The Right Way to Pay

After decades of paying employees in the same old way, cutting-edge CEOs are solving their worst compensation problems by adding one critical factor: risk.

by Christopher Caggiano

Richard Rhodes learned the usefulness of sharing equity when he started his company, in 1998. Rhodes is CEO of Seattle-based Rhodes Ragen Smith, a $10-million, 32-person company that recovers and sells handcrafted stone building products. Rhodes and his start-up team had plenty of experience in masonry and construction, but they lacked expertise in overseas business development, which would be critical for the new business in recovering architectural elements from abroad. "We needed someone with deep relationships in China who knew how to manage the export/import logistics," Rhodes says. Rhodes had some start-up capital but not enough to offer the kind of salaries the people he needed would be looking for. So he offered a share of the company to two potential hires -- and got the necessary know-how in return for 20% of the company.

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Luring potential partners with equity is a tried-and-true way to start a business, but Rhodes decided to take the ownership concept company wide by installing an ESOP at the beginning of this year. He set aside 24% of the company's equity in the program but dropped the percentage to 17% recently when he took on outside investors. Employees receive options based on their level of responsibility. The shares have no street value until the company is acquired or goes public, but at any time employees can use their options to purchase a portion of the company, which would make any future liquidity event a lot more meaningful.

Rhodes had initially hoped that the ESOP might transform his employees into business owners. "We wanted to have an entrepreneurial culture," he says. "I also hoped we would attract new-economy workers in an industry that pretty much defines old school. We're literally bricks and mortar. The stone industry is pretty stagnant, and we're looking for tools to make it sexy."

But after a year's experience, Rhodes feels that lower-level employees either don't understand the idea of ownership or simply don't care. "It's a great democratic principle that everybody gets stock at our company," he says. "But I would have thought it would have inhibited more people from moving to new jobs." Rhodes recently lost some key employees who had significant amounts vested in their stock-purchase plans but left without exercising their options. "In exit interviews they said that they never really thought the options were going to be worth anything anyway," he says. "They didn't even ask what it would cost -- they just abandoned them. I just scratched my head."

Still, Rhodes is convinced that the ESOP makes a huge difference to his four management-level employees. "We have people on our executive team who took major pay cuts to come here, because they feel they're really participating in the future of the company," he says. "It has allowed us to bring in a higher caliber of execs when we can't really afford to pay the going rate." Rhodes thinks the discrepancy in the ESOP's impact on the two groups may be due to the fact that his managers are more invested in the business and have greater responsibility, but it may also have to do with education. "[The managers] typically have more business training, and they may also have aspirations to someday have companies of their own," he says. "Ownership feels like a stepping-stone."

Rhodes says he could also be the victim of a cultural shift in attitudes about ownership. "When we were putting this program together, we were riding on the coattails of Microsoft," he says. "Options really meant something in Seattle, and we were trying to tag along with some of that goodwill." But gone are the days of the overnight Microsoft millionaire, as are the days when the average worker placed much personal stock in stock. "Options are much more interesting when they hold the promise of infinite growth -- as an abstract article of hope -- than as a 30-page document of nitty-gritty details," he says.

Bonuses, profit sharing, equity. What it all comes down to is risk -- and finding opportunities for employees to share not only that risk but also the upside. Finding the right comp program -- one that perfectly balances risk and reward -- can be tricky. But not even trying could be the biggest risk of all.

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