin	Chairman, Board of Directors, General Motors of Canada	1918	29		53,153	53,153	318,918
Charles S. Mott	Chairman, Board of Directors, United States Sugar Corporation; Director, water utilities in Missouri, Illinois and New York; President, Charles Stewart Mott Foundation	1917	30		500,000	500,000	3,000,000
John L. Pratt	Farmer	1923	24		147,354	147,354	884,124
John J. Schumann, Jr.	President, General Motors Acceptance Corporation	1934	13		17,809	17,809	106,854
Alfred P. Sloan, Jr.	Chairman, Board of Directors	1918	29		583,924	583,924	3,503,544
John Thomas Smith	VP and General Counsel	1920	27		124,554	124,554	747,324
George Whitney	President & Director, JP Morgan & Co.	1924	23		1,000	1,000	6,000
Charles E. Wilson	President, Chairman of Operations Policy Committee	1934	13		17,076	17,076	102,456
Average			**14.75**			**438,515**	**2,631,089**
Median director share ownership						**18,293**	**109,755**
Aggregate shares represented							73,670,496
Shares outstanding							264,454,140
Percent of shares outstanding							28%

Source: General Motors 1947 proxy statement.

Table 3 **The 1977 GM board, representing just 146,434 shares, with median director ownership of 500 shares**

Name	Occupation	Director Since	Years Of Director Service	Shares Owned By Director
Catherine B. Cleary	CEO, First Wisconsin Trust	1972	5	100
John T. Connor	CEO, Allied Chemical Corporation	1964	13	400
Johh D. deButts	CEO, AT&T	1976	1	845
Elliott M. Estes	President & COO	1972	5	34,062
Walter A. Fallon	CEO, Eastman Kodak	1972	5	313
Charles T. Fisher III	President, National Bank of Detroit	1972	5	568
Richard C. Gerstenberg	Retired from GM	1967	10	33,327
Shearon Harris	CEO, Carolina Power & Light	1977	0	200
Robert S. Hatfield	CEO, The Continental Group	1974	3	600
Reuben R. Jensen	EVP in Charge of Overseas Operations	1974	3	12,226
Howard H. Kehrl	EVP in Charge of the Technical Staffs	1974	3	7,778
John A. Mayer	Retired CEO, Mellon Bank	1968	9	500
F. James McDonald	EVP in Charge of North American Automotive Operations	1974	3	12,583
W. Earle McLaughlin	CEO, Royal Bank of Canada	1967	10	500
Howard J. Morgens	Retired CEO, Procter & Gamble	1963	14	500
Thomas A. Murphy	CEO, General Motors	1972	5	18,834
Ellmore C. Patterson	CEO, Morgan Guaranty Trust	1974	3	500
Edmund T. Pratt, Jr.	CEO, Pfizer	1977	0	100
Gerald A. Sivage	Retired CEO, Marshall Field & Company	1970	7	200
J. Stanford Smith	CEO, International Paper	1976	1	500
Roger B. Smith	EVP in Charge of Finance	1974	3	7,849
Leon H. Sullivan	Minister	1971	6	100
Richard L. Terrell	GM Vice Chairman	1972	5	13,651
Charles H. Townes	Professor of Physics, UC Berkeley	1973	4	200
Average			**5.1**	**6,102**
Median director share ownership				**500**
Aggregate shares represented				**146,436**
Shares outstanding				**286,546,045**
Percent of shares outstanding				**0.05%**

Source: General Motors 1977 proxy statement.

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