

Lessons Learned: When broad based stock options don't work

Two partners launched Company X, a software business, in the mid-1980s, and implemented a range of benefits early on for employees including profit sharing, bonuses, and broad based stock options. [The founder asked that the firm remain anonymous for this publication.]

While the profit sharing and bonus plans were understood and enjoyed by employees throughout the firm, regardless of market conditions, the company's experience with stock options during difficult times was less straightforward.

Company X founders planned to award stock options broadly from the beginning. Options were awarded each year to a varied group of employees, including many non-management employees, often as incentives for performance. As the company grew and the potential to go public became increasingly likely, the value of options shot up ten-fold, which was very motivating to employees. Had the company succeeded in going public, it would have been a very good story for all involved.



Regrettably, a turn in the market prevented a public sale, the company did not connect with a buyer for seven long years, and option values plummeted, severely damaging morale. When the company was eventually able to sell, the founders wanted to make sure their employees, who had watched the value of their options make a meteoric rise and subsequent fall, got something from the deal. Together with their board, the founders decided to revalue the options at zero. Then, using their own proceeds from the sale, they generously paid employees the current value of the shares (about \$62/share).

Company X's founder said he would not share stock options broadly again, but not because he doesn't believe in performance based incentives and employee engagement. Rather, stock options in this situation were simply too complicated and he never felt that his college educated workforce fully understood what stock options meant.

Because seeing options steadily lose value in a market downturn was such a disincentive to his employees, Company X's founder thinks that bonuses are a more straightforward and understandable way to reward employee performance.

KEY TAKEAWAYS:

Carefully consider the pros and cons of broad based stock options before implementing.

Comprehensive and repeated education of employees about what options mean is key.

Finding other ways to reward employees' hard work when market conditions result in underwater options is important to maintain morale.
