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Why Companies Hand Out New Options Every Year

It's clear by now that many High Tech 100 employees showed a net profit from the stock options they received, including many who exercised their holdings after the bust. Yet this bottom-line way of looking at stock options doesn't reveal the whole story. It considerably understates just how much these employees already have benefited from partnership capitalism, and stand to gain again when the stock market eventually improves.

The reason lies with what experts call the run rate, which simply means how much equity a company hands out in the form of employee options in a given year. You might think the amount is fairly obvious. After all, in Chapter 4 we learned that the top five officers of the typical High Tech 100 firm owned 14 percent of their company's total equity as of 2000. All other employees at the firm owned another 19 percent. So you might reasonably conclude that on average, each group probably got roughly the same amount of stock and options every year. Otherwise, they wouldn't have ended up with more or less the same total equity stakes after years of option grants.

However, what actually happened was more complicated. In a typical year, High Tech 100 firms hand out many more options to average employees than they do to the top officers. This generosity allowed workers to catch up to the equity stakes held by the firm's founders, who are also often CEOs or other top officers.

Usually, the person or small group of people who founded the company owned most or all of it to begin with. In order to bring in the financial resources necessary to expand their firm, high-tech founders gave up a lot of their ownership, just as most corporate founders do. Employees got some, mostly through stock options. Then venture capitalists were allowed to buy shares at insider prices. When the firm did its IPO, the public at large got to buy the company's stock, too, although they usually paid the highest price for their ownership stake. Despite all this stock being issued to so many groups, a high run rate that goes mostly to employees allows employees to gain ground on the founders and other shareholders.

By looking at the SEC filings, we determined that the average run rate among the High Tech 100 was about 8 percent a year between 1997 and 2001. In other words, they granted 8 percent of their total equity to employees and top officers in the form of options every year. The bulk of this combination of actual and potential ownership—typically 7 of the 8 percentage points—went to average employees. The top five officers received only the remaining point. As a result, employees quickly caught up with and then surpassed the top five, despite the huge ownership stakes with which most top officers started. Nor was there any sign that the bust caused these companies to change the pattern: High Tech 100 firms gave employees about 90 percent of all outstanding stock options in the years before and after the stock market sell-off.

The run rate gives a more comprehensive picture of the industry's extensive commitment to sharing risk and reward than the 19 percent snapshot of employee equity we saw in the last chapter. It's one thing to find that many workers lucked out by getting into the industry before its stock soared to unbelievable heights, and that many were left with quite a bit more than worthless dreams when the market sank. But to get an idea about whether options are likely to make much of a financial difference to employees in a more normal economic environment, we need to look at what happened on an ongoing basis.

Examining how high-tech firms hand out options every year also sheds light on the ability of stock option capitalism to withstand wild market gyrations. We've already seen how the popular perception that high-tech workers got stuck with worthless paper after the 2000 crash was at least partly inaccurate because of all the cheap pre-IPO options they had received early on. However, an equally important reason lies in the run rate, which shows that high-tech firms continue to grant options every year. Since each new grant comes with an exercise price pegged to the current stock price, the stock option model automatically readjusts employee risk sharing for even the most severe market swings, by renewing the upside potential every year. While employees still had plenty of underwater options after the crash, the run rate has been steadily building up a new stock of in-the-money ones.

"At times, the market may get ahead of itself; at times, behind," Cisco CEO John Chambers told an interviewer in May 2000, shortly after the high-tech stock collapse had begun. "We pass out stock options every year so that [employees' holdings] don't go up and down based upon what their initial [exercise price] was. So I don't worry about the short-term fluctuations" of the stock market.

A widespread lack of knowledge about the run rate has contributed to the inaccurate notion that the high-tech bust proved what a lousy deal options turned out to be for average workers. Even many experts don't take into account how annual option grants re-equilibrate employees' ownership stakes and keep intact the partnership among capital, management, and labor. In mid-1999, for example, a leading national expert on employee relations gave a newspaper interview that illustrated the misapprehension. "The great Achilles' heel of all these [stock option] programs is that if the stock market turns, . . . you've built an enormous castle of sand," said Edward Lawler III, director of the University of Southern California's Center for Effective Organizations. "All of a sudden, you've got a lot of people with underwater options [that are worthless] and nothing to hold them to the company."

While Lawler is correct in pointing out that many employees suddenly found themselves with worthless options, he didn't stress the fact that many employees are given new options at in-the-money prices every year, no matter how many underwater options they're stuck with from prior years.

The run rate helps to make sense of something else, too. For all the grand talk about sharing the wealth and having employees think like owners, some high-tech companies—like Amazon, for instance—consistently underpaid their employees in the early years. Economists have their own name for this phenomenon as well. They call it "wage substitution," meaning that the company is substituting options for a part of the normal market wage.

While not every high-tech firm lowballed salaries in this way, the run rate became particularly crucial for those that did: The new options they granted every year were necessary to continue to offset the artificially depressed wages. From the perspective of the employees, the more options they received, the more likely they were to come out ahead from the wage substitution. Either way, there was no guarantee, since the stock market can be so fickle. But to learn whether employees lost money from wage substitution, we need to determine the value of the options they received every year through their company's run rate.

To get a better handle on the run rate, think of the difference between a snapshot and a motion picture. The total equity table in Chapter 4 took a snapshot of the High Tech 100 as of December 31, 2000. It told us that employees had accumulated 19 percent of their firms' total equity over the years. But because that table measures employees' potential ownership stake as of a certain point in time, it says nothing about how many options they received on an ongoing basis every year. All we discovered was that employees held 19 percent as of the time the camera flashed at the end of the year.

The run rate, on the other hand, measures the flow of options to employees every year. It's like training a financial video on the industry, to follow the trail of options as companies grant them. To get a better feel for the average High Tech 100 run rate, look at Table 5.1. It shows the share of the firm's total equity granted as options each year, and how the pie was divvied up between employees and the top five officers.

These are extraordinary numbers. They tell us that the average High Tech 100 firm granted about 8 percent of its future ownership to employees every year. True, this is potential, not actual, owner-

TABLE 5.1 **The Annual Option Spigot: High Tech Workers Get More Than Their Bosses** (Share of the High Tech 100's total equity granted as options each year)

	Employees' Share %	Top Officers' Share %	Total %
1997	8	1	9
1998	8	1	9
1999	7	1	8
2000	6	1	7
2001	4	1	5
Average	7	1	8

NOTES: All outstanding shares and all options after dilution, i.e., assuming that all the options had been exercised.

Employees refers to everyone but the top officers, who are the five highest-paid executives at each company

SOURCE: Authors' analysis of SEC filings.

ship, because options can't immediately be cashed in for stock. Still, it's clear that most options go to rank-and-file employees and lower-level managers, not CEOs or upper-level managers, as is the case in most of the rest of corporate America. The founders and executives of these companies seem committed, by an ethos that hardened into a competitive standard, to spreading the wealth to generate more wealth.

Take a look at 2000, for example. The High Tech 100 handed out 7 percent of their total equity to employees and the top five officers that year. Nearly all of this run rate—about 6 percentage points—went to average employees. The top five executives in each firm received just 1 point. To put it another way, the High Tech 100 granted 1.5 billion options in 2000. The top five officers got 164 million of these, while everyone else split the remaining 1.36 billion. In a fifth of the companies, the top five received 5 percent or less of all the options granted that year. Not one High Tech 100 firm gave the top five officers more than employees.

If you run the video for all years since the High Tech 100 were founded, you find that they had granted 11.5 billion options as of the end of 2000 (including the ones that had been exercised). Of that total, some 9 billion, or nearly 80 percent, had gone to employees. The top five officers got the remaining 20 percent.

These figures drive home the extent of high-tech firms' commitment to stock option capitalism. Sure, executives took plenty of options for themselves, especially when you consider that there were only 500 top five officers and 177,000 employees as of 2001. But there's no question that executives back up their shared-ownership rhetoric to a vastly greater degree than their counterparts in any other industry in America.

The moving picture view of options also makes clear why employees so quickly caught up with the ownership stakes of their company's founders. The original owners may have started with most or all of the company's stock. But in every subsequent year they gave their employees nine options for every one they gave themselves. At that rate, it didn't take long for employees to pass them by. As a result, the employee share of the High Tech 100 total equity pie expanded steadily, from 17 percent in 1999 to 19 percent in 2000 to 20 percent in 2001.

To illustrate the point with a typical company, take Yahoo. When Jerry Yang and David Filo started the Internet search engine in 1994, they owned 100 percent of the stock. Soon after, they sold shares to Sequoia Capital, a venture capital firm, for $1 million. They diluted their holdings again when they got more funding from Softbank, another Internet firm. They also granted a slew of options to most employees. Then Yahoo sold shares to the public in 1996. At that point, Yang and Filo each owned only about 11 percent of the company (after accounting for the potential dilution from stock options). Other officers and directors held 7 percent, including Tim Koogle, Yahoo's first CEO. Sequoia held 13 percent and Softbank had 27 percent. Employees' options came to another 17 percent, leaving public shareholders with the remaining 14 percent.

Yahoo continued to grant options to employees in subsequent years that represented about 9 percent of the company annually. Overall, Yahoo handed out almost a quarter of a billion options between 1994 and the end of 2000. Of that total, it gave 12 percent to the top executives and 88 percent to employees. By 2000, Jerry Yang's and David Filo's ownership stakes had shrunk to 6 percent each. Employees had accumulated a total potential ownership of about 20 percent, almost entirely through options. This is the amount they hadn't exercised, either vested or unvested. They also had exercised many options along the way. That's more than Softbank and more than Jerry Yang and David Filo combined.

The run rate shows that high-tech firms didn't just share the wealth once, in a burst of generosity during their heady startup days. Instead, they did it every year. This renewed commitment became very important after the market crash. The bursting of the stock bubble drove more than 80 percent of the options held by employees underwater. If options had been one-time deals, many would never see any value from those they still held at the time.

Of course, High Tech 100 companies didn't continue to issue options just to keep employees in the money. Their primary motive was the same as it had been during the boom days: a need to be competitive in attracting, retaining, and motivating talented employees. The setback in the market, which undermined confidence in the Internet as the market of the future, tested this human resources strategy. Some high-tech companies really hadn't had enough time to get out of the startup mode, though over time the strongest of them had begun to resemble solid operations likely to survive and thrive over the long haul. But after the bubble burst, even the most promising high-tech companies that focused on the Internet were once again viewed as risky job situations. Traditional companies looked more secure as a place to build a career.

In mid-2001, Vivek Ragavan, then CEO of Redback Networks, a Cisco rival that builds Internet equipment, explained why he continued to grant options even though the labor market for high-tech workers had cooled. "We don't have billions of dollars of cash sitting on the balance sheet, and we don't have a stable base of revenue yet," he said. "The early guys who joined took more risk, and now they are taking a little less, but it's still risky. And because we are still a startup, people feel that if they take a risk they should get the reward, and they are willing to work for it."

Other high-tech companies believe that employees' stake in the firm must be constantly refreshed so the ownership culture will thrive. We've seen how the special culture that options helped to form is as important as the options themselves, for employees as well as the company. But the financial stake for employees is the glue that helps hold it all together. If that stake isn't renewed, especially after a big stock slump, employees may lose their motivation and the culture might well begin to atrophy or even dissipate altogether. "If you took Juniper and said, We're going to do the same things, but we won't have stock options, I don't think you would get the same results," said Marcel Gani, Juniper's CFO.

The run rate helps to keep alive the sense of employee ownership and the productivity gains it brings. The high-tech companies that issued new options after the market collapse did so at the sharply lower stock prices that prevailed at the time. As a result, workers continued to earn a fresh stake every year in any future gains their labor might help produce. In addition, new hires were brought into the ownership fold. One testimony to the retention value of options is the fact that High Tech 100 employees didn't desert in droves for traditional companies after the stock market meltdown.

"We have had a policy since day one of sharing the equity with employees, and we continually refresh [their] option positions," Siebel Systems CEO Thomas Siebel said in a television interview in April 2001, after the company had announced a doubling of its first-quarter profits. "We've been doing that now over the last seven years to make sure that we have a company where all the employees are owners. I think they find their stock options are very motivating. This has been a major, major reason why Siebel Systems has been as successful as it has."

Pegging the strike price of newly issued options to current stock levels automatically injects new hope for financial gain. Old options that had a paper worth of $100 at the height of the bubble were undercut when the stock price fell to $40 or $20 or even $1. But the new ones carry the lower exercise price, so employees stand to make a profit if there's any upward movement at all.

Lower-priced options can even make a company look more attractive to new hires. This may seem counterintuitive. After all, few people want to sign on to a company whose stock had just lost 90 percent of its value, since there's a big risk that it might go out of business altogether. But when the market had been at its peak, some potential hires had begun to wonder just how much higher it could go. Getting options in a company whose stock already had shot up 1,000 percent didn't always seem likely to lead to a new windfall, since it would be increasingly difficult to keep growing as such an incredible pace.

But if the underlying business remained sound, options in a company whose stock had fallen back to a few dollars left plenty of room for another payoff. "It becomes increasingly difficult to hire people when your stock is so high," said David Callisch, director of market communications at Alteon Websystems in a 2000 interview. "The fact that the stock is lower now, that's the one good thing now about this whole stock market collapse." Alteon, an Internet software firm later acquired by Nortel, was trying to hire about 100 people at the time and offers stock options to all its employees.

Still, the crash was an acid test for the High Tech 100's stock option culture. Some employees became disheartened as they watched the value of their potential ownership shrivel or even vanish altogether. Many had felt a sense of entitlement during the boom times. So it was a heavy psychological blow to wake up one day and find out that a lot of their unexercised options were worthless, despite the 17 percent that were still in the money and the profits they already had made from those they had cashed in.

"This is an incredible challenge now in the Valley," said Jay Wood, the chairman of Kana, in early 2001. "People were so motivated in that frothy market we saw in the beginning of last year. Now the market is depressed, and there are people that have $100 options but their stock is sitting at $1. They are not going to realize anything from that and probably never will. So what companies have been challenged with is, 'How do you reset the bar and give these people value?'"

Added VeriSign CEO Stratton D. Sclavos: "Over the last twelve months, you see a dramatic number of companies whose stock price has gone down by 70 percent to 99 percent. You have a high degree of your workforce who believed options were a wonderful thing, but now they're not necessarily convinced that those options will ever achieve an above-water situation. This is a time that tests the stock option recruitment and retention theory."

To preserve employee loyalty and motivation, many high-tech firms took extra steps to offset the psychological impact of the crash. Although the options employees get from the run rate each year give them a new reason to remain at the company, they do little to compensate for the great sense of loss they suffered when their old options became worthless. High-tech firms used a variety of stratagems to deal with this problem.

One approach was to hand out a pay raise, as Microsoft did to its lower-ranking workers. In a seven-page memo sent to employees in December 2000, Microsoft CEO Steve Ballmer explained why it did so:

> It's critical that we continue hiring great new people and investing in our existing employees. Our ongoing goal is that our base salaries are higher than two-thirds of the companies in the industry. We have drifted behind that target and the stock market drop makes employees, new and old, more sensitive to cash compensation. Stock options remain a great long-term opportunity for employees to share in the success of the company. That remains important, but reality has set in—here and industry-wide. The world is not full of get rich quick opportunities, but everyone here has an opportunity to do very well long term.
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> In the next month we will review all employees at level 67 and below (roughly the bottom half of Microsoft's workforce) for consideration of a base salary increase, or, for sales people, an increase in bonus opportunity. These increases are not automatic; they will target strongest performers, and good performers who are lower in their salary ranges. None of this is in lieu of the normal August reviews. While we will have many fewer open positions, we must ensure we continue to find and hire the right new people and fully use our salary ranges as an aid.

That year, Microsoft had moved to solve another personnel problem brought on by one of its employee ownership programs. The firm's full-time employees get an option grant when they're hired, plus continuing grants, and they get to buy stock at a discount in the employee stock purchase plan. However, one long-running sore spot at the company had been management's strategy of excluding employees it designated as temporary workers from the purchase plan. They sued in a case that eventually covered 10,000 current and former temp employees, or a quarter of the company's total workforce. In 1999, Microsoft lost a lengthy court battle in which temps had argued that they should be considered regular employees. After losing the case, Microsoft sharply reduced its temp workforce, bringing a larger share of its workers into the stock purchase plan.

Not many high-tech companies had the financial wherewithal to follow mighty Microsoft's move and raise pay to offset employees option losses, especially in a sinking stock market. Instead, the majority used their option programs in various ways to compensate employees for their underwater ownership stakes.

The most straightforward tactic was to simply raise the run rate and hand out more options. If, for example, a company had planned to issue options worth 8 percent of the company in 2000, it could lift the grant to 9 percent or 10 percent. Microsoft had done this in April of that year, even before the pay raise and just days after the tech sell-off began. The company made an extra award of 70 million options at $67 a share, a much lower price than the $90 ones employees had received the previous July.

Overall, 47 percent of the High Tech 100 lifted their run rates in 2000. Most did so without stinting: The average increase came to 4.4 percentage points, lifting the run rates of this group to more than 12 percent. "We will go and look at the entire base of employees, determine how much of their vested and unvested shares are underwater, and then do an incremental grant [of new options] between zero and 30 percent [of the number employees already had], to create some adjustment," said VeriSign CEO Sclavos, who issued new options that year.

While the other 53 percent reduced the number of options they granted in 2000, many nonetheless used options in other ways to help workers who had lost out in the market slump. In fact, nearly half of this group—roughly a quarter of the entire High Tech 100—pursued a controversial approach that exchanged old options for new options after six months. This essentially repriced employees' options. Repricing means that your employer changes the strike price of an option you already own, reducing it to the current market price or even lower. Say your options came with a strike price of $10. Then the stock price shot up to $100, but sank back down to $5. The company would reset your strike price to $5 or less.

Repricing kicked up quite a fuss, for understandable reasons. Outside investors saw it as cheating. After all, being a part owner means sharing in the risk as well as the reward of ownership. Other shareholders lose just as much as employees when the stock price tumbles. In fact, they're usually worse off, since most had to shell out hard cash to buy their stock. Employees, on the other hand, got their options just by working. So why should they get protected from a market slump if no one else does? "Shareholders out there say, Well, no one is repricing my shares," said Jay Wood, Kana's CEO. "I bought them at $100 and now they are $1. Why should you get any more?"

Still, Amazon repriced in early 2001. Owen, the manager who told the story about Amazon CEO Bezos and the beach rental, explained why. The company's stock price had plummeted in the prior year, from a high of $107 all the way down to $30. As it fell, it drove an increasing number of employee options underwater. "It just grew and grew and grew until we got to a point where, because I joined before the company went public, I was one of 3 percent or 4 percent of the company that actually had options worth anything," Owen said. "This was a huge problem, because now everybody is left with options that are worthless, and retention becomes an issue."

A combination of disappointment, resentment, and a diminished confidence in the company's future was soon reflected in changed work habits. People stopped working as hard, Owen explained, and began going home at 5 P.M. or 6 P.M.—something that never used to happen when the stock was soaring. "I felt that I really couldn't push on people," Owen said. "It's hard to do anyway, because we really don't have that kind of culture. But I can't really ask people to feel like they are in some kind of jihad anymore. I was always walking on thin ice with folks, wanting to motivate them but not wanting to push too hard, because they might walk out the door."

Amazon employees expressed similar views. "Morale in the group was directly tied to the share price," said James, a thirty-six-year-old software engineer who had come to the company as a contractor and become a permanent employee in mid-1999. "The group I was in had about thirty people in it," he told us in the spring of 2001, not long after he had left Amazon again for another job. "You could see as the share price started slipping, people still did the work but the morale wasn't there, and the fervor was not as high as it was back in 1999. The morale was pretty low after that. It's like, why are we bothering implementing new features, it's not going to change anything."

In fact, you could track morale levels by the comments employees wrote on the white boards Amazon had in its elevators. Some, said James, would write "'We hope that'. . . and then they drew a little *boing* like we were going to bounce. Then other people drew a slow vertical drop straight down off of that and said: 'No way, we're going down, this is it.' When the share price started sliding comments show up about Amazon.bomb and Amazon.gone. Then when it went back up, you'd start seeing more positive things in the elevator."

By August of 2000, Bezos decided to take action. In an email to Amazon employees, he explained that the company was giving them a special new grant of options. But by the following February, it had become clear that the supplemental grant wasn't enough. Nearly 70 percent of the 70 million options held by Amazon employees had strike prices ranging up to $83, yet the stock was trading at $16. This time, instead of another round of new options, Bezos repriced. Technically, what he did was allow workers to trade in older options with higher exercise prices for fewer options that carried strike prices that were at least 15 percent lower.

This was a bold move. Although Amazon had been the poster child of the e-commerce boom, some investors had begun to sour on it by 2000. Stock analysts complained that Amazon kept pushing back the year when the company would turn its first profit. In 2000, Amazon posted a $545 million loss. Bezos "was making a pretty big statement," said Owen, "which is that I still believe in ownership of the company as the way to go. He has not abandoned that as a guiding philosophy for the company. We responded by trying to get it so that ownership once again can become the driver for us." Indeed, Bezos was so aggressive about swapping out his workers' high-priced options that by July of 2002, only 13 percent of them were underwater even though Amazon's stock was still trading in the $16 range.

The repricing strategy was a risky one for many companies, because they had to reduce their earnings when they did it. The need to do so was spelled out in 2000 by the Financial Accounting Standards Board (FASB), an industry oversight body that sets the accounting rules for corporations. That year, FASB issued guidelines saying that employers who reprice must subtract the gain employees get from the company's own earnings statement. In other words, their profits are cut by the amount they reprice.

Few high-tech companies took the official repricing road, largely because they didn't want to take an earnings hit. All told, we found only three High Tech 100 firms that used this approach in 2000. "The FASB rules really have tied the hands of management in trying to incent people," said Wood. "I think it is a bit of a shame really, because what we want out of our economy is better productivity out of our employees. By instituting these accounting standards, it makes it virtually impossible to re-incent employees with stock. Some companies have done repricings and their shareholders have punished them mercilessly for it."

To get around FASB, many high-tech firms employed a loophole that first seems to have been uncovered by Sprint, the long-distance telephone company. In the fall of 2000, Sprint realized that the newly issued FASB rules didn't bar it from simply canceling underwater options. All a company had to do was wait six months, then issue new ones at the market price of the day. The move, called a slow-motion swap or a 6-&-1 repricing (six months and one day), didn't trigger the rule requiring an earnings charge, even though it clearly is intended to achieve the same result as a repricing. The time period is the key factor. FASB considers it repricing if a company cancels old options and issues new ones within a six-month period. One that does exactly the same thing after the six months and a day is just exchanging or swapping options, and isn't required to take the earnings hit. After Sprint spotted the strategy, many high-tech firms jumped to exploit it, including a third of those High Tech 100 firms that had decreased their run rates.

In reality, a swap is still a form of repricing, even if it does skirt FASB's fine print and avoids the official label. High-tech companies also faced other limitations in how far they could take it. Companies must ask shareholders' permission to grant options. They do so by specifying how many options they want to give out, and then allowing shareholders to vote on it. If stockholders say yes, as they almost always do, the company can't exceed the specified amount without going back for another shareholder vote.

"Some of us have tried other creative ways that are acceptable by the accounting standards, but it's not easy," said Kana's Wood. "If you're going to increase it beyond what has been preset, you have to go to your shareholders and get approval. And shareholders are not very happy when the price is down. So you get yourself caught. Some companies have such large pools that it doesn't matter. But it still looks messy."

When shareholders ask why repricing or regranting is fair, said Wood, he responds by telling them, "'Because you're asking the employee to work their tail off to give you more value. You're not sitting here working sixteen hours a day. Let these people have an opportunity to be successful again and you'll get more out of the company by getting these people to work hard.' If I were a shareholder, I'd say, 'Reprice the damn things, I don't care.' But it's not the way it works."

Other high-tech CEOs disagree. "I never reprice options," said Bill Coleman, the chairman and cofounder of BEA Systems, an Internet software company based in San Jose, California. "Right now, there's a bunch of software companies out there that do because they found a new loophole. My view is, if you're repricing, you're admitting to the world that you are never going to build enough value to get back to that price again. The second thing is, you are taking the responsibility for failure away from the people who maybe made that happen."

Still, nearly half of the High Tech 100 did some version of an exchange or repricing in 2000. When you throw in those who jacked up their run rates (some of whom also repriced), fully two-thirds helped employees to offset the market crash in one way or another. Overall, the number of cancelled options jumped to 29 percent in 2000, from 11 percent the year before, as companies wiped out old high-priced options and replaced them with ones carrying strike prices at lower market levels. The practice accelerated dramatically in 2001 as the stock market continued its swoon. In fact, cancellations soared to a stunning 62 percent that year as employers struggled to cope with the morale impact of so many worthless options. All these cancelled options had the odd effect of driving down the run rate, which sank to 7 percent in 2000 and to just 5 percent in 2001. In reality, companies were handing out more options in those years, not less. But because they cancelled so many old ones, the net number fell.

Investors who just looked at the falling run rates might conclude that high-tech firms were scaling back their option grants. While new grants were in fact smaller, the extra options they handed out to offset the cancelled ones meant that the scaling back was much less than it appeared. Indeed, the drop in the run rate had nothing to do with de-emphasizing partnership capitalism. Just the opposite was true. Companies were canceling options with $100 exercise prices and replacing them with fewer options that carried $10 exercise prices. Public shareholders, of course, are bearing more of the risk of dilution when this happens.

Shareholders gain risk either way, but most of the companies felt they had little choice but to try to help employees. "Every employee has the power to reprice their options package. . . . It's called, 'I quit,'" said Amazon spokesman Bill Curry in a 2001 news interview. In other words, they can simply walk out the door and get options at a new company that carries the current market price.

Another reason why some high-tech companies were so anxious to make sure employees didn't wind up with worthless options involves the implicit promise they extended to employees. This has to do with the wage substitution issue we mentioned earlier. While most paid salaries equal to those at any other company, some undercut the market wage and used options to make up the difference.

For the most part, this happened in the company's startup period. Some high-tech CEOs offered a fairly sophisticated explanation—or perhaps it was really a justification—for why they did it. Naveen Jain, the CEO of Infospace, argued that in the early days of his company, employees were in effect subsidizing its startup phase by working for below-market wages. He could have gone to venture capitalists to raise enough money to pay them more. But then they would take a piece of the ownership pie, along with the potential rewards it would bring. Why not instead let employees play the role of venture capitalist?

"When I started Infospace, I went to each employee and told them, 'Look, if you were going to the open market, you can make $100,000 a year,'" he said. "'I will pay you a $100,000 a year, too, but that means I have to go raise that money. If I do, I have to give part of the equity to somebody else. Do you want to take a $30,000 salary and become the venture capitalist yourself? That way, the only person who will make the money from your blood and sweat will be you, not somebody else. How would you feel when somebody is sitting at the beach, and you're working hard twenty hours a day but he's the one making the money? Probably you'll not feel very good.' So I think turning the employees into the venture capitalist is probably the best thing you can do."

Here, too, Amazon was perhaps the most prominent example of a high-tech company that paid below-market wages. During its first few years, Amazon did surveys of labor markets to determine how much it should pay employees. The surveys, which usually are done by private consulting firms, tell companies what the average salary is in a given city for any type of worker, whether it's a midlevel manager or a low-skilled warehouse worker who packs the books Amazon ships to its customers. Most large companies use these surveys to set pay levels. However, Amazon deliberately pegged its salaries in the bottom quarter of the levels found in the surveys.

Amazon and a few other high-tech companies skimped on wages for a simple reason: They couldn't always afford to pay competitive wages. While they wanted the most talented workers, so did the likes of IBM and Intel, which had a lot more money to throw around. "When you are starting a company, a high-tech company in particular, most of the alternatives these people have in terms of other jobs come from more established companies, whose salary scales are probably higher than yours," said VeriSign CEO Sclavos. "So [an option program] gives you an offset to that."

Many employees were willing to go along, especially after high-tech stocks started to soar. They watched other high-tech workers getting rich from options and thought a lower wage would be a good tradeoff for a chance at the jackpot. A broad range of workers felt this way, from managers who could earn six figures to the customer service representatives who handle calls from the public.

Owen, for example, started at Amazon with a salary of $60,000 a year, plus thousands of options. "I had also gotten an offer from a consulting firm that I had worked for over the summer," he remembered. "Their offer was $120,000, including a salary of $95,000 or $100,000, with bonus on top on that. If I had gone to a consumer products company, it probably would have paid me $80,000 or $90,000. So I knew I was not only below market but probably at the bottom of my entire [business school] class." Bezos, he said, was open about the tradeoff, and told employees that Amazon was giving them ownership in the company instead of a full salary.

Zach Works thought options were worth a lower wage, too. A senior customer service representative in Amazon's Seattle office, Works had earned $10 an hour when he started with the company in 1998. While this was $2 less than what he had made at his prior job, Works also received 1,500 options. In December 1999, when Amazon's stock hit its peak, they had been worth $169,000, far outweighing the $4,000 or so a year he was giving up by earning $2 an hour less.

But by the fall of the following year, Amazon's stock was at $29. Since Works's strike price was $21, the bonanza he was counting on had shriveled to just $12,000 and was getting closer to zero every day. “And I’m the exception, since most of my colleagues started later and are underwater,” he said that fall. Toward the end of 2000, Amazon’s stock sank to almost $15 and Works’s golden pile was worthless.

As this happened to more high-tech employees, wage substitution all of a sudden became a major morale problem for companies like Amazon. Instead of feeling like they had lucked into an opportunity, many felt ripped off, and perhaps a little foolish for having uncritically accepted their company’s grand vision. Some may have been angry with themselves for having bought into what seemed increasingly like a bad deal.

So it wasn’t surprising that Amazon led the way on repricing. “We ask people to take lower salaries when they come to Amazon.com in exchange for ownership in the company,” Bezos said when making the case to shareholders at Amazon’s 2001 annual meeting in May of that year. “Since the stock price went down, employees were granted an opportunity to exchange their options for ones at a lower price.”

Amazon’s repricing proved to have tactical value as well. Disappointed workers in several cities actually tried to form labor unions in the fall of 2000—a shocking break from the hip, individualistic culture of high tech. That November, the Washington Alliance of Technology Workers (WashTech), which had been formed to help permatemp programmers at Microsoft, began a union recognition petition among Amazon’s 400 or so Seattle-based customer service representatives. Works joined, along with dozens of others.

The wage versus options issue exposed other grievances as well. The service reps called their group “Day2@Amazon.com,” because “Bezos is always telling us, ‘It’s Day One, we can’t stop or rest,’ and we think five years of Day One is generating lots of problems for us,” said Works.

He and other reps complained that management no longer listened to their problems. They routinely worked fifty-hour weeks, going up to seventy in the holidays, said Jennifer McDaeth, another rep in Amazon’s Seattle office. The company also changed their shifts, sometimes on as little as a day's notice, making the job even more stressful, she said. Reps complained repeatedly, she said, but management did nothing to solve any of the problems. The group's mission statement called on Amazon to make "a true commitment" to reps on compensation, job security, and respect, among other values.

The morale problems cast a light on the distinctly Old Economy underbelly among the workforce at Amazon and some other high-tech companies, one that almost no one ever talked about. As one of the largest Internet firms serving the public directly, Amazon had built up an extensive national operation to ship books and other products to customers' homes. It included seven warehouses, staffed by some 5,000 workers who were even lower paid than the service reps.

Two labor groups tried to form a union among the warehouse workers that fall. One was the United Food and Commercial Workers (UFCW), a large union that represents supermarket and other retail workers, including warehouse staff much like those at Amazon. The second group was called the Prewitt Organizing Fund, an unusual freelance union recruitment outfit based in Washington, D.C.

Although Amazon's warehouse workers comprised more than half of the company's workforce, they were largely excluded from the stock option culture Bezos worked so hard to cultivate. They earned $7.50 to $9.25 an hour, with skimpy benefits. This was considerably less than what similar workers made who belonged to the UFCW or other unions. Warehouse workers, too, often had to put in fifty- and sixty-hour weeks, especially during the holiday rush. But unlike the reps and other high-tech workers, they got only 100 options, vested over five years. These, too, had been rendered largely worthless by Amazon's falling stock price.

Amazon successfully defeated the union drives. In February 2001, it cut back operations when the peak Christmas season didn't bring as much business as management had planned for. In the process, it shuttered the Seattle office, laying off all 400 sales reps—effectively squelching the union drive.

On a second front, Bezos moved to phase out the wage substitution. Amazon began trying to peg salaries to the 50 percent mark in market surveys, up from the 25 percent it had previously targeted. In other words, the company began adjusting wages so they would be closer to the market average. "You bet the wage substitution has diminished," said Owen in the spring of 2001. Between this change and the repricings, employee morale gradually began to improve.

Other high-tech firms had to reverse course, too. "When the market starts going down, you find that you can't compete (for good employees) when your stock isn't growing at the rate that it used to, so suddenly we had to start getting our wages into the market arena," said Chris Wheeler, the chief technical officer and co-founder of InterNAP Network Services Corporation in Seattle. His company, which had 770 employees at the end of 2000, provides companies with Internet routing services. Wheeler estimates that InterNAP paid engineers 20 to 30 percent under the market wage from its founding in 1995 to the market crash in early 2000.

Some companies began to phase out wage substitution for newer employees who had missed the wealth that options brought during the boom days. "Our executive salaries are particularly low for a company that has 2,000 employees," said VeriSign's Sclavos. "But most of my executive management has been with me for four years and has seen the positives of the stock. New executives, on the other hand, end up having not quite the same upside potential. Therefore, executive comp on the salary and bonus is going up. You have to start balancing it back the other way."

It's difficult to say just how many High Tech 100 companies used options as a substitute for below-market wages. Most of the employees and executives we interviewed said that companies primarily did this in the startup phase, and usually abandoned the practice in later years. Two surveys back up this notion, although neither measure the High Tech 100 directly. One, by a high-tech compensation consulting firm called iQuantic Incorporated, surveyed 200 high-tech firms in 2000, some of which were likely in the High Tech 100. It found that 86 percent of the 200 companies said that they paid between the fiftieth and seventy-fifth percentiles of the market wage. The other 14 percent paid more. The other survey, also taken in 2000, looked at twenty pre-IPO dot-coms in Silicon Valley and the San Francisco Bay Area. It found that the companies had begun paying competitive salaries.

While wage substitution was a way for companies to make employees shoulder a larger share of the risks of ownership, options sometimes can have the opposite effect. For a few heady years during the late 1990s, some high-tech employees made so much money that they could just up and leave whenever they wished. At some companies, some workers, even a few lucky low-level ones, enjoyed windfall gains far beyond what they ever imagined possible. When that happened, some workers decided to drop out or retire and enjoy their newfound wealth.

During our discussion with the Portal employees, for example, Francine, the vice president, mentioned how she had cashed in $6 million worth of options before the stock price fell. Most of the others, who hadn't profited as handsomely, thought they might not still be working there if that had happened to them. "I mean, frankly, I'd be out of here," said Tom, a technical staffer. "Six and a half million, I'd have gone, too," agreed Jack, the finance administrator. Even Geoff, the engineer, said: "Yeah, I have to say, I'd be gone."

High-tech employees also talked about the mixed or even negative effect on morale that can occur when their vesting period approaches. Some employees start to focus on the riches they stand to make and tend not to care as much about their job. Vest in Peace, the joke went.

High-tech companies may have inadvertently contributed to the problem by being too generous with options at various times. During the market runup, companies as well as employees were caught up in the let's-all-get-rich-quick frenzy, so much so that even some employees thought their companies were passing out too many options. "A lot of the equity problems in the Valley and elsewhere come from kind of a 'They're doing it, so I have to,' thing," said Jerry, the Excite@Home engineer who at one point had options worth $15 million. "That's how it has gotten out of hand. A lot of us played other companies off of each other to get our current jobs. We said, 'Well they're giving me 10,000 options, so give me

20,000.' Then that offsets the scale internally to what other people have been brought in at. So it's just been this huge mess."

His colleague, Joe, felt likewise. "When I vested, I had my initial 10,000 options. Three months later, I got another 8,000 options, and a month later I got another 7,000. So I had 15,000 more options in my first four or five months of working there, and I don't even know why. I thought that I was doing a good job, but the person who was the senior VP of our work at the time just really liked me. The senior VP must have been given large pools of options every month to give out and I think he just picked out his favorites."

Whether it was the excessive generosity of employers or the excesses of investors madly driving up high-tech stock prices, CEOs had to cope with the inflated expectations many employees came to hold. Some executives dealt with the issue by trying to get employees not to obsess about the stock price. There's a story at Tibco about how Vivek Ranadive, the CEO, once tried to drive the point home. It was 1999 and the company had just gone public. The stock was shooting up and up every day and employees were buzzing in the halls, talking about the new kitchen they would put in or the new car or house they wanted to buy. One employee in particular—call him Paul—just couldn't contain himself. He was a New Yorker, an Italian, very loud, very funny, and his enthusiasm for the topic infected everyone.

One day, Ranadive happened to walk by when Paul, gabbing in the hall with friends, said: "If the stock hits a hundred in another week, I'm going to wear a dress to work." Ranadive heard him, and sure enough, the next day Tibco's stock not only hit a hundred but went to a hundred and twelve. So Ranadive put on a fashion show for Mr. Stock Obsessed. He brought in a catwalk, put on lights and music, and corralled some employees to act as judges. To outfit Paul, a large man, Ranadive got an aide to buy half dozen size 13 pumps and six long gowns, size 18.

Paul was a good sport about it. He agreed to put on makeup and wear hats and gloves, plus a sash and a crown. Employees voted on the dress they liked the best and crowned him Miss Tibco. Everyone laughed and had a good time, including Paul. At the end, Ranadive got up and grabbed the mike and thanked him for playing along. But, he said, the point he wanted to make was a serious one: Don't focus on the stock price. Instead, everyone should focus on the customer. "I don't want to hear anyone else talking about it," he warned, "or you never know what will happen to you."

Sclavos, the VeriSign CEO, had a similar view. He pointed out that it can be risky for management to hype potential option winnings as the motivation for working so hard, since the stock market can be so volatile. Workers quickly realize that the up and down movement of the stock price doesn't correlate to their own dedication to the job day by day. Those whose options hadn't vested by the time the market peaked saw their paper wealth go up in smoke, no matter how much time they had put in.

Still, the wild stock market ride has proven the durability of the stock option model. A lot of employees significantly expanded their incomes with option wealth. A few super-lucky ones made millions and quit with their loot. Plenty of others thought they made millions while the market was flying high, then watched in frustration and dismay as their paper wealth slipped away when share prices sank. Latecomers could only stand by helplessly as sagging stock values made their high-priced options worthless.

Throughout it all, the good relationships have survived. Options lifted up the hopes of many employees to crazy and unreasonable levels, and dashed them right down again, but most high-tech employees didn't turn against their employers. "The underlying motivational results that we see options create for people is real," said Excite chairman Bell. "I don't know why that would go away."

Bill, the young Tibco techie who helped out Jennifer, the events planner, had similar feelings, even after his company's stock sank in early 2001. "In these last couple months, when we've lost 80 percent of our value, or 92 percent, I have buddies calling me to say, 'What happened to your stock? Is everybody grumbling and talking about leaving?' I don't hear any of this. Because there is so much meat to the company, and everybody believes and is motivated. It's a good place to work."

We've described options as a form of risk sharing between employees and corporate owners. Originally, high-tech firms offered options to lure workers to a new industry. Workers took on a greater risk of losing their livelihood than they would have had if they had taken a job in a better-established corporation. In exchange, the company's founders and outside shareholders gave them a chance to share in any wealth the company would create if it was successful.

The run rate adds to the complexity of the equation. If options were offered solely to induce an employee to join a company with uncertain prospects, why should management keep issuing more every year? The answer from executives was retention; they needed options to make sure they didn't lose the talent they had worked so hard to get.

However, repricing or exchanging options seem to undercut some of the risk-sharing aspects of partnership capitalism. After all, high-tech workers knew when they signed on that options would only pay off if the company prospered and its stock value increased. Making sure they get paid even if it doesn't seems like changing the rules of the game after it has been played. It seems to turn options into something of a free lunch.

Wage substitution, on the other hand, seems to cut the other way. Although the practice diminished in most companies after their early years, it nonetheless implies that at least some high-tech firms wanted employees to foot part of the bill for options, on top of the job-security risk they took on by joining a new and untested industry. Alternatively, you might argue that the company founders were really trying to freeload not so much off of employees, but off outside investors. A skeptic might say that entrepreneurs like Bezos and Sclavos used investors to pay part of their wage bill. Companies too unprofitable to support the market wage for qualified workers used investors' equity to help them out.

To make sense of all these puzzling issues we need to answer another question: How exactly do options create wealth for the companies that grant them? If high-tech companies only handed them out because they were startups desperate to attract and retain workers in a tight labor market, they would have stopped doing so as the industry matured or when the national unemployment rate shot up in 2001. If that had occurred, it would suggest that stock options are a short-lived phenomenon that probably don't have much to offer to the rest of corporate America, at least over the long term. A large corporation might consider options for all its workers if it was caught in a particularly frenzied labor market, as indeed many were in the late 1990s. But a prudent CEO might not want to start passing out ownership stakes that stretch out over a decade or more just to deal with a labor crunch that would very likely ease after a few years. Certainly after the 2001 recession that reason didn't seem so compelling anymore.

However, stock options, and the employee ownership culture that goes with them, are part of a larger shift in corporations towards sharing equity with knowledge workers. This is happening because a partnership approach generates value for corporations that goes beyond recruitment and retention. To understand this new reality, let's look at the economics of options for the companies that issue them.

6
What Shareholders Gain by Giving Up Some of Their Ownership

Despite the staggering wealth high-tech employees lost when the stock market sank, by and large options have been a good deal for many of them, certainly for those who joined the company early on. But what about their employers? Do companies and their public shareholders come out ahead when they grant options to workers? Many High Tech 100 stockholders rightly believe that most of these companies' founders and many of their employees got a lot more from options than shareholders got from their stock. After all, employees cashed out a total of $78 billion from an industry that wiped out more than $1 trillion of investors' money.

So are options a zero-sum game? If that were the case, every grant would represent a potential gain to employees and a corresponding potential loss of equal value to the shareholders. Our view is that options can be a net plus for both sides, at least in a normal economic environment. High-tech workers did indeed come into a windfall that was at least partially undeserved during the market bubble. But in a market that rises and falls with less extremes, as is mostly the case in modern economies, options will bring benefits to shareholders and employees alike if they're used as part of a broader commitment to a culture of employee participation.

No question, though, public shareholders initially surrender something of value every time a company whose stock they own grants an option to an employee. The reason: Options water down their ownership, at least if they're exercised. Whenever an employee cashes in an option for a share of stock, the company then has more shares outstanding, diluting the percentage each stockholder owns. Of course, if the stock price doesn't increase, outside shareholders face no dilution from options. In effect, options have a built-in self-moderating mechanism. When the pie is growing, stockholders face a diminution of their percentage of ownership, but when it's not, they give up nothing.

Shareholders may feel generously inclined toward the workforce when the company's stock price is rising. But options represent much more than a good-times expression of gratitude. We believe they can help to create extra value that offsets the dilution. How? First, by attracting and retaining employees with experience, talent, and drive, options help management to build a workforce that can create innovations and grow the company. Second, in a participative corporate culture, options encourage employees to think and act like owners, thus spurring them to work more diligently and more efficiently. In addition, because options are a handoff of value from outside shareholders to employees, they put pressure on management and employees alike to make the company more successful than it otherwise would have been. The company must create enough extra wealth to offset the potential shift of ownership to employees.

Let's look at the mechanics of dilution to see how this works. Take a company that we'll call America Incorporated. It's founded with three shares of stock and is trading at $1 a share, so it has a market capitalization of $3. The founder owns one share, or a third of the outstanding stock. Two outside investors, maybe venture capitalists, each own one as well. All three owners thus have a third of ownership, entitling them to a third of the voting rights.

One day America Inc. decides to grant a stock option to an employee. The option entitles her to buy one share for $1 any time within the ten-year window that's typically found at most companies. America Inc. doesn't actually issue the share until the employee exercises the option. But the company has made a commitment to issue a new share, at least if the stipulations are met, such as a requirement that the employee remain with the company throughout a set vesting period. Finance experts often refer to the share promised through an option as the stock option overhang. In this case, America Inc.'s overhang is 33 percent.

If the stock price rises and the employee goes ahead and purchases her share when she's allowed to do so, the company then will have four shareholders, and four shares of stock outstanding. As a result, the 33 percent overhang will transform into a 25 percent real ownership stake. When that happens, the three original shareholders have their ownership diluted, from 33 to 25 percent each. Before the option was issued, the original shareholders could count on getting one-third of the future wealth America Inc. produced. Or if the company had been sold, each stockholder would have been entitled to a third of the sale price. Now, each person has only a 25 percent share of any transaction. Their voting rights in the corporation are likewise slashed to 25 percent.

Of course, employees have to pay money to buy the stock that an option entitled them to purchase. This goes to the corporate treasury. However, employees only exercise an option if the strike price, that is, the amount they must pay to the company, is below the market price. So if the option is exercised, the company won't gain enough income to completely offset the dilution of the original stockholders' ownership stake.

In large public corporations with millions of shares, the company often tries to offset the dilution by repurchasing shares on the open market. In other words, if our employee sold her $1 share on the open market, as most employees do when they exercise options, America Inc. could simply buy it back. However, it would have to pay the current market price. So if, for example, America Inc.'s stock had jumped to $2, the employee would sell it for a $1 profit. America Inc. would get the $1 strike price from the employee, and it would have to pay $1 to buy the stock in the marketplace. The original three shareholders would now each own a third of the company again, but America Inc. would be out $1 that could have gone toward expenses, profits, or new capital investments. So the cash cost of options to a company is the difference between the strike price and the market price at the time the option is exercised.

Most financial experts use the overhang as a measure of a company's potential dilution. Companies that offer options typically publish the information needed to compute this figure in their annual SEC filings. Wall Street looks at this and says: "America Inc. has a 33 percent overhang, so it has promised to dilute its ownership by a third."

We decided to use another approach to calculate a company's potential dilution. Instead of overhang, we looked at the amount of stock ownership employees and investors would have if all options were exercised. We use the term "total equity" to describe this combination of stock and option ownership, the same phrase we used in previous chapters to measure ownership in a company that issues options. We think this is a useful way to measure the potential dilution a company faces from options.

To see how much dilution occurred among the High Tech 100, let's look again at who owns these companies. We have already discussed the numbers in a different context, in Table 4.2 in Chapter 4. There, we showed how much potential and actual ownership High Tech 100 employees had accumulated through 2000. (The potential part was the total number of unexercised options they held as of that year. The actual part was the amount of stock they had.)

Table 6.1 shows employee options again, but this time with the dilutive effect they would have if they were cashed in.

Look how much public shareholders stood to have their ownership diluted by employee options. If no options were exercised in subsequent years, their ownership would represent 74 percent of the High Tech 100. If employees cashed in all their all options, the outside shareholders' stake would get knocked down to 58 percent. The only way they wouldn't lose these 16 percentage points is if the stock had remained flat or had fallen, dragging the options underwater. But of course, in that case the options would have no effect on outside stockholders.

Stock option capitalism involves risk sharing by all three partners in a corporation: shareholders, management, and employees. For example, the same dilution effect suffered by outside share-

TABLE 6.1 The Dilution Public Shareholders Face from Employee Options
(Average ownership shares of the High Tech 100 as of December 31, 2000)

	Stock before Dilution (%)	Options after Dilution (%)	Total Equity after Dilution (%)
Public shareholders	74	0	58
All insiders*	26	22	42
Employees**	3	17	19
Top five officers	13	4	14
CEO	9	2	9
Other four	4	2	5
Directors***	10	1	9

NOTES: *Total holdings of employees, top five officers, and directors.

**Excluding top five officers. Stock holdings include estimated purchases through employee share purchase plans.

***Includes stock owned by companies, such as venture capital firms, with which directors are affiliated.

The first column shows the percent of the High Tech 100's stock each group owned, before any outstanding options are exercised.

The second shows the percent of stock each group's options—both vested and unvested—would represent if they all had been exercised.

The third shows the percent of the stock, both from direct purchases and from options, that each would have owned if all outstanding options had been exercised.

SOURCE: Authors' analysis of SEC filings.

holders applies to the CEOs, other executives, and to the directors and the shareholders with whom they are affiliated. In trying to make the case that options are perks that management awards to the employee at the expense of the company's public shareholders, the press and many shareholder groups often lose sight of the fact that management's equity is diluted just as much as that of public stockholders. This is why a company's leaders must truly believe that options improve a company's performance; they're putting their own equity on the line with every option they issue to the workforce.

Another point to keep in mind: Even employees get diluted. While High Tech 100 workers don't hold that much direct stock ownership, even their 3 percent stands to be reduced when new options are granted. In fact, every new option issued also stands to dilute any existing options employees still own. So while the run rate replenishes an employee's ownership stake, it simultaneously waters it down as well. This adds further incentive for employees to strive to create extra value and increase the size of the pie for all stakeholders.

It's also clear that dilution isn't the same as the cumulative run rate. In the last chapter, we saw that the High Tech 100's run rate averaged 8 percent a year between 1997 and 2001. Yet shareholders in 2000 faced only a 16 percentage point dilution, not the 40 points you might expect if they gave away 8 percent a year for five years. You can't measure dilution simply by adding up how many options a company hands out every year. If that were the case, a company with a 10 percent run rate would transfer its entire ownership to employees after ten years. This doesn't happen because employees typically sell the stock they get from exercising their options. Since these shares are sold in the public market, they revert to outside shareholders again. As a result, annual option grants continually dilute outside shareholders, but the total dilution—and employees' collective ownership of the company—is kept largely in check.

The 16-point loss is thus a snapshot of the potential dilution outside shareholders faced as of 2000. It doesn't tell you how much their ownership already had been diluted in prior years. Nor does it tell you how much value they gained as an indirect result of that dilution. In addition, the number doesn't completely predict how much dilution shareholders actually will experience in the future. The 16 points may be lifted up or down by exchanges, regrantings, and repricings. It also may be altered by a lousy stock market, which could render some options worthless by the time their expiration date arrives. Still, this is about the best way possible to get a ballpark idea of how much ownership high-tech firms have promised to transfer from outside stockholders to their employees.

Now that we know at least roughly how much potential dilution high-tech shareholders accepted, we can begin to think more clearly about what they stood to get in return—and whether it was worth it. The first point to keep in mind is that options cost shareholders nothing if the company's stock price falls below the option's exercise price. Other stockholders are worse off due to the falling value of their shares, but the unused options don't alter their plight one way or another. This is just what happened to many high-tech and Internet firms after the market crash. Most employees lost much of the value of their options, so shareholders weren't diluted and won't be unless their company's stock price recovers.

If stock prices do rise, however, companies get numerous benefits that help to offset the dilution their shareholders face. One is a break on federal taxes. Typically, when an employee exercises an option, the tax code allows the company to deduct the "spread," which is the difference between the exercise price at which workers bought the stock and the market price at which they sold it. This can be a whopping number. For example, Microsoft racked up a $2.1 billion tax benefit from options in 2000, according to one estimate, while Cisco took $1.4 billion and Dell and Intel got roughly $900 million apiece.

The company gets the tax deduction even though it didn't actually spend any money to provide the option. The reasoning goes something like this: If the company wanted to replace those shares, it would have to go into the market and pay the going price. So it has given that much value to employees, a value the government treats as compensation. (We don't believe that it's accurate to think of options as compensation for labor performed; instead, it represents capital income that workers receive for sharing the risk of property ownership. But we'll leave that discussion for later on.)

Employers get to deduct the wages they pay their workers from the corporate tax bill, and they receive a similar deduction for the money employees get from their options. The result is that the company gets a nice tax subsidy from the feds for options. The tax break is no greater than the amount the employer would get if it had paid employees the same sum in wages. But of course, by using options the company didn't have to part with actual cash to get the tax savings.

The same thinking, however, doesn't carry over to the way a company reports its earnings to the public. Some critics of options see this inconsistency as allowing executives to dress up a company's image. Even though employers get a tax break for the cost of an option, they don't have to treat that very same option as an expense when it comes to reporting their profits to shareholders. Say Cisco gives its employees options worth 10 percent of its total outstanding stock this year. Now it's the end of the year and Cisco issues its annual report, telling stockholders how much money the company earned. Instead of calculating its profits by subtracting an estimate of the value of the 10 percent that employees stand to earn if they exercise their options down the road, Cisco can simply state the total profit figure as if the options never existed.

The critics say this allows companies to hide the true cost of employee options from their outside shareholders. While Cisco doesn't spend any actual cash to issue the option, it has given the employee something of value. In addition, many companies do wind up spending their profits after an option is exercised, in order to offset the dilution that occurs. This group holds that options should be treated at a real expense by the company, which should subtract their cost from its profits. Supporters, however, argue that the true impact of options is measured by the share dilution they bring. Companies already are required to report their earnings as diluted by options, they say, which is good enough.

The critics say it's a double standard to treat options as an expense for tax purposes but not for earnings reports. It can also be deceptive to shareholders, they argue. In 1997, Microsoft became one of the first companies to tell shareholders how much options might slice off the company's bottom line, although it did so only in a footnote. The answer was a lot: 17 percent to be exact, at least that year. Microsoft said that calculated the traditional way, it had earned \$3.43 a share in the twelve months ending in June 1996. However, its profits fell to \$2.85 once its estimate of the cost of employee options was included.

Microsoft acted because a few years earlier, the Financial Accounting Standards Board had tried to force all companies to treat options as an expense when calculating their profits. But the board had run into a flurry of protest and ultimately backed off. As a compromise, FASB required companies to report their option expenses in a footnote, which even today, after options have become so widespread, is all they must do. Microsoft hadn't changed its mind about the FASB effort, which it had opposed. But "we do recognize that options have a cost," Greg Maffei, Microsoft's chief financial officer, said at the time.

In 2001, the collapse of Enron Corporation drew attention to the issue all over again. Critics pointed out that Enron had received a large tax break for the options it gave to executives and other employees, which was part of the reason it paid no federal taxes between 1996 and 2000. The ensuing outcry triggered a great debate in Congress the following year about whether to get FASB to draw up new rules requiring companies to knock option costs off their profits. Critics such as Federal Reserve Board chairman Alan Greenspan began to push the idea. Earnings grew by 12 percent a year among the S&P 500 between 1995 and 2000, a figure that would have been slashed to 9.4 percent if companies had expensed their stock options, he said, citing internal Fed research.

In the summer of 2002, Senator Carl Levin, a Michigan Democrat, tried to get an amendment passed in Congress that would require companies to treat options as an expense. After it was blocked, he vowed to introduce the idea as a stand-alone bill in the fall. He won support from others, including Senate Majority Leader Tom Daschle, a Democrat. Several companies decided to get on board, too. The Coca-Cola Company, the Washington Post Company, Bank One, General Electric, General Motors, and Citigroup all announced that summer that they would begin counting options as an expense against profits. Even Amazon, which relies much more on options than those companies, said it would start expensing them.

Once you set aside the tax issues, however, the primary benefit options bring to companies is a motivated workforce. As we keep saying, giving workers an incentive to think like owners can be valuable to shareholders if it helps to make the firm more productive.

Initially, most high-tech companies threw options at employees not to make them more productive, but just to get them in the door. Very quickly, options became the norm and high-tech firms found that they couldn't hire anyone without an option grant, even if they had wanted to. "Silicon Valley is now twenty years into it, so everybody expects" options, said BEA Systems chairman Bill Coleman. "In a high-growth industry, the options are imperative. You are only high growth if you can hire the great people. You can only hire the best people if you are giving them not only the challenge and the opportunities, but the ability to benefit from the growth."

Still, options work as a long-run strategy only if they cause the company to grow fast enough to support a reasonable run rate. If options are not an ongoing part of the picture, employees may slip into a "What have you done for me lately" mindset.

At a more conceptual level, partnership capitalism is an attempt to address one of the great mysteries of economics: Where do productivity advances come from? To economists, productivity means how much someone can produce by working for some unit of time, usually an hour or a day. Increases in productivity are the key to higher living standards in industrialized countries. The more value each person can produce in an hour, the more wealth there will be in the economy. If productivity grows faster, the economy has more goods and services to offer. If it slows or falls, so, over time, will consumption and living standards.

The same holds true for individual companies. If stock option capitalism helps firms to boost their productivity and profitability and, ultimately, the value of their shares, the options will pay for themselves, even over and above the recruitment and retention value they bring.

Economists have never really been able to pinpoint the precise causes of productivity growth. For decades, they focused mostly on capital investment, which helps companies buy the new equipment that makes it possible for the same number of workers to produce more in an hour or day. Investment also funds the research and development needed to come up with advances in technology that achieve the same purpose. But as the economy began to shift away from manufacturing toward services, economists began to consider the role of human capital as well.

Today, 80 percent of the U. S. workforce is involved in nonmanufacturing activities that depend as much on human knowledge as on the equipment workers use. As a result, economists are no longer so confident that they know the precise causes of productivity growth. "Knowledge is not like a stock of ore waiting to be mined," wrote Zvi Griliches, a leading productivity expert and Harvard University economist, in a 1994 article on the subject. "It is an assortment of information in continuous flux . . . . It takes effort . . . to access, retrieve, and adapt to one's own use."

In fact, in most modern theories of how economies work, a good portion of productivity gains are simply assumed to happen. Economists have been unable to define with absolute clarity the conditions that bring about the breakthrough technologies or work methods that lead to higher productivity. They know some advances come from inventions, such as the light bulb, the personal computer, and so on. Others come from a critical examination of current production methods, leading to innovative changes that promise to wring more goods or services out of an hour's work.

But why such advances happen when they do is less clear. Inventions and innovations are the deus ex machina of economic productivity theory. They're what economists call "exogenous" or outside, factors, meaning they're not something for which they can specify the cause. Although economists do discuss how factors such as market structures can enhance or retard innovation, they can't predict when these things are going to happen. Sometimes they occur more frequently, sometimes less so.

Partnership capitalism is an effort to sidestep the unresolved questions about the sources of productivity improvements. While the partnership approach doesn't exactly answer those questions, either, it does rely on the assumption that changes in employee behavior can be a key cause. High-tech companies certainly haven't come up with a way to guarantee the invention of the steam engine, the assembly line, or the next Internet. But the atmosphere of employee ownership they have cultivated improves the conditions in which inventions and innovations are most likely to occur.

How? By encouraging employees to put their minds to work. Scientists and researchers need to be motivated to strive for the inventions. Similarly, innovations in the workplace, which often come from those directly involved in producing a good or service, require a collection of people sharing common attitudes toward group goals. The financial incentives options bring are designed to spur individual employees to work together, so that the social bonds among them encourage everyone to work harder or smarter on the job every day.

If the options culture works properly, it spurs workers to produce more in a day's work, bringing gains for employees and outside investors alike. "There is a tradeoff between dilution of the shareholders and wealth creation," explained Vivek Ragavan, the former CEO of Redback Networks. "I come up on the side of more dilution, because ultimately it creates more value. The more equitably options are distributed among the company's employees, the better, because it helps to grow the company fast, to create faster cycles of innovation, to create more new compelling products. So the dilution is drowned out by the value created."

Other executives express similar views. Richard Tavan, the then executive vice president for Engineering at Tibco Software, explained to us how he thinks about this issue in a 2001 interview.

> We're creating a company in which human resources are key, in which innovation is our lifeblood. The physical barriers to entry in the software industry are very low. Anybody can put together a team of programmers and write a piece of software. Our advantage is in the experience that our employees build up working with us, their ability to make the thousands of decisions. Programmers make a lot more decisions than assembly line workers. For programmers, every line of code is a decision. You want to make sure that they make every one of those decisions in a way that's going to further the objectives of the company.
>
> There is no way management can control that directly, so you just have to create an environment where people are learning all the time . . . and a culture where everyone feels a sense of ownership. An engineer gets out of a meeting and he walks off in a snit and he sits down in his cubicle to write a piece of code, if he is sitting there fuming at the boss, chances are he is not going to be doing the best programming that he

> might otherwise be capable of doing. If that ends up in a bug being delivered to a customer in an obscure situation a year later the customer is going to be upset and it's going to reflect negatively on our company.

Many high-tech founders believe firmly that options pay back more than they cost. "When you start a company, you own 100 percent of this pie, which consists of zero at that point," says Naveen Jain, the Infospace CEO. "If you can somehow have ten other people who believe it is their pie and they want to make their small section of it be bigger, that means you're going to have an even bigger pie. So [granting options] is a very selfish thing to do. If my employees work hard for themselves, they are really working hard for me."

The same logic, Jain argued, applies to outside shareholders as well, who prosper when the company they own goes well. "For the company to be successful, everybody has to think they own that piece of pie, and that they are trying to make a big pie out of it."

Still, it's possible that the option incentive will create extra productivity, but not enough to offset the dilution it entails. One famous statement of this view comes from Warren Buffett, the chairman of Berkshire Hathaway Incorporated and one of America's most successful investors. Buffett once called options a "royalty on the passage of time." In other words, if a company's stock price improves, employees get wealth from their options even if they do nothing to earn it. His notion is that options give employees a free ride, since the stock market has generally gone up (even after you factor in all the down periods like the most recent slump). Employees get wealth not for investing capital as other shareholders do, but simply because they happen to be employed at a company that offers options.

Buffett fired off a related criticism in early 2002. In a letter to Berkshire shareholders, he said that options don't require their holders to take as much responsibility for their decisions as direct stock ownership does. He described a firm Berkshire had acquired the year before in which fifty-five executives and managers had put up $100,000 each to buy part of the company. "As they would not be if they had options, all of these managers are true owners," Buffett wrote. "They face the downside of decisions as well as the upside. They incur a cost of capital. And they can't 'reprice' their stakes: What they paid is what they live with."

While Buffett frequently is quoted as a critic of options, he mostly seems concerned with executive options. It's not entirely clear if he holds the same views about partnership capitalism, which extends options to most or all workers. In 1985, long before the high-tech option culture became widespread, he wrote about employee options in his annual letter to shareholders. He said: "I want to emphasize that some managers whom I admire enormously—and whose operating records are far better than mine—disagree with me regarding . . . options. They have built corporate cultures that work, and . . . options have been a tool that helped them. By their leadership and example, and by the use of options as incentives, these managers have taught their colleagues to think like owners. Such a culture is rare and when it exists should perhaps be left intact—despite inefficiencies and inequities that may infest the option program." Buffett may well have in mind the culture at Microsoft; his respect for Bill Gates, reportedly a personal friend, has been widely noted in the press.

The critique implicit in Buffett's negative view of options is powerful, but we believe ultimately unpersuasive. What Buffett misses is that employees aren't really getting something for free, at least not if options work as they're designed to do and the company builds a strong "think like an owner" culture. While workers don't part with financial capital to get their ownership stake, most do invest their human capital: their skills, their know-how, their teamwork, their willingness to participate in a demanding entrepreneurial work culture, or even just their plain hard work, as so many high-tech employees have done.

The valid aspect of Buffett's criticism is that public stockholders have no guarantees about how much extra productivity employees will bring about if they're granted options. But the problem is narrower than Buffett's statement assumes. To see why, imagine that a company's stock price would rise by 10 percent a year if it didn't issue options to employees. Now take the same company and assume that it does grant options, diluting public shareholders by, say, 8 percent a year (the average run rate of the High Tech 100.) For investors to come out ahead, employees generally must generate enough extra productivity gains to offset the 8 percent dilution, and still leave the company with a return that surpasses the 10 percent investors would have enjoyed if they hadn't gone the option route.

If the company's stock price improves only as much as it would have done anyway, then Buffett's criticism would be accurate. Employees would have gained option wealth without producing enough extra value to offset the dilution shareholders experienced. This is a real issue, and not a trivial one. But it by no means stands as a reason to reject the whole option approach. Instead, the potential gap between shareholder dilution and the extra productivity options can bring represents the portion of the risk investors assume under stock option capitalism.

For companies and their investors, the risk is that employees won't work any harder or smarter even if they get their options. If the stock nonetheless rises above employees' strike price, their options would be in the money and they would get the free ride Buffett worries about. In that case, investors would foot the option bill with diluted ownership. But if the incentive works, productivity rises more than it otherwise would have done, leading to greater profits and a higher stock price, at least in the long run. When that happens, stock option capitalism isn't a zero-sum game, since investors and workers both come out ahead.

Buffett's concern, that options provide investors with no guarantee of a payoff, is certainly valid. But that's true of any corporate investment. A company can overpay for an acquisition, or sink money into a new product that doesn't work or that no one wants to buy. Likewise, it can invest in a worker incentive program and get no return. However, this isn't a good reason to dismiss options as worthless, as long as the chance of the reward is commensurate with the risk involved.

Options are actually even better than many other investments, because they offer a greater measure of downside protection than usually is available. Why? Because unlike most investments, failure costs stockholders nothing since no dilution will occur if the stock price goes nowhere at all. Buffett is right if companies reprice or exchange their options, as many High Tech 100 companies indeed did. Aside from this, however, shareholders gain if options bring a higher stock price than would have occurred, but they lose nothing if the stock goes nowhere. So their only risk is the relatively narrow possibility that the stock will muddle along somewhere in between, giving workers a free ride. That's the nature of risk sharing. It's possible to shrink the risk to shareholders even more, as some investors want to do, by indexing options to a company's performance. For example, a company could grant options that only can be exercised if the firm's stock price beats the average share performance of the industry it's in, or of a broad market average. Of course, doing so would put more of the risk onto workers and lower the incentive effect options bring.

One big exception is a stock market bubble like the one high-tech and many other companies experienced in the late 1990s. Employees' creativity and hard work certainly played a major role in the birth and success of the Internet, which contributed greatly to the meteoric stock gains of the era. But even ardent supporters might be hard-pressed to argue that rank-and-file tech workers created an average of $300,000 each in extra value (the amount High Tech 100 workers got from cashing in options prior to the 2000 crash). In light of that $1 trillion investors lost when the bubble popped, workers' options winnings may seem excessive and at least partially undeserved in terms of how much economic value they likely created.

While we believe that some of this windfall was indeed excessive, it's also true that many investors made windfall profits as well during the stock market bubble. Remember that for every person who bought a share as prices rose, there was someone else on the other side of the transaction who made money by selling. Stock bubbles are like games of musical chairs: Everyone wins except those stuck holding the stock after the peak. The investors who raked in billions didn't deserve that money any more than employees.

One indication of this can be found in the track record of the High Tech 100. We saw in Chapter 4 that on average, their shares collapsed by 96 percent from the peak of the market in early 2000 to the end of July 2002. Fully 57 percent of these companies were trading below their IPO price as of that date, leaving most of their public shareholders with substantial losses. However, the other 43 percent were still ahead, even after all the air had gone out of the high-tech bubble. Eight of the companies, including Cisco and AOL, still boasted astounding returns of more than 1,000 percent since their IPOs. Many of the others still above their IPO prices posted returns of 100 to 500 percent over their lives as public companies. Despite the downturn, some investors clearly came out ahead, just as some workers did—assuming, of course, that they had the foresight to invest in the companies that would form the High Tech 100. (See Appendix B for their stock performance.)

Risk sharing in extreme situations like stock market bubbles is much messier than in a normal stock market environment. But it remains risk sharing nonetheless, with investors and workers both subject to gains and losses from the property they share.

Bubble aside, if we return to Buffett's passage-of-time statement, it's clear that it misses another aspect of how options distribute risk to both employees and investors in a normal stock market. If options function like they're supposed to, employees work smarter or harder. Yet just as investors can spend their ownership and suffer more in dilution than they win back in higher productivity, so can employees expend their human capital and get back nothing in return.

This can happen if their company's stock price doesn't rise above their strike price despite all their extra effort, as is bound to occur in some companies at least some of the time. After all, markets aren't perfect. Even when a company does well, its stocks can fall as part of an industry or market retreat. Employees also may find themselves working at a company with a lousy management. If the top officers make major strategic mistakes and the stock suffers, workers with options will lose out right along with other shareholders. In such cases, no amount of additional diligence on their part will make up for management's errors.

Workers take on risk individually as well. They may be highly motivated and work harder than they have ever done before. But their effort may be wasted if, for example, they have the misfortune to be thrown in with fellow employees who don't become motivated by their ownership, or simply aren't very talented.

The conclusion we reach is that partnership capitalism spreads both risks and rewards fairly evenly between shareholders and employees alike (particularly if companies don't reprice). For both groups, it's a little like the old saying, "You have to spend money to make money." Employees face relatively little risk if they just do their job the normal way and earn a standard wage. But if they work harder, and invest extra human capital in their firm, options may return them a measure of the extra wealth they helped to create. Stockholders face a complementary equation. Options entail a risk that a stockholder will surrender equity and receive little or even nothing in return. But they bring a promise of greater reward as well.

SAIC CEO Bob Beyster says he granted workers majority ownership of his company because he thought it was fair, but was surprised at what happened. "The crazy thing about it was, the more I gave the company away, the more money I made," said Beyster. "At one time, I had 20 percent of the company. Now I have 1.5 percent." (SAIC had a market value of about $6.7 billion in 2002.) "I don't know what would have happened if I had kept it all. But I do know that the more I parceled the stock out to people in the company, the more my own stock was worth. When I founded SAIC, I could have chosen to not make available as much equity to the employees. Had I done that, I am convinced that today I would own a much larger percentage of a far less valuable company." Today, SAIC's 41,000 employees own 79 percent of its stock.

Plenty of other high-tech founders feel the same way. For example, Chris Wheeler, the InterNAP Chief Technology Officer, owned 25 percent of the company when he cofounded it with colleagues in 1995. By the end of 2000, he owned just 3 percent and employees owned 16 percent. Why did he go along with such dilution? "Here in Seattle it all centers around Microsoft," he told us in mid-2001. "Microsoft was a great example for us. They got great people and those people worked like crazy, twenty-four hours a day. We thought that this sharing-the-ownership issue was a gigantic piece of why people did that. People we knew who worked there felt like they were part of the company, like they were making a difference, and the company actually rewarded you for making that difference. So we looked at ourselves and said, 'We want the employee ownership of this company to be as large as it possibly can be."

Still, if options make sense for investors when employees produce more than they otherwise would, that leaves the question of whether this in fact actually happened with the High Tech 100. Put it another way, would investors have fared any differently if the companies had not diluted shareholders by handing out so many employee stock options? There's no way to answer with ironclad certainty, since no one can repeat history to see what would have happened absent options. However, there are several clues that suggest that the answer is yes for many of the companies and their investors.

One very broad answer is that many of the High Tech 100, or maybe even most, might not even have existed without such financial incentives. We already discussed how the Internet industry was born amid intense competition for the kind of talent these firms needed. Many of the firms very well may not have been able to hire or retain competent people in such a labor market. Many of the breakthrough ideas might not even have happened if these mostly startup firms hadn't been able to use options to lure some of the most innovative employees away from more established companies.

Another perspective comes from the dozen or so high-tech CEOs and top officers we spoke with about the issue. Most of them remain convinced that options more than paid for themselves. Since most were major stockholders, and usually the founders to boot, they personally would bear much of the financial loss if they were wrong. Also, high-tech CEOs continued to pass out options after the market crash, suggesting that even such an extreme test didn't shake their faith in the partnership approach.

There's also some evidence that Wall Street went along with the theory of options. After all, few high-tech firms encountered a wave of investor complaints about the practice, even after their stocks plunged by 90 percent.

Some critics argued that the entire industry gave away far too much equity to workers, and that the excessive dilution ultimately led to the 2000 crash, or at least exacerbated it. To test this hypothesis, we did numerous statistical analyses of the relationship between the size of option grants and the stock performance of the High Tech 100.

We found no correlations to support the hypothesis. The stock prices of those firms that had been the most generous with options didn't do any worse in the crash than their stingier rivals. Their fall was no greater from the top of the market in March of 2000 to its first bottom in September of 2001. What's more, the shares of the firms that handed out more options actually rebounded more quickly in the initial recovery that had taken place by the end of January 2002. We found that for every 1 percent increase in option ownership by employees, there was about a 3-percentage-point higher rebound in the stock price from that September to January of 2002. Similarly, the High Tech 100 firms with the most total employee equity, from both stock options and direct stock ownership, also had a better rebound.

The implication: Excessive options played no role in the bursting of the high-tech bubble, at least not among the top hundred companies in the sector of the industry focused on the Internet. The findings also suggest that it made sense for High Tech 100 companies to keep partnership capitalism going through the bust, and that it would have been self-defeating to abandon the idea when trouble came along.

These data suggest that stock options may have helped—and certainly didn't hurt—the performance and survival of the High Tech 100. Nonetheless, these companies can't tell us definitively whether options are a net plus for shareholders or not. Most of them simply haven't been around long enough to compile a track record that would satisfy a rigorous economist. In addition, there's no control group: They all use options, so there's no way to get an objective comparison with similar firms that chose more traditional ways of recruiting and compensating workers.

Instead, the most compelling evidence that shareholders gain over the long term from employee ownership through options comes from corporate America itself. High-tech and other traditional firms have used options for several decades, most just for top executives, but some of them for all or almost all of their employees. Other companies have embraced employee ownership through ESOPs, as well as profit sharing and similar financial incentives.

In addition, since at least the late 1970s, U.S. companies have experimented with just about every workplace innovation used by the high-tech firms, as well as many others, including teamwork systems; the Japanese notion of *kaizen,* or continuous improvement; "horizontal" (that is, more equal) management; employee participation in decisionmaking; and quality circles.

As we'll see in the next chapter, economists and academics have raked over every one of these efforts, and come to the conclusion that in general, they all pay off if done properly. Not for every firm that has ever tried one, and not in every year. But on average, over the years, numerous studies have shown that every form of shared ownership has added to the corporate bottom line in a multitude of ways.

7
The Evidence that Shareholders Come Out Ahead

The High Tech 100 didn't come up with the idea that sharing ownership with employees might be a good way to stimulate greater productivity. For more than a century, major corporations have been experimenting with a variety of such plans, including stock options, profit sharing, and direct employee ownership of stock through ESOPs, 401(k)s, and stock purchase plans. Many employers also have embraced nonhierarchical workplace themes designed to encourage employees to think and act like owners, such as bottom-up decisionmaking, teamwork, and fewer levels of management. These are often summed up by terms such as employee participation, employee involvement, or high-performance work systems.

The High Tech 100's signature contribution has been to fuse all of these elements together and attempt to make them the norm across an entire industry. We came up with the phrase partnership, or stock option, capitalism to get across the idea that there is more at work here than options alone. A new form of capitalism, and of the corporation, has been created by the combination of financial ownership for a broad group of workers and far-reaching changes in workplace culture.

But does this new corporate form really make sense for corporate America? In the last chapter, we explained how partnership capitalism can pay off for companies and investors over the long term if they gain enough added productivity to offset the dilution of shareholders' ownership that stock options entail. But is there any tangible evidence that companies do in fact enjoy such gains?

Our answer is that such evidence exists in abundance, even though we can't prove it with companies as new as the High Tech 100. Instead, the proof lies in the rich history of sharing the risks and rewards of ownership at traditional companies, which has existed in various forms in the United States for more than 200 years. Stock options are one of the newest forms, but as we'll see in more detail in the next chapter, most companies have reserved them for the corporate elite.

Even setting aside stock options, though, employers today share ownership with workers at nearly 12,000 U.S. companies that offer their employees shares through one or more of these plans. All told, they covered about 24 million workers in 2002, or 23 percent of the workforce. Employees owned a majority of their company in nearly a fifth of these firms, and 31 to 50 percent in another third of them. Nearly 70 percent of the 24 million employee owners work in large public companies, where they typically own less than 5 percent of the stock. However, those with stakes above 5 percent owned an average of 12 percent of the stock. The other 7 million or so work at some 9,000 private companies, mostly smaller ones. (See Appendix C for a more detailed picture of employee ownership in America.)

In the past twenty-five years, researchers have done more than seventy empirical studies of these forms of risk sharing. Taken together, the studies provide compelling evidence for the net gain that the partnership approach can produce for a company's public shareholders.

This is a pivotal point of the book. We believe that the high-tech approach of bundling together a range of different risk-sharing ideas, with stock options at the core, is a worthwhile investment for many traditional companies and their shareholders, no matter what industry they're in. We will show that on average, over many years, each one of the ideas the High Tech 100 pulled together clearly has boosted corporate performance in traditional companies—even after dilution is taken into account.

The three of us have been studying and writing about various forms of employee ownership and profit sharing for most of our professional careers. The two academics among us have written numerous books and articles on most of the elements of partnership capitalism. For example, in 1988, Blasi surveyed everything he could find on the subject in a book called *Employee Ownership: Revolution or Ripoff?* In 1991, he and Kruse wrote *The New Owners,* which documented the emergence of widespread employee ownership through ESOPs, 401(k)s, and profit-sharing plans. In a 1993 book called *Profit Sharing, Does It Make a Difference*?, Kruse analyzed all the studies others had done on profit sharing up until then, and added new evidence. In 1995, we surveyed the literature on ESOPs for the National Bureau of Economic Research, which we then did again in 2001.

For this book, we did a similar survey of all the major studies we could find on the four key aspects of partnership capitalism: direct employee stock ownership, profit sharing, broad-based stock options, and employee participation. The studies look at how each one affects measures of corporate performance such as productivity, profit margins, return on assets, and return on equity. In addition, we looked at studies that tried to analyze the combination of financial ownership and cultural changes.

The results surprised even us, not because they were positive, but because they were so extensive and so uniform. We had read most of the studies when they came out, and of course we had done a fair number of them ourselves. But no one, including the three of us, ever has taken the time to stand back and synthesize all the findings gathered over the years. When we did so for this book, it became clear that more than enough evidence now has accumulated to draw firm judgments about the economic effects of employee ownership.

The most striking conclusion: Every major study found that investors come out ahead if their company adopted key elements of partnership capitalism. Not one found a negative result in terms of the total returns shareholders experienced. In fact, when you look at the major studies of stockholder returns, none even found that investors simply break even by investing in a basket of companies that adopted these approaches to employee ownership. All showed that public shareholders came out ahead. Of course, not every single company profits when it pursues one or more of these ideas. Studies look at averages, and by definition some companies are above the average and some below it. Still, it's clear that on average, the various approaches to employee ownership produced strongly positive results for shareholders.

So how big are the gains to investors? While each study found somewhat different results, they all came within more or less the same broad range. We added up all the conclusions and averaged them into a single finding for each of the four elements. Roughly speaking, we found that the partnership approach improves a company's productivity level by about 4 percentage points, compared to firms that don't adopt such practices. Total shareholder returns increase by some 2 percentage points relative to other firms. Profit levels—as measured by return on assets, return on equity, and profit margins—jump by about 14 percent.

It's important to be clear about the difference between higher levels and higher rates of growth. The studies we looked at found that productivity, profits, and shareholder returns get a one-time bump up to a higher level. In other words, if a company's productivity is one hundred units of goods or services an hour, partnership capitalism would bump that up to a hundred and four. It doesn't mean that the company's productivity growth rate would improve from say, 3 percent a year to 7 percent a year and remain at the higher level, which would be unrealistic.

Similarly, if a company's total shareholder return averaged 10 percent a year without employee ownership, it came in 2 points higher, at 12 percent a year, with it. The higher levels, not a higher annual rate of increase, are sustained indefinitely. So a company that creates a successful culture of risk sharing will lift its productivity and profits, and keep it at the higher level. It's a one-time gain, but a permanent one as long as the risk-sharing system remains in place.

There's another important point to keep in mind here as well. The gains in profits and returns came after the dilution borne by outside shareholders has been factored in. On average, we estimate that the companies in all these studies granted roughly 8 percent of their shares to employees. These shares are counted in each company's total, along with all the shares held by outside investors. So when a study examines how the company's stock price fared, for example, it's looking at the performance after this 8 percent dilution has occurred. In other words, the studies show that on average, companies and their investors made a profit on partnership approaches, including stock options, over and above any ownership they dished out to employees. They gave workers an 8 percent ownership stake, and in return enjoyed an average of a 2-percentage-point higher return on the diluted shares they still held.

TABLE 7.1 How Risk Sharing Pays Off for Companies and Their Shareholders

Performance Measure	Gain from Partnership Capitalism
Total shareholder returns	2 percentage points
Productivity	4 percentage points
Return on equity	14%
Return on assets	12%
Profit margins	11%
Average employee ownership	8%*

NOTES: *After dilution

Total shareholder returns include stock price appreciation and reinvested dividends.

Productivity is defined as output per employee in some studies and as value-added per employee in others.

Return on equity is defined as after-tax profits divided by the outstanding shares.

Return on assets is defined as pretax profits divided by a firm's assets.

Profit margins are income before extraordinary items, taxes, and depreciation, divided by total sales.

SOURCE: Authors' analysis of more than seventy empirical studes.

These numbers are based on evidence gathered over the last several decades. However, similar experiments have gone on for much longer. To fully appreciate the context in which such ideas arose and just how solid the findings about them are, you need to understand the extensive history of partnership capitalism in the United States. The idea, broadly conceived, has a lengthy pedigree that actually predates modern capitalism, stretching back to seventeenth- and eighteenth-century America. Indeed, the underlying concept—sharing property ownership to produce greater economic wealth—has popped up in the most unexpected places in American history. For example, before the European settlers showed up, the Iroquois allocated land to clans who used it to jointly farm and hunt (although their notion of property as communal rather than individual provided a much different context).

Not long after, European settlers employed indentured servitude as a way to share economic uncertainty within the Western concept of individual private property. Indentured servitude today is usually seen as something akin to virtual slavery, which indeed the practice often degenerated into. Still, it also sometimes helped property owners in the New World to attract and motivate workers from Europe. Similarly, it allowed some workers a chance to escape feudal Europe and work toward a financial independence they could never achieve at home. American landowners shared some of the cost of the voyage across the Atlantic, as well as the value of their property, with people willing to come from Europe and work for a set period of time. Rather than today's wage and salary system, servants worked for food and lodging, plus in many cases capital assets such as tools, a share of the crop, or even plots of land they could get after being released from their contract. Like modern-day companies that share stock ownership with employees, property owners sometimes extended rough forms of profit sharing or a promise of partial ownership rights to workers in the hopes that the land would generate more value than it otherwise would.

Probably the purest form of risk sharing between capital and labor in America came on nineteenth-century whaling ships. Early in the 1800s, most whalers were small vessels that took short voyages. Each trip was organized as if both the ship's owner and all the crew were investors. No one got a wage, and all profits were split amongst owner and crew according to a set formula that gave each person a share called a "lay." The lay certainly isn't something that most Americans today would perceive as an equitable division of risk and reward. But the practice, at least in abstraction, represented a clear notion of owners and employees as partners. As such, it was a marked departure from the standard view of property owners as capitalists who hire workers for a fixed wage, even though the system often degenerated into the exploitation of sailors.

Another manifestation of the partnership approach came in the Homestead Act of 1862, which was an ambitious effort to use the power of government to stimulate widespread property ownership. The law, signed by President Abraham Lincoln, allowed men over twenty-one and women who headed a household to take legal ownership of any public land, up to 160 acres, after they had farmed it for five years. (However, native Americans largely were excluded.) While homesteading involved farming, a job far afield for most Americans today, the basic concept shared many similarities with modern-day stock options. Homesteaders could get property from sweat equity, that is, from the work they performed, rather than from any cash they paid. The right—or option—to obtain the property could only be exercised after a specified period of work. In other words, it vested over a certain number of years. Individuals could buy and sell both their option to the property, and the property itself, once they gained possession. The option was made available to a broad number of people, and individuals could accumulate several options over their lifetime.

The intent of homesteading (though not always the reality) was to extend property ownership to those who couldn't accumulate enough capital to purchase it on their own. The idea illustrates just how deeply the notion of widespread property ownership is embedded in the American psyche—and how the federal government time and again has acted to advance it. Homesteading represented a remarkable attempt at social engineering, and gave a wide range of Americans access to property ownership in an economy where farmland was a key source of capital wealth. By doing so, the government blurred the line between owners of capital and common workers, allowing the latter to share in some of the wealth that comes from owning a productive asset.

About the same time that (usually white) settlers were homesteading in the West, newly freed slaves adopted a very different form of property sharing during the Reconstruction era of the post–Civil War South. Sharecropping emerged after promises to extend land ownership to free blacks were abandoned by the government. The term "sharecropping" leaves a bad taste in the mouth today, conjuring up images of dirt-poor black farmers in thrall to abusive white owners. These connotations have much validity, since there was considerable racism and exploitation in many sharecropping relationships, which grew directly out of the slave system that preceded it. Still, the practice, at least in theory, had elements of broad-based risk sharing that are not widely recognized today.

Sharecropping evolved as a way for white landowners to cope with the uncertainties of farming amid the ruined economy of the defeated South. Landlords provided the land and all supplies, including food, a horse, a mule, and use of a house. In return, the worker supplied the labor, and agreed to hand over a quarter to a half of the crop to the landlord at the end of the season. The worker also promised to live up to the landlord's expectations and be open to advice. Every plantation owner had to worry about whether there would be a crop each year, as well as whether it would get harvested and what price the market would pay for it. Sharing crops split these risks between the owner and the workers even though these risks weren't fairly shared and sharecropping did little to lift up American blacks.

While we certainly don't endorse sharecropping or indentured servitude, they illustrate the repeated efforts America has made to create alternatives to the standard wage system. Neither represented true partnerships between capital and labor, and in practice both caused extensive suffering. But to the degree that the idea can be separated from the practice, they and homesteading can be seen as attempts to spread the fruits of property ownership among many people as a way of coping with economic uncertainty. One goal was to entice employees to work harder and share in the risk of ownership so that the property could be used more efficiently, thus creating more wealth than the original owner could do alone.

By giving up partial rights to their property or profits, asset holders hoped to persuade workers to act like owners and take part in new labor markets, despite the tremendous uncertainty and risk involved for them. Owners also wanted to get the labor they were having trouble obtaining by just paying a wage, as well as more motivated workers. For their part, workers at least sometimes became stakeholders in a profit-making venture. They often gained access to capital that they couldn't afford simply by saving money from their wages. Some also got the right to a portion of the financial reward typically reserved for property owners.

In the end, whaling, indentured servitude, and sharecropping all failed as alternatives to the system of paying conventional wages. They did so in part because workers in those days largely lacked the power to defend their interests, and no authority did it for them. As a result, property owners took advantage of them, which ultimately caused each idea to collapse when workers found alternative ways to earn a living. Still, imperfect as they were, all of these experiments demonstrate the powerful incentive property owners have had to share ownership and risk with workers. They also show that Americans have tried numerous times to create alternatives to the standard practice of paying a wage for a day's work. All of these approaches involved an easing of the rigid definition of private property that has dominated Western political thought since the days of the philosopher John Locke.

Similar efforts have been tried time and again within modern capitalism. Throughout American history, some of capitalism's most illustrious stalwarts have preached, and practiced, the virtues of making employees part owners of the companies that employ them. Some of the earliest efforts involved sharing profits with employees. While not every profit-sharing plan gives workers actual stock ownership, they all divvy up its risks and rewards with them. Albert Gallatin, who was secretary of the Treasury when Thomas Jefferson was president, set up a profit-sharing plan in 1795 at a company he owned called the Pennsylvania Glass Works. Other businesses tried similar approaches throughout the 1800s, often involving a significant degree of ownership by workers. For example, starting in the late 1790s, small groups of skilled craft workers such as ironmongers and glassblowers set up firms they owned themselves. They did so to resist mounting efforts by entrepreneurs to organize skilled workers into factories and pay them low wages.

By the late 1800s, profit sharing and employee ownership were widespread in a variety of industries, including shoe making, furniture production, gas companies, and printing and publishing, including the *Boston Herald.* In 1886, John Bates Clark, a founder of the American Economics Association, wrote a book calling for widespread profit sharing and employee stock ownership because he believed such incentive plans improved business performance.

In 1882, Charles Pillsbury, founder of the baking company, began splitting profits with a quarter of his mill workers, an idea he later extended to half the workforce. Rand McNally, the mapmakers, shared profits with all of its workers starting in 1886. The following year, Robert Brookings, after whom the Brookings Institution is named, espoused widespread employee ownership as a way to increase efficiency. Colonel William Procter, a founder of Procter & Gamble Corporation, set up a profit-sharing plan at the soap maker the same year. In 1890, it gave workers stock in the company as their share of the profit. Even today, both ideas continue to play critical roles at the company.

In 1903, Lincoln Filene and his brother, Edward Albert Filene, who helped found the U.S. Chamber of Commerce, combined profit sharing and an employee council at Filene's Department Store in Boston to create a model that received a lot of attention in the press and led to much public discussion. Kodak started profit sharing in 1912 that gave workers corporate earnings in the form of stock, as did Sears in 1916. Both plans became famous for the wealth they brought to average workers.

About the same time, a few influential business leaders took the next step and began systematically to turn their employees into shareholders. In 1893, the 61,000 officers and employees of the Illinois Central Railroad were allowed to buy the company's stock on favorable terms. One traveling salesman, a man named King Gillette, was so taken by the general idea of cooperative wealth sharing that he wrote a book about it in the 1890s. When his views got no notice, he invented the safety razor to make money to promote the idea, or so he later claimed.

In 1900, the Pittsburgh Coal Company began selling stock to its employees, as did the National Biscuit Company and the First National Bank of Chicago the next year. Alfred DuPont, an heir of the chemicals company that still bears the family name, began a profit-sharing plan in 1909 that paid out stock to his workers. DuPont was also one of the first companies to use stock ownership to hold onto workers. In 1927, the company began giving employee shareholders a special bonus in stock if they were employed on February 25 of each year. DuPont believed that turning workers into owners would "gradually result in the elimination of the line between capital and labor."

In 1919, George Eastman became one of the first "high technology" moguls of his day to embrace employee ownership. That year, he offered more than 8 percent of Eastman Kodak's stock—from his personal holdings—to employees at a steeply discounted price. The reason he gave: to reward employees for developing the company and to encourage them to remain as employees. All those who had worked at the company for two years were eligible to buy in. By 1927, 15,000 workers—58 percent of Eastman Kodak's workforce—owned stock in the company.

Most of these early advocates pushed employee ownership as much for ideological reasons as for economic ones. Gallatin thought it would help to develop democracy in the United States. He introduced his profit-sharing plan by saying: "The democratic principle on which this nation was founded should not be restricted to the political process, but should be applied to the industrial operation as well."

Other proponents saw sharing the wealth as a way to tamp down worker unrest and head off unions, or even to inoculate America against socialism and communism. The United States experienced extensive labor unrest in the early 1900s, when labor unions doubled their share of the workforce. In response, hundreds of corporations cooked up all kinds of labor-friendly practices. They tried everything from employee stock ownership and profit sharing to private unemployment insurance, pensions, athletic facilities, worker councils, paid vacations, health insurance, mortgage assistance, and employee training. By 1914, the National Civic Federation, a reform group comprised of prominent business and community leaders, counted 2,500 firms pursuing one or another of these policies. In 1917, Charles W. Eliot, who had been Harvard University's president for forty years until 1909, wrote a forceful article advocating profit sharing as well as the sale of company stock to workers at reduced rates to make them owners. "Cooperative management," wrote Eliot, was needed to tie it all together.

Many of the country's largest companies set up employee ownership plans of one type or another in the hopes of buying industrial peace. In 1919, John D. Rockefeller Jr. formed a group called the Special Conference Committee, composed of executives from two of his former companies, Standard Oil of Indiana and Standard Oil of New Jersey, as well as from many of the industrial giants of the day: AT&T, Bethlehem Steel, DuPont, General Electric, General Motors, Goodyear, International Harvester, Irving National Bank, U.S. Rubber, and Westinghouse Electric. The goal was to come up with an approach to industrial relations that would unite labor and capital. "The only solidarity natural in industry is the solidarity which unites all those in the same business establishment," Rockefeller said.

The committee was chaired for many years by Clarence Hicks, Rockefeller's personnel manager from Standard Oil of New Jersey. Rockefeller adopted the committee's ideas, such as selling discounted stock to workers. Within ten years, employees owned about 4 percent each of Standard Oil Company of New Jersey, Standard Oil Company of California, and Standard Oil Company of Indiana, making workers the second largest shareholder block in each company.

Other companies on the committee also sold stock to the rank and file, who by the late 1920s owned about 6 percent of AT&T and 7 percent of Bethlehem Steel and of International Harvester. Employees owned 12 percent of Proctor & Gamble, a majority of the Philadelphia Rapid Transit Company, all of the Belmont Iron Works, and nearly all of the Fuller Brush Company. The General

Electric Company even organized a separate corporation, the General Electric Employees' Securities Corporation, which sold GE bonds to employees that paid 6 percent interest, plus an additional 2 percent if the employee held the bonds and stayed on the payroll. The company, an investment trust, was an early precursor to today's ESOP. GE's president, Gerard Swope, wrote articles endorsing widespread employee stock ownership.

Many business chiefs espoused employee ownership in other forums as well. Owen D. Young, GE's CEO in 1927, gave a speech at Harvard University that year in which he suggested that workers should buy into the American business system through stock purchases and create a peoples' capitalism. His views were one reason why the *New York Times* suggested him as a Democratic presidential nominee that year.

Still, despite all the big names, employee ownership never really spread beyond a thin layer of the leading companies in the early 1900s. In 1928, the Conference Board, a business group founded twelve years earlier, estimated that about 800,000 employees owned a billion dollars worth of stock in more than 300 companies. At the time, that represented about 1 percent of the stock market's total market value.

These efforts came to a crashing halt with the Great Depression. The stock market debacle of 1929 wiped out the value of many worker investments, underscoring the excessive risk workers bore when employee ownership was based almost entirely on the use of their savings to buy company stock.

Risk-sharing ideas resurfaced as the Depression wound down, only now the motivation of corporate leaders shifted from politics to economics. In 1939, Republican Senator Arthur Vandenberg sparked congressional interest by holding hearings on the subject. He concluded that profit sharing was associated with business success and "was essential to the ultimate maintenance of the capitalistic system." The evidence, he said, was too significant "to be ignored or deprecated."

World War II gave profit sharing a major, though unintentional, shot in the arm. To boost production during the war, the U. S. government slapped controls on prices and wages. But the caps didn't apply to benefits. The new rules also allowed companies with profits that exceeded certain limits to get a tax break if they shared some of their earnings with workers.

This kicked off an explosion in benefits of all kinds as companies and workers, patriotic though they might have been, looked for ways to skirt wage controls. Many companies set up profit-sharing plans in order to keep and attract workers at a time when the war made labor scarce. The tax breaks also prompted companies to expand stock bonus programs as well as stock ownership plans, mainly for salaried employees.

After the war ended, the prosperity of the 1950s and 1960s brought a boom in corporate profits, which further fueled the profit-sharing binge. Thousands of companies, large and small, set up such plans. Many of them functioned like savings or pension plans, by deferring the payout until retirement. Many also covered all employees, such as those at Sears, Procter & Gamble, and Harris Bank. Fisher Price provided up to 22 percent of its profits to employees, capped at 15 percent of their salary. Through profit sharing that often was distributed in company shares, employees became major shareholders at Safeway Stores, Standard Oil of California, and J.C. Penney.

Profit sharing reached its peak in the early 1980s, when a sixth of the 500 largest companies had such a program. Some plans gave workers significant economic rewards. However, others faltered because of insignificant amounts of profit sharing that were more symbolic than real, or because there was little or no attention paid to supporting cultural changes designed to create mutual interest between employers and workers.

At that point, federal policy and the economy intervened once more, effectively stalling a trend of nearly forty years. A few years earlier, in 1978, Congress had created the 401(k) plan as part of an overall move to use tax incentives for individuals to encourage more retirement saving. Little happened at first. The 401(k) allows workers to put pretax income into a retirement plan, with the company kicking in if it wishes. While many profit-sharing plans functioned like retirement plans, too, there was no significant tax penalty to a company if it did both. Many companies integrated their profit-sharing plans with 401(k) plans and made them dependent on worker savings.

However, in 1986 Congress enacted major tax reform to lift taxes and slow down the burgeoning federal deficit. The new rules set overall limits on how much a company could sock away for an employee in all types of retirement plans. As employees signed up for 401(k) plans and increased their pretax contributions, companies with existing profit-sharing plans began to bump up against the limits. Ever since, 401(k)s have been squeezing out most serious attempts at profit sharing. Many workers choose or are steered to buy their employers' stock as part of their 401(k), and companies often add even more by paying part or all of their match in the form of stock. As a result, employee ownership has expanded steadily. But it has become even more like a retirement plan than it was in most profit-sharing plans.

Meanwhile, in a parallel development after World War II, employee ownership also got a big boost from the advent of the ESOP. An investment banker named Louis Kelso set up the first one in 1953 at Peninsula Newspapers Incorporated, a California company. Kelso and the philosopher Mortimer Adler wrote *The Capitalist Manifesto*, a book about broad-based employee ownership. For years afterward, Kelso proselytized tirelessly for the idea, as did Russell Long, a powerful U. S. senator from Louisiana who played a key role in shaping retirement tax law from his lengthy perch as head of the Senate Finance Committee. The two of them were primarily responsible for convincing Congress about the merits of ESOPs. Congress passed the first laws to encourage them in 1974, and has passed more than a dozen changes since then.

While ESOPs can be structured in several ways, the basic concept involves workers obtaining their company's stock through a trust that management sets up. The company puts some of its shares in the trust, which sets up stock accounts for each employee. Employees usually build up stock ownership over a number of years, only taking possession of it when they retire or leave the firm. Some companies borrow the funds to buy the stock, so they can give it to employees immediately. The employer gets a tax break on the contributions it makes to the ESOP or on the payments it makes on the loan, if there is one. The idea, Kelso pointed out, was to let companies use debt as leverage to buy ownership for workers, just as they use loans to purchase machinery or assets that they repay from the profits produced.

Kelso and Long argued that ESOPs produce many economic benefits, as well as social and political ones. Ownership makes workers more committed to their jobs and their companies, they said, lifting productivity and profits. Such plans also lead to more equality in the workplace and eases tensions between workers and managers. (Union strife was once again a major national concern in the late 1960s and early 1970s, when Kelso and Long campaigned to get ESOP laws enacted.)

The number of ESOPs in the United States climbed steadily through the 1970s, then soared dramatically in the 1980s. During that decade, thousands of companies rushed to put stock in workers' hands to gain the tax breaks or to ward off takeovers by putting a big chunk of their ownership into the friendly hands of employees. Many also acted out of a conviction that employee-owners would give a boost to the bottom line.

The growth of ESOPs stalled out in the 1990s, in part because some companies had set up modest ESOPs without making any real commitment to creating a culture of ownership. As a result, they found the idea difficult to sustain. Employees also lost interest at companies that didn't set up ESOPs large enough to give them a meaningful financial stake.

At the same time, the threat of takeovers diminished among public companies, leaving CEOs less worried about creating a block of friendly stock. In 1992, the accounting profession also changed the rules for how public companies book ESOP purchases on their income statements. Because the new method made corporate income look smaller, it put downward pressure on an ESOP company's stock. So CEOs began to shy away from the idea. Some firms continued to use ESOPs to stave off bankruptcy, funding them with wage and benefit concessions. However, they represent a small percentage of all ESOPs.

ESOPs still flourish at privately held companies today. One big reason is the federal tax incentives they provide their founders and family owners, who can be excused from capital gains taxes if they sell more than 30 percent of the business to employees. The memberships of the country's two major ESOP groups, the ESOP Association and the National Center for Employee Ownership, increasingly are made up of such companies, which now often have a majority of their stock in the hands of employees.

Employee participation in managerial decisions doesn't have quite the pedigree that financial incentives do, but the idea still dates back nearly a century. In the 1920s and 1930s, some British companies looked for ways to boost productivity and quality by making work more meaningful and less repetitive. Several high-profile factory experiments attracted great interest.

The idea of involving employees in decisionmaking spread rapidly after World War II, in both Europe and the United States. The Germans took a top-down approach, setting up formal factory councils, or groups of elected worker representatives with which companies must consult by law. Companies there also must have employee representatives on their boards of directors. So-called works councils remain a key facet of German labor relations today and are found across much of Western Europe. In 2002, the European Union decided to establish similar councils at most of the companies of its member states in the coming years.

Teamwork, too, took off in the 1940s, initially in Britain, Sweden, and the United States. The idea has gone by many names and has taken various forms. Quality circles, for example, are usually groups of workers that meet to solve problems that crop up on the job. Cross-trained teams, often also called self-directed teams, typically means five or ten employees trained to do each other's jobs who often rotate through several jobs during the day. All the variations involve the basic concept of giving workers a greater say-so over the day-to-day tasks they perform on the job.

In the United States, labor relations experts extolled the virtues of worker participation starting in the 1950s. Within a decade, it was taught widely in business schools. Teams and other ways to empower workers got a further boost in the 1970s, when many U.S. factories fretted about job alienation among blue-collar workers. While many labor unions were skeptical at first, the competitive threat from Japan, which set up teamwork-run factories in the United States in the 1980s, spurred widespread imitation in the United .States.

Over the past two decades, much of corporate America has adopted some kind of teamwork or worker participation system. A majority of workers are involved in a group similar to a quality circle in roughly half of workplaces, while about a third of all workplaces have at least one self-directed work team somewhere in the organization, according to an analysis of Census Bureau data Blasi and Kruse published in 2000.

Although teams seem like an integral part of the corporate landscape in America today, they're actually not all that common. For instance, while a lot of workplaces have teams, only 12 percent of companies actually have a majority of their employees on one. Despite all the hype in the business community about high-performance work systems in recent years, most companies involve only a fraction of their workforces in most of these practices. In fact, only 1 to 2 percent make widespread use of multiple innovative work methods.

Because employee participation, as well as all the financial risk-sharing ideas, has been around for so long, economists and labor experts have had plenty of time to scrutinize them closely. Many of the studies they've done have focused on one specific form or another, largely because few companies have melded all these ideas together the way the High Tech 100 have done. Below we summarize the most important studies of each element separately, starting with options. We focus on those done in the past two decades, which tend to be more rigorous than ones done earlier in the 1900s.

Stock Options

There are only three significant studies of stock option plans that include most or all employees, largely because the idea only took hold in the past decade or so. Blasi and Kruse, along with Rutgers colleague James Sesil and Maya Kroumova of the New York Institute of Technology, published one in 2000 that examined 490 companies, in a variety of industries, that offered options to most or all of their employees. (No High Tech 100 firms were included.) They were sizeable companies, averaging $3 billion in sales with 14,000 workers. Nearly 90 percent had set up their plans after 1987. The study compared the firms to all public companies, except those few that also had broad-based option plans. It also compared each company to the next largest and the next smallest firm in its industry.

The result: The broad-based option companies performed better on a range of corporate measures. Between 1985 and 1987, and 1995 and 1997, their average productivity grew 6 percentage points faster than the companies with no employee option plans. It also climbed 7 percentage points faster than the productivity of the matching firms. Their return on assets increased more over the period, too: 16 percent more than all public companies, and 10 percent greater than the larger and smaller firms with which each had been matched.

The stock market returns of the companies with options for everyone were higher as well. Between 1992 and 1997, the years for which complete data existed, the broad-based option guys saw their average annual stock returns jump by 23 percent, versus 18 percent for all nonoption companies in the public stock market and 22 percent for the 500 largest public companies.

A follow-up study in 2002 by the same authors homed in on 229 "knowledge industry" companies out of the first sample, most of them in communications, high-tech manufacturing, pharmaceuticals, and computer software. It found that between 1985 and 1987, and 1995 and 1997, these companies' average productivity grew 20 percentage points more over the decade than the firms that had no broad-based option plans. They also posted higher stock market returns: The option firms gained an average of 26 percent a year between 1992 and 1997 (the period for which complete data exist), versus 23 percent for nonoption companies in the public stock market and about 17 percent for comparable "knowledge companies" among the 500 largest public companies.

Another study found that options pay off the most when they go to mid- and lower-level employees. It was done in 2001 by three professors at University of Pennsylvania's Wharton School of Business who are widely respected experts on compensation issues. They looked at 217 high-tech firms, 70 percent of which had gone public in the previous ten years and had median market capitalizations in 1999 of about $1.6 billion. (Although they didn't name the companies, some almost certainly are in our High Tech 100.)

Between 1998 and 1999, the companies that gave more options to employees posted higher-than-average returns to shareholders. By comparison, those that granted more options to top officers, including the CEO, vice presidents, and directors, did no better for their shareholders than the rest of the group. "The benefits to providing additional grants to mid-level employees can be greater than grants to executives," the study concluded. In other words, options create added value, but only if they go to many levels of employees.

Employee Stock Ownership

Because ESOPs have been embraced by so many mainstream corporations, they've been studied more closely than any other form of risk sharing. Many experts believe that employee ownership spurs workers to do a better job when combined with a participative culture. As a result, the most common question researchers have asked is whether ESOPs or similar plans have any effect on a company's productivity. Four times since 1995, two of us have reviewed the major ESOP studies (including several by us) done in prior decades that had focused specifically on the productivity question. The studies ranged in size from one that examined forty-five ESOPs to another that covered almost 2,000 in a wide variety of industries.

Our last effort was in 2001, at which point eleven such studies had been done. They all compared companies with ESOPs to similar non-ESOP firms, using common statistical methods to rule out as many distorting factors as possible, such as the size of the company, the industry it was in, or how capital intensive it was. They also looked at each company over time, to see what had happened to productivity before and after the ESOP was adopted. If you average the findings of the eleven, companies saw a 4.4 percent increase in productivity after they put in an ESOP.

Another study Blasi and Kruse coauthored in 1996 looked at how all forms of employee ownership, not just ESOPS, affected productivity between 1980 and 1990. We used data we had collected in our 1991 book on the subject, *The New Owners*, which documented the existence of a thousand employee ownership plans in public companies. The study compared all public companies in which employees owned more than 5 percent of the stock (there was data for the whole decade available for 562), to all other public firms with that much data (a total of 4,716). On average, employees held 13 percent of their company's stock. The result: The companies with 5 percent employee ownership enjoyed productivity growth that was 7 percentage points higher over the decade than that of all public companies (although the effect diminished as the employee stake grew).

Employee ownership seems to pay off in the stock market, too. After publishing *The New Owners,* we looked at the stock gains of those 562 companies with more than 5 percent employee ownership. Between 1980 and 1990, they had an average total return to their shareholders of 207 percent, compared to a 94 percent average for all other public companies. That translates into a 2-percentage-point annual edge. The effect was stronger in smaller companies.

Other analysts also have found that ESOPs correlate with higher stock prices. In 1999, for example, the consulting firm Hewitt Associates and an economist now at the Federal Reserve Bank of New York looked at data on 382 companies for two years before they set up ESOPs, and for four years afterward. The ESOP companies saw significantly faster growth in their average annual return on assets, compared to similar firms in the same industry. ESOP firms also enjoyed total shareholder returns of 26 percent over the four years, compared to 19 percent for their non-ESOP peers.

Similarly, a study Blasi and Kruse completed in 2000 with economist Margaret Blair of the Brookings Institution looked at the stock performance from 1984 to 1997 of all twenty-seven publicly traded companies that had at least 20 percent employee ownership in 1983. No matter how we sliced it, the employee ownership firms came out ahead of either the S&P 500 or forty-five matching firms comprising the next largest and next smallest companies in each industry.

We grouped the twenty-seven together as if they were holdings in a single mutual fund, weighting each one as an equal investment. They beat the average annual total shareholder return of the S&P 500 by 2.5 percentage points over the thirteen years, and the forty-five matching firms by about 2 percentage points. We got similar findings when we weighted the group according to each firm's market capitalization, and when we adjusted the returns for any greater risk they had compared to the S&P and the forty-five firms.

The employee ownership firms also proved to be more stable than other companies. Some 60 percent survived from 1983 to 1997, compared to 51 percent for the matching firms and only 38 percent of all public companies. None succumbed to bankruptcy, compared to 2 percent of the matched firms and 4 percent of all public companies. Some 37 percent of the employee ownership firms were acquired or merged, compared to 25 percent for the matching companies and 27 percent for all public companies.

We also did an analysis of ESOPs' effect on sales and employment growth. In 2001, two of us completed the most extensive examination yet done on the subject. We looked at all privately held ESOPS set up between 1988 and 1994 for which complete data was available (a total of 343 companies), comparing how the firms performed before and after the ESOPs were established. We also matched up each ESOP firm with a company of similar size in the same industry that had no ESOP.

The outcome: The employment of the firms that adopted an ESOP climbed 2.4 percent a year more rapidly in the subsequent three years, compared to those of the non-ESOP firms. Among those with sales data, per employee grew 2.3 percent a year faster, too, while their overall sales expanded 2.3 percent more rapidly. These might seem small at first glance, but they imply that a company would be about 25 percent larger after ten years with an ESOP than it would have been without one.

This isn't just true for the first few years after companies set up an ESOP. We compared all ESOPs at companies with more than fifty workers in 1988 to non-ESOP companies in the same industries and with similar workforce sizes. We found that both the sales and the sales per worker grew about 1.2 percent a year faster at the ESOP companies between 1983 and 1999.

The same study also suggested that ESOP companies even seem to survive better. It compared 1,200 privately held ESOPs that existed in 1988, most of them small businesses, to 1,200 matched non-ESOP firms of similar size and industries. Some 70 percent of the ESOP companies were still in business as of 1999, versus 55 percent of the non-ESOP companies. Of the companies that did disappear, the ESOP ones were less likely to have gone bankrupt. Only 35 percent of them vanished due to bankruptcy or a cessation of operations, versus 58 percent of the disappearing non-ESOP firms. (Presumably, the rest were acquired by another firm.)

Profit Sharing

Today, it's accepted wisdom among many prominent economists that profit sharing can lift a company's productivity. In 1984, Harvard University economist Martin Weitzman wrote a book called *The Share Economy,* which suggested that there might be important macroeconomic effects from profit sharing. In 1990, he and Kruse summarized the firm-level evidence on productivity for a book called *Paying for Productivity,* which was edited by Alan Blinder, the former vice chairman of the Federal Reserve Board.

In his 1993 book on the subject, Kruse examined twenty-six studies that had been done over the prior fifteen years. A majority of them concluded that splitting profits with workers did indeed improve a firm's productivity level, by an average of about 4 percentage points. However, cause and effect weren't clear, because most didn't try to look at companies before and after they had adopted profit-sharing plans. Kruse's book tackled the issue with new evidence, finding that the adoption of a profit-sharing scheme lifted a company's productivity level by an average of up to 5 percentage points.

Six years later, Kruse updated the survey, examining 34 studies, including all of the original twenty-six. The findings were similar:

Profit sharing brought productivity gains of about 4.5 percentage points.

A more recent study, in 2000, echoed those results. An economist from Tufts University and another from the Federal Reserve Board of New York looked at 760 randomly selected manufacturing worksites that had been surveyed in 1994 and again in 1997. They, too, found that the adoption of profit sharing heightened productivity, by an average of about 16 percent over that period.

Employee Participation

While the studies of financial incentives for workers to act like owners show unmistakable benefits to companies, none of them have been able to discern if it's really the incentive alone that does the trick. The reason: Some of the monetary reward schemes adopted by companies in recent decades have gone hand-in-hand with efforts to create a workplace culture of employee participation. So is it the prospect of extra money that motivates employees, or the new workplace culture that comes with employee participation efforts?

The answer, many experts say, is that both are necessary. Money talks, but employees can't think for themselves and make more creative contributions to productivity if companies don't alter the traditional, "I'm-the-boss, do-what-I-say" mentality so often found throughout corporate America.

At the same time, the reverse holds true as well. As Robert, the Tibco Software employee pointed out, telling employees to "take ownership" of their jobs rings hollow if management doesn't offer actual financial ownership or some share in the improved performance for which they are responsible. Without wealth sharing in some form, it feels like the company is just trying to con you into working harder.

Several studies have come to this conclusion. A 1995 book of the history of employee involvement called *Re-inventing the Workplace: How Both Business and Employees Can Win*, argued that sharing financial gains is a key element of participatory corporate cultures. It concluded that it's difficult to sustain effective participation if workers don't feel that they share the benefits of their extra efforts and commitment.

A 2000 study found much the same thing in one of the most thorough analyses ever done on the subject. Two economists randomly chose 193 manufacturing worksites and looked to see if innovations such as problem-solving groups and self-directed work teams had any effect on productivity. Those that used such ideas by themselves, with no financial rewards, showed no significant impact at all.

The following year, two economists looked at 433 worksites over a sixteen-year period and 660 more over nineteen years. They, too, found that high-performance work practices such as self-directed work teams, job rotation, cross-training, and problem-solving groups had no effect on productivity. But self-directed work teams contributed more to productivity when they were combined with profit sharing.

One of the few studies to look at the combined effect of both employee participation efforts and financial incentives came out in a 2001 book called *The HR Scorecard*. It examined 2,800 publicly traded corporations between 1992 and 1999 with sales above $5 million and more than 100 employees. It focused on those that had dramatically altered both their corporate cultures and their approach to pay. These were firms that carefully selected most new hires, trained them extensively, and involved almost half of them in self-directed work teams. The companies also paid above-average wages and tied more than 6 percent of workers' incentive pay to clear improvements in individual performance.

The results were stunning. The companies that did such a big overhaul increased their market value in the subsequent year by 24 percent. Their return on assets climbed by 25 percent, and their sales per employee by about 5 percent. Turnover was cut by about 8 percent. Firms that took a more modest approach show similar, but much less dramatic, results. "We find very powerful support for a relationship between a High-performance Work System and firm financial performance," the authors concluded.

Earlier studies found a similar pattern of synergy between participation and incentives. One of the earliest, done by the National

Center for Employee Ownership in 1986 and published in the Harvard Business Review, was also the first to show a specific causal link between employee participation and company performance. It examined forty-five ESOPs set up in 1981 or earlier, assessing their track records for five years before and after the ESOP was established. It also compared each company to about five similar non-ESOP firms in the same industry and geographic region.

First the study assessed the ESOP itself. It found that the sales of the companies that had set up ESOPs grew 3.5 percent a year faster than they had before it was established, while their employment climbed nearly 4 percent a year faster.

The study then ranked each company's culture of participation, based on an extensive survey the authors had conducted of both managers and workers at these firms. The companies were grouped into three categories. The ones with lots of participation saw their annual employment grow 8 percent faster than before the ESOP. Their annual sales grew 16 percent faster, and their sales per employee climbed 4 percent more rapidly. The midrange companies had 6 percent better employment growth, 5 percent faster sales growth, and 6 percent quicker productivity growth. The bottom group, companies that ignored participation altogether, showed a 4 percent annual decline in employment growth, a 16 percent annual decline in sales growth, and a 6 percent annual decline in productivity.

A year later, in 1987, the General Accounting Office, an arm of the U. S. Congress, shed even more light on the issue. It, too, did a before-and-after study of ESOPs, and also matched each one to similar non-ESOP companies in the same industry. The GAO collected data for six years on 110 firms that had set up ESOPs between 1976 and 1979, using information from corporate tax returns supplied by the IRS.

The agency found that just putting in an ESOP had little effect on profitability or productivity (although it also said that the sample of firms may have been too small to make a reliable judgment). However, when the ESOPs were coupled with various forms of participation, productivity grew by 52 percent in the year after the ESOP was set up, compared to the non-ESOP firms. "We found that the greater the degree of employee participation in corporate decisionmaking, the higher the rate of change in our measure of productivity between the pre-ESOP and the post-ESOP periods," the GAO concluded.

Four years later, in 1991, the National Option Research Center of the University of Chicago surveyed 727 employers. The center found better performance at companies that offered profit sharing or stock options and that also had invested in training their employees.

Perhaps the most unusual assessment of the whole subject came from a 2000 Harvard University study. Instead of looking at external criteria such as productivity or sales growth, the authors asked employees themselves about how the company and their fellow workers performed. The idea grew out of a national random survey of all American workers the authors had commissioned that had questioned 2,400 employees across the country in 1994 and 1995. This was more than enough to adequately sample the 70 million employees who comprised 70 percent of all private-sector workers at the time (excluding the self-employed and those at companies with just a handful of employees). It represented the most extensive analysis of American workers' attitudes toward the workplace in more than two decades.

The purpose of the broader project was to look at what workers wanted from their companies, a subject that was turned into a 1999 book called *What Workers Want*. The survey included an elaborate set of questions about participation, ownership, and pay. In 2000, one of the authors wrote up a separate analysis on this issue.

The survey asked employees about any participation efforts going on at their companies, as well as about employee ownership and any shared compensation plans, such as profit sharing. To get a measure of productivity gains, it also asked them how often they made productivity-related suggestions, and how often these suggestions were heeded by the management.

The companies with shared compensation had higher levels of this self-reported productivity than companies that just paid a regular wage or salary. Workers at these companies also said they were more satisfied with their jobs and more loyal to their employers.

However, firms with more employee participation ranked even higher on productivity, job satisfaction, and loyalty. Workers at the shared-compensation companies gave their colleagues higher marks on their concern for the success of the company and their willingness to take on new responsibilities and work hard than did workers at companies without shared compensation schemes.

The highest scores came at companies that combined shared compensation, participation, and employee ownership—in other words, something very much like what we call stock option capitalism (although some of the companies that do this used ESOPs and other ownership stakes instead of options). "The highest outcomes occur when firms combine three shared institutions: pay for company/group performance, ownership stake in the firm, and employee involvement committees," the study concluded. Echoing earlier findings, it also found that "the impact of (shared) compensation practices appears to be contingent on such decision making structures."

We pointed out earlier that employee participation isn't really all that widespread in the United States today. One reason may be that many companies have been unwilling to provide the financial incentives, such as stock options or other forms of employee ownership, that are required to make the idea work properly. Financial ownership for employees is much more limited than participation efforts. Yet ownership provides the motivation that spurs employees to throw themselves into teams or an entrepreneurial culture and actually make them pay off for the company.

This link came through clearly in the analysis of Census Bureau data we did in 2000. It showed a strong tie between higher pay and the more widespread use of various participation methods. In other words, the 1 to 2 percent of companies that involve most of their workers in teams and other participation efforts also pay them more for doing so. Other companies refuse to pay a lot more for the extra effort these ideas require to function correctly.

The conclusion we draw is that employee participation alone isn't enough. The tangible rewards of employee ownership or some form of sharing the fruits of ownership must go hand in hand with work practices that give workers greater decisionmaking. Where the two aren't paired, a company's productivity isn't likely to improve enough to make the effort worthwhile. The same holds true of the culture of the High Tech 100. Stock options give companies a way to compensate workers for accepting more demanding work systems that contribute to higher productivity—and therefore higher profits.

We hope by now we've convinced most readers that partnership capitalism benefits companies and their shareholders, as well as employees. By virtually any measure, companies that use any aspect of the partnership approach are better off. The studies we summarized give a range of outcomes, not a precise set of numbers like those in the table at the beginning of this chapter. Still, if you average all the results together and sum them up, as we did in that table, it gives a fairly good idea of the order-of-magnitude gain that investors stand to make if they pursue stock option capitalism. The conclusion: Shareholders come out ahead, whether you look at productivity, profits, or stock gains.

However, these findings present a challenge of another sort. Why hasn't the new approach swept across corporate America and become the norm at most companies? Sure, tax and accounting rules stymied profit sharing and ESOPs. But stock option plans like those adopted by so many high-tech firms don't face that problem. Nor do employee participation efforts.

If the substantial economic payoff from partnership capitalism is really as great as the studies show, why haven't corporate leaders been pursuing it? Why didn't other industries adopt it wholesale before high-tech? Surely, CEOs in every part of the economy are in the business of maximizing their company's profits. Why has corporate America basically ignored all these voluminous studies—particularly since they were done at many of these same traditional companies, not new-fangled high-tech ones that you might argue have atypical workforces?

We believe there are a number of complex reasons. All these studies were done largely by academics in a piecemeal fashion. Until now, no one really took the time to pull them all together and say: Hey, this stuff really works. As a result, no one has presented corporate America with the evidence. In addition, while many companies have tried both participation and financial incentives, separately or together, such efforts can be difficult to pull off. They involve a cultural transformation of the workplace that requires managers and executives to take a lot of risks.

However, it also seems that some basic human emotions have played a role. All too often, the CEOs and other top executives of corporate America have been unable to let go of the traditional, top-down power structures they have used, in one form or another, since capitalism began. Some of them also may have been driven by self-interest to avoid sharing the wealth with employees, the better to keep it for themselves.

At the same time, public shareholders, and the boards of directors whose putative duty it is to represent them, have let CEOs get away with such self-interest because they were distracted by two factors. As we'll see in the next chapter, one was the bull market of the late 1990s. The other was the superficially compelling justification CEOs have given for grabbing the wealth for themselves.

PART THREE

A New Corporate Model

8
Top-down Capitalism

What Would Have to Change in Corporate America

Most traditional companies are just as concerned as high-tech firms are about motivating employees and improving their efficiency. In a trend that spread quickly in the 1980s and became virtual dogma in the 1990s, corporate America, at least rhetorically, embraced much of the same philosophy expressed by the High Tech 100. Most CEOs today would readily volunteer that owners treat property better than renters. They're fully aware of the payoffs that stem from flattening rigid corporate hierarchies, setting up teams, and getting employees more involved in decisions. Many say that's what they're trying to achieve in their own companies. Employers routinely try to connote shared ownership by referring to their employees as "associates." They exhort their employees with phrases such as "act like an owner," "sense of ownership," "run it as if you own it," and "think like owners, not caretakers."

But for most companies outside the Internet and high-tech industries, the reality belies the rhetoric. As we saw in the last chapter, less than 2 percent of companies actually involve more than half of their employees in joint decisionmaking and back them up with the right approach to recruitment, training, incentives, and culture. They do little better when it comes to sharing ownership with workers. Many companies pay lip service to the idea, and quite a few also have an ESOP, profit sharing, or incentive plan of one sort or another. However, most of these either don't involve meaningful financial rewards or aren't integrated into a culture of employee participation.

What's more, the largest chunk of employee ownership in corporate America doesn't represent extra wealth that employees get on top of their regular wages and benefits, as is the case with most of the options granted by the High Tech 100. Instead, workers buy much of their stake with their own earnings. Consider the 24 million workers in the last chapter who own shares in the companies they work for. If we exclude stock options, the aggregate market value of all these shares came to roughly $400 billion, or about 5 percent of the total value of all publicly traded shares in the country.

However, we estimate that employees paid for about 64 percent of all this stock ownership themselves. This includes shares they bought through employee share purchase plans and company profit-sharing plans. Workers also used savings they diverted from other investments to buy employer shares through 401(k)s. Only the remaining 36 percent of the $400 billion represents true property sharing. Included here are company contributions to profit-sharing plans, ESOPs, and the matching stock that many companies contribute to their employees' 401(k) plans.

By contrast, executives have used the same justification—that ownership in the company spurs them to better performance—to lift their own pay to Olympian heights. Options, of course, have been the primary vehicle. As of 2000, the 1,500 largest public companies in the United States had issued about 12 billion options (both vested and unvested ones). The shares underlying these options had a market value of some $1.2 trillion at the end of that year (which had plunged to roughly $820 billion by August 2002). This comes to about 10 percent of the value of all outstanding shares in these companies, which themselves represent most of the value of all publicly traded shares in the United States.

Almost all of this fantastic wealth is held by the corporate elites. Roughly 30 percent of all options—some $400 billion worth in

2000—are in the hands of the top five executives. If they could have cashed them all in at the end of 2000, America's business leaders would have pocketed profits of some $80 billion. This is additional paper wealth they hold even after taking home profits of about $58 billion on options cashed in between 1992 and the end of 2000. Most of the remaining 70 percent is spread very narrowly among other executives and managers, who typically comprise less than 5 percent of traditional companies.

Except for a minority of firms that have embraced high-tech-style options for everyone, very little goes to average employees, whether they're blue-collar workers or white-collar and professional ones. Millions of workers hold options in public companies in the United States. However, most get a handful on one occasion, or are given a small symbolic grant every few years. We estimate that only about 6 percent of the country's 10,000 public companies offer most of their workers options on a regular annual basis. However, many of them are on the smaller side, so only 2 percent of the U.S. workforce, or 2 to 3 million employees, get options every year.

To put it another way, executives have grabbed 10 percent of the ownership of corporate America for themselves and a small group of top-tier managers, up from 5 percent in 1992 and virtually nothing a decade earlier. Very little of this goes to average workers, who also must buy the majority of their ownership with their own money.

Shareholders, and boards of directors, allowed companies to turn away from the employee ownership path many had set out on in the 1980s because it no longer seemed to matter in the 1990s. In the 1970s, U.S. productivity growth collapsed from around 3 percent a year to about half that. The resulting stagflation prompted CEOs to search for ways to reinvigorate their companies. The onslaught of globalization and other factors in the 1980s ratcheted up the pressure even more. Throughout the decade, many companies, led by large manufacturers, embraced employee involvement and participation as an answer. The crises also led some traditional companies to pursue ESOPs and other employee incentives in the 1980s and early 1990s.

But the booming economy of the late 1990s took the edge off these concerns. As productivity sprang back to near its preslump levels, U.S. factories regained their competitive edge against Japan and other global rivals. As a result, stockholders no longer felt a need to pressure CEOs into bold, creative action to increase company performance. Further, the stocks of traditional companies also shot up much faster than any rational investor could have expected. In a market that was jumping up at 30 percent a year, no one really cared whether the CEO was being greedy or not. After all, the amount he or she took out of the pot seemed very little compared to the total wealth the company generated for shareholders. The idea that there could be a better way, which had seemed so important in the tough times of the 1970s and 1980s, seemed irrelevant. The fact that employees were left out of the bargain got lost in the process as well.

The top-heavy approach that prevails today undermines corporate America's efforts to achieve the motivated workforce many companies claim to desire. Many corporate leaders want the higher productivity gains that an employee ownership mentality can bring. But they want it on the cheap, without having to pay for it with dilution that accompanies a true sharing of property and risk. Companies urge workers to act like owners, but when they refuse to make them actual owners the exhortations ring hollow. Instead of offering to share the pie as an enticement to hard work, too often the message at traditional companies is: "Treat this place like you own it, work like crazy, produce as much as you can—and here's your annual wage, plus maybe a small bonus if you do a bang-up job."

At the same time, most employers have failed to significantly alter the hierarchical pyramid of power that has characterized large companies for so long. Indeed, they've reinforced it by doling out huge amounts of corporate wealth to the upper crust of executives, widening the gap between those at the top and everyone else.

The justification many CEOs used for their wealth accumulation highlights the discrepancy. While many companies today still use the rhetoric about how employees are their most important asset, some CEOs have argued that they deserve the lion's share of employee options because they were responsible for the leaps in shareholder value during the bull market. Of course, few CEOs actually say, "My actions alone lifted the stock price, the employees had nothing to do with it." But that's the implicit rationale when they explain their option millions. They take the reward, leaving little for all the other employees, and then cite the stock gains as justification.

The financial press exacerbated the problem. With fawning stories about the glamorous lives and bold actions of individual CEOs, it fueled a cultlike worship of CEOs as all-powerful Masters of the Universe single-handedly capable of turning around huge corporations. The media wrote about how the management style of one CEO or the strategy of another turned red ink to black in one company and vaulted another to heights never before scaled. This encouraged the impression that the CEO alone makes the difference between a corporation's success and failure.

Many CEOs naturally fell into this flattering role, acting as if they and a relatively small group of other executives and managers are the only ones who matter in a company, or are motivated by corporate ownership. Human capital may provide a growing share of the value the U.S. economy creates every year, but in most companies it seems to be only the intellectual assets of a small number of people who count. The theory of aligning employee interests with those of outside shareholders holds for this group, but not for the broad rank and file.

The irony, of course, is that there's plenty of evidence that companies perform better when employees are owners, as we showed in the last chapter. However, there's very little proof that this holds true for the gargantuan ownership stakes executives have claimed.

To flesh out the stark difference between employee ownership in mainstream corporate America and high tech, we created an index of traditional public companies comparable to the High Tech 100. We call it the Corporate America 100. We constructed the index in much the same way we did the High Tech 100. We took a representative group of corporations listed on the New York Stock Exchange with market values that exceed $1.6 billion (the size of the smallest High Tech 100 firm in October 2000). We chose the hundred at random so they would be representative of corporate America as a whole. (These companies can be found in Appendix D.) Filings

TABLE 8.1 Corporate America's Top-heavy Wealth Sharing
(Average Ownership Stake* in the Corporate America 100 as of December 31, 2000, by Type of Owner)

	Corporate America 100 %	High Tech 100 %
Top five officers		
Stock	5	10
Options	3	4
Other executives and managers**		
Stock	—	—
Options	6	—
Total top tier	14	14
Employees***		
Stock	2	2
Options	***	17
Total employees	2	19
Total for both groups	16	33

NOTES: *Total potential ownership, i.e., the percent of all stock and options each group would have owned if all issued options had been exercised.

**Typically less than 5 percent of the company. Many undoubtedly own stock directly, but the SEC doesn't require companies to report it. Also, the High Tech 100 offer options to everyone and don't break out the holding of this group separately. So their assets are lumped in with those of employees.

***All other employees in the company

****Less than 1 percent

SOURCE: Authors' analysis of SEC filings.

from the SEC told us how much stock and options were held by executives and employees as of 2001. The comparison is shown in Table 8.1.

The broadest conclusion we draw from the table is that risk sharing in corporate America is barely over half what it is among the High Tech 100—and essentially stops at the upper management level. Look down at the totals in the bottom row. The average large company in the United States has granted 16 percent of its actual and potential ownership—that is, stock and options—to officers and employees, roughly half the 33 percent found in High Tech 100 firms.

Of that 16 percent, the top five corporate officers have 8 percent. Another 6 percent goes primarily to the company's lower-level executives, occasionally including some managers and professionals. However, this group typically constitutes less than 5 percent of the workforce, leaving just 2 percent to be split among the other 95 percent of employees.

Now contrast this with the High Tech 100. As we've said, their top-tier officers certainly aren't shy about rewarding themselves. They get the same 14 percent share as their Corporate America 100 counterparts. The figure would be even larger if we had been able to segregate the holding of the other high-tech executives and managers. However, high-tech companies typically don't have special option plans restricted to this group. Instead, their stake is lumped in with all the other workers in the firm.

Many high-tech CEOs may not be quite as open to criticism for their wealth taking as their counterparts in traditional corporations. Remember that a lot of these companies are new, so their executives often are still the founding officers. As a result, they're more likely to hold some of the assets they had when they set up the firm in the first place. So you'd expect them to hold bigger stakes than CEOs in corporate America, who are usually hired managers, not founders.

The big difference, though, is that high-tech executives are even more generous with average employees than they are with themselves. Their employees hold a 19 percent ownership stake. By comparison, Corporate America 100 officers give their workers just 2 percent. The small amount of direct stock ownership derives principally from ESOPs, 401(k)s, and employee share purchase plans. Except for the ESOP stock and employer matches in 401(k)s, employees bought most of this with their savings. Executives' shares, by contrast, come mostly through options, which represents wealth sharing on top of their regular salaries.

What's more, there's little evidence that average employees actually get much option ownership. Instead, much of their options are held by a small fraction of workers. Only 6 percent of the Corporate America 100 regularly give options to a majority of their workers the way the High Tech 100 do: 99 Cent Stores, Charles Schwab, Compaq Computers, Guidant, PepsiCo, and Wells Fargo. Even some of these provide relatively small numbers of options to lower-level employees. Another 5 percent have given options to most employees, but only on a one-time or occasional basis. Aetna, Conoco, Lexmark, and Sunoco fall into this category, as does AOL Time Warner since its merger, which has significantly watered down AOL's original partnership capitalism culture. Overall, corporate America doesn't even grant options worth 1 percent of its shares to regular workers.

The same pattern holds true if you look at the run rate. The Corporate America 100 devote about 2 percent of their shares to options every year, compared to 8 percent annually at High Tech 100 companies. But because CEOs at traditional companies are rarely the founders, they didn't start with a huge ownership stake. Instead, they typically take a large chunk of options for themselves every year, and give most of the rest to a narrow group of other leaders in the company. Of course, since this group can consist of hundreds or thousands of people in a very large company, the top five get hundreds or even thousands of times more options per person than the rest of the managerial ranks. For example, of all the options the Corporate America 100 granted in 2001, 27 percent went to the top five executives alone. Most of the rest went to the next few levels of management.

This is employee ownership for the bosses. Almost everyone else, including most middle managers and professionals, are left out. Of all the Corporate America 100, fully ninety-six offer an employee stock option plan. But only the six firms named above include most of their employees in their option plans.

(There is a widespread misperception that a greater number of large companies offer broad-based option plans. It stems in part from a 2001 survey done by William M. Mercer Company, a benefits consulting firm, that was widely quoted in the media as finding that 54 percent of the 350 largest U.S. corporations made most employees eligible to receive stock options. That's an accurate statement as far as it goes, but putting employees in an eligibility pool doesn't always assure that they will get to enjoy the benefit. The details of the study made clear that a broad group of employees actually only got options in about 5 percent of these companies, and some only get them over a two-year period at that. Moreover, many companies gave just one-time or occasional grants of a small number of shares to each employee, and then forgot about the whole thing. The average paper value of all these grants was insignificant, too, at just $2,000 per employee.)

To put traditional companies' employee ownership figures in perspective, we calculated them in dollar terms. As of August 2002, the 2 percent stock ownership of employees in the Corporate America 100 was worth an average of about $6,727 per worker. However, employees in about half of the companies owned no stock in their employers at all, in any form. So the true holdings of the other half actually was much larger than $6,727, perhaps as much as double.

At first glance, this seems to be a significant amount, since the average annual salary of the 3.5 million employees in these companies was about $40,000 in 1999. However, it's a lot less than you might think. Remember that employees bought a lot of this investment with their own cash, through 401(k)s and stock purchase plans. In addition, this $6,727 was largely accumulated over many years, because ESOPs, 401(k)s, and share purchase plans usually are set up to stretch out over time. So the sum represents long-term savings, most of which is locked up in plans that workers can't get at until they retire or leave the company. It's very different than high-tech-style option wealth that workers usually receive every year and cash out on an ongoing basis.

By contrast, executives in the Corporate America 100 have used employee ownership to enrich themselves to an ever-increasing degree. In 1980, the two highest-paid executives at a sampling of nearly 500 of the largest U.S. corporations earned an average of $1.35 million each, in today's dollars. Most of their pay came from a base salary, plus annual bonuses. Only about a fifth came from stock options. By 2001, their average total pay had multiplied to $11 million each, with 80 percent of the total coming from options. "Twenty years ago, CEOs made fifty times as much as the average worker," venture capitalist Arthur Rock told us in the midst of the corporate scandals of 2002. "Now they make 500-fold more. This is unconscionable."

You can see how this occurred by looking at how executive options paid off over the past decade. We calculated how much the top five executives at the largest 1,500 U.S. firms made from cashing in their options every year. Their collective annual winnings jumped from a total of $2.4 billion in 1992, when the first detailed data became available, to $18 billion in 2000, an increase of nearly 650 percent. Overall, the top five collected some $64 billion through 2001.

They got more, too. Bonuses and long-term incentive plans—which sometimes include stock grants—multiplied from a total of $1.6 billion in 1992 to $4.7 billion in 2000. Grants of restricted stock more than tripled, to $6 billion. In sum, executives granted themselves higher annual increases than workers in every form of compensation.

But these annual compensation figures are dwarfed by the paper wealth executives have accumulated from the stockpile of options they own but haven't yet cashed in. If these options were all exercised at once, they would have brought the top five officers a total net profit of nearly $80 billion at the end of 2000, after they had paid the market value for each share. This is a more than tenfold increase from 1992, when the top five held options with a paper value of $7 billion.

It's no secret why this happened. For all intents and purposes, many CEOs in corporate America set their own salaries. In most large corporations, the board of directors decides, at least on paper, how much to pay top management. But everyone knows that CEOs handpick many of the directors and usually dominate the board.

Indeed, shareholders' advocates have been agitating for some twenty years to reform boards controlled by management. There has been halting progress, and CEOs in many large companies have grudgingly gone along with a move toward more independent directors. Still, the basic system remains largely in place. A recent description of it was given in a 1999 article by Kevin J. Murphy, an economist at the University of Southern California who is a leading expert on executive compensation. He wrote:

> Although all major decisions related to top-level pay are passed through this [compensation] committee, the committee rarely conducts market studies of competitive pay levels or initiates or proposes new incentive plans. Rather initial recommendations for pay levels or new incentive plans typically emanate from the company's human resource department often in conjunction with outside accountants or compensation consultants. These recommendations are usually sent to top managers for approval and revision before being delivered to the compensation committee for consideration. The CEO typically participates in all committee deliberations, except for discussions specifically dealing with the level of the CEO's pay.

The ability of executives to influence their own pay explains many puzzling features of the CEO compensation system in the United States, according to a 2001 study by a Harvard University Law School professor and two others. In early 2002, Federal Reserve Board chairman Alan Greenspan also expressed concerns about the dominant role of the CEO in determining who sits on his or her company's board: "The board of directors appointed by shareholders are in the overwhelming majority of cases chosen from the slate proposed by the CEO. . . . Shareholders usually perfunctorily affirm such choices."

In a system like this, it takes a brave director to tell a CEO that his or her pay is out of line and should be reined in. Certainly, there's scant evidence that anything like that has happened in any systematic way. It's no easier for directors to suggest that there's a wider pool of intellectual capital in the company that should share in the benefits of successful company performance.

Then there's the role of the executive compensation consultants. These are firms such as Buck, Mercer, Pearl Meyer, and Watson Wyatt, which offer a wide range of consulting services to corporate America. One of the more lucrative is running the executive pay schemes.

The consultants take elaborate steps to set up these plans. They diligently perform "market surveys" of CEO pay, which are used to determine how much each client company should pay its own chieftain. This gives the plan a veneer of objectivity, allowing the board of directors to sign off on it without seeming to be favoring the guy who gave them their board seat. It also gives directors legal cover, since angry shareholders would find it more difficult to take directors to court for overpaying executives if an outside professional creates and signs off on the pay plan directors adopt.

The problem is that the consultants, too, get their job designing the plan at the discretion of the CEO. They wouldn't last long if the person who signs their check saw his take-home languishing while his rivals soared up to the golden pinnacle of success. A 2001 article in *Fortune* magazine expressed this in stark terms. The authors interviewed seven directors at major corporations about how CEO pay is set, promising confidentiality in return for candid talk. One of them, himself a CEO who serves as a director of several other companies, put it like this:

> You can have a very sophisticated board—and it'll still be amateurs vs. pros. . . . I'm classing the directors, in most cases, as amateurs, and management, together with the compensation consultants they hire, as pros. . . . I would say that it is unusual to find a consultant who does not end up, at the least, being a prostitute. The consultants are hired by management. They're going to be rehired by management. There's some thought given by conscientious compensation committees to hiring their own consultants. But the consultants don't want to be hired that way, because then they cut themselves off from management.

Many directors feel trapped by the system, too. As *Fortune* put it:

> The directors come from varying spots on the spectrum of opinion, though all believe unequivocally that pay should be related to performance. The trick is in making that happen. The surprise in what many of these directors say—and they are all smart, strong-minded people—is how helpless they sometimes feel in the grip of a system

that inexorably sweeps executive pay toward ever higher levels. Said one director defeatedly: 'You sort of get rolled over by the system even if you try to do well.'

CEO wealth has been fueled further by the Lake Wobegon effect. The market surveys used to justify outsized executive rewards are usually fairly objective in themselves. But every corporate leader seems to think that he or she is above average. So their pay packages are rarely designed to keep pace with average CEO pay, the way most employee pay plans keep pace with average worker pay. Instead, executive compensation plans often target the upper quartiles of the companies surveyed.

The result has been a glorious game of financial leapfrog. Once a few executives struck it rich with options and other long-term stock incentive pay systems in the 1980s, others quickly followed suit by citing the new, higher "market" average for CEO pay. Since they all try to put themselves in the upper brackets, their pay has spiraled ever upward.

This is where Warren Buffett's gimlet-eyed view of options as a free ride applies in spades. The theory behind options for CEOs is similar, at least in broad terms, to the one that explains why they make sense for all employees: Ownership spurs them to do a better job of creating wealth for shareholders. But they should get premiums over and above their regular annual salaries only if they generate extra value. Some experts have found at least superficial evidence that this occurs. The benchmark study of current CEO pay practices was done in 1998 by two Harvard economists, Brian J. Hall and Jeffrey Leibman, who examined the total compensation of CEOs at large public companies between 1980 and 1994.

They found that CEO pay closely tracked a firm's stock price. For example, those whose annual stock price change ranked in the bottom 30 percent of the group over the fifteen years earned $1 million each. But CEOs with returns in the top 30 percent took home $5 million. A CEO whose company's stock performed in the top 10 percent earned $9 million more than one whose stock came in at the bottom 10 percent. The authors' conclusion: There's "a strong link between the fortunes of CEOs and the fortunes of the companies they manage," with virtually all of the link being "attributable to stock and stock options."

But this doesn't tell us whether CEOs create extra value that offsets the dilution triggered by their stock and option compensation, the way employee ownership typically does. To begin with, there's no clear evidence of cause and effect. In 1999, Murphy reviewed decades of evidence on this question. He noted that there's what he calls a mechanical relationship between the value of CEO stock and stock options and total shareholder return. In other words, if a CEO owns 2 percent of his company's stock, either directly or through options, then of course the value of his stake will parallel the company's stock performance. If the stock performs in the top 30 percent of all stocks, so, more or less, will the CEO's pay.

The real issue, though, is whether the CEO whose company performed above average caused the higher growth (or caused the sub par performance of a laggard). On this score, Murphy is clear (if a bit academic). "Unfortunately . . . there is surprisingly little direct evidence that higher pay-performance sensitivities lead to higher stock price performance." It's difficult, he concluded, "to document that the increase in stock-based incentives has led CEOs to work harder, smarter, and more in the interest of shareholders."

Our conclusion is that America's top executives have taken 8 percent of their company's stock for themselves, plus another 6 percent for their chief lieutenants, without any clear evidence that the shareholder dilution this brings has been offset by their extra contribution. A charitable analysis might hold that there's little hard evidence to the contrary. Still, it seems clear that investors have accepted largely on blind faith the substantive dilution brought about by the award of stock to executives.

There are ways to hold CEOs and other executives to the same standard of risk sharing as employees. One method would be to make their option awards pay out only if their company's share price exceeds the overall market average, or at least the average for their particular industry. The conventional view in corporate America is that a CEO's primary job should be to maximize value for shareholders. If CEOs do their jobs adequately, they should be expected to match the market or their peers in similar companies.

But they shouldn't get a windfall just because they did their job adequately and the market happened to soar, as it did in the late 1990s. After all, why should investors agree to give a CEO part of their ownership stake just for returning them as much value as they could get by investing in an index fund that tracks the market?

If, for example, GE's stock goes up 10 percent a year and so does the market, CEO Jeff Immeldt shouldn't get extra compensation from options. However, if he delivers 12 percent when the market rises 10 percent, then investors have earned something in return and his options should reward him. Plenty of other experts on CEO pay have made this argument, including Hall and Liebman. As they put it, "CEOs should be paid relative to some market or industry-wide index."

By this standard, it's clear that many high-tech CEOs, too, have taken too much wealth for themselves. One of the more egregious examples came in 2001, when E*Trade Group Incorporated CEO Christos M. Cotsakos managed to earn a total of $80 million (of which only about $6 million came from options). He did so even though the online brokerage company's stock had plummeted from around $70 in 1999 to barely over $7 in mid-2002, when the company released his compensation figures. So great was the outcry that several days after the news was announced, he agreed to give up about $21 million of his pay.

Across corporate America, even a rough calculation makes it clear that CEO compensation has vastly outpaced the stock market for many years. For example, we said earlier that the top five executives at the largest 1,500 companies enjoyed a 650 percent increase in the value of the options they exercised annually between 1992 and 2000, and a more than 1,000 percent increase in the paper wealth of their unexercised options. Yet these companies' total market value climbed by only 350 percent over this period. Of course, the market crash that followed has made the discrepancies much more glaring. What did executives do to deserve so much more than what they delivered to their shareholders?

Even this approach doesn't tell you whether the dollar amount of options executives receive is the level required to spur better performance on their part. No one has studied how large an award is needed to get them to beat the market, or even to match it, for that matter. CEOs' influence over their own pay has largely governed the size of option grants, which are often justified by market surveys that simply report what CEOs have given themselves at other companies. Do executives really need to get almost $11 million worth of options every year, plus millions more in unexercised options, to stimulate them to do better? Why not half that, or twice as much? Have they really performed better than when they took home just $1 million a year?

One answer, or at least some context, comes from other industrialized countries. For example, in 1997, the CEOs of the largest U.S. public companies earned 190 percent more compensation than their counterparts in England. The Americans received 1.48 percent of the average increase in shareholder value that year, versus 0.25 percent for the English CEO. Why do Americans require, or are allowed to take, so much more? Maybe during the U.S. bull market you could argue they turned in a better performance, but that argument doesn't look so good after the market stopped growing.

Many critics in the business community have been making these arguments for years, but to no avail. Executive pay has continued to climb, and executives maneuver to make sure that no brake will be put on it. One example came in mid-2002, when in the wake of the Enron collapse the New York Stock Exchange (NYSE) mounted an effort to require the companies it lists to put all stock option plans before shareholders for a vote. Even before NYSE officials had announced the plan, executives swung into action to head it off. The Business Roundtable, a prominent group of CEOs of large corporations, initially wrote to the head of the NYSE to denounce the move, with General Mills Corporation CEO Stephen W. Sanger calling it "counterproductive."

Perhaps the most startling finding about American CEOs' share of the option pie relative to employees came from a study we did in the course of writing this book. Using the same data on the 1,500 largest public companies in the United States, we calculated the total amount of options they granted between 1992 and 2001. We then determined what share went to the top five officers in each company, and tried to correlate their relative share to the performance of the firm's stock three years after the options were granted. (You need the time lag because of the vesting period that applies to most options.)

Our finding: There's no correlation. The companies whose executives took more had no better returns in the following three years than those that took less. Worse, the firms whose corporate chieftains were most likely to take a bigger share had sub par performance to begin with. Since the extra ownership made no difference, the shareholders with the greediest CEOs were just throwing good money after bad. The relationship held true regardless of the size of the corporation, as measured either by its market value or by how many employees it had.

At a minimum, we conclude that there's little rhyme or reason to the disparity between the number of options many CEOs receive and those granted to the employees they govern.

Overall, it seems clear that options have been seriously misused as a tool for motivating executives. CEOs have taken much more wealth than they can justify, and they've shared too little with average employees if the goal is to create a more entrepreneurial workplace. Corporate America's CEOs cut themselves and an elite group of executives and other employees in on an unbelievably lucrative ride, and left almost everyone else in their companies sitting back on the roadside.

Investors have lost out, too, since they've surrendered tremendous ownership to executives with no clear evidence that all of these stock options were judiciously spent. They've also lost out on the proven gains they could have received if their companies had shared the wealth with average employees and changed their corporate cultures accordingly. "Management has an obligation to recommend option grants that make the pie bigger for all shareholders," said Adam Blumenthal, New York City's first deputy comptroller, whose job overseeing city employees' massive pension fund makes him a leading advocate for institutional shareholders. "They also have a responsibility to not recommend grants that are only good for them personally." But in light of the scandals at companies such as Enron, WorldCom, and Global Crossing, "we see that there's no reason to think those two are the same. Many executives have shown that they have a conflict of interest in deciding who gets options in their own companies."

The ultimate irony is the stated justification many corporations employ for their executive compensation practices. The language comes right out of the rich tradition of employee ownership. Listen to how General Motors describes its executive risk-sharing program. "A significant portion of each executive's total compensation is linked to accomplishing specific measurable results intended to create value for stockholders both in the short-term and the long-term . . . . Options are granted to emphasize the importance of improving stock price performance and increasing shareholder value over the long term and to encourage executives to own GM stock." GM approved its most recent plan in 1997, allotting more than 100 million shares to it. The company said it expected to give options to 4,000 employees a year. While 4,000 may sound like a lot of people, it represents only about 1 percent of the auto giant's 365,000 employees.

Even companies that have extended motivational wealth sharing to a broader group typically still top-load their plans. For example, in its 2001 shareholder letter, GE said:

> Over 30,000 employees below the executive officer level have been awarded one or more stock option grants under a broad-based stock option program initiated in 1989. This program . . . reinforces in the Company the entrepreneurial environment and spirit of a small company by providing real incentives for these employees to sustain and enhance GE's long-term performance. The Committee believes that the superior performance of these individuals will contribute significantly to the Company's future success.

Still, the 30,000 are mostly executives and managers, and they represent less than 10 percent of GE's 317,000 workers. That's a far cry from the solid majorities or entire workforces included in the option programs of the High Tech 100 and some other high-tech firms. Like most other traditional companies, GE acts as if the fate of the company lies with a small minority of its employees. All the rest don't matter.

Lurking beneath these explanations is a view of the world that comes straight out of the American thinker Ayn Rand's paeans to individualism. In novels such as *The Fountainhead* (1943) and *Atlas Shrugged* (1957), Rand waged ideological battle against the evils of socialism by arguing that the entrepreneurs and titans who run corporate America are the true "creators" or "prime movers" of capitalism. Their genius, their ingenuity, their spark of initiative, she proclaimed, is responsible for all the bountiful wealth our economy produces. Her books sold millions, and she developed a cult following

In *Atlas Shrugged*, Rand drove home her point with a tale about what would happen if all the CEOs went on strike. Sure enough, the motor of capitalism is cut dead. Economic activity sputters to a crawl, and the country sinks into a barren existence even gloomier than life in the old Soviet Union.

Corporate America's pay practices embody a similar view. Few people express it this way and maybe most CEOs and shareholders don't even think it consciously. But you sometimes get a glimpse of such a mentality when overpaid CEOs are put on the spot about why they don't share the option wealth more broadly with their fellow employees. For example, at a 1999 corporate meeting of Disney Inc., CEO Michael Eisner said: "You don't think we should give stock to the guys [attendants] in the parking lot, do you?" A Disney spokeswoman later explained that he was referring to the dilution costs of widespread options. But Eisner exemplifies the overpaid CEO whose option payouts far exceed the return to shareholders Disney has delivered under his rule.

The boss-gets-almost-everything stock option philosophy doesn't square with a perspective that sees the corporation as a complex ensemble of people who all must be motivated to play their part in a harmonious whole. Nor does it mesh with the mounting importance of intellectual capital in advanced economies. Instead, most large companies act as if the director of the marching band alone, or maybe the top few percent of those directors, determines its fate. All of his or her band members are just so many interchangeable players, who can be replaced with another just as able to carry a tune if only the director tells them when to play and how.

Corporate America's standard employee option plans dilute public shareholders on the belief that five employees, or at best a small slice at the top, alone determine the company's fate and fortune. Traditional companies have taken all the lessons about employee participation and ownership they learned in the past two decades and applied them only to this thin top layer.

There is a better way to do it, namely, sharing options more broadly. This approach also makes sense in other corporate settings, as some CEOs realize. The general theory behind most employee option programs in corporate America "is that only [senior executives] make a difference," said D. Wayne Calloway, the CEO of PepsiCo, in a 1989 newspaper interview. "We don't think that fits our company." That year, Pepsi put that philosophy into action by rolling out a stock option plan, called SharePower, which now covers 500,000 employees who average at least 1,500 hours a year. On average, they get options worth 10 percent of their annual pay.

To see how other companies can do the same thing, let's look at what it would take to apply the principles of partnership capitalism in a traditional corporate setting.

9

Partnership Capitalism

How to Put It All Together

We believe that partnership capitalism as practiced by the High Tech 100 provides constructive lessons for corporate America. They're not model companies in many respects, particularly in light of the vast wealth they lost for many investors. Still, the new form of the corporation evolving in the industry offers a role model on which others can draw.

As we've stressed throughout the book, high-tech firms haven't really discovered anything new. Instead, they have synthesized a range of ideas about employee ownership that traditional companies have grappled with for many years. Quite a few early technology firms came to similar conclusions many years ago, especially in Silicon Valley, as did thousands of mostly closely held companies that have used ESOPs as the center around which to build participatory cultures.

The one aspect that is new, however, involves the comprehensive use of stock options to turn their employees into owners. We've come to the conclusion that the addition of options to the employee ownership mix offers both companies and workers a more attractive and versatile approach than ESOPs, 401(k)s, and other methods of employee ownership. The fact that virtually all the leading companies in the industry have articulated, and put into practice, the same vision also shines a powerful light on the concept of stock option capitalism. More established companies now can see for themselves that combining the financial and cultural aspects of employee ownership into a unified approach can, if done right, provide a better alternative to the traditional corporate relationship among shareholders, managers, and employees.

The partnership approach to sharing the risks and rewards of property ownership promises to improve the prospects of the major stakeholders in a public company. For companies and for shareholders, the idea makes sense if the ownership they surrender inspires employees to work harder or smarter. If motivated workers generate sufficient extra growth for the company, public shareholders will own a smaller, but more valuable, share of a bigger pie. Stock options also provide a measure of downside risk not available with most other forms of employee ownership, since investors suffer no dilution if their company's share price falls or fails to rise.

For employees, partnership capitalism can provide a less hierarchical workplace environment, one that gives them greater input into their daily jobs. It offers the satisfaction of owning a piece of the company for which they work. Employees also enjoy the prospect of a significant financial reward beyond their basic salary. One important lesson from the High Tech 100 is that a partnership built around options allows employees to become capitalists without investing their own savings to purchase company stock. Options allow average workers to buy ownership with their sweat equity, a much more affordable prospect.

Such rewards may offer one way to reverse the stagnation of the average American worker's hourly paycheck, which has risen by a grand total of only about 3 percent since 1973, after adjusting for inflation. While wages have outpaced consumer prices since 1996, capital has provided a far greater source of increased income in America in the past three decades. Partnership capitalism can bring average workers into the capitalist ranks, letting them share more fully in the bounty the economy creates.

Stock option capitalism also offers a more prudent division of risk and reward than other kinds of employee ownership. Critics have rightly pointed out that the single largest form of worker ownership today, the company stock held in 401(k)s, ties up savings in the shares of a single company, which violates the time-proven investment caveat against having all your eggs in one basket. Many employee share purchase plans do the same thing. This became all too clear after the stock market slump, which wiped out that $260 billion worth of employee ownership in America—about 90 percent of it from these two kinds of plans. (See Appendix C for more details.)

Employee options minimize these problems or avoid them altogether. Workers can cash out when their options vest, so they're not locked into one stock for many years and won't face the Enron calamity of losing their job and their savings in one stroke. Because employees lose nothing if their options aren't in the money, options also put important circuit breakers on their risk of capital ownership by providing limits on the downside.

Such an economic partnership does involve risks, but they're shared more or less equally by everyone. For shareholders and companies, the risk is that they will surrender future ownership stakes that, at least under some circumstances, may accrue to employees even if they don't lift the company's value to a higher level than it would have achieved without the options. Similarly, employees may throw themselves into their jobs with much more vigor than they would in a conventional corporate setting, only to watch their stake in the firm's future profits evaporate due to a slowing economy, poor luck or lousy management at their particular company, or some external factor like a recession. Some of these problems can be overcome by, for example, indexing employee options to an industry or market average. Either way, the partnership approach to value creation would bring a range of gains to most corporate partners, most of the time.

Having said this, however, any company intrigued by the idea still is left with the question of how to apply it to a more traditional corporate setting. The first task must be to alter the less flexible corporate hierarchy that still grips many large U.S. companies. Clearly, changing a corporation's culture is a much more arduous undertaking than setting up a financial scheme to share wealth with employees. For that reason, it's probably the most important component of partnership capitalism. The top-down approach made more sense when it was devised a hundred years ago, under the name of scientific management, or Taylorism (after Frederick Winslow Taylor, an early proponent). Back then, many large companies were manufacturers that maximized efficiency by telling their workers every move to make. Today, most companies need employees to think on the job, whether they labor in a factory, write software, or work with customers in a retail establishment.

Partnership capitalism works best in an entrepreneurial corporate culture. It requires firms to try to spread power, prestige, and resources broadly among employees, and attempt to equip them with the skills and information they need to achieve the goals of the company. Flat corporate hierarchies require managers and executives to listen to employees and even to accept criticism from them. "If you are not able to allow people to criticize you, you will never be able to make the best decisions," said Infospace CEO Naveen Jain.

"It doesn't mean that you make the decisions by committee. But you do allow people to come and say that is the stupidest thing they ever heard. You allow them to explain why they believe that. You sit down and say, 'Look, for these five reasons I don't think what you are saying is right.' You may still say, 'Look, great, why don't you stick to your coding and let me do my job.' But nonetheless you heard their arguments, and lot of times you come back and say, 'You know what I think, you are right.'"

A true partnership requires meaningful wealth sharing as well. Over the past decade or so, corporate America has used stock options to create a form of partnership with CEOs and other high-level executives and managers. Average workers, for the most part, mostly hold ownership in 401(k)s and employee stock purchase plans. Aside from ESOPs, much of this isn't risk sharing at all, since workers usually must purchase their ownership stake with their own money.

Essentially, corporate America has extended the least risky ownership stake—stock options—to those who can afford to take on the most risk, that is, the highest-income people at the top of the pyramid. It has given the riskiest stake to average workers, who can least afford to gamble their savings on one stock. This is just what happened at Enron: Average workers lost most of their 401(k) company stock, while executives used their more flexible option and other stock incentive plans to bail out before the company collapsed.

Any large company that wants to embrace a true partnership with its employees must decide how much property to share with them. The High Tech 100 may not be a particularly useful guide for much of the rest of corporate America in this regard. Most conventional companies aren't startups in which a few founders have invested small sums of capital that they often perceive as a financial gamble. Instead, a mainstream company has many thousands of shareholders who spent hard cash to buy their stake and want a sound, steady return on their investment. Most corporations also operate in industries that have been around for decades or even longer. It's unrealistic to expect that they can grow at anywhere near the rates achieved by high-tech companies in the late 1990s, no matter how motivated employees become. So it may not make sense to part with the 17 percent option ownership stake the High Tech 100 have extended to their workforces.

In addition, high-tech firms are built mostly on knowledge, or human capital. Their primary asset resides in the minds of their employees, who must think up the new software or design the new hardware. While traditional companies are moving in this direction, most still rely more heavily on physical capital, whether it's an auto factory required to produce cars or the computers and real estate a bank needs to service its customers. You can see the dividing line clearly by looking at how much capital is invested in each.

On average, the High Tech 100 give each of their employees just $65,000 worth of equipment, while the Corporate America 100 back up each one of theirs with $250,000 worth. Companies that use more human capital to produce wealth usually can reap higher returns from employee ownership than ones that rely more heavily on physical capital. After all, partnership capitalism creates extra value by spurring employees to do a better job. If they're responsible for a greater share of the wealth produced in the first place, the amount of extra gain they are capable of producing should be higher as well.

So instead of using our High Tech 100, we can turn again to corporate America's own experience to get some guidance as to what level of worker ownership might make sense in a conventional business setting. There are several relevant examples. The first is the extensive employee ownership history we reviewed in Chapter 7. We saw that companies that used significant employee ownership in the past several decades, such as ESOPS or profit sharing, gave their workers a rough average of 8 percent of their shares (after dilution is taken into account).

This 8 percent is broadly analogous to the 17 percent option ownership stake held by High Tech 100 workers. It suggests that as a very rough guide, the average large corporation could expect to reap higher profits and see its stock price jump if it shared a total of about 8 percent or so of its ownership with its workforce. That's not a hard and fast figure by any means. But it offers a reasonable starting point.

There's also the question of the annual run rate. Here other guideposts illustrate what might make sense for much of corporate America. Most traditional companies might overdilute if they tried to match the high annual option grants found in the High Tech 100, which by coincidence happen to come out at 8 percent, too. (Don't confuse these two figures. The 8 percent in the preceding paragraph refers to the total amount of employee equity a company has outstanding at any given time. The 8 percent run rate measures how much employee equity high-tech firms grant every year.)

Probably the best example can be found in the traditional companies that offer options to most employees. For instance, in Chapter 7 we discussed a study of 490 firms that did so. They exclude Internet and other technology firms and thus provide a good idea of what companies in other kinds of industries might be able to do. The study showed that these companies, which include everything from industrial manufacturers to communications and pharmaceutical firms, outperformed similar companies on several measures. On average, these 490 companies had run rates of about 3 percent.

Another study was done in 2000 for a handbook on broad-based stock options by the National Center for Employee Ownership. It looked at 150 traditional companies with such plans (software and e-commerce firms were excluded). Those had run rates averaging a little over 4 percent.

Further guidelines come from the run rates that fund the executive stock option plans of virtually every large company. The 1,500 largest corporations in the United States gave a little more than 2 percent of their ownership to top-level executives in 2000 in the form of options (a number, by the way, that doubled for the 500 largest firms over the 1990s as executive stock options ballooned). Of course, as we found in Chapter 8, there's scant evidence that shareholders have profited from such large handouts. However, since all the research we've found shows that companies would make money if they shared ownership with the rank and file, it could make sense to use at least part of the existing run rates to make partners out of everyone in the company. The other possibility, of course, is simply to increase run rates to make more options available for the rank and file, which is what many companies with broad-based option plans have done.

All of these figures are very rough averages that summarize what has happened at many companies over a number of years. So they certainly don't constitute a precise answer about the level of total dilution or the run rate that would produce greater returns for the shareholders of a typical company in corporate America. Still, they provide some parameters about where to start constructing the financial side of partnership capitalism in a traditional setting. Indeed, the numbers provide a conservative view, since most of the firms in these examples didn't put together the entire package of cultural and financial changes the way the High Tech 100 have done. Theoretically, companies that are able to shift to full-fledged partnership capitalism might see even greater returns from greater risk sharing with employees.

Our conclusion, then, is that many large corporations in the United States could safely set up a stock option plan that gives employees something like 3 or 4 percent of the company each year, with a maximum employee equity of something on the order of 8 percent. If they did, they could expect to see their stock price climb by at least 2 percentage points more than it would having done otherwise (the average gain from all the employee ownership studies we reviewed in Chapter 7).

This may not sound like much, but in fact it's a lot. To see why, look at how the average company performs. Since 1926, the U.S. stock market has risen by 10 percent a year. This is a long-run average, which includes wide swings such as the Great Depression and the bull market of the 1990s. As a result, it doesn't tell you with any precision what the stock of an individual company is likely to do in a given year, or even in a given decade. But it's the most conservative guideline to use for our purpose, since it tells you what all companies on average can reasonably expect to achieve over the long haul.

Adding 2 percentage points to the 10 percent average means that stock option capitalism can give shareholders 20 percent (2 points out of 10) more value than they would get if their company just sticks to the conventional corporate model. Compounded over time, this quickly adds up to a meaningful advantage. For example, say you invest $10,000 in the S&P 500 or the corporate America 100. Using our 10 percent guideline, your investment would grow to about $16,100 after five years. Now say you invest an equal sum in an index fund comprised of similar large corporations that have chosen to pursue stock option capitalism. On average, you should earn 12 percent, which would leave you with about $17,600. This additional $1,500 means that the stock of the partnership firms returned 25 percent more after five years. In fact, the gain would be even larger, since we haven't accounted for reinvested dividends here. Remember, this is how much you would earn after you've accounted for the extra stock ownership you dole out to employees each year. A return of that magnitude should be enough to cover the potential risk that comes from trying a new corporate model.

Of course, these general guidelines, an 8 percent maximum employee equity and an annual run rate of 3 or 4 percent, only describe the expected tradeoff between dilution and shareholder return in very broad terms. For stock option capitalism to pay off for traditional companies, they must carefully adapt the concept to fit their own financial structure and prospects. They also must do so within the context of an entrepreneurial corporate culture, or the financial returns are likely not to occur.

In some companies, it might make sense to complement options with other forms of employee ownership. For example, as a general rule of thumb, firms with higher stock market values for each employee will have an easier time issuing options. The reason: The 3 or 4 percent they grant to employees annually will come to a larger amount per worker than the same percentage would be at a company with lower market values. As a result, these firms can deliver more wealth sharing to their employees for the same run rate.

Companies or industries with low market values per worker could find it easier financially to pursue partnership capitalism by mixing option grants with ESOPs, employee share purchase plans, or profit-sharing plans. ESOPs, for example, can sometimes bring companies a greater tax advantage than options, which allows them to share more wealth with their employees. Stock purchase plans might sometimes be more affordable, too, since they require less dilution from public shareholders. Profit sharing brings the advantage of only costing public shareholders after the profits are earned, which can put less of a strain on the company's finances than option dilution. Given the tremendous diversity in corporations' financial structure and outlook, the best approach is for a company to begin with a vision of the employee ownership it wants to achieve, and then figure out which mix of methods can work best given its situation.

From the standpoint of employees, partnership capitalism offers the prospect of significant capital gains. There is a widespread notion in the United States today that employee stock options are just another form of compensation, like salaries and benefits. Many experts made this point repeatedly during the national debate on stock options that arose after the failure of Enron in early 2002. Luminaries such as Federal Reserve Board chairman Alan Greenspan and his predecessor Paul Volcker both described options as compensation numerous times (although they were focused almost entirely on CEO options, not the broad-based kind we're talking about in this book). In May of that year, Standard and Poor's Corporation, which rates corporations for investors, introduced a new set of measures for earnings that count options on a company's expense line, just like other compensation.

We believe this view fundamentally misunderstands the nature of employee ownership in general and stock options in particular, at least regarding average employees. Far from being compensation for labor performed, options are instead a form of capital income. They represent risk sharing based on joint property ownership. Options turn employees into economic partners in the enterprise. As such, they stand to share in the stock appreciation that they help to bring about. Essentially, options offer employees a way to become shareholders by spending their human capital instead of their cash. They're still employees and they still get paid their regular wages and benefits. But options provide an additional dimension to their employment relationship, allowing workers to participate in both the risks and the rewards of property ownership.

There's substantial economic evidence that options bring workers capital rather than labor income. Labor economists typically think of compensation as an earnings package whose value is set by the supply and demand for the particular labor the employee can provide. From this standpoint, there's little distinction between hourly wages, an annual salary, and benefits such as health care or pensions. All of it adds up to a compensation package whose level is largely determined by market forces.

However, the earnings workers get from options comes on top of their regular market wage. It's true that some high-tech firms, the ones that engage in wage substitution, do effectively require workers to pony up their own money to become property owners. These firms basically get employees to buy their options with a part of their salary. But this isn't a necessary feature of employee options, or a usual one.

Several studies demonstrate this. For example, the point came through clearly in the study of the 490 non-Internet firms with broad-based option plans. On average, they paid their employees about 8 percent more than all other public companies between 1985 and 1987, when most of them set up their option plans. A decade later, they still paid about 8 percent more, excluding any money workers got from options. In other words, these employees got option income on top of the same pay hikes everyone else in the United States had received over the decade.

The same is true for ESOPs. Several studies show that companies offer them in addition to any other retirement or savings plan they set up to be competitive in the marketplace. For example, a study we mentioned in Chapter 7 that compared 1,200 ESOP firms to 1,200 similar non-ESOP ones showed that the ESOP companies were four times more likely to have a traditional pension and five times more likely to offer a 401(k). The conclusion: ESOPs don't substitute for a retirement benefit that companies give their employees to remain competitive. Instead, it comes on top of market-level benefits.

Two smaller studies buttress the point. One compared ESOP and non-ESOP firms in Massachusetts, while the other did the same in Washington state. Both found that the levels of pay and other benefits were higher at the ESOP companies. Similarly, the wealth of literature on profit sharing indicates that such earnings generally don't substitute for pay or benefits.

Options and other forms of employee ownership deliver extra gains because employees do something more than their regular jobs in the companies that grant them. For partnership capitalism to work, employees must make more use of their abilities and intelligence, or their options or other property sharing could wind up worth nothing. The harder they work, or the smarter, the more their equity will be worth. Working harder or more efficiently is a real cost to employees, but it's often a lot easier way to pay for ownership than the direct wage sacrifice typically required when workers buy company stock in 401(k) or stock purchase plans.

So how much could workers in a traditional corporation expect to get if their employer adopted partnership capitalism? The reward must be large enough to command the attention of employees, otherwise they won't be motivated to put out more effort. We have concluded that workers should get a minimum of 15 percent of their annual paycheck every year to begin to achieve the desired incentive effect.

In the model we've sketched out so far, all the employees of a company would split options worth 3 or 4 percent of its ownership every year (on a diluted basis, as usual). But the monetary worth of this figure to employees will differ widely, depending on the nature of any particular company and how the total option pie is split up among the workforce. Once again, many high-tech firms aren't too helpful in illustrating what workers stand to earn, since very few companies are lucky enough to experience the jackpot stock runups they enjoyed in the late 1990s. However, we can get at least a ballpark idea by looking at more conventional companies that offer options to most of their workers.

One example can be found in the study of 150 such companies we mentioned above by the National Center for Employee Ownership. The study didn't report how much income employees at these companies actually had made from their options. However, it did tell us the average number of options employees received in 1999, according to broad job type, as well as the average strike prices at which they had received them. These two facts allowed us to calculate the initial value of all the options the average employee got that year. This is the amount each employee would have to pay to exercise the options when they vest. They get to keep any additional money that would come if the stock price rises from the exercise price.

Of course, we have no way of knowing how much the shares of all these companies rose after 1999 or will rise in the future. But to get some idea of what employees could expect, we returned to the same 10-percent-a-year scenario we used to estimate the returns shareholders stand to make. Using that assumption, we calculated how much individual employees would earn if the options they received in 1999 vested in five years and they sold the stock as soon as they were able to exercise them. The outcome: Hourly workers would take home option profits of roughly $5,600, or 16 percent of

TABLE 9.1 What Employees Could Expect to Earn from Partnership Capitalism
(Average Profit on 1999 Option Grants after Five Years, Assuming 10 Percent Annual Stock Price Increases)

Job	Salary	1999 Option Grant	Profit in 2004*	Profit as a Share of 1999 Salary (%)
Hourly	$33,000	$9,200	$5,600	16
Non-technical	$53,000	$29,300	$17,800	34
Technical	$76,000	$48,000	$29,300	38
Sales	$92,000	$76,500	$47,600	51
Middle mgr.	$83,000	$70,800	$43,300	52
Senior mgr.	$134,000	$173,800	$106,100	79
Executives	$159,000	$531,000	$324,800	204

NOTES: *Projection based on the assumption that employees exercise all their 1999 options after five years and sell the stock for an immediate cash profit.

SOURCE: Authors' analysis of "Current Practices in Stock Option Plan Design." National Center for Employee Ownership, 2000.

their 1999 pay, after five years. Employees at higher levels get an increasing share of the profits. The breakdown for all the employee groups is shown in Table 9.1.

Obviously, employees wouldn't be guaranteed these sums, just as shareholders aren't assured of getting an extra 2 percent return in exchange for the options the company issues. For example, in the bull market of the late 1990s, when stocks climbed by 20 to 30 percent a year, these figures would have been more than several times larger. In a flat market, employees may go years with little or no profit. But these figures give us at least a rough estimate of what employees might initially earn if corporate America embraced stock option capitalism with annual run rates of 3 or 4 percent a year.

Over time, they would probably get quite a bit more. The reason: Option profits grow with the market value of the company. In the survey described in the table, employees' option grants totaled about 4 percent of their company's ownership on average (after dilution). In our model, they would receive that much every year. As a result, their option profits would increase in tandem with their company's market capitalization, at least within reasonable limits. So, for example, if a company had a market value of $1 billion in 1999, employees' 4 percent stake would have been worth $40 million that year. If the stock rose by 10 percent a year as we assumed in the table, they would earn a collective $24 million profit after five years. (Their stock would have a market value of $64 million and they would have to pay $40 million—their strike price—to buy the stock when the options were exercised.) This is just another way of describing what workers could earn from their 1999 options, only now we're lumping all employees together.

Now look at what would happen if the company prospered and its market value doubled to $2 billion. Say this occurred in seven years, which it would if the firm's stock price rose at 10 percent a year. Every year, employees would get option grants that climb by that much as well. By 2006, they would split 4 percent of the $2 billion, or $80 million. Five years after that, they would earn a collective $49 million profit—nearly double the amount earned five years earlier. (Again assuming 10 percent annual stock price growth, their shares would be worth $129 million and their strike price would be $80 million.)

Of course, any company growing at such a steady pace would undoubtedly be hiring along the way. So that $49 million would be split among more workers. In addition, salaries hopefully would climb over the ten years, so each worker's share of the $49 million wouldn't double as a percent of their annual pay. Still, it's clear that even hourly workers would be earning much more than 16 percent of their annual pay at that point. After all, their capital income would be rising at 10 percent a year, far more than anyone could reasonably expect average wages and salaries to increase.

Indeed, a smoothly functioning partnership company would go a long way toward offsetting a repeat of the wage stagnation that gripped the U.S. economy starting in the early 1970s. For more than twenty years after U.S. productivity growth began to stagnate in 1973, the typical American worker saw pay hikes that gradually left them farther and farther behind inflation. Wages did finally grow fairly quickly in the late 1990s, as the economy boomed and productivity growth soared. But by 2001, average wages for nonsupervisory workers were just 3 percent higher than they were at the 1973 peak. If even hourly workers could have earned something like 16 percent more each year, with the amount increasing annually with the stock market, American family incomes would be dramatically higher today.

Options also alleviate a major drawback that exists with most other forms of employee ownership, namely the lack of diversification they entail. It's a staple of financial investing that you shouldn't own too much of one stock, because the risk that it will underperform the market is just too great. Enron, where most workers had a lot of their 401(k)s locked up in the company's shares, is a prime example. ESOPs have a similar problem, although it's much less of an issue since they aren't purchased with worker savings and provide employees with a benefit that comes on top of their regular pay and benefits. Workers would come out ahead if they could sell their ESOP shares and diversify, but since they probably wouldn't get those shares without the ESOP, they're better off getting extra earnings in a single company's stock than not getting the extra earnings at all.

Options, however, allow workers to take their wealth as soon as they vest. If options are granted every year, employees can and usually do cash out on an annual basis as options granted three or four years ago vest and become exercisable. This allows employees to diversify their wealth on an ongoing basis. It doesn't completely eliminate the diversification problem, but it minimizes it.

The greater liquidity options provide mean they offer an extra financial buffer against corporate failures like Enron, Global Crossing, and WorldCom. Most companies don't go bankrupt, of course. But when those collapsed, many employees lost much of their retirement savings, which had been tied up in their company's stock through 401(k) and stock purchase plans. At Enron, for example, 60 percent of the company's 401(k) was invested in Enron stock, a practice management had strongly encouraged. As a result, workers and retirees lost more than $1 billion worth of retirement assets in 2001 as the company's shares collapsed.

This generated tremendous debate about the extremes of employee ownership, prompting the introduction of several bills in Congress to limit the share of company stock employees could have in their 401(k)s, to force companies to allow employees to diversify their 401k company stock holdings, and to limit management's ability to prevent employees from selling their shares in down markets while management safeguards its own interests. Although none had passed by the time this book went to press, the last two proposals had widespread support. The episode gave something of a taint to employee ownership. While the critics have a point, stock options limit such damage, because workers can cash out a portion of their wealth each year instead of being forced to keep it in a 401(k) until retirement.

Sharing the wealth doesn't mean socialist egalitarianism. Partnership capitalism doesn't necessarily undercut the traditional system of pay differences, which, at least theoretically, rewards individuals according to what they contribute to an organization. High-tech firms cultivate flat hierarchies that promote workplace equality, but that doesn't mean the financial rewards need to be distributed equally. Employee ownership is a way for property-holders to motivate the people who can enhance the value of their property. If those with higher skills can bring greater value, they get greater reward.

BEA Systems chairman Bill Coleman said:

> The more senior people get more stock options, because they can influence a lot more of the success of the company. Relative to their income, you need to give them more to actually make a difference in their thinking and their perception. I spent ten years at Sun [Microsystems] and Sun had the same philosophy that we do. We do an annual merit refresh for the top 75 percent [that is, he gives a new round of options every year to employees whose individual performance puts them in the top 75 percent of the workforce]. The top 25 percent get probably twice as much as the third quartile. And the bottom quartile, they don't get any refresh [just their initial option grant]. You really want to retain those top people. You want their handcuffs [from the option wealth they stand to collect when they vest] to get bigger and tighter.

It may be, in fact, that high-tech firms doled out larger option shares to lower-echelon workers in their earlier days simply because they were growing so rapidly. As growth rates come back to earth, option compensation may start to tilt even more toward the top. Rick Tavan, an executive vice president of Tibco, put it like this:

> If you look at a seventy-five-year-old smokestack industry company, you're going to find a very different distribution of equity than you find in a Silicon Valley startup. When that startup is seventy-five years old, [it will have] something closer to what you call the old economy distribution of wealth potential. No, I don't think it's temporary. I think the concept of universal ownership is here to stay. When my company is seventy-five years old, everybody will be a shareholder. But I think maybe we'll see more disparity between the top and the bottom, because it is easier to attract more junior people into an older company than to attract executives.

It's clear that companies don't necessarily have to hand out options equally to everyone for partnership capitalism to be successful. True, executives in corporate America can't easily justify the large equity stakes they already take out for themselves. As a result, it could be psychologically difficult to persuade shareholders to issue even more options. Still, a number of large corporations have begun to move in this direction, including the 6 percent in the Corporate America 100. Doing so makes sense for shareholders, since the same philosophy of ownership executives apply to themselves should hold equally well for their employees. History also shows that most investors will come out ahead if they do.

10
Conclusion

The central argument of this book is that most corporations in America would enjoy more motivated workers and larger profits if they embraced partnership capitalism centered around employee stock options. This model of the corporation stimulates better economic performance through a new division of the risks and rewards of property ownership. Many technology companies came to this conclusion as their industry grew. It seems likely that their approach will survive the tech shakeout and stand as an example for other industries. "Awarding stock options to all of our eligible employees has been a successful practice for our company," Microsoft CEO Steve Ballmer told us in mid-2001. "It's clear that a sense of ownership seems to be strongly linked to corporate success in many industries. I think you'll see a continuing shift towards remuneration packages that incorporate some form of ownership for employees."

These lessons aren't new. Traditional companies have learned at least parts of them several times over the decades. They in turn were tapping into a much longer history in the United States of property holders discovering and rediscovering the benefits of sharing the risks of ownership with employees. Government, too, has played a key role at various stages, supplying new tax incentives and accounting rules that have fostered different types of employee ownership.

But somehow, these ideas never seem to stick. Many corporations pursued employee ownership, but often based it largely on worker savings rather than true property sharing. Many also skimped on the amounts, failing to provide workers an opportunity to earn a meaningful incentive every year relative to their salary. Similarly, many corporate leaders began to alter their companies' cultures to give employees more input, then lost sight of that goal when it no longer seemed so necessary. It's almost as if American companies behave like the proverbial monkeys, who only think of fixing the leaky roof when it's raining outside. When corporations run into problems, like slumping productivity, fears of foreign competition or domestic takeovers, or chronic labor shortages, they turn to their employees for help and relearn the benefits of employee participation and ownership. Then when the picture brightens, executives tend to forget all that and slide back into the old, easier habits of autocracy and top-down management.

Many new tech companies may well turn out to be no different. They reinvented employee ownership largely out of a desperate need for talent, just like some technology companies before them. Now that the industry's growth has slowed and workers aren't in such short supply, the High Tech 100 may start to find that it's easier to tell employees what to do, instead of involving them in decisions. However, there are few signs of that happening so far.

Partnership capitalism may not be suitable for every company or even every industry. Certainly, many high-tech companies are a specialized breed that seem especially well-suited to a jazz-ensemble management style. They tend to be smaller and many have a stronger sense of camaraderie, born of shared technical interests, than many other companies in corporate America. These factors may limit the applicability of the model, or at least make it more difficult to achieve at companies that have more diverse workforces.

To some degree, the model offered by the High Tech 100 also may be limited by their knowledge-intensive nature. Most of these come close to being pure knowledge corporations that rely almost entirely on brainpower instead of physical equipment. Their employees tend to be highly educated, with many holding college degrees. That's not true of the American rank-and-file as a whole, among whom only about a quarter have graduated from college. "We don't have any manufacturing, we don't have any distribution," said Bill Coleman, the BEA Systems Chairman. "Virtually everyone in this company is a college graduate, and we hire almost nobody out of school. They're only here because they are good at what they do. If you're not empowering them, all you are doing is handicapping all this brainpower you've got."

Still, we believe a fundamental shift is under way as the role of intellectual capital looms larger than physical capital throughout much of today's postindustrial economy. As late as the early 1980s, tangible assets such as equipment and goods held in inventory comprised more than 70 percent of all the assets of nonfinancial corporations in the United States. By 2000, that figure had fallen to just above half, with the rest coming from intangible items such as patents, copyrights, software, and research and development—in other words, assets created by thoughts rather than muscle.

In emerging industries that depend as heavily as the Internet on human knowledge—such as biotechnology, for example—employee equity delivered through stock options approaches High Tech 100 levels in many leading firms. As far back as 1979, two senior experts on the corporation, Professor Michael C. Jensen of the Harvard Business School and Professor William H. Meckling, the then dean of the University of Rochester Business School, wrote that "in circumstances in which a disproportionately large fraction of an individual's wealth is represented by his human capital . . . we also expect to see profit-sharing partnerships arise."

There's some initial evidence that the partnership approach is starting to be taken seriously in a broad range of companies, and for workers with almost any level of skill or education. Just look at the 6 percent of the Corporate America 100 that have option plans open to a majority of their employees. These companies aren't practicing all the elements of partnership capitalism. Some, for example, don't give meaningful amounts of options to their employees. The difficulties some have encountered, such as media giant AOL Time Warner, underline the complexity involved in introducing an entrepreneurial culture to an old-line enterprise. Still, their efforts suggest that traditional corporations can at least begin to move in that direction.

Mainstream companies who wish to pursue employee ownership must adapt the concept to their own circumstances. To be successful, they can't simply pluck out one element of partnership capitalism and hope that it will be a magic wand to boost performance. Instead, traditional companies must look at the full range of financial incentives and participation methods, and combine those that make the most sense in their situation. They also must extend the changes across the entire organization, embracing everything from recruiting and training to teams, daily management, and compensation.

Most companies will never expand at the phenomenal rates the Internet firms achieved during their heyday. Rapidly growing companies or industries can support a lot of dilution. Slower-growth ones must proceed more cautiously, because growth can't compensate for as much dilution. As a result, options aren't going to shower most employees with riches of the magnitude many high-tech workers enjoyed in the late 1990s. "The highest value of a stock option is at the small companies that are going to grow explosively," said Covad vice chairman Frank Marshall.

Most investors in non-high-tech parts of the economy aren't going to reap such rewards either, so they shouldn't give away such large amounts of ownership. If they do, they're quite likely to lose more in dilution than they can ever hope to earn back from higher productivity. However, modest incentives can make a huge difference if combined with the right corporate culture.

Stock option capitalism may very well be more difficult to get right at established corporations. It's tough to ask managers and executives to give up power that they already have and treat employees more like partners than underlings. Most high-tech companies have had the benefit of creating their workplace cultures from scratch. A General Motors or an American Express would have to change an existing system that has a rich—or maybe entrenched—history. That's a far tougher proposition.

A partnership approach also is likely to be more of a challenge at big companies. Many companies in corporate America are much larger than high-tech ones and have many more employees. The Corporate America 100 average 35,000 workers each, while the High Tech 100 average a mere 1,760. Size tends to breed bureaucracy, which can be a daunting thing to change. There are some very large companies that so far seem largely to be making it work, such as Cisco, which is a High Tech 100 firm, and Microsoft, which isn't. But of course, they're both high-tech firms, with a similar culture.

A company with a cast of thousands is more likely to be dragged down by free riders, too. Skeptical economists long have argued that the incentive effects of employee ownership can get hopelessly thinned out as the size of an organization grows. In a large company, they say, rewards that flow to the entire group give each individual a powerful reason to shirk. The reason: Any employee's contribution to the firm's overall success will of necessity be very small. After all, if there are just ten workers and all contributed equally, any slacker would cut the company's performance by 10 percent. But if there are 10,000, any individual may correctly think, If I don't put in extra effort, the effect will be minuscule and I'll still collect the benefit of the extra productivity gain everyone else produces. The problem, of course, is that if everyone did this, there wouldn't be any extra gain.

"Even in the New Economy, as the company gets bigger, each person cannot make as much impact," said Naveen Jain, the Infospace CEO. So some employees may become "what you call 'tagalongs,' in other words, they become successful just because they happen to be there" as the company prospers, Jain said. "This is the Microsoft phenomenon. A lot of people made money not because they contributed to the wealth, but because they just happened to be there when the wealth was created. That does happen."

Some high-tech employees feel this way as well. John, the Excite engineer who didn't sell his options before the crash, said that "Equity in a bigger company doesn't seem that important, because it's harder to affect the stock price. Sure, I own a piece of the company and I can definitely make a difference. But how much does that difference matter? It is not like I can move the stock price myself, so it's much harder to make a long-term difference."

In recent years, experts on employee ownership have come to believe that the free rider problem can be overcome by encouraging cooperation among employees. Although significant financial incentives help to sustain workers' interest in collaboration, money alone won't suffice. Instead, companies must adopt teams and other forms of employee participation, which inhibit free riders by making individual employees feel a sense of obligation to their colleagues. Teamwork also motivates everyone to monitor the behavior of those they work with, to make sure they pull their weight. Many high-tech companies back up this approach by awarding larger option grants to team players.

"You can be a real star performer, but unless the entire team does well that doesn't count," said Tom, the head of a Cisco market group, in a 2001 interview with us. "You better operate as a team or none of us survive. We're all measured on our customer satisfaction rating every time we go in front of a client. Our customer client scores are posted and everybody has a right to look at them. So I (might) say, 'John, you're one of my team mates and you're dragging us down.' Or I may have a very very high score for a quarter, but the fact is, if my other teammates aren't meeting a certain minimum, we're all in trouble. I can't pull them out alone."

Still, the challenge this represents for large companies adds to the difficulty of spreading partnership capitalism widely throughout corporate America. The culture of employee ownership may not "translate very well to large traditional corporations," says Marcel Gani, the Juniper CFO. "I don't think you are going to change the behavior if you just add a lot to the ownership pot. You have to change the organization itself and the employee involvement has to feel true. It has to be kind of a cradle-to-grave thing, where people feel proud and you have an open culture where people feel like they can speak their mind. This goes together with having shares in the company. It's all of those things that make people willing to contribute. If the culture of the company changes tomorrow and we became more of a rigid, bureaucratic company, people would have the equity, but I don't think they would put in the extra effort."

Other high-tech CEOs see a culture clash, too. "The biggest thing I notice when we work with Old Economy companies is the slow decisionmaking processes," said Sclavos, the CEO of VeriSign, a 2,000-employee company that registers Internet addresses. "Part of that is the size and the bureaucracy. Part of it is forgetting how to make fast decisions, and not empowering decisionmaking down lower into the organization. There's almost a bull-in-the-Chinashop analogy: We go in assuming that everybody at every level feels comfortable making decisions quickly for the corporation and takes risk. But that's not generally true."

Sclavos argues that traditional companies should use options to help change the culture. If he were put in charge of one, he said, that's just what he would try to do. "I believe that's the most important thing. Equity participation would be part of helping to show that management is sensitive to everyone needing to change. And if we do it, everyone will benefit. Options are the reward for the culture changing."

Employee ownership also helps to focus employees on the company's larger goals—the same rationale executives use to explain why they should get options. "There is a psychological buy-in that needs to take place in more traditional industries," said David Allen, the CFO of Interwoven, a High Tech 100 software firm. "You want people to participate because then they'll share in the ultimate objective of the company, which is to create shareholder value."

Jay Wood, the Kana chairman, agrees, although he acknowledges the magnitude of the challenge traditional companies face. The partnership culture "is transferable, but it's the old analogy of turning a big ship in a small river. In those large companies, cultures are so ingrained. People come in through the training process and are told, 'This is how we do things here.' So it's like moving a mountain. It's hard to take a traditional company and change the way it operates. Companies make these changes when they fall on difficult times. Then all of a sudden, there's an attitude shift."

The shift must also take place in the minds of the executives who champion partnership capitalism. SAIC CEO Bob Beyster said he came to see a policy of granting options to everyone as a means of rewarding and motivating employees at all levels of his company. "Employees earned it," he said. "They made something a success, helped solve a problem, all the things that make companies hold together. Those that were willing to do that deserved to own some of it. You have to subjectively say, 'This guy, although he did something different, is equivalent in importance to this guy over here who sold this ten million dollar contract.' A lot of people that do different things are in the same category."

Another key aspect of this attitude shift involves the concept of a career that undergirds the conventional corporate pyramid. The bureaucracy in many traditional companies is fueled and maintained by the calculating maneuvers of those trying to climb the narrow slopes of the pyramid. The flatter hierarchy found in many high-tech firms, coupled with the prospect of financial reward that options bring, can help to mitigate the corporate infighting that plagues many large companies. The partnership approach allows employees to share the wealth at different levels of the corporate hierarchy, which undermines the traditional corporate bureaucracy. "We don't have nearly as much of the politics associated with people worried about checking that box in my career, I should have that job, that's where I need to go," says Interwoven's Allen. "The people who come here say, 'How can I contribute. I want to work for a good company. I want to make some money.' We don't have nearly that type of water-cooler bullshit going on, and in talking to my peers in other Internet companies, I don't think they have as much of that either, because the classic career ladder just doesn't exist."

Partnership capitalism has potential pitfalls. For example, it's possible that a company can get carried away and grant too many options. If so, the dilution would be greater than any return and shareholders would lose out. As we saw in Chapter 5, even some High Tech 100 employees thought that their companies sometimes overdid it.

"They handed out options like they were going out of style, for bonuses, just for no reason," said Randall, a product engineer at Excite who spoke to us before the company's bankruptcy in 2001. At one point, he said, "It was almost every other month or something. It was at price points that are underwater today, but back then it was a big thing. They did it more when the stock had started to slide. I think they tried to use it more as an incentive. In June of 1999, they gave us a ton of options, but a month later all of them were underwater by the time we received the letter in the mail saying we got them. So they reissued even more than they had done before."

A related problem is whether employees who hold options might be tempted to look for ways to artificially pump up their company's stock, even if it means cutting corners. There was much discussion of this issue as it relates to executive stock options in 2002, following the collapse of Enron, which gave options to a majority of its workforce. In hearings on Capitol Hill, luminaries debated whether the lure of option wealth drove the company's top management to cut corners on accounting and break accepted business practices or even federal laws.

"I think there is a legitimate question in some cases as to whether the slogan of aligning the interests of management to the stockholders gets reversed and the interest of the stockholders is being aligned with the interests of the management, which is not the way it's supposed to be," said former Federal Reserve chairman Paul Volcker at one Senate hearing on Enron.

The partnership approach may offer some help in preventing options from distorting management's perspective. Because most rank-and-file workers aren't likely to rake in hundreds of thousands of dollars from their options, much less millions, their long-term financial interests still link primarily with their regular salary and overall health of the company. As a result, they have less incentive to cut corners to hype their company's stock. In fact, most have a good reason to object if top executives try to cook the books the way WorldCom leaders were charged with doing in 2002.

Another safeguard against the perverse incentives options created for corporate chieftains is to have a strong, independent board of directors. The Enron debacle prompted renewed calls for corporate America to embrace directors with more independence from the CEO. Enron directors, like so many of those at other companies, were handpicked by the company's CEO and often had relationships with the company of various kinds that seemed likely to compromise their independence. While there's no sign that many High Tech 100 firms have run into widespread corner-cutting like Enron or the other scandal-ridden companies that were exposed in 2002, their boards are even more insular than those at other large companies.

In part, that may be because many of these companies are still relatively new and relatively small. High-tech firms have an average board size of seven, compared to twelve at the typical large corporation, one study found in 2000. We looked more closely at the boards of the High Tech 100 and found that two of the seven are from top management. Of the remaining five outsiders, one was often from a venture capital firm or someone else closely connected to the company. In addition, even many of the five outside directors often have historic ties to management, lessening their neutrality. High-tech boards tend to have fewer independent directors and make virtually no use of special director committees to monitor corporate governance.

All of this seems inadequate. Both high-tech firms and any others that pursue partnership capitalism need powerful boards that can closely monitor the company's culture and ensure that wealth sharing doesn't warp behavior and mores. A strong board is also necessary to make sure that broad-based option programs are combined with the shift to a less hierarchical culture. Otherwise, public shareholders may not benefit and options can turn into a corporate giveaway.

Partnership capitalism also would seem to call for an employee representative to sit on the board. After all, if workers own a total of 8 percent or so of the company, as our model suggests would be feasible, they should be entitled to as much say-so on its top decisionmaking body as outside shareholders who own such a large stake. In fact, the standard assumption on Wall Street is that a 5 percent ownership stake is the threshold that entitles a shareholder to participate in the company's governance. Nor is an employee director such a strange idea. It happens on occasion in the United States, usually at unionized firms with large amounts of employee ownership. Workers on boards also have long existed in many European countries, where the practice came about as part of their more consensual style of labor-management relations. In the long run, a partnership corporation is only likely to succeed if boards of directors are truly independent from management. Part of that independence includes separate representation for employees—an idea that would serve technology companies well, too.

Another way to mitigate any perverse incentives for executives and employees to pump the stock would be to ensure shareholder approval of all option plans. Currently, management has the discretion to set up such plans and decide how much dilution shareholders should swallow. Some major shareholder groups called for this during the 2002 corporate governance debates following the scandals at Enron and WorldCom.

Partnership capitalism raises plenty of other issues. For instance, what happens in a prolonged bear market? Even if options do motivate employees, how many would stay psyched up if their employer's stock price is dead in the water for five or ten years? The cultures of most High Tech 100 firms seem to have survived the 2000 crash. However, it's not clear how well the model would hold up if employees had to wait many years for their company's stock price to grow again. One solution, which many high-tech firms used, is to set up or add to cash profit-sharing plans during times when the stock market is weak but the company continues to prosper. However, most companies can't and shouldn't continually reprice, regrant, or exchange options to keep employees motivated. Doing so usually would shift too much risk onto outside shareholders.

In fact, it's possible that the employee ownership culture found in the High Tech 100 only really works if the company's stock price is rising, even if it's not shooting up at double-digit rates. Amazon, if you remember, repriced its employees' options in early 2001, after its stock price had plunged from $107 to $30. Not long after, Owen, the Amazon middle manager, talked about employee morale before the repricing.

> I think the ownership culture depended on the stock price. It really did. The 'think like an owner' culture worked when the stock was going up. And it fell on deaf ears when the stock was going down. It ate on people's belief in the company. Not right away. But it just sort of ate on peoples' mood.

> I'm a manager of about forty or fifty people, and I'm constantly looking for ways to motivate those folks. To be honest, I feel that trying to motivate them with a speech about ownership in the company at this stage would be very unwise. It's a sore subject for people. We now have a year and a half where the stock has been going down. Everybody who joins the company over that period gets their options set, and then a few weeks later they're below water, then deeper below water, then deeper below water. To feel the ownership, you have to start to feel that you have something. They never really felt like they had anything. The options were like window dressing for them.

Still, using options to support a culture of employee ownership is likely to achieve better results than methods that rely on direct stock purchases. This seems to be one lesson to be learned from United Airlines Incorporated's ESOP, which has been one of the largest experiments in employee ownership in the United States in recent times. In 1994, most of the airline's unionized workers bought 55 percent of the company's stock, which they paid for through large wage and benefit cuts and work rule concessions. The effort began to transform employee attitudes and lift productivity in the first few years under the leadership of CEO Gerald Greenwald. However, his successors increasingly alienated many workers. A lot of employees also became increasingly disillusioned with their investment as the company's once-soaring stock sank in the late 1990s.

By the time the ESOP came up for renewal, labor and management were at each other's throats and the unions decided not to set up a second one. The bitterness has been so great that much of the cultural changes have long since dissipated. So has most of the positive views toward employee ownership, which has seemed like a lousy deal to many as the carrier's continued woes dragged on and on. Stock options might not have kept the new attitudes alive in the face of all the missteps. Still, with the company teetering near bankruptcy in the summer of 2002, workers' expensive stock purchases seemed unlikely to ever pay off. If, by contrast, their ownership stake had come largely through options that hadn't involved pay and benefit cuts, the experiment might have stood a better chance of weathering so many years of financial turmoil.

The most important ingredient in partnership capitalism is the cultural transformation it entails. Vivek Ranadive, the founder of Tibco Software said:

> There are scary elements to it. There are many in Russia who say, 'Maybe we would be better off if we went back to communism. At least things were secure. There was some order and we had to wait in long lines but at least we got food when we waited in those lines.' Now, you're going to have to be responsible for your own career. You're going to have to think about how I am going to have value and there is no such thing as a stable job. I have to do this, too. I'm the CEO, but if I don't add value I'll be tossed out. I should be tossed out.
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> On one level it can be viewed as being scary, because there is no stability. Now, every person is an entrepreneur, just like the old days. You were a shopkeeper, and if your shop didn't do a good job then you went out of business. And so that's the world. It's back to the future, back to how it was 200 years ago. There were no corporations and every person was a value creator. Every person was an individual entrepreneur. And so the Web makes that possible. It's the craft economy.

Perhaps the biggest transformation must come from top executives. As the cult of the CEO grew in the 1990s, many large U.S. companies have become even more autocratic than they were before. Part of this may stem from the enormous chasms in pay that opened up with the spread of executive stock options and the soaring stock market. With CEOs now taking home an average of $11 million a year, they typically earn several times more than the next layer of management. The inner circle, in turn, takes home much more than the next group, and so on down the line.

Since how much you make frequently denotes power and prestige, wider pay gaps tend to push authority up the corporate pyramid. The effect is magnified because a larger share of white-collar pay comes in the form of options and bonuses related to performance. How someone performs has a large subjective element to it, which means that bosses have even more power over their underlings' immediate financial prospects than they do under a fixed salary system. As a result, everyone has an even larger incentive to please the boss than before. On a psychological level, the glorification of corporate America's top leaders makes it difficult for many executives to become true partners with employees. It's a challenge for most people to give up power. It's also a lot harder to listen to other people's ideas, instead of just telling them what to do.

But when employees are also owners, this approach won't work anymore, even if gradations in pay remain. "You need to be more persuasive than demanding," said Kana's Wood. "Employees feel like they own something here, and they want to understand why. If you're making a salary of $60,000 a year and someone says, 'Paint that blue instead of yellow,' you say, 'Okay, what's it matter to me, I'm getting my $60,000.' But if you think, 'Wow, painting that blue is going to change how successful this company is, and I own some stock in this company and it could affect my value,' well, then you're going to approach it differently. You might come back and say, 'Hey, how about we paint it green, and here's why.' It affects attitudes and it affects the way you have to approach people."

Corporate America has already been pushing for more employee teamwork and worker input into decisionmaking. To make these ideas work, managers have had to become less authoritarian. Partnership capitalism pushes managers in the direction of becoming coaches. Indeed, in the long run, corporate managers may have to become more like pro sport coaches, who must learn to draw out talent rather than command it. Such a redefinition of roles, which requires managers to share prestige with underlings, touches virtually every aspect of management.

This doesn't mean some kind of radical egalitarianism, where everyone has an equal voice. "We try to set up an environment that has participative management, which means that somebody is empowered to do something and they involve all the stakeholders when it's necessary to make a decision," said BEA's Coleman. "But when they make a decision, everybody else gets out of the way, as opposed to the consensus management that ends up happening when everyone can say no, no one can say yes, and everybody is in everybody else's way. So it is a balance."

Jain and other high-tech CEOs believe that sharing information is equally important. There's not much point in making employees shareholders, or partners in an enterprise, if they don't have enough information to identify with the company. "Most shareholders have more information about the company than the employees themselves," said Jain:

> That's very counterproductive. If your most important shareholders, the ones who can make a difference to other shareholders, don't even have the information that can allow them to change something or make it successful, then sharing equity is not going to solve the problem.
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> The idea is to listen to your shareholders to see how to improve the company and the wealth in the company. Unless you can change the way management communicates with employees, making them shareholders is not going to fundamentally change how things happen in the company. So my advice, if you are the CEO of a large railroad or some other traditional company, is make sure you treat your employees like shareholders first, before you make them real shareholders.

This is a skill that much of corporate America has yet to learn, despite all the rhetoric about pushing decisionmaking down the ladder. To make employee ownership work, executives and managers must figure out how to help workers relate their daily activities to the company's larger goals. "I know as a manager that I have financial targets that I have to deliver to the company, so that we can make all of our numbers," said Owen, the Amazon manager.

> I'm an MBA, so it is very easy for me to tie my efforts to the company, and to my stock price and my personal wealth. Especially when companies are bigger, you need managers—it can't just be the CEO—to translate your team's goals into an individual's specific day-to-day responsibility, and to draw out that math from what you do to how it affects the stock price.
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> That does not happen a lot. It really requires managers who are good teacher types, because it is not clear to the average employee how this connects. You can't feel ownership unless you understand how your actions affect this thing that you own. That doesn't work for a lot of people who haven't had that explained to them or haven't really thought it through. Especially in large organizations. When the company was small, everybody's job had a noticeable impact. Today, it has to be explained.

Although the decision to pursue partnership capitalism must come from a company's executives and employees, the federal government has a motivation to step in and play a role as well. Over the decades, Washington has been key to the spread of employee ownership in the United States. Congress established both ESOPs and 401(k)s, providing some favorable tax treatment as an incentive for companies to pursue these ideas. Doing the same with broad-based stock options would be a continuation of the same effort. ESOP incentives, too, should be expanded, to provide more flexibility for public companies that can't move toward partnership capitalism entirely with options.

There are many approaches under discussion. In 2002, politicians spent much time debating whether and how to rein in stock options for executives, which were widely perceived to be excessive and abused after the Enron disaster. One response might be to use tax breaks to encourage companies to pursue partnership capitalism by tilting the balance of options away from CEOs toward employees. Congress could, for example, reduce or eliminate the current tax deduction for options at firms that don't grant most of their options to most or all employees.

Supporters see plenty of precedent for such an approach. Already, the Feds slap a higher tax on regular executive pay, excluding options and bonuses, that exceeds $1 million a year. In addition, companies with 401(k)s must run financial tests every year to make sure that the highest-paid employees aren't getting too big a share of the firm's contributions. If they are, the company must reduce its contribution as well as the amount high-end employees can contribute.

Another possibility would be to give preferential tax treatment to companies that offer options to most workers. Some political and business leaders have suggested this at various points. For example, in the spring of 2002, Al Gore's vice presidential running mate Joseph Lieberman, who had long defended executive options, proposed a zero capital gains tax rate for companies that offer options to at least half of its nonexecutive ranks. Although he did so to fend off the critics that spoke out after the Enron debacle, the idea won support from some others as well. "Stock options are one way capitalism has been democratized in recent years, but too many companies still have plans that exclude all but the top echelons of management or give a disproportionate percentage of options to those top executives," Lieberman said in a speech.

Or Congress could require companies with top-heavy option plans to subtract the cost of the options from their profits, as critics such as Greenspan and Levin had proposed in mid-2002. After it became clear in 2002 that top Enron executives had enriched themselves through options by artificially pumping up the company's profits, the Federal Reserve's Greenspan and others proposed that corporations be required to count all options as a corporate expense. Doing so would make investors more aware of the true cost of options, the reformers argued, and prompt them to curb excessive executive options. The idea triggered a storm of protest from corporate America, particularly high-tech and Internet firms that make liberal use of options. They argued that their profit statements would be devastated if they had to take this approach.

However, requiring companies to expense options unless most grants go to a broad group of employees could help to achieve two purposes. It could put a damper on runaway executive options, and simultaneously spur the spread of broad-based option plans. If executives were willing to share the corporate bounty with employees, as so many high-tech firms do, they could keep getting options without damaging their profit records, although they might get fewer options than they do when most are given only to the company's top tier. The mere suggestion of this strategy raised anxiety even among high-tech firms, who feared that any proposal to expense options might steamroll through Congress or other oversight bodies without the exception being made for broad-based option plans. This would be a big mistake.

Still, the strategy of excluding broad-based options firms from any expensing requirements squares with the nature of employee options as we've elucidated it. The reform advocates argued that companies get a tax deduction for the options they issue even though they don't have to count them as a cost of doing business when it comes to reporting profits to shareholders. Many made the argument that executive options are compensation and thus should be treated just like salaries, bonuses, and other forms of pay, which also are counted as a corporate expense.

But as we've said, options, at least for nonexecutives, in fact aren't compensation at all. Instead, they represent risk-sharing profits that workers receive on top of their normal market wages and benefits. As such, it makes little sense to deduct the value of those options from profits. Unlike wages, which companies must pay out in cash, options require no expenditure by the corporation. Instead, they come out of the pockets of the company's shareholders, in the form of dilution.

Some experts contend that companies incur an opportunity cost when they grant options. They argue that if an employee gets an option at say $50, and the stock has climbed to $75 when they vest, the company loses $25. After all, it could have sold that share in the public market for $75, but instead it receives only the $50 the employee must pay to cash in the option. Others point out that this logic doesn't account for the economic benefit that options can bring to the company. When options work right, employees create extra value, which companies and their shareholders share in along with workers.

The only cash expense that a company incurs from options comes when they're actually exercised. This happens if the firm buys back shares to offset the dilution involved. Some experts have suggested that companies should deduct this expense from their profits, which makes more sense than trying to predict what the cost will be when the options are actually issued. If they did, the company should only expense the true cost, that is, the amount required to buy back an option minus the strike price it receives from the employee who exercises it.

A public policy favoring options for all employees would also be a more equitable use of taxpayer subsidies. In the late 1990s, options provided U.S. corporations with a break from federal taxes that added up to a stunning 27 percent of all corporate net income, according to a study by Mihir A. Desai, a Harvard Business School economist. In 2000, the largest 150 corporations alone used options, the bulk of which go to top executives and managers, to take $78 billion worth of tax deductions. Desai concluded that stock options emerged in the past decade as one of corporate America's main tax shelters. They are a key reason why corporations only paid about 10 percent of all the tax money collected by the U.S. government in 2001, down from 20 percent in 1977.

The United States. might consider other policies if many more employers and workers pursue a partnership approach. Congress, for example, could endorse the idea as a national policy, just as it did with ESOPs in the 1970s. To give companies more choices, it might reinstate some of the ESOP tax incentives and expand those for profit sharing. The SEC also might consider requiring companies to disclose more details about employee option ownership.

Stock options have been thoroughly abused by most major companies, whose executives have used them to transfer ownership of 10 percent of the nation's corporate wealth from public shareholders to a small coterie of top officials. But companies that have offered options to their entire workforce offer a much different example. They illustrate the potential to unleash an explosion of entrepreneurial activity, which undeniably has occurred in the United States, the dot-com crash notwithstanding. They also have changed the entire idea of a wage from a fixed salary to a share in capitalism itself. Together with the alternative work culture embraced by partnership companies, the new model illustrates how a different kind of corporation can be organized. "You're seeing a transformation of capitalism as a whole here, in that no longer are workers seen as tools for companies to expend as they see fit," said Vivek Ragavan, the CEO of Redback Networks. "I don't think the fundamental rules of valuation will be changed significantly. But the relationship of the corporate organization to its employees, and of management to its employees, has to be transformed to a different type of relationship. This is the type of corporate model that is more sustainable in the long term."