IN THE COMPANY OF OWNERS

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The Truth about Stock Options (and Why Every Employee Should Have Them)

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BASIC BOOKS
A Member of the Perseus Books Group

Published by Basic Books, A Member of the Perseus Books Group

Designed by Lisa Kreinbrink
Set in 11.5-point Berkeley Book by the Perseus Books Group

Library of Congress Cataloging-in-Publication Data
Blasi, Joseph.
In the company of owners: the truth about stock options (and why every employee should have them) / Joseph Blasi, Douglas Kruse, and Aaron Bernstein.
p. cm.
Includes bibliographical references and index.
ISBN 0-465-00700-7 (alk. paper)
1. Employee ownership—United States. 2. Employee stock options—United States. 3. Employee Motivation—United States. 4. Chief Executive Officers—Salaries, etc.—United States. I. Bernstein, Aaron, 1955– .
IV. Title.

HD5660.U5 B5 2002
338.6–DC21 2002013468

03 04 05 / 10 9 8 7 6 5 4 3 2 1

0465007007_FM.qxd 10/25/02 11:36 AM Page v

To Dr. J. Robert Beyster

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Preface

Stock options have come in for a torrent of richly deserved criticism in the past year or so. It has become all too clear that the runup in the stock market during the 1990s proved to be too great a temptation for many of America's leading corporate executives. At least some of them pursued unethical and maybe even illegal strategies designed not to advance the company's long-range goals, but to pump up their stock and cash in on the profits their options brought them. At a parade of once high-flying companies—icons of the boom such as Enron, WorldCom, and Quest Communications—option-induced avarice spurred corporate chieftains to cut corners, cook the books, and dupe investors into buying shares at inflated prices. Some accountants, analysts, and investment bankers played along, wreaking serious damage to our financial system. The resulting crisis of confidence made options synonymous with greed and excess that distorted the entire U. S. economy.

But the problem with stock options is much larger than a handful of people who flouted the rules to line their pockets. The real issue involves the rules themselves. Most American corporations—including the vast majority who haven't broken any laws—have been on a stock option binge for more than a decade. An overwhelming majority of the country's CEOs used their company's ever-rising share prices as an excuse to stuff their wallets with vast profits from options that they essentially awarded themselves. We calculate that just the top five executives at the 1,500 largest U.S.

companies reaped a total of $18 billion in option profits in 2001, up more than fivefold from the beginning of the 1990s. Over the entire decade, they made a collective total of about $58 billion.

That doesn't count the vastly larger mountain of riches they're still sitting on. Overall, CEOs and a thin layer of other executives and managers in corporate America own a collective total of some 12 billion options today. This gives them control over about 10 percent of all outstanding public shares in the United States, up from next to nothing two decades ago. Even at the end of 2000, after the stock-market had tumbled far from its peak, the top five officers in the largest U. S. companies would have pocketed a total of some $80 billion in profits if they could have exercised all those options at once.

Executives have justified this incredible transfer of wealth by arguing that the incentive it provided would spur them to create more value for their company's stockholders. Unfortunately, economists have found scant evidence to back this theory up, much less to show just how large executives' option grants should be to bring about an improvement in a firm's stock price. Investors bear some of the blame here, since most were all too willing to brush aside questions about executive wealth-grabbing when the market was soaring by 30 percent a year. However, the more fundamental issue with stock options is who gets them, how much they get, and why.

We believe that the corporate malfeasance brought to light by the stock market's collapse stems from the abuse of stock options, not from the concept of an option itself. Most large corporations today are still run on the same top-down pyramid of power that has characterized U.S. business for generations. The CEOs who perch at the pinnacle enjoy virtually unchecked control over most of the major decisions, including their own compensation. Not surprisingly, they have grabbed the largest chunk of stock options for themselves and a small group that usually comprises less than 5 percent of a company's workforce. In the process, corporate leaders have excluded the vast ranks of employees whose dedication and motivation are central to a company's success.

Executive greed has victimized many employees, too. Some have been tossed out of work at the fallen icons such as Enron, which were brought down by the excesses and possible criminality of their leaders. But the greatest losses have come from practices that are much more ubiquitous—and perfectly legal. Many U.S. workers have suffered from their employers' practice of stuffing 401(k) and other retirement plans with company stock. Overall, we calculate that employees have lost more than $260 billion this way since the stock market tanked in 2000.

At the same time, most companies have restricted stock options, a much safer form of employee ownership, largely to the corporate elite. Millions of employees own options in U.S. public companies. However, most of them got a token amount on a one-time or occasional basis. We estimate that at most 3 million workers get options every year, the way CEOs do.

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. Yet it has given the riskiest stake—direct stock ownership locked up in long-term retirement plans—to average workers, who can least afford to gamble their savings on one stock.

The argument of this book is that investors and employees alike would gain if companies turned employees into corporate partners by granting stock options to most of the workforce. Most U.S. corporations would be better run, and in the long run more profitable, if America pursued this approach. We say this because unlike the case with executive options, there's compelling evidence that broad-based employee ownership does in fact produce more value for shareholders. Although many CEOs have twisted the concept of employee ownership for their own narrow self-interest, the underlying idea of using ownership to motivate employees is in fact a good one that has been proven to work. As you'll hear in our book, a number of executives, mostly in high tech, realize this. We will explain how corporations can operate more efficiently when employee ownership is used in a reasonable and appropriate fashion.

The reason is that granting options to an entire company has a very different effect than doling them out to a favored few at the top. The underlying rationale is much the same: to create an incentive to accept a job the executive or the worker might not have taken at the pay offered, and then to work harder or more creatively once they're in it. As Federal Reserve Board chairman Alan Greenspan noted in mid-2002, many high-tech startups might not have survived without employee options.

The basic notion is that options can help to form a partnership of interests between companies and employees. The idea began to emerge as early as the 1950s in companies such as Intel and Hewlett-Packard. As you'll see in the first two chapters, it was developed further over the following decades by Microsoft and other high-tech firms that blossomed in Silicon Valley and elsewhere, finally reaching full form in the Internet companies that sprang up in the 1990s. Even a handful of non-high-tech companies have begun moving in this direction. A few, like Pepsi and Wells Fargo, routinely give options to all workers, while others, including Aetna and Conoco, have made small or one-time option grants to most employees.

The concept has been pushed the furthest, however, at the Internet companies that survived the dot-com shakeout. Although the dot-com heyday has long since come and gone, a viable Internet industry remains today that's no more likely to vanish than the Internet itself. It consists of firms such as Cisco, Yahoo, and eBay, that invented and applied the core technology that made possible the whole phenomenon of individual computers linked up into a global network.

We created an index of the 100 largest high-tech firms that focus on the Internet, which we call the High Tech 100. It shows that employees and executives at these firms hold fully a third of their company's stock. Break that down, and the top five officers hold only 14 percentage points. The other 19 points belong to average employees, 17 of them through options. By contrast, executives in the rest of corporate America own 8 percent of their company's stock, while employees hold just 2 percent—mostly through 401(k)s and employee stock ownership plans (ESOPs).

Instead of an autocratic hierarchy of executive decisionmaking, these companies invented a new version of the employee-owned company. They shaped an enterprise that tries to bring people together as collaborators in a joint undertaking, rather than as workers being told what to do by a boss.

We've dubbed the idea partnership capitalism because it involves thinking of a corporation as a partnership among the people who work there, as well as one between them and the investors who own its stock. You might also call it stock option capitalism, since options for most or all employees are the key economic idea that drives the concept. By offering them to most of their employees, these companies have blurred the notion of private property, spreading ownership among everyone who's using the corporation's assets to generate value. They are engaging in a new form of risk sharing between economic partners. Employees assume some of the risk of ownership in return for a claim on part of the wealth they help to create. Investors, for their part, risk parting with some of their ownership in the hope that doing so will create even greater wealth than they had before.

The new work environment cultivated by companies that extend options to everyone is as important as the options themselves. While they certainly haven't invented a workplace nirvana, many of these firms strive to transform the traditional boss-employee management mentality into something richer and more diverse. Their aim is to spur employees to think of their jobs as activities they do for themselves, not just for their superiors.

The goal of partnership capitalism, then, is to get employees to think of themselves as owners. Doing so motivates employees to work smarter or harder, bringing about a more productive company and, ultimately, rewarding employees and outside shareholders alike. Society at large gains as well, since more productive companies create faster overall economic growth that usually benefits everyone.

The proof that this in fact occurs can be found in America's lengthy history of sharing profits and ownership with employees. For decades, in fact for nearly 200 years, many of the country's leading capitalists have experimented with the notion in one fashion or another. In fact, the broad concept of sharing the risks and rewards of property ownership with workers dates back to the country's earliest days. Usually, property holders have surrendered a portion of their ownership rights in the hope that the prospect of capital income would spur people to come to work for them or apply themselves more vigorously, thus creating more wealth than the original owner could do alone. At various points, many of the most illustrious names in American business have used profit sharing, ESOPs, or other plans that grant employees shares in the company for which they work.

Many traditional companies also have attempted to create workplace cultures that allow employees to take on more responsibility than they do in a conventional corporate hierarchy. Very few have managed to achieve a complete partnership model that couples the financial aspects of employee ownership to cultural changes in the working environment. But each part of the model has been tried by traditional companies for many years, and economists and labor experts have studied the pieces in much detail.

These studies offer powerful evidence that partnership capitalism, unlike executive options, really is a smart investment for companies and their public shareholders. If you sum up all the studies done just in the past two decades or so, they show that even corporate America's limited experiments with the partnership approach produce a one-time, but permanent, boost to a company's productivity of about 4 percentage points, compared to what it would have been without employee ownership. Total annual shareholder returns go up by an average of about 2 points. On average, the companies studied devoted roughly 8 percent of their stock to employee ownership. The higher returns they got came on top of this 8 percent, and thus reflect the net gain corporate stockholders reap from partnership capitalism. This track record strongly suggests that if corporate America used options to share ownership with all employees, and not just top executives, investors would gain more than they give up.

The partnership approach is the closest thing to a free lunch you can find in economics. The higher productivity it brings allows both workers and shareholders to earn more than they otherwise would. Just as employees get option wealth on top of their regular market wage, so do companies and their shareholders stand to earn higher profits and share appreciation than they would if the company didn't engage in partnership capitalism. Of course, nothing in life is really free, and a partnership entails some risks for all involved. For the idea to work, employees must work harder and smarter, and get along in a more demanding and entrepreneurial corporate culture, which is a real cost to them. What's more, they run the risk that their extra effort may not pay off for reasons over which they have no control, whether it's a corrupt or inept management or a larger industry or market collapse.

Shareholders also may extend the promise of ownership to the company's workforce, only to see their stock climb no more than it would have anyway. In some cases, employees might earn extra wealth even though they produced no extra value for shareholders. Still, these risks can be circumscribed for both sides and distributed fairly equally between them. Given the rich evidence that most partnership approaches indeed have paid off for both sides over the long term, the reward seems well worth the risk for everyone, despite today's troubled markets.

That's not to say that the partnership approach could have prevented any deliberate wrong-doing at an Enron or a WorldCom, much less forestalled the collapse of confidence and stock prices that hit corporate America in 2002. Nor will it stop recessions, a slump in a particular industry, or lousy business decisions by a company's CEO. However, forming a wider partnership with employees helps a company to perform better than it otherwise would in most circumstances.

A less autocratic corporation is also far less likely to be a breeding ground for executive malfeasance. If everyone in a company owns a piece of it, they have the same interest in boosting the stock price as the CEOs who let their greed get the better of them in so many firms. Unlike executives, however, average employees usually aren't going to make tens of millions of dollars from their options. Some Internet workers did rake in windfall profits during the 1990s market boom. But most employees in more typical firms and more typical markets stand to make substantial, though not tremendous, sums, on the order of 15 to 30 percent of their annual pay.

As a result, employees in a partnership company are likely to remain concerned primarily about the long-term stability of the company and their jobs. If top executives are cutting corners, workers will have a strong motivation to speak out or resist, as one or two did even at Enron and WorldCom. This is even more likely to be true after the examples these companies set, where thousands of average employees lost both their jobs and their savings while a handful of corporate kingpins walked off with hundreds of millions of dollars. While a nonhierarchical atmosphere can't ward off an executive determined to fiddle with the books, employees are more likely to be attuned to unethical leadership in a culture that isn't the usual "the boss gets everything and the boss is always right."

Just as important is the corporate governance structure a company adopts. U.S. CEOs have been able to award themselves millions in option grants because they essentially set their own pay. Many still handpick the boards of directors that are supposed to oversee management and safeguard shareholder interests. Directors are often former executives of the company, others who have dealings with it in some way, or people the CEO considers unlikely to challenge management. They also almost always run on a single slate proposed by management, so shareholders have no effective choice of candidates. Most boards don't meet separately from the CEO whom they're supposed to be monitoring, nor do they have a separate chairman or lead director who could call such meetings. Until a company runs into problems, many CEOs exercise the full powers of an autocrat. Very few behave like stewards of shareholders' money who must report to a truly independent board of overseers.

Directors have allowed CEOs to ratchet up their compensation to excessive levels with no proof that shareholders gain—or that anyone else who works at the company gets any credit for its success. Cozy boards allowed executives to take most options for themselves, turning away from the pursuit of broadly based employee ownership that some large corporations embarked on in the 1980s through ESOPs.

A partnership approach won't necessarily cure all these ills. In fact, many high-tech firms that grant options to most workers have an even greater proportion of captive directors than more established companies. For the idea to work well over the long run, they, too, will have to change. All companies need better protections for lower-level whistleblowers, and truly independent boards that can hire CEOs who will put a priority on creating entrepreneurial corporate cultures that give all employees a stake.

Investors may rightly feel burned by options today, given how many executives have abused them. But as this book makes clear, using broad-based options to create a partnership model of the corporation will, over the long run, help to make most companies more competitive and create more wealth for shareholders.

Similarly, many employees may not be too interested in the prospect of options in light of the woes of the stock market in recent years. But options remain a good deal for average workers, even today. For one thing, most companies grant them over and above the market wage they pay. They do so because options represent a share of the firm's future wealth; they're a form of profit sharing, which means they're capital income, not labor income. So employees won't lose anything even if their employer gives them options that turn out to be worthless down the road.

In addition, most companies issuing options to all employees do so every year, which means the options carry the lower price if the stock plunges. As the company's fortunes improve, employees will still make money on the new options, even if those granted at the market peak remain worthless. Since most options have a ten-year life span, it's reasonable to assume that stocks will resume their historical upward trend, eventually putting most options in the money.

By massively misusing stock options to enrich themselves, the leaders of corporate America have hijacked what could be one of the most important business innovations in many decades. It would be wrong if the calls for reform lead to the curtailment or elimination of options for a broader group of employees. Adopting a partnership approach in itself wouldn't bring about all the reforms critics have suggested. But it would make U.S. corporations more competitive and profitable, as well as better places to work.

Acknowledgments

This book is dedicated to J. Robert Beyster, who has been one of the most insightful executives in the area of employee ownership over the past three decades. Beyster is the founder, CEO, and chairman of the board of Science Applications International Corporation (SAIC), a privately held Fortune 500 research and development firm that's owned by its employees. Since founding SAIC in 1969, Beyster has been committed to building the company on entrepreneurial employee ownership and technical excellence. In 1986, he started the nonprofit Foundation for Enterprise Development, which today works to encourage the growth of small- and medium-sized enterprises and the development of entrepreneurs through international contracts and education programs. In 2002, the foundation launched the Beyster Institute for Entrepreneurial Employee Ownership. The institute educates the public through the Internet (www.beysterinstitute.org), national conferences, publishing, consulting, and training programs. We would like to thank the institute for grants to Rutgers to support this study. The ideas presented in the book are those of the authors and do not necessarily represent those of the institute or Dr. Beyster. Blasi is an unpaid member of the institute's board of directors.

We are especially grateful to the managers and employees of many companies who hosted our visits and allowed us to interview them, camp out at their offices, and challenge them in focus groups over many lunches and dinners. All of the nonexecutive employees we interviewed were promised confidentiality and their names appear as pseudonyms. This book could not have been written without the help of dozens of executives and employees and the cooperation of the support staffs of each company. We particularly extend our thanks to several employees of Amazon.com; the management and employees of: Bea Systems, Cisco Systems, Covad Communications, Excite@Home, Infospace.com, Internap, Interwoven, Juniper Networks, Kana Communications, Microsoft, Network Solutions, and Portal Software; several employees of RCN Corporation; and the management and employees of: Redback Networks, RealNetworks, Tibco Software, VeriSign, and Vitria Technology. Nicole Miller of Waggener Edstrom was a helpful host at Microsoft. We also wish to thank Arthur Rock who gave generously of his time on the early history and values of high-technology companies.

A number of experts were kind enough to read drafts of the book during its development and engage in long discussions on our study. Adam Blumenthal has given us special assistance on finance issues. We would also like to acknowledge the continuous assistance and encouragement of Corey Rosen, Ronald Bernstein, David Binns, and a number of occasional readers, including: Al Fortunato, Michael Higgins, Dean Jeff Garten of the Yale School of Management, Stanley Lundine, Bill Scott, Raymond Smilor, Matt Tobriner, Stan Vinson, Joseph Walkush, and Peggy Walkush. Others who have made themselves generously available to help are: Ralph Callaway, Ed Carberry, Michael Keeling, Scott Rodrick, and David Wray. Rutgers historian David Bensman and University of Nebraska historian Bruce. E. Johansen gave comments on the history sections. We would like to thank Richard Freeman of Harvard University for his encouragement and support. Several companies helped us understand their broad stock option programs, especially Louise Blackwell of Charles Schwab & Company, Michael S. Barker of Guidant Corporation, and Nicolas de Porcel of Wells Fargo. Paul Cyr of the New Bedford (Massachusetts) Free Public Library Whaling Archive helped with research on risk sharing among whalers. Jerry of Hello Limousine drove us around Silicon Valley.

Joseph Blasi and Douglas Kruse would like to thank several colleagues at the School of Management and Labor Relations at

Rutgers University: Dean Barbara Lee and Dean John Burton and our department chairs, Steven Director and Paula Voos, who helped us with funding and sabbaticals during the time the book was under preparation, and our graduate program directors, Charles Fay and David Bensman, who were understanding about course scheduling. D. J. Gafgen and Bettylou Heffernan of Rutgers managed our accounts and solved every problem that came up. Joanne Mangels provided computer support. We are especially grateful to Professor James Sesil of Rutgers University School of Management and Labor Relations and Professor Maya Kroumova of the New York Institute of Technology for their important work on stock option research that was key to our argument. Our colleague at Rutgers, Mark Huselid, was helpful in answering questions about his important research. The staffs of the Rutgers University Libraries and the Princeton University Firestone Libraries helped us enormously. The company research would not have been possible without the U.S. Securities and Exchange Commission. We especially want to thank Ms. Seretha R. Pearsall, assistant branch chief of Public Reference at the SEC and Joe Rogers for their assistance to us in tracking down documents. Steve Hekker and Rachel Stern of Factset also provided certain data and assistance. Aaron Bernstein would like to thank his editors at *Business Week* for allowing him to pursue this project.

Our agent, Susan Rabiner, has gone above and beyond the call of duty by serving as a traditional agent, as well as a critic, cothinker, editor, and all-around strategic advisor. She was irreplaceable. Our editor at Basic Books, William Frucht, has believed in this book from the first moment we met him. He has been a patient taskmaster through the many stages of its development. We are very thankful for his staying power. We would not have found either of them without the help of Eric Johnson.

Any errors are the responsibility of the authors. We undertook considerable research that we were unable to include in the print version of the book. Some of this added material can be found on the web site we set up, www.inthecompanyofowners.com.

Most of all, we cannot find the words to express our thankfulness to our families for their unending patience and warm support. For us, their assistance was decisive. Joseph Blasi would like to thank his wife, Nancy, and his family for their steadfastness. Doug Kruse would like to thank his wife, Lisa. Aaron Bernstein would like to thank Margaret, Amanda, and Adam Monahan, who took time out of their lives to support him on this project.

This book is written for general education and interest and should not be used as the basis of investment decisions. More extensive footnotes and additional material are available on our web site: www.inthecompanyofowners.com.

J.R.B., D.L.K., and A.B.