Share Options as an instrument to attract & retain talent for Dutch startups

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Preface

This thesis is the result of a study towards effectiveness of share options as an instrument to attract and retain employees in Dutch startup companies. The study was conducted as a completion of the Master of Science in Business Administration at the University of Twente with a specialization in Human Resource Management, to complement my bachelor Human Resource Management at Saxion. This study was conducted independently, by means of existing research and literature, to which is referenced as well as possible, and interviews with startup companies in the Netherlands.

Writing this thesis has been challenging because existing literature generally does not make a distinction between size of the company, age, financial status, if it is private or public and if it is listed on the stock market. Furthermore, a large part of the information is out of date due to legislative changes in recent years, such as the abolition of the savings scheme ('spaarloonregeling') and the introduction of the Flex BV, both in 2012. On the other hand, conducting this research proved to be very educational considering I was still a layman on the subject of shares in the beginning. The positive feedback and interest I received for this research worked very motivational and I was pleasantly surprised by the enthusiasm and willingness to cooperate by all participants despite the limited time available.

Finally, some words of acknowledgement are in place. First I would like to thank my supervisor Dr. A. Fritze for giving me the opportunity to conduct this research via Oni Labs, but also for providing critical comments and useful tips during the research process. From the University of Twente I would like to thank my supervisors Prof. J.C. Looise and Dr. J.G. Meijerink for their feedback during the period of my research and for writing this thesis. For their participation in my research, I would like to thank Drs. J. Annink from Grant Thornton (Enschede), Drs. P. Nieuwland-Jansen from the Dutch Participation Institute (SNPI) and the many startup companies of whom most wished to stay anonymous. Last but not least, I would also like to thank my family and friends for their support during my study.

Inge Meeuwenoord,
Enschede, June 2014

Abstract

Startup companies typically have very limited funds and cannot offer their employees the same job security as established firms. Therefore they often find it particularly challenging to attract and retain talented employees. In several countries, such as the US and UK, Employee Share Ownership is a commonly used tool to aid in the attraction and retention of employees and its efficacy is generally backed up by the existing literature. This practice however, does not seem to extend to the Netherlands and little research on the topic has been done in this country. This has led to the following research question: *Can share options be used by Dutch startups to attract and retain talent, and how are they best implemented?*

This research builds on recent studies from Ten Have and Kaarsemaker who explored the use of Employee Share Ownership in the Netherlands- and expands these to the use of share- and STAK options in Dutch startups specifically. It aims to fill the gap in the existing knowledge and research about share option schemes for startups in the Netherlands who seek ways to attract and retain talent. It offers not only information but also practical guidelines in the form of an ‘Employee Share Option Plan-model’ which startups can use in their quest to find the right employees without having to offer unsustainable salaries and risk solvency.

An extensive literature study was performed to assess the effectiveness of Employee Share Ownership Plans in attracting and retaining employees in Dutch startup companies. In addition to the literature review, more specific information was gathered via accountancy and consultancy firm Grant Thornton and the Dutch Employee Participation Institute. In total, 11 startup companies in the Netherlands were willing to share their experiences with various employee participation plans, such as (options on) shares or certificates via a STAK. The participants were asked about the effectiveness of employee participation plans in attracting and retaining employees and the design and implementation of the approach in their company.

Share(- and STAK) options are found to be an appropriate instrument for Dutch startups for attracting and retaining talent, as long as the Employee Share Option Plan matches the company and its employees in its design and implementation. The ESOP-model developed in this study will provide guidelines for the orientation, design, implementation and evaluation of a suitable and fitting plan.

Abbreviations

ESO	Employee Share Ownership
ESOP	Employee Share Option Plan
FEP	Financial Employee Participation
SAR	Stock Appreciation Rights
SNPI	Dutch Employee Participation Institute
STAK	Stichting Administratiekantoor (foundation to hold shares)
UK	United Kingdom
US	United States of America

Contents

1. Introduction

This master thesis about Employee Share Options in startup companies started as a wish from the small software company ‘Oni Labs’ to find out if the use of share options as instrument to attract and retain talent works as well in the Netherlands, as it seems to in the US.

Attracting and retaining highly skilled employees is particularly challenging for startup companies which typically have limited funds and cannot offer the same salaries, job security and career progression as more established companies.

One characteristic that differentiates startups from mature companies is their potential for meteoric growth in a very short timeframe. This is particularly true for companies in the knowledge industry. This is exemplified by the 7-year old company Dropbox which, after a recent investment, is being valued at $10B, Zalando (valued at $4,9B 6 years after being founded) and Spotify (valued at $4B 8 years after being founded) (Thole, 2014).

Especially in the US it has become common practice for startup companies to use the allure of big payouts to attract employees by offering them a stake in the company through the instrument of share options.

While truly successful ventures like the startups Facebook and Dropbox are few and far between (in fact, according to research by Harvard Business School lecturer Shikar Ghosh (Gage, 2012), 3 out of 4 startups fail and only very few will yield even moderate paybacks for their employees), they do capture the imagination of potential employees. In particular in the high-technology internet startup scene in California’s Silicon Valley, founders and early employees of successful startups enjoy somewhat of a ‘rock star’ status, with many young talented software developers wishing to emulate the success of their idols.

While the need to attract and retain talent is just as crucial for startups in the Netherlands, share options do not seem to be as popular here as in Anglo-Saxon economies. This leads to the research question under investigation in this thesis:

Are share options an appropriate instrument for Dutch startups for attracting and retaining talent, and how are they best implemented?

The remaining sections in this chapter will provide insight in the research background, problem statement, research questions and the objectives that this research aims to achieve.

1.1 Research background

The number of entrepreneurs starting businesses in the Netherlands has grown with 13% from 2012 to over 150.000 startups in 2013. Of these companies, 80.1% are without personnel and 18.9% have between two and four employees (Chamber of Commerce, 2014).

Typical startups have little or no revenue in the beginning, and on average it will take them over six years to become profitable (Twaalfhoven, 2010). This is a particular problem for startups developing products, considering no sales can be made during the initial development phase; yet qualified staff is needed. For a software startup company like Oni Labs, this development phase can stretch over several years.

In addition to their precarious financial situation, startups are inherently risky. Following a recent study in America in 2014, 25% of all startups fail within the year and 44% after three years (Statistic Brain, 2014). In fact, only 37% of startups in the Information sector still operate after four years. The survival rate for startups in the Netherlands looks even more grim; 30% fail in the first year and an additional 60% in the first three years (Boukema, 2013). This is one of the main reasons why these companies are associated with a very low job security for their employees. Other downsides in working for startup companies compared to more established ones are found to be a lack of structure, e.g. inexperienced leaders, unclear roles and procedures and long working hours (Venture Village, 2013).

'Startups are intrinsically risky. A startup is like a small boat in the open sea. One big wave and you're sunk. A competing product, a downturn in the economy, a delay in getting funding or regulatory approval, a patent suit, changing technical standards, the departure of a key employee, the loss of a big account—any one of these can destroy you overnight. It seems only about 2 in 10 startups succeeds' – Paul Graham (2005)

The fortunes of high-technology product-developing startups such as Oni Labs depend significantly on being able to attract skilled, talented high-in-demand employees from the start, which is challenging given the limited funds typically available to them (Crowne, 2002; Twaalfhoven, 2010). Lawyers Schwartzberg and Weiner (2007) mention that an alternative to paying employees a high salary is to offer them alternative incentives like equity based compensation such as Employee Share Options. Employee Share Options grant employees the right to buy or sell shares of the company they work for, at a fixed price per share (Duarte, 2008; Schwartzberg & Weiner, 2007). The preservation of cash flow is for many (later-stage) startups a major reason to prefer employee share options. According to researcher Mawani (2003), this instrument is used especially by companies in the technology industry with its higher proportion of startup firms that are experiencing growing pains.

At this moment, Oni Labs is considering issuing early employees of the company share options that they can exercise after having worked for the company for a certain period of time. If the company grows as planned, this will amount to a large future payout for the employee. The idea is that this prospect of having a material stake in the success of the company can motivate and retain employees and make them forego some of the benefits, such as higher salary and job security which they would otherwise enjoy when working at a more established company.

Even though Employee Ownership schemes like this are common-place in the US, especially in the Information Technology sector (Hand, 2005; Maas, 2011; Poutsma, Kalmi, & Pendleton, 2006), they do not seem to enjoy the same popularity in the Netherlands (Kaarsemaker, 2009; Smits, 2011; ten Have, 2013) and particularly not in startup companies. According to researcher Hand (2005, p. 4), smaller firms, especially if they are knowledge-intensive, are likely to use option plans to lure and retain top talent. Startups benefit more from such a plan due to their flatter and clearer organizational hierarchy and structure and because lines of communications are shorter (van der Heijden, Grapperhaus, & Heerma van Voss, 2012, p. 73). Since understanding and deploying plans like Employee Share Option Plans (henceforth: ESOPs) can mean the difference between success and failure for a startup according to Schwartzberg & Weiner, it is important to understand the reasons behind the difference in popularity and prevalence of these plans.

1.2 Problem statement and objectives

As exemplified by Oni Labs, startup companies with limited funds and job security experience difficulty in attracting and retaining skilled, talented and high-in-demand employees (Hand, 2005). In the US, share option schemes are seen as a popular approach to reach this goal (Hand, 2005; Schwartzberg & Weiner, 2007), yet in the Netherlands, only limited research has been done, and very little specifically on share option schemes in startups. Existing literature focuses mostly on larger, multinational corporations (Lavelle, Turner, Gunnigle, & McDonnell, 2012; Pendleton, Poutsma, Brewster, & Van Ommeren, 2001; Poutsma, Blasi, & Kruse, 2012; Poutsma, Ligthart, & Schouteten, 2010; ten Have, 2013). Against this background, the central question that motivates this thesis is if share options are also a useful instrument for attracting and retaining talent in *Dutch* startups.

Since existing literature has focused mainly on multinationals and established firms, this research can be qualified as exploratory (Elshof & Pieters, 2006), aimed at finding an answer to this practical problem for Dutch startups. The objective is to describe the theoretical concept and occurrence of share options in general and in Dutch startups specifically, to combine that with practical knowledge and to give practical guidelines in the form of a model for designing and implementing such a scheme for a company like Oni Labs. The information in this thesis should be clear and understandable for startup managers and founders who do not necessarily have prior experience or knowledge of share option plans.

1.3 Research question and sub questions

The problem statement and objectives have led to the following research question:

Are share options an appropriate instrument for Dutch startups for attracting and retaining talent, and how are they best implemented?

This thesis aims to provide answers by examining the following sub-questions:

1. What does the literature say about the concept, use and implementation of Employee Share Options and their effectiveness in attracting and retaining employees for Dutch startups?
2. What do experts and practitioners say about the concept, use and implementation of Employee Share Options and their effectiveness in attracting and retaining employees for Dutch startups?
3. Which advice can be given to Dutch startups regarding the main question, based on the results of sub question 1 and 2?

These questions can be defined as applied questions, specifically ‘remedy questions’ (Babbie, 2013); existing knowledge on share options in general and on US startups is applied to Dutch startups that have the real world problem of attracting and retaining talent, because of limited funds and a lack of job security to offer.

The research question consists of two parts, the effectiveness of share options to attract and retain employees in Dutch startups and how to design and implement a proper Employee Share Option Plan. The answers to the sub-questions will provide information on the definition of startups and share option plans, their prevalence in the Netherlands, associated conditions and positive effects and risks of Employee Share Options. The effectiveness of share options to positively influence the decision of someone to start working for a Dutch startup and to keep working there are explored by examining existing literature and interviewing subjects with first-hand experience. The goal then is to give practical advice including an implementation model, not only to Oni Labs but to all startup companies in the Netherlands, regarding the use of Employee Share Options for these companies to attract and retain valuable employees.

1.4 Chapter outline of the thesis

Chapter 2 will go into detail on the theoretical concept and practice of share options and alternative forms of financial participation. The concept, rules and prevalence of share option plans in general will be addressed before exploring the benefits and risks of such a plan in Dutch startups. Then, the influencing factors and mediating conditions of a share option plan and its design are discussed. Finally, the conceptual model developed in this research for the design and implementation of an Employee Share Option Model for Dutch startups is discussed. This is elaborated on further in a practical implementation plan in appendix 3.

Chapter 3 addresses the type of research, methodology and operationalization of the research, as well as the design of the questions and preparation of the interviews and questionnaires.

Chapter 4 summarizes- and analyzes the interview and questionnaire results by comparing them with the results of the literature study.

A final conclusion is given in chapter 5 after which the implications and limitations of this study and future research possibilities are discussed in chapter 6.

2. Literature review

2.1 Existing relevant studies

This research builds on recent studies by ten Have (2013), Kaarsemaker (2009), Brandes, Dharwadkar, Lemesis, and Heisler (2003) and the Dutch Employee Participation Institute (SNPI).

Ten Have and Kaarsemaker analyzed the use of various forms of Share Ownership in the Netherlands and found this practice to be more dominant in larger companies which have a more solid financial footing than a typical startup company. This finding is supported by van der Heijden et al. (2012, p. 73) who claims that share ownership is more prevalent in companies that perform well financially. However, Kaarsemaker (2009) argues that share ownership might actually be an even better fit for starting companies since a startup culture and strategy are more easily adapted to a new Employee Share Ownership (henceforth: ESO) scheme and there is less chance of a troublesome history between management and employees to complicate the implementation or diminish the intended results. Unfortunately, there is no existing research or academic literature on this topic specifically targeted at Dutch startup companies.

Brandes et al. developed a model for designing ESOPs in a way that optimizes the individual stakeholders' interests while also taking into account the overarching strategic goals of the company. While this model is not fully compatible with the target group of this thesis, the basis still applies and will be used to develop a new model, design- and implementation plan for private startup companies in the Netherlands.

Another source of information was the SNPI, in the form of their website, e-mail contact, an employee participation congress (2014) and sources like SNPI (2011), Smits (2011), Nieuwland (2012) and Soppe and Houweling (2014). The institute created the *'Dutch Model'*; giving guidelines to implementing a proper share (option) scheme for employees in the Netherlands (see chapter 2.6.1). Information from the institute was used as a source for practical information, as basis for the interviews and for creating the practical implementation plan in appendix 3.

2.2 The concept of share option schemes

2.2.1 Definition of employee share options

Employee share options grant employees the right to buy or sell shares of the company they work for, at a fixed price per share (*exercise price*), and guided by a number of rules set out in a formal options contract (Duarte, 2008; Schwartzberg & Weiner, 2007). The idea is that employers can offer (key) employees the prospect of part-ownership, share-based payouts and/or a big future payout from sale proceeds in an exit, to attract and bind these employees to the company or to motivate them to reach certain organizational goals (Kaarsemaker, 2009).

Share options are a common route towards ESO, which is a form of Financial Employee Participation (henceforth: FEP). FEP can also take the form of profit sharing, direct shares or certificates of shares (van der Heijden et al., 2012, p. 19). These forms are further discussed in chapter 2.2.3.

The theory discussed in this thesis also largely applies to options via a STAK, which is a common form of FEP employed in the Netherlands. Whenever 'share options' are mentioned in this thesis, it can be applied to options on certificates via a STAK as well. For more information about the differences between share options and STAK options, see chapter 2.2.3.

2.2.2 History of share options

Share options were initially conceived in 1957 in the US as a means to compensate company executives only (Hoody, 2001). They were primarily used as such until company-wide option schemes became popular in the 1970s; especially in California's Silicon Valley where many startups were able to attract and retain valuable employees with options without having to drain scarce capital (Hoody, 2001). By tying a portion of the employees' compensation to the company's stock, motivation and productivity of these employees would increase, helping align possible differences in goals of the employer and employee (Maas, 2011). The popularity of employee share options was further increased by several tax advantages introduced in the US. Nowadays, employees control about 8% of corporate equity in the US (NCEO, 2014a).

2.2.3 Other forms of Financial Employee Participation

Even though this thesis focuses on share options specifically, these other common forms of FEP need to be discussed as well to provide an overview of the possibilities when considering employee equity remuneration.

2.2.3.1 Share options vs. direct shares

Offering share options instead of direct shares has both its benefits and drawbacks. Options are a form of *deferred* compensation: employees can only reap possible benefits in the long run, when options vest or when the company is sold (which usually goes hand in hand with an immediate vesting of all outstanding share options, as per the options contract). This can decrease the direct positive results of share ownership such as increased motivation and the feeling of ownership (Poutsma et al., 2006). Rewarding employees for their present loyalty in the long run can however increase the retention effect. Eventually exercising the options to buy shares can still increase the ownership-effect at that point (Schwartzberg & Weiner, 2007). One positive feature of options is that the employee can choose to exercise his options only once the company is profitable, e.g. when dividends are paid, or when the company is sold.

2.2.3.2 Certificates via a STAK

A very common form of ESO by private Dutch companies is a one-to-one certification via a STAK ('*Stichting Administratiekantoor'*) (Kaarsemaker, 2009). A STAK is a foundation that a company can start through a notary, to hold shares of the company. Instead of the company offering shares to employees, the STAK can issue depositary receipts (*certificates*), which give a right to dividends and other distributions attributable to the shares (*residual claim*). Certificates can be issued without the use of a notary since the shares stay with the foundation. Especially in companies with limited funds this can this be an advantage. A downside is that the use of a STAK is not well known in other countries like the US and can possibly form a complication for foreign investors.

The certificates do not give voting rights as this right stays with the foundation, or more specifically: the board of the foundation. The board of the STAK can be formed by board members of the company to maintain control (Dirks, 2014) but often consists of employee representatives as well (Kaarsemaker, 2009). In other words, the legal and economic ownership is split, with only the opportunity of increase and risk of decrease in value still lying with the certificate holder (Vlasveld, 2012). The foundation is free in its voting right but agreements can be made between the certificate holders and the STAK on voting issues. Another possibility is to include several employees as board members in the STAK to represent all certificate holders (Maas, 2011). The relationship between certificate holders and the STAK falls under contract law. It is up to the company to decide if the holders are allowed to participate in shareholder meetings[1], to which extent certificates can be traded or sold and how much should be paid for them. This is typically described in the statutes or STAK-conditions. Just like shares, certificates can be offered to employees in the form of options. Note that there are additional regulations for *public* companies using a STAK, which are not discussed in this thesis.

A certificate can represent the value of one share of e.g. €1,-, yet another possibility is to give out e.g. 10 certificates of €0.10. This flexibility makes it easier to divide (certificates of) share amongst a group of people (Kooijman Lambert Notarissen, 2014).

Blasi, Freeman, and Kruse (2013) found that a reason for companies to choose certificates instead of shares is to prevent conflicts. They are reluctant to give their employees voting rights because that would traverse the hierarchy and make the company more difficult to control.

2.2.3.3 Stock Appreciation Rights (S.A.R.)

SAR are technically not a form of ESO but are still a share-based incentive. In this form of FEP, employees do not receive shares or certificates in the company but can receive a reward, of which the amount depends on the value of shares in the company. Because there is no actual ownership, no notary is needed. In short, SAR give a future right to a cash-payment, based on the value development of a share in the company. This means that SAR do not give voting rights, nor the right to receive information or to attend shareholder meetings. SAR is very similar to ‘phantom stock’ where employees not only enjoy the increase in value but also receives dividends as well (NCEO, 2014c). If specifically stated in the SAR-agreement, employees can receive dividends and part of the sale proceeds of the shares in case of an exit as well. Profit sharing or ‘tantièmes’ are the most common form of FEP in the Netherlands yet also the most passive according to SNPI (2014) because it does not involve employees intrinsically, meaning that some of the proposed benefits (e.g. the positive influence of the ‘ownership feeling’ on motivation, decision-making, etc.) as listed in chapter 2.3.1 are supposedly less or even non-existent.

2.2.3.4 Comparison

There is no single solution that fits the requirements or goals of every company and its employees. Each form of ESO has unique attributes, the most common of which are summarized in table 1.

Since shares and a STAK can both be offered as options, only direct shares and certificates are compared. There are of course fiscal differences between these alternatives which are not mentioned in this thesis due to their complexity and changeability. A fiscal advisor can give more information on the tax implications.

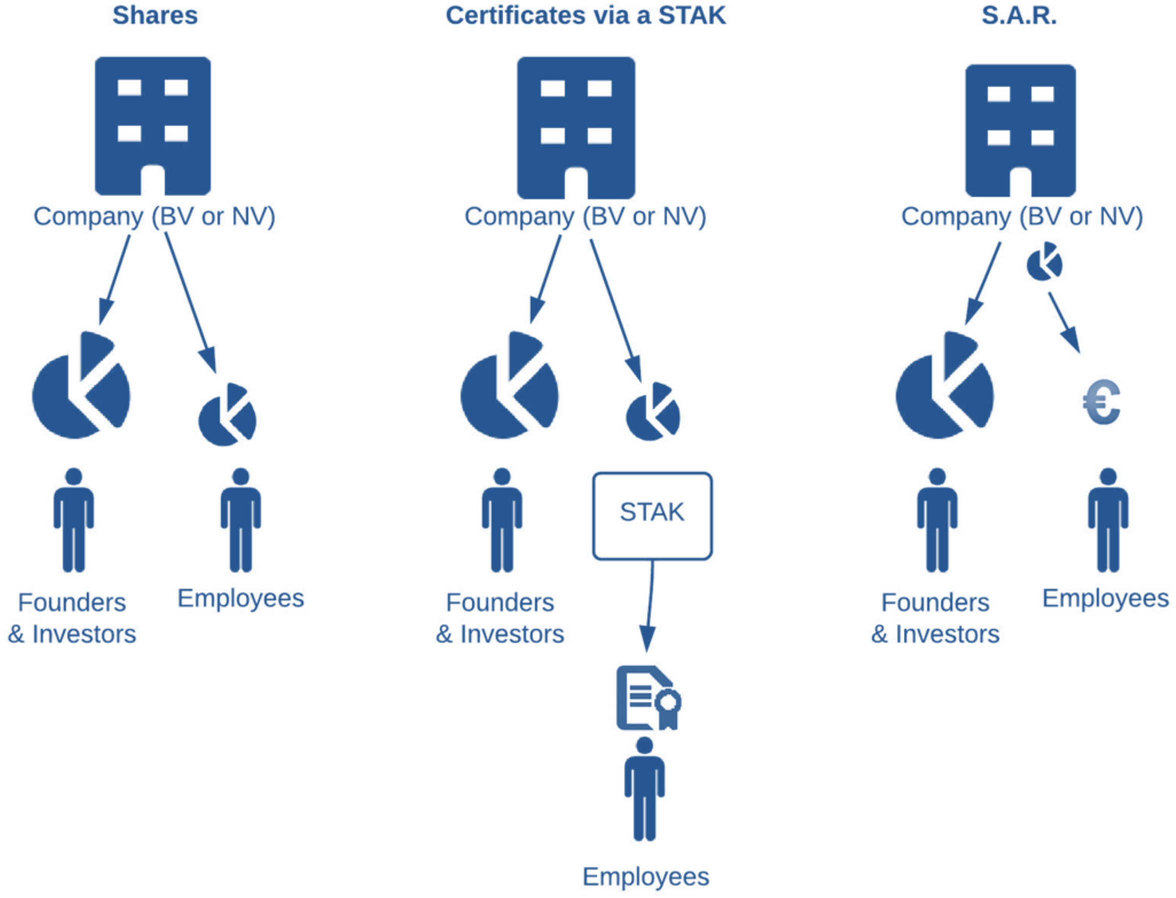
[1] See art. 2:227 from the Dutch Civil Code.

Table 1. Common attributes of ESO forms.

	Shares	STAK	SAR
Right	Right to sale proceeds. Non-voting or non-dividend is possible.	No voting rights. Right to sale proceeds is optional.	No voting rights. Right to sale proceeds is optional.
Shareholder meetings	Right to information and to attend shareholder meetings (Grant Thornton, 2013).	Optional	No right to information and to attend shareholder meetings.
Notary	Needed to issue shares.	Needed to found the STAK.	Not needed.
Internationally	Known.	Unknown.	Known.
Other	Most direct form of employee ownership and thus associated with a higher level of the proposed benefits.	1 share can be split into several certificates of smaller value.	Less direct and thus associated with a lower level of the proposed benefits (e.g. motivation).

Figure 1 is a representation designed for this thesis, of commonly used forms of Financial Employee Participation; shares or certificates via a STAK or as alternative, SAR. To simplify, 'options' on shares/certificates, the role of executives and management and other different forms and adaptations are left out of this visualization.

Figure 1. Three forms of Employee share 'ownership', simplified.



This thesis focuses on options instead of direct shares, profit sharing via bonuses or SAR or direct certifications, but can mean either options on shares or options on certificates via a STAK. To simplify, the term 'share options' in this thesis is used for both cases.

2.2.4 Rules of share options

2.2.4.1 Offering employee share options

There are two methods to offering share options: entering into a one-off agreement with each employee to lay out the term of the options grant or use an ESOP which governs the options grant and which employees must agree to in order to receive their options (Smith & MacLean, 2012).

When the decision is made to use an ESOP, the company reserves a fixed portion of the overall shares for the employees to be offered under certain conditions, matching the strategic goals of that company (Poutsma et al., 2010). Typical conditions are discussed in chapter 2.5. One effect of reserving new shares for employees is that the current shareholders will suffer dilution when the options are exercised (Schwartzberg & Weiner, 2007). This means that exercised options will increase the number of outstanding shares decreasing the ownership percentage of the current shareholders (See chapter 2.4.2).

The board of directors, management or the current shareholders use their discretion in the decision to which (group of) employees the options will be granted, which are usually directors, management and other key employees (HM Revenue & Customs, 2014). This decision depends on the goals the company wants to achieve, e.g. if that is to retain a particular key employee, a company-wide scheme might not be necessary.

David Dessers from Ambos NBGO states that share options company-wide is mostly done in startup companies where this typically is narrowed down to key-employees only, after a certain amount of growth (HRMagazine, 2012). Kaarsemaker (2009) concluded that most Dutch companies give out share options to less than 50% of the employees. In another study, Smits (2011) found 37% of Dutch companies researched to have a company-wide plan, 44% management-only and 12% only offered options to executives and owners. Most of these companies only offered options to key employees.

Hand (2005) warns not to grant options too deeply or not deep enough; meaning that options should only be granted to employees who contribute to equity value or who are in other ways connected to the ESOP goals. Other studies suggest that the shape of the share option plan influences the effectiveness and efficiency of organizational performance since a company-wide plan would be better for overall productivity and performance (Blair, Kruse, & Blasi, 2000; Braam & Poutsma; Nieuwland, 2012; van der Heijden et al., 2012). Nieuwland - advisor at SNPI - even suggests that offering share options to (top) management only, will lead to a bad image for the company and agrees with Lowitzsch, Hashi, and Woodward (2009) that it may cause a fragmented or dual labor force when not all employees receive similar rights to ESO; influencing the organizational culture. Conversely, Schwartzberg and Weiner argue that being awarded by share options in a non-company-wide plan can be seen as prestigious by those employees. This could strengthen the attraction and retention effect of the ESOP for those employees.

According to a recent study by the Erasmus University in Rotterdam and the SNPI (Soppe & Houweling, 2014), the common opinion of both employers and employees is that the connection of freelancers and temp agency workers to the company is too weak to include them in share plans.

There are several other conditions a company could place on participation in the ESOP: Kaarsemaker (2009) found that 42% of Dutch companies require the employee to have an indefinite/permanent employment contract to be able to participate. He also found that 38% of the Dutch companies require a minimum time period of employment between 3 months to a year, for employees to participate as well. A part-time or full-time employment does not seem to be a requirement in any of the researched companies.

Furthermore, Kaarsemaker explains that a decision needs to be made about the relative stake each employee receives and which procedures are followed. How much of the total shares to reserve for the employees depends on the number of employees and the goals for the ESOP. According to a study by Sprout (Smits, 2011), Dutch companies with ESO reserved the following percentage of shares for their employees: 34% of the companies reserved less than 5% of total shares for employees, 24% between 5 and 10%, 13% of the companies between 10 and 15% and 29% of the companies researched reserved more than 15% of the total shares for the employees. Other sources show percentages of 10-20% (Basu, 2014), 10% (NCEO, 2014d) and 5-20% (HRMagazine, 2012).

The simplest option might be to divide the shares equally amongst the participating employees, yet not everyone contributes equally to an organization and not everyone takes the same risks by working for a startup. Kaarsemaker found in his research that 17% of Dutch companies use the same maximum for all employees. Other companies base the maximum on the number of years employed (17%), on individual performance (13%), on company performance (8%) or on salary (8%). Shares based on function or group/team-performance did not occur in those 2500 companies. 17% left the decision of how many shares to buy up to the employees themselves without a specified maximum (2009, p. 32). Kaarsemaker found that the scope of the shares that an employee is able to receive correlates positively with the level of effect it has on the benefits of an ESOP. Venture capitalist Babak Nivi (2007) recommends 0.4- 1.25% for middle managers and 0.2-0.33% for junior managers and engineers in technology companies. When thinking about potential share option profits per employee, as reported by Blasi (2014) the average in the US is 184% of annual pay and as median 100% of their annual pay.

Kuvaas (2003) shows in his study that ESO can strengthen commitment, even when the percentage remains relatively modest (10%) and when pay-outs are limited (number of shares equal to one month's pay after tax). Contradictorily, Barend van den Brande from Hummingbird Ventures claims that only a high percentage will motivate an employee when it comes to startup companies with potential to hyper growth because of the big risk that they have to take (HRMagazine, 2012). Whatever the decision is based on, the key should be to provide a reward that is financially meaningful to employees - one big enough to attract, retain, and motivate them, but not so large as to waste corporate assets (NCEO, 2014d).

An employee being offered participation in an ESOP typically receives this offer in the form of a formal contract. He can choose not to accept or sign this contract if he does not wish to participate in the ESOP. However, since employees do not need to make any (direct or indirect – e.g. tax -) payments for participation alone, and a later exercising of the options is at the employee's own discretion, enrollment for options should be risk-free. Employees do not have to pay money or goods for the options, yet they can be traded for labor that they already performed or that they will perform for the company in the future (Dingeman-Manschot, 2013; Vlasveld, 2012).

2.2.4.2 Participating in the ESOP: the grant date, vesting period and exercise period

The moment the employee signs is typically also the *grant date*; which is the date the *vesting period* officially starts. This is the period of time the employee minimally has to wait before he can exercise the option to buy the shares at the price indicated in the share options agreement (Summa, n.d.). As there are no known averages for Dutch startups to go by, it is up to management's own discretion and the goals the company pursuits to decide on the period of time for the exercise and vesting period. A vesting period of four years is typical in the US where it is common to have options vest in portions (*tranche vesting*) instead of all at once (*cliff vesting*) (Brandes et al., 2003; Fitzpatrick, 2013; Revsine, Collins, Johnson, & Mittelstaedt, 2011; Schireson, 2011; Summa, n.d.). Having options vest completely in four years binds employees further to the company and locks today's value of the shares for that time. For successful companies, this makes the options more valuable for employees (Casserly, 2013). A downside is that tranche vesting is more complicated and takes more time and administration than to have all the options vest at once. Other vesting periods mentioned in existing literature are typically between 1-5 years (Casserly, 2013; HM Revenue & Customs; Schwartzberg & Weiner, 2007).

Example of tranche vesting
When an employee is with the company for the first full year, 25% of his options vest. After a second year of employment, another 25% of the original amount vests. This goes on until 100% of the shares are vested after 4 years of employment.

An *exercise period* often only has a maximum of 10 years. For early stage companies, it often takes 7 years to reach an exit according to Hassan (2013), CEO at VentureLynx and university guest lecturer on entrepreneurship, which is why it is important to issue the options for as long as possible. If employees are not able to sell shares and the exercise period runs out before an exit, they have to make an uncomfortable decision between losing money on buying shares now or losing the options. At the end of the vesting period (on the *vesting date*), the options vest and can be exercised. This is when the exercise period starts.

If the employment is terminated during the vesting period, the options will expire, sometimes with a few exceptions like pensioning or sickness ('*good leavers*'). It is important to decide upfront what will happen when the employee leaves. A reason for employees to lose their options is that they cannot contribute anymore to the future success of the company. On the other hand, they 'earned' them from their contributions to the company. Hassan recommends basing this decision on the employee's salary*: 'If they were drastically underpaid then they should keep vested options since that was an implicit part of the compensation.'*

The percentage of eligible employees actually participating in an ESOP is called the *participation rate*, and is found by Poutsma et al. (2006) to be a little more than 50% on average in the Netherlands.

2.2.4.3 Vesting conditions

Apart from time as influential factor to vesting, other conditions can be set as well, which need to be fulfilled before the employee can exercise his options. If options do not have a vesting period, they are 'unconditional' which makes them exercisable immediately at grant.

Vesting can be dependent on achieving certain performance goals, which is called a *performance condition*. Performance conditions usually involve financial performance goals of the organization or of a group or team; e.g. the Total Shareholder Return. Other vesting conditions are *service conditions* (Dingeman-Manschot, 2013); e.g. the employee has to be employed (in service) for a certain period of time before options can vest.

In some events, mostly in a change of control or acquisition, options can have '*accelerated vesting'*, meaning that unvested options vest before their actual vesting date to give employees the chance to buy shares before the shares e.g. are bought for a good sum of money. According to M. Schireson (2011), a software executive in Silicon Valley, this happens more for senior executives than for 'rank-and-file employees'. He lists three main types of acceleration: on change of control, on termination or 'double trigger' acceleration which includes both events. Acceleration can be done for all unvested options (*full acceleration*) or for part of it (*partial acceleration*), e.g. 50% of unvested shares.

The vesting conditions are set in the share option agreement or contract that the employee signs. Schwartzberg and Weiner mention in their article that these contracts can also contain the provision that the shares can be repurchased by the company when an employee's employment with that company is terminated.

2.2.4.4 The shareholder agreement

The shareholder agreement clarifies the role of the shareholder within the company, the relationship and agreements between shareholders, protects minority shareholders and prevents conflicts between the board and the shareholders (Jongbloed, 2012). The agreement can be drawn by a notary or a (tax-) lawyer and usually contains at least the following:

- Control granted to the shareholder;
- Value of the shares and how it is determined;
- What happens when a shareholder leaves the company;
- What happens if a third party wants to buy shares (Exit '*tag along' – 'drag along'*);
- Rights associated with the shares regarding voting and dividends;
- Decision-making in the company (e.g. regarding fusion, liquidation or emission);
- Dividend-policy.

'Drag along' empowers shareholders to require other shareholders to sell their shares to the same third party as well. *'Tag along'* empowers shareholders to be able to sell their shares to the same third party in the same way as other shareholders (Jongbloed, 2012).

2.2.4.5 Exercising the options

When an employee decides to exercise his options, he notifies the employer and usually signs a note of exercise, which is subject to the ESOP. A notary will set up a deed for the transfer of shares when the employee decides to exercise his options. In case of certificates via a STAK, a notary is not needed and certificates can be issued by the board of the foundation. Options can be exercised during the exercise period under condition that the individual is still employed by the company. The exercise period is in practice usually max. 10 years (HM Revenue & Customs, 2014) and options not exercised in that time will expire. The employee could receive a 'grace period' however, to still exercise his options in a short period of time (Summa, n.d.). In the literature, a distinction is often made between *American options* and *European options*, where the former can be exercised at any moment during exercise period and the latter can only be exercised at the end of this period (Europese Commissie, 2003). If a company only wants to have his employees share in the profit in case the (startup) company will be sold, European options could be the way to go, while American options would increase the feeling of ownership for employees much more as they can become shareholders when they choose to (after vesting).

There is not one 'best way' to handle rules and procedures regarding the sale and trade of shares. A possibility is that there is an internal market for share trade (van Ruiten, 2003) but it is common in the Netherlands that they have to be sold back to the company when an employee leaves, for the original paid price or with a discount (Kaarsemaker, 2009). The employee could possibly sell his shares after exercising outside of the company but unless the statutes state otherwise, shares need to be offered to fellow-shareholders or approved by them before selling to a third party, following a 'blocking scheme' (blokkeringsregeling).[2] Most companies have a restriction in their statutes or in the contract on selling options externally. Another consideration is what to do when the employment of a shareholder is terminated. Are the shares then sold back to the company, to fellow-share holders of does he remain share holder without employment at that company? Usually these shares have to be bought back by the company or by the other shareholders. The former could have a large financial impact on small, financially unstable firms however.

Example of exercising shares
On the date of grant, an employee receives 100 options (worth €25,- at that moment). After waiting three years (the *vesting period*), the options vest and the employee is able to exercise his options. He now has the right for one year (the *exercise period*) to buy shares for €25 per share (the *exercise price*).

Imagine that the value of the shares has increased to €30,- in those three years. If the employee decides to exercise his options now, he pays 100 x €25 = €2.500. If he immediately sells his shares (if possible), the profit is 100 x €5 = €500. If on the other hand, the value of the share has decreased to €23,-, it is wise for him to wait with exercising, to avoid any losses.

Schwartzberg and Weiner claim that employees of private limited companies usually wait with exercising their options until that company is sold if there is no internal market. Other reasons to exercise the options can be if dividends are being paid to shareholders of if the employee wants to exercise the rights as stated in the statutes or contract; like having influence on decision-making. It is possible however for private limited companies to grant non-voting shares or shares without right on dividends (Rijksoverheid, 2014). Shares with voting rights and the right of profit made however can strengthen the ownership-effect and motivation (see chapter 2.3.1). It is up to management or shareholder's discretion which rights to give along with employee share options. Soppe and Houweling mention in their research that employers generally do not use FEP like share options to give employees a voice in the company but see it mostly as a means to reward and engage employees. The fear of conflict due to the combination of shareholding and employeeship can be a reason for them to give out non-voting shares to employees instead.

2.2.4.6 The price of options

Options are derivatives, meaning that the price of the share is derived from the book value of the organization (for private limited companies) on the date the share options are granted to the employee. The value of the shares and of the company are determined using a certain formula, based on the visible intrinsic value of the company (Kaarsemaker, 2009).

[2] See art. 2:195 paragraph 1 from the Dutch Civil Code.

2.2.4.7 Dutch fiscal consequences

One common objection raised by researchers like Lowitzsch et al. (2009), Kaarsemaker (2009) and ten Have (2013) is that there is relatively little legal and tax incentive for companies to implement an ESOP compared to other countries which makes it financially relatively less interesting for Dutch companies. According to Vlasveld (2012) using share options purely for fiscal purposes would not be advantageous.[3]

Even though there are no laws and rules about ESOPs specifically, there are some laws and provisions that apply to the situation (Maas, 2011). In the Netherlands, shares are taxed as ordinary income based on the positive difference between exercise price and the actual share value on exercise date; with the tax being due when the option is being exercised (Belastingdienst, 2014). Owning 5% or more shares of a company as an employee is seen by the tax authorities as having a significant interest in the company which can result in a significantly higher tax rate compared to owning less than 5% of the shares.[4]

A plan under the name 'StartupNL' is currently being discussed in the cabinet, including a proposal to improve the provision of information in the Netherlands about 'paying in shares'. The reason is that it was made apparent that entrepreneurs do not know about all the possibilities regarding the use of share plans for their company (Brisk Magazine, 2014)[5].

2.2.5 International prevalence of ESOPs

2.2.5.1 Structural and legal differences

ESOPs are still a lot more of a common practice in the US or European countries like the UK or France, compared to the Netherlands. The most common form of ESO in the US according to the National Center of Employee Ownership (NCEO, 2014b) is the Employee Stock Ownership Plan, not to be confused with the ESOP abbreviation that is used in this thesis for ESO plans in the form of (options on) shares or certificates via a STAK. A company sets up a trust to which it usually makes annual contributions of shares or cash to buy existing shares. Shares in the trust are generally given to employees rather than having them purchase the shares. A vesting schedule and several conditions are still placed upon participation. In private companies, voting-rights are associated with these shares for major issues. When the employee leaves, the company must buy back the shares at its fair market value.

The main reason for the difference in popularity between the US and the Netherlands is that the US offers several tax advantages for both the company and the employees (Beatty, 1995; Kaarsemaker, 2009; Maas, 2011; Soppe & Houweling, 2014). For example, Google is in the hands of 'common' employees for 5%, Procter & Gamble for 10% and Southwest Airlines for 10% as well (Blasi et al., 2013). Blasi states that almost 1 in 5 Americans owns a part of the company where they work for. The Dutch government has given little support to FEP, having concluded that such plans, particularly the most prevalent limited to executives only, do not contribute to a more equitable distribution of wealth (Lowitzsch et al., 2009, p. 131). In 2009, over 10% of US companies had a form of ESO compared to 3,5% in the Netherlands (Kaarsemaker, 2009, pp. 26-27). It is interesting to note that 50% of these Dutch companies

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[3] This, in itself, does not say anything about the usefulness of share options for other purposes, such as those discussed in this thesis.

[4] See art. 4.6 from the Dutch Income Tax Law 2001.

[5] See for more information the website: http://startupnl.nl/ and the reaction from the government on the 43 items in 'StartupNL' via http://www.rijksoverheid.nl/documenten-en-publicaties/kamerstukken/2014/03/17/reactie-43-punten-uit-agenda-startupnl.html.

have a foreign 'parent' company and only 12% had less than 15 employees. Kaarsemaker found that most Dutch companies with ESO perform relatively well in financial terms. Soppe and Houweling (2014) found that Dutch companies and employees generally would like to use FEP in their company yet do not because they do not know what it entails or think that it is too complex or too expensive. In fact, 78% of employers and 62% of employees are positive about employee participation in general but only 4% actually uses it or experiences it in their company.

2.2.5.2 Sociological differences

According to Hofstede and Hofstede (2009), the Dutch score higher on uncertainty avoidance than Americans. The authors define uncertainty avoidance as *'the extent to which carriers of a culture feel threatened by uncertain or unknown situations; this feeling is, among other things, expressed in stress and in a need for predictability: to formal and informal rules'* (2009, p. 173). Compared to their American counterparts, the Dutch experience on average more stress at work, have a greater need for a regulated workplace and have a desire to stay employed at the same company for a longer period of time. Hofstede & Hofstede stress that uncertainty avoidance is not the same as risk avoidance. 'Risk' refers to the probability that a particular event will occur. 'Uncertainty' on the other hand, refers to situations where several unpredictable things can happen. To avoid uncertainty, a lack of clarity needs to be reduced. The Dutch worry less about 'known risks' like driving too fast on the highway, than about a lack of clarity. By the same token, Dutch employees can be comfortable with the risks involved in working for a startup like job insecurity, but avoid uncertainty by investigating possible consequences and a potential 'Plan B'. The authors did not find a significant difference between employees in different functions or between genders but older employees scored higher in uncertainty avoidance than younger respondents. It is interesting to note that Lowitzsch et al. (2009, p. 131) found that specifically owners of small Dutch family firms generally oppose ESO because they fear loss of control.

The fact that the Dutch value job security more highly than Americans correlates with Hofstede & Hofstede's conclusion that they typically hold more of a long-term focus than Americans do. They say that a long-term orientation stands for striving towards future rewards through perseverance and thrift. A short-term orientation on the contrary stands for *'pursuing virtues from the past and the present, especially respect for tradition, prevention of 'lost face' and for fulfilling social obligations'* (2009, pp. 211-212). The authors conclude that the biggest difference between both cultures lies in 'thrift' for the Dutch or for the Americans: the ease to spend money.

These findings correspond with the European *Rhineland model*, which is a system for economic order, used as the European alternative for the American Anglo-Saxon model. The Rhine model is based on the power of the collective, societal consensus, an active role of the state and a long-term mentality. The Anglo-Saxon model revolves more around money and is focused on shareholders' value and short-term profit (Vlasveld, 2012, p. 13)

2.2.6 The prevalence of Employee Share Ownership in different sectors and industries

In the US, ESO is common practice in high tech companies and tech startups (Blasi, 2014). Kaarsemaker found 38% of Dutch companies with some form of ESO to be in the service sector, 38% in the trade sector and 25% in the industrial sector (2009, p. 27). According to Nieuwland (2012), ESO is most prevalent in financial stable or growing knowledge organizations with a flat organizational structure where people are the main resource of the company.

2.2.7 ESOPs in startup companies

2.2.7.1 Definition of 'startup' companies

The term startup is predominantly used to refer to a recently formed or fledgling company (Davila, Foster, & Gupta, 2003; Merriam-Webster, 2013). The dictionary websites Techopedia and Investopedia go a little further in stating that it is not necessarily about the age of a company but about being in the early stages of business development, which for some companies may last for years. The startup phase is often coupled with the inability of the company to sustain itself without some form of venture capital involvement (Investopedia, 2014c; Techopedia, 2013). By one definition, the 'startup phase' of a company can be seen as the period between product conception and the very first sale the company makes (Crowne, 2002), although a very first sale does not mean that the company is profitable yet. BusinessDictionary defines it as: '*the early stage in the life cycle of an enterprise where the entrepreneur moves from the idea stage to securing financing, laying down the basis structure of the business and initiating operations or trading'* (2013). The focus in this research lies mostly on the early stages where the company has not made a profit or secured financing yet since the target company is a private limited startup with limited funds, looking for an alternative way to attract and retain talent without having to pay top salaries.

2.2.7.2 The use of ESOPs in startups

Companies in the beginning phase usually need a (small) team of employees with the necessary skills to start developing the product or service and to reach profitability, but can have difficulty attracting and retaining talent. It will take Dutch startups on average over six years to become profitable, which can cause funds to be limited. Aside from several upsides - like more flexibility and a steep learning curve -, a lack of structure, inexperienced leaders, unclear roles and procedures, low compensation, long working hours and job insecurity are named as the biggest downsides of working at a startup compared to more established companies (Venture Village, 2013).

The possibility to participate in an ESOP can be an extra incentive for employees to start working for such a company and evidence shows that it could even work better than it would in a large company as mentioned in chapter 2.1.

According to Nieuwland (2012), implementation of an ESOP lasts between 4-6 months, including the design of both the ESOP and a communication plan. Unfortunately, these numbers are mostly based on larger companies and it is not known how long it takes the average startup to design and implement an ESOP. However, one can imagine that this would take less time since ESOPs are usually easier to implement in startup companies for several reasons mentioned in chapter 1.1 and 2.1. There are several other factors that can make ESOPs particularly effective in startup companies: due to the small number of employees in a typical startup company, individuals have a relatively large influence on company performance which would increase their motivation and performance to create value. Furthermore, the 'free-rider effect', by which employees enjoy the benefits of the ESOP without putting in effort themselves (Poutsma et al., 2006), that larger companies could suffer from does not play a big role in startups considering that the individual's input is much more visible with a small employee base (Blasi, Conte, & Kruse, 1996; Kim & Ouimet, 2013; Lazear, 2000; Meng, Ning, Zhou, & Zhu, 2011; Oyer, 2004).

2.3 The goals and benefits of share options

2.3.1 Benefits of an Employee Share Ownership scheme in general

Kaarsemaker concluded in his research that most Dutch companies implement ESOP to stimulate employees to think like owners and to attract and retain key employees (2009) yet in other existing literature, ESO is associated with many other benefits, the most common of which are listed in table 2.

Table 2. Benefits of Employee Share Ownership

Psychological Benefits	
Stimulate employees to think as owners	*Klein (1987); Orlitzky and Rynes (2001); Kaarsemaker (2009); Schwartzberg and Weiner (2007); Vlasveld (2012)*
Attract employees to the company	*Schwartzberg and Weiner (2007); Thierry (2008); Kaarsemaker (2009); SNPI (2011); Smits (2011)*
Retain and involve valuable employees and align them with the long-term interests of the firm	*Jensen and Meckling (1976); Klein (1987); Core and Guay (2001); Rosen, Case, and Staubus (2005); Schwartzberg and Weiner (2007); Thierry (2008); Kaarsemaker (2009); SNPI (2011); Smits (2011); ten Have (2013); la var Harline (2013); (Ricken, 2013; Soppe & Houweling, 2014)*
Stimulate performance and productivity	*Uvalic (1991); Blasi and Kruse (2001); Schwartzberg and Weiner (2007); Thierry (2008); Kaarsemaker (2009); Stichting Nederlands Participatie Instituut (2011); (Ricken, 2013); Smits (2011)*
Motivate employees	*Klein (1987); Uvalic (1991); Orlitzky and Rynes (2001); Schwartzberg and Weiner (2007); Kaarsemaker (2009)(Ricken, 2013)*
Increase employee satisfaction	*Orlitzky and Rynes (2001); Kaarsemaker (2009)*
Develop a sense of community	*Thierry (2008); SNPI (2011)*
Reduce alienation between management and employees	*Davidson (2012)*
Financial Benefits	
Associated with more profitability of the company	*Europese Commissie (2003); Schwartzberg and Weiner (2007) ; Kaarsemaker (2009) Stichting Nederlands Participatie Instituut (2011); (Blasi et al., 2013); Smits (2011).*
Associated with a competitive advantage	*SNPI (2011); Smits (2011)*
Decrease in absenteeism	*(Blasi et al., 2013)*
Financially attractive alternative to a performance bonus	*Schwartzberg and Weiner (2007); Thierry (2008)*
Can lead to more solvency due to lower salary costs	*Core and Guay (2001); Oyer and Schaefer (2005); Kaarsemaker (2009)*

These benefits are interconnected and overlap frequently; e.g. the increase in participation by an employee in the decision-making process of a company and the ownership-effect (to stimulate the employees to think as owners) both lead to an increase in motivation and satisfaction of that employee (Orlitzky & Rynes, 2001; Vlasveld, 2012). The ownership-effect makes employees more cost-conscious as they feel partly responsible for the company (Kaarsemaker, 2009; SNPI, 2011). It encourages employees to think about the company's holistic success and rewards employees for taking a risk by betting on an unproven company (Rachleff, 2014). Over time, the effects of ESO can eventually even lead to a family culture or strengthen a community (SNPI, 2011).

Soppe and Houweling (2014) found that the most important reason for implementing FEP in the Netherlands is to have the employees share in the profit (80%), to bind them to the organization (74%) and, surprisingly, to give the employees more control in the company (26%). This is surprising because in practice, companies tend to choose non-voting shares or certificates to maintain control.

Besides providing a financial incentive to employees, an ESO scheme can furthermore be financially beneficial for the employer as it is associated with an increase in organizational performance and profitability. Although shares are not a substitute for a salary, they can be used instead of a salary raise or bonuses when facing cash flow constraints or when a company wants to save funds for investments (Hand, 2005; Kaarsemaker, 2009). A study by Blasi et al. (2013) suggests that it can lead to a decrease in turnover, increase in revenue and a higher return on equity. Another benefit is that ESO plans can be used as protection against hostile takeovers, giving the owner(s) the possibility to hand over the company to its employees in an Employee Buy-Out (SNPI, 2011).

In conclusion, ESO is associated with many benefits to an organization and its employees. However, these positive effects do not happen unconditionally or automatically (Kaarsemaker, 2009; Kruse & Blasi, 1995). This is further examined in chapter 2.5.

2.3.2 Attracting and retaining employees in startups

Nieuwland (2012) claims that especially knowledge organizations have difficulty in finding and attracting skilled and qualified employees. Chambers, Foulton, Handfield-Jones, Hankin, and Michaels Ill (1998) did an extensive study amongst 77 large US companies and concluded that a lack of good personnel can be a threat to the competitive advantage and ultimately to the survival of a company. They call this search for skilled key employees *'the war for talent'* and found that small firms offer equity ownership to be able to offer a *'superior employee value proposition'* (1998, p. 46) compared to their competitors. Schwartzberg and Weiner (2007, p. 1) came to a similar conclusion and stated that companies which rely on just a basic salary and annual bonus can be in competitive disadvantage compared to companies offering equity-based incentive compensations like share options. According to a study by William W. Mercer Inc., 45% of employees in Silicon Valley (startup) companies claimed they would not even work for a company that did not grant options (Estes, Holsinger, & Shannon, 2001). Brandes et al. (2003) concluded that employees come to expect options in certain branches which causes organizations to have to provide them to just remain competitive in the labor market.

2.3.2.1 Attracting talent to startups

There are several models that try to explain how individuals choose a company to work at. Thibaut and Kelley (1959) suggest that individuals perform a *cost-benefit* ratio analysis before choosing to work for a certain company, in which they weigh out the pros and cons. Similarly, the *classic economic theory* indicates that individuals choose the job or company that will offer the most net advantages (Paffen, 2007). In contrast to these rational economic decision models, the *coincidence- or chance theory* builds on the observation that chance and coincidence are often given as explanation for how people ended up in their job (Bright, Pryor, & Harpman, 2005; Crites, 1969; Miller & Form, 1964).

> *'The people you want to attract to your business are the people who want equity. You need people who are willing to take risks. And then you need to reward them. For that, stock options are the best' – Bill Harris, the brains behind the startup Paypal (Casserly, 2013).*

A third, and more accepted theory is the *sociological theory* which explains career choices as the interplay of factors on several levels (Paffen, 2007). On a macro-level, technological and economic factors influence the preference-balance between intrinsic and extrinsic motivation. E.g. a bad economic climate might persuade an individual to work for an established company which can offer a greater secure job and higher pay, even though he would prefer the work and challenges of a startup company. Political, societal and cultural factors play a part in career choices as well, e.g. the known startup successes from companies like Facebook and Instagram can give the idea of working for a software company a lot more allure. On a meso-level, family has been shown to be the biggest influence on (early) career choices. On the micro-level, a persons´ work ethic, decisiveness and the confidence he has in his career influence career decisions (2007, pp. 35-36). While the sociological theory emphasizes environmental factors, there are also psychological theories which emphasize characteristics of the individual as most important factor in career choices. These are further discussed in chapter 2.5.1.

A broad-based share option plan is seen in most literature as an effective and sometimes even necessary instrument for entrepreneurs to attract and retain the right employees, particularly in technology-intensive startups (Hand, 2005; Heesen, 2003). However according to ten Have (2013) it is insufficient as only method to attract personnel as the decision to work for a certain company would mostly depend on intrinsic factors like pleasant co-workers, a nice atmosphere, challenging projects, a firm that matches the individuals experience and philosophy. Ten Have found in his research a paradox in which the employee's psychological ownership and affective commitment increase but that the retaining effect will decrease over time. This means that even though employees participate in an ESOP, if another company offers better intrinsic incentives, they will still switch jobs (2013, pp. 9-10). The author suggests for this reason that intrinsic incentives weigh heavier in attracting employees than 'fringe benefits' like ESO. Although the sample size of his research was low and the results are therefore not generalizable, it is important to keep in mind that intrinsic incentives like challenging work are very important in attracting and retaining employees. After all, *'people who join the company for money will leave the company for money'* (van Duren, 2014). Ricken (2013) agrees that intrinsic motivation for employees is very important but found that it doesn't conflict with extrinsic rewards, in fact, according to him they could reinforce each other.

2.3.2.2 Retaining talent in startups

In today's environment, switching jobs is easier and more common than it used to be (Denton, 2009), even more so for talented, high-in-demand employees. This poses a big risk for startups in the 'war for talent' when their main resource are their employees. Losing that intellectual capital (to competitors) could mean the end for knowledge-intensive startups (Brandes et al., 2003; ten Have, 2013). On top of that, the costs of selecting, recruiting, interviewing and eventually replacing and training employees can have a significant financial impact for small firms (Brandes et al., 2003; Kaarsemaker, 2009; Oyer, 2004). Brandes et al. argue that managers should compare the costs of replacing valuable employees with the costs of offering share options to employees who likely leave the company if they do not get them for this reason.

Finally, the relatively low survival chance of startup companies influences the concept of *sustainability* and *retainability*. Startup companies may focus more on retaining talent for the next two years instead of the five or more that larger, profitable companies could set as a goal for ESOPs.

2.4 Risks and pitfalls of a share option scheme

2.4.1 Social risks and pitfalls

Existing literature discusses several risks and pitfalls of (implementing) an ESOP, of which several can be prevented by optimizing the design of the share option plan.

The main issue is that share options always carry a certain risk of not being worth as much as anticipated, since they usually are long-term focused and based on future performance with uncertain results (Braam & Poutsma, 2010; Lowitzsch et al., 2009). Nieuwland (2012) explains that this is the main reason why it is important that participation in a share option scheme is voluntary for all employees. As previously mentioned in chapter 2.3.1, share options should be no supplement for the basic salary but an addition, in order for the employee to maintain his income security (Alblas & Wijsman, 2005). Research from Hall and Murphy (2002) claims that less risk-avoiding employees will more easily accept that a part of his compensation is future-based and unsure.

Depending on the type of organization and employees, implementing a share option scheme could be met with general resistance to change (Markus, 1983; van der Linde, 2012); e.g. in knowledge-intensive startups with a higher risk-acceptance, this effect would be minimal, assuming that certain HR instruments (see chapter 2.5.4) are incorporated in the design of the ESOP. Concerns from employees for peer pressure and mutual monitoring within the company, as found in research by Blair et al. (2000), Blasi, Kruse, and Freeman (2006) and Conyon and Freeman (2004), may not occur in ventures with a small group of employees at all, since these effects were only found in larger companies. Kaarsemaker did not find any negative consequences for the relations between management and employees and between employees themselves in his study (2009, p. 50).

There is limited to no research done on measured effects of only granting share options to a limited number of employees specifically in a startup company, but Lowitzsch et al found in larger companies that it could lead to a fragmented labor force (2009, pp. 191-192). On the other hand, limiting the number of participants could yield positive results if the main goal of the ESOP is to attract certain high-in demand talent. As mentioned before, being offered share options in such a situation can provide a privileged status and weigh heavier in the employee’s decision to start working for that startup company.

Blasi et al. (2013) noticed in his research that there is a group of critics that view share systems *‘as a bit of a sham’* because it would elicit more effort and risk-taking from employees without actually increasing their pay. Blasi however does not agree because usually share options come on top of- rather than instead of fixed wages and benefits. Evidence even suggests that workers with share options typically have greater job security than other workers, have better work conditions, greater participation in decisions and get generally better treatment by the employer.

Noomen (2004) writes that one of the possible pitfalls of an ESOP is that employees in many large companies have limited influence on the performance of a company as a whole. The resulting disconnection between individual performance and an eventual share-based payout can reduce the feeling of ownership and the influence on decision-making in the company (Meng et al., 2011). In startups, this effect is typically compensated for by the small size of the company.

Finally, one pitfall of an ESOP that can occur in both startups and larger established companies is that bad organizational performance can decrease the company's capacity to retain talented personnel (ten Have, 2013). Brandes et al. (2003) mentions that poor stock performance can have a ripple effect on retaining employees and even more so on participators close to retirement who can end up leaving the organization earlier than expected. There is a relatively big chance that the company will not be doing as well as hoped and when options finally vest, they can turn out to be worthless for employees. The employees can perceive this as empty promises in the here-and-now for hard work in the past (Parrish, 2013). This is one reason why transparency and proper information about the ESOP and possibilities is so important for employees to participate in the ESOP (see chapter 2.5.4).

2.4.2 Financial and organizational risks and pitfalls

2.4.2.1 In general

One consideration is that having employee shareholders can complicate selling the firm to an outside party and according to Parrish (2013), *'investment bankers will say that buyers are hesitant to pursue deals where there are a number of small stock options and minority shareholders in the mix. It complicates the negotiations and drags out the close'.*

Furthermore, designing, implementing, administrating and maintaining a suitable plan (customized to the type of company and the goals it wants to achieve) consumes a large amount of time and money (Poutsma, 2001), let alone what it costs to inform and educate the employees to deal with the new arrangements (ten Have, 2013). Poutsma and van den Tillaart (1996) found that these costs in time and money can have an especially large impact on small startups that typically have few employees and limited funds. Soppe and Houweling (2014) found that 60% of Dutch employees and 57% of employers agree that the financing of FEP should be shared, and as second option that the employer should be responsible.

The eventual worth of rewarded shares is uncertain for both the employee as for the company itself. Yet, Ten Have argues that one advantage of share options is that they are usually only exercised when the company is sold or when it is making a profit, which contains the financial risks somewhat. When shareholding employees leave the company however, their shares usually have to be bought back by the company or by the other shareholders. Ten Have argues that this can have a financial impact on small, financially unstable firms in particular.

A last consideration is that when options are exercised, employees can become involved in the company and the books, which can mean having new critics to analyze every decision made about deployed capital, distributed earnings and business deductions (Parrish, 2013).

2.4.2.1 Dilution

Each share represents a piece of ownership in the company. The more shares there are, the less value each one represents. After starting out with an initial number of shares, companies can issue more shares for a new group of employees hired or for a new round of funding. For this reason, it is important not to make promises to employees regarding specific percentages that they can own in the company if there is a chance of dilution in the future. Another reason to do that is because typically employees eventually (after several funding rounds) end up with a percentage significantly less than a percent of shares in the company, and talking about small fractions could make the share ownership seem trivial.

However, dilution is not necessarily a bad thing; it can help raise money for the company or attract new valuable employees. The goal of dilution is mainly to increase the overall value of the company: Money raised in this way can enable the company to carry out a strategy to increase its value enough to compensate for the dilution (Schireson, 2011).

A company can be authorized to issue a total number of shares yet only have a part of it 'outstanding', which means that only that part is owned by e.g. founders, employees or investors. The 'unissued stock' can be used for dilution (Investopedia, 2014b). The term *'fully diluted'* means the sum of both issued and unissued stock (Investopedia, 2014a).

Example of dilution
An employee receives 500 shares when he joins a company. There are 25,000 total shares outstanding which means that he now owns .02% of that company.

After 2 years, the company issues another 25,000 shares, which makes the total 50,000 shares. He is now left with .01%; half of the original percentage which equals to 50% dilution.

2.5 Influencing factors and mediating conditions

The level of influence of an ESOP on the attraction and retention of talent depends on several aspects. Relevant factors logically associated with share options were adopted from Kaarsemaker (2009) who found the following five main influences on the effectiveness of an ESOP.

2.5.1 Personal characteristics

There are many (matching- or congruence) theories based on the fit between individual characteristics - like interests, needs, personal orientation, personality type and experiences - and attributes of a job like job security or the possibility of owning shares. Differences in how employees react to an ESOP according to Kaarsemaker (2009) and Matthews, Deary, and Whiteman (2009), mostly depends on the 'big five personality traits': *openness, conscientiousness*, *extraversion*, *agreeableness* and *neuroticism*, e.g. openness to new experiences and extraversion will make it easier for an employee to participate. Kaarsemaker gives the example that some people care more about money, ownership and status and others tend to live more risk-avoiding, preferring a fixed, guaranteed income above a riskier, yet possibly higher income.

Alblas and Wijsman (2005) discuss two types of people with different personality traits; *Type A* and *Type B*. As mentioned before, startups offer relatively low job security compared to more established companies. The authors suggest that job insecurity can lead to stress and burn-out and that it depends on the type of person on how he handles such a situation. *Type A people* typically cannot handle a high level of job insecurity and will either want to avoid working in this situation or their performance will suffer. *Type B people* contrastingly are tolerant, calm, patient, outgoing, and more inclined to enjoy life and will be a better match with the typical startup situation. Unfortunately there is no easy test to find out who exactly type A is and who *type B*.

Schein (1996) developed eight career anchors which each attract different personality types; *Technical/functional competence*, *Managerial competence*, *Autonomy/independence*, *Security/stability*, *Entrepreneurial creativity*, *Service/dedication to a cause*, *Pure challenge* and *Lifestyle*. Startups typically score higher on *pure challenge* but score a lot lower on *security/stability*. This means that people, looking for *security/stability* in a job, would shy away from most startups and that someone looking for *pure challenge* would welcome the chance and opportunity to (help) create something they can call their own, and to have a big influence in making a startup a success. In order to make more than suggestions on how these anchors in combination with personality types would correlate with startup companies in particular, more research would need to be done on this subject.

Finally, attitude is found to be a major influence by Alblas and Wijsman on the attraction and retaining value of an ESOP towards high-in demand talent. They argue that people with an '*instrumental'* attitude (when they work for economic reasons), will change employers as soon as they can get a higher salary somewhere else which makes them difficult to engage and retain in an organization.

The question is what type of personality a company is looking for; according to comparative research by Hoff and Jehoel-Gijsbers (1998), a higher education correlates with concern for intrinsic aspects like challenging work and a lower education correlates with concern for extrinsic aspects of work like job security and a good salary. Sesil, Kroumova, Blasi, and Kruse (2002) and Core and Guay (2001) conclude that a startup company with an ESOP is likely to attract more risk-neutral employees and likely to seek less risk-averse workers as well. Furthermore, personality traits like neuroticism and introversion would not fit well with a startup since they typically cannot handle stress, risks, emotional situations and setbacks well (Dolan, 2007; Madnawat & Mehta, 2012).

2.5.2 Organizational characteristics

The organizational characteristics include the branch, industry, the organizational phase that the company is in, the organizational history, company size, financing, and their reasons to implement an ESOP. As mentioned previously, a share option plan is used most in the technology industry or IT sector with its higher proportion of startup firms that are experiencing growing pains and use such a scheme to preserve cash flows while still attracting and retaining key employees. The type of company to have an ESOP is usually financially stable or growing and knowledge-intensive with a flat organizational structure, where people are the main resource of the company.

2.5.3 Business strategy

When employees are the main resource in reaching organizational goals, it is important that they are involved in the business strategy to be able to do so (Kaarsemaker, 2009). Kaarsemaker suggests that options on shares provide an excellent opportunity to increase the interest of these employees to organizational performance because it increases their sense of ownership and responsibility. Sharing relevant and strategic information and showing how the employees can personally participate in reaching these goals is considered crucial by the author and works motivational. When employees understand their own influence on the strategic interests of the company, they can use their functional discretion in accordance with the strategy. This also means that share options work better when the employees have room for discretion and practical freedom to act. According to Blasi et al. (2013), results of ESO plans are maximized if the employees can take responsibility for the results. Kaarsemaker suggests for that reason that a share option scheme is a better fit with companies that *'specialize in the needs of certain customers, and companies that compete on innovation, on inventing and on bringing new functionalities on the market for existing products and services, or even completely new products and services'* (2009, p. 43). Main suggestions to the strategy to bring the ESOP to a success are to give enough information, periodic feedback and to connect strategic and financial information to make employees' influences visible.

2.5.4 Human Resource Management

When employees exercise their option on shares, depending on the contract, they can gain certain property- and corporate governance rights like the right to participate in the yearly shareholder meeting, to receive dividend if that is distributed or the right to sell their shares. These rights should fit with the following organizational HRM instruments adapted from Kaarsemaker (2009), to be able to make the ESOP, and specifically the goal of retaining employees, effective.

2.5.4.1 Participation in decision making

The ownership- and therefore the retaining effect of share options depends on the level of influence the employees get in the decision making about their own job, the work environment and strategic decisions (Kaarsemaker, 2009). If these employees have a feeling that they are powerless when it comes to the direction the startup is going and their own influence on the company, the connection of their performance to the eventual possible payout of shares could diminish.

2.5.4.2 Information sharing

The same argument goes for the importance of information sharing. Granting employees share options without informing them sufficiently about company performance, financial matters and company strategy, could diminish the ownership and retention effects of the ESOP (Kaarsemaker, 2009; Poutsma et al., 2012). CEC (2002, p. 12) even suggests that sharing relevant information should start well before implementing the plan. Nieuwland (2012) recommends that a new policy or ESOP is introduced with an information campaign, including concrete examples for the employees and periodic feedback. In startup companies with only a few employees, this 'campaign' can be less formal but not less informative.

2.5.4.3 Financial education

To avoid confusion, concerns and a feeling of powerlessness, the employees need to understand their rights, the risks and the consequences of participating in an ESOP. Kaarsemaker argues that this information will help employees make a well informed decision whether or not to participate and when to exercise their options. Financial 'education' is often combined with the *information sharing*.

'Options are meant to be given away to recruit, retain and motivate, but you can only achieve that if its understood' - Casserly (2013).

2.5.4.4 Clarity

Another important aspect is to introduce clarity and transparency in the ESOP. This means that the rules and procedures regarding this scheme should be clear and understandable to anyone involved to prevent chaos and conflict (Kaarsemaker, 2009).

2.5.4.5 Conflict resolution

Finally, Kaarsemaker found that participation in an ESOP can lead to conflicts within the organization. This can occur in the form of peer pressure and mutual monitoring among employees or employees risking a promotion or even their job if they exercise their right to influence decision-making in the company. Usually there are no formal procedures for conflict resolution but Kaarsemaker concluded that it can be handled in a formal and objective manner when conflicts arise (2009, p. 41).

Another result of Kaarsemaker's research is that the managers of a company have a big influence on the success of the ESOP considering that employees will not take it seriously if management does not. Kaarsemaker stresses that employees who exercised their options should be treated as fellow-owners and shareholders to be able to achieve the ESOP goals. Furthermore, management should be on board in early stage, before employees will be informed, for a number of reasons: they set the tone and have a big influence on how the plan is perceived and they should be able to answer the most important questions from the employees about the program. Aside from taking the employees and the ESOP seriously, management should also use the five instruments mentioned above to involve the employees in the program and the company as a whole. According to Kaarsemaker, employees will adjust their attitude and behavior accordingly.

2.5.5 External environment

Share options are found to have a different impact in Europe compared to a more Anglo-Saxon context which contains more of a shareholders culture and stock trading popularity. Kaarsemaker (2009) calls it one of the main reasons why ESOPs are more common in the US than in countries like Germany or the Netherlands. Legislation in the US has been more stimulating of ESO for decades while in the Netherlands it has mostly been ignored as argued by researchers (Kaarsemaker, 2009; Lowitzsch et al., 2009). The Netherlands is bigger on collective values however which would fit an ESOP perfectly. More of these differences can be found in chapter 2.2.5.

2.6 Practical design

The way the ESOP is designed and implemented is up to the discretion of the company; its current shareholders and/or management. These decisions include how to project the value of an option; how to determine the amount of share options to grant each employee; which employees to offer options to; how to determine the vesting schedule and how the parameters of the ESOP relate to the attempted goals.

2.6.1 The Dutch Model by the SNPI

The SNPI (Nieuwland, n.d.) offers a checklist to companies wanting to implement a share participation plan for employees. It is specifically directed to shares and not share options, which is why it can only be used partially for this thesis. The SNPI recognizes 4 phases in the process: orientation, design, implementation and evaluation.

According to the SNPI, in the first phase, not only the goals are defined but also the specific conditions, participation criteria and percentages. In the design phase, the right structure is established, the statutes and policies are checked and adjusted, regulations are set and the company is valued for setting prices for shares. In the implementation phase, a communication plan is drafted, participants will be informed, a STAK is founded (if necessary for the type of plan), all legal documents are drafted by a notary and finally, employees will be able to participate. The final step is evaluating the plan after one or two years to see whether the process runs according to expectations. The plan possibly needs to be adjusted at this point to ensure maximum fit and effectiveness.

The participation institute recommends using the following specialists during this process: a lawyer, notary, valuation specialists, the company's own accountant and possibly a tax consultant, project manager and communications advisor. Take into account that not all specialists specialize in share participation and that these functions can overlap as well. It is also probable that small companies with fewer employees and a less complex plan need fewer advisors and advisory hours.

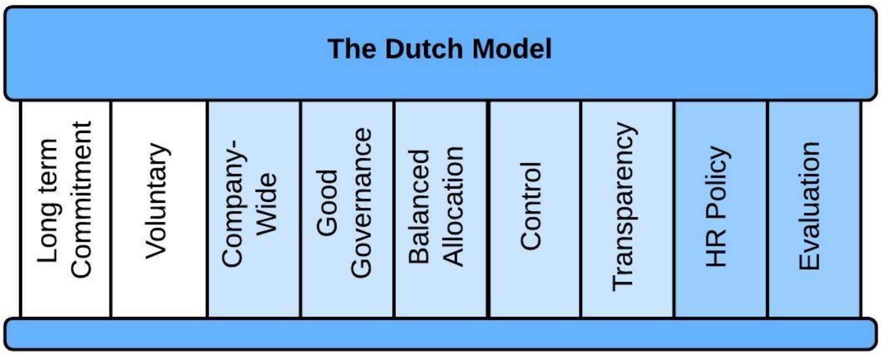
In the average Dutch company, implementing a plan takes about 6 months (Nieuwland, n.d.). The costs can vary significantly and mostly depend on the number of specialists used and the complexity of the plan. For the average company, the SNPI mentions numbers between € 7.500,- and € 25.000,- but the numbers will likely be different for startup companies.

To make the design and implementation of an ESOP easier for Dutch companies, the *'Dutch Model'* was introduced by the SNPI (2011). This model, developed in collaboration with various parties and experts, can help simplify designing a good company-wide share plan and to implement it effectively and efficiently. The model is built on European and American principles and guidelines.

The main goal for an ESOP in this thesis differs from that of the 'Dutch Model', in that the objective is to attract and retain talent in a startup company, rather than just stimulate commitment of current employees in a 'regular' firm. Nevertheless, the model is - with a few adaptations that will be explained later - very useful in offering proper guidelines for designing an ESOP in the Netherlands.

The Dutch Model is based on several important pillars, which are shown in figure 2 and will be discussed in this chapter.

Figure 2: Pillars of the Dutch Model (SNPI, 2011)



2.6.1.1 Long term commitment

Awarding employees with share options creates a long-term commitment for employees to the company which will help retain valuable key personnel.

2.6.1.2 Voluntary basis

As discussed earlier in the thesis, it is important in the Dutch model that participation from employees is always on voluntary basis and that share options are no substitute for a basic salary. Blasi et al. (2013) concurs and claims that offering shares instead of a competitive salary will lessen the positive effects of ESOPs. He thinks that employees are not better off by losing a part of their wage in return for a stake in the company, because it is such a gamble.

2.6.1.3 Company-wide

The Dutch model encourages company-wide plans, which means that options should be offered to at least 75% of the employees with an employment contract. As discussed before, for the goal of attracting and retaining certain key employees, a company-wide plan might not be necessary so this decision is left up to management's own discretion. Participants in the

Dutch Model are usually employees with fixed employment but they can be offered to employees in temporary employment as well.

2.6.1.4 Good governance

Companies using the Dutch Model handle the principles of good governance and apply them (especially in control and accountability).

2.6.1.5 Carefully balanced allocation

The allocation of shares among different employees needs to be carefully thought through.

2.6.1.6 Control

Control that participants gain in the company (voting rights) is secured if shares are certified. When following the Dutch Model in using a STAK, 50% of the board of the STAK should represent the employees. Employees who have exercised their options to become shareholders, have (under the Dutch Model) direct control through shareholder meetings.

2.6.1.7 Transparency

There is no standard for a communication plan but it should include what options are, how they work, what they could be worth and there must be clear and transparent communication about the share plan, the company performance results and the consequences of participating for employees. This information will be essential for employees to decide whether and when to exercise the options. Part of the transparency is that all stakeholders (e.g. HR, legal, finance, administration) are involved in the design and implementation of the plan in an early stage.

2.6.1.8 HR Policy

Implementing the ESOP should be seen as a part of the Human Resource policy of the company (see chapter 2.5.4).

2.6.1.9 Evaluation

The ESOP needs to be evaluated yearly to discuss the participation rate, if the company still meets its objectives and if the plan still fits the actual situation of the company. Kuvaas (2003) agrees and mentions that companies can reduce the risk of investing in plans that lead nowhere of even have a negative effect by monitoring reactions to the plan.

2.6.1.10 Design according to the Dutch Model

In the Dutch Model, max. 10% of the yearly gross salary can be used by employees to buy shares from the company with a max. of 4,99% of the total number of shares outstanding to prevent ‘substantial interest’. Substantial interest, which occurs when an employee owns 5% of the shares or more, is prevented to avoid different tax regimes as previously mentioned in chapter 2.2.4.7.

When an employee has exercised his options to buy shares in the Dutch Model, he is able to buy or sell the shares internally at least once a year. It is possible to do this more often but this will be more expensive for the company. Nieuwland (2012) argues that no trade at all is not in the interest of the employee-wellbeing and doesn’t stimulate participation[6]. When employment is terminated or when there is insufficient demand internally, the company is obligated to buy back the shares of the employee, unless the continuity of the company is at stake. It needs to be stated in the ESOP what to do with oversupply and demand. An example

[6] This can be different if the goal is not to stimulate participation of all employees.

is that a certain order is followed: e.g. prioritize when it comes to buying by rate, years of employment and years of participation.

A good responsible share plan according to the Dutch Model offers employees several possibilities for buying shares; via salary, bonus, profit payout, gratuity, tax-effective savings and other (own) means (a company loan is not one of the responsible solutions, unless under very strict conditions). The value formula for valuing the worth is based on the sum of the intrinsic value and profit, adjusted by a branch correction. The value needs to be stable, meant for internal share trade and not for cash flow. The ESOP should contain intent of the proposed dividend policy. It is recommended to use a generous dividend policy for optimal involvement of the staff with a good balance with the performance of the share. The payment of dividends remains a firm decision.

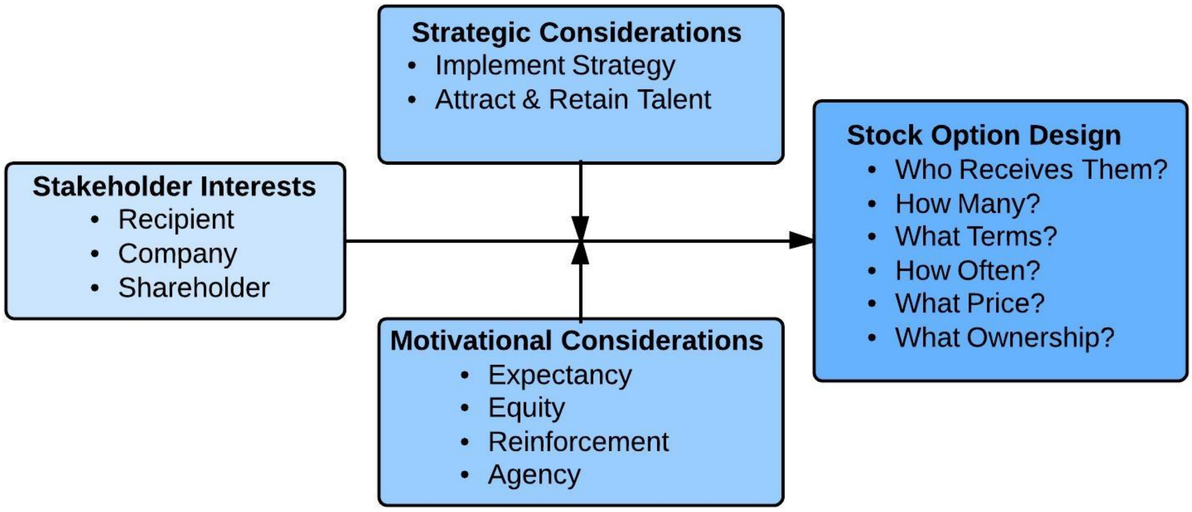
In the Dutch Model, options typically vest in portions across time in the form of a vesting schedule (*partial vesting*). This is spelled out in the options agreement. The ESOP will normally vest at predetermined dates, e.g., have 25% vest in one year, (one year from the grant date) another 25% in two years, and so on until it is ‘fully vested’. If there are no options exercised after year one (the 25% that vested in that year), then there is a cumulative growth in percent vested, and now exercisable options, across the two years. It is also possible to exercise only part of the fully vested options (Summa, n.d.). When employment is terminated, the employee is not able to hold on to his options before or after they are vested, although some consideration can be given by the company to special circumstances *(‘good leavers’)*. A *grace period* can be set in the Dutch Model as well to offer the employee a small window to exercise vested options after termination of employment.

A central contact person should be appointed for handling the communication about the ESOP. The Dutch model recommends official brochures, information by means of intranet and training meetings.

2.6.2 Model for effective stock option design by Brandes et al.

Brandes et al. (2003) developed a model for effective stock option design, suggesting that it starts with the stakeholder interests and is influenced by strategic and motivational considerations.

Figure 3. Effective Stock Option Design (Brandes et al., 2003)



Although the model in figure 3 is targeted on (average sized) American companies that are on the stock market, the basis is very similar to the design of a suitable ESOP for Dutch startups. Stakeholders to consider in this research are employees, the company, current shareholders and according to interviews (see chapter 2.4.2), ‘future investors’ as well. This thesis only focuses on the strategic considerations ‘attracting and retaining talent’ and not on using share options to implement a certain strategy or to motivate employees for certain goals, which is why these considerations are not further discussed. Brandes et al. recommend companies to consider the following six questions when designing an ESOP:

2.6.2.1 Who receives them?

The choice of offering shares broad-based or restricted should be based on company growth prospects, management style, organizational culture and on the strategic and motivational considerations. Brandes et al. suggest that restricted plans are more suitable in slow-growth conditions and when lower-level employees have a marginal impact on the organizational growth or market value. A broad-based plan on the other hand would be more suitable for rapid-growth where lower-level employees can perform tasks crucial for organizational growth or the implementation of strategies, which can be the case in a typical startup company. Management style and culture are important because if most employees are encouraged to act strategically and are involved in the decision-making, then broad-based options make more sense than in more bureaucratic cultures. Brandes et al. mention downsides of broad-based plans are dilution and re-purchasing.

2.6.2.2 How many?

Whether to initially offer a large or small percentage of employee income in the form of shares should match the company’s growth prospects. Brandes et al. recommend startup companies that focus on innovation and growth to provide a high level of options relative to total compensation because more risk is shared with the employees compared to more established, low growth companies.

2.6.2.3 What terms?

Brandes et al. found that incremental vesting is much more prevalent (in the US) than having all the options vest at once but it should match the company’s strategy and business cycle. The exercise period after vesting ranges from 4 to 15 years but 10 years is mentioned as standard.

2.6.2.4 How often?

Whether to offer once, annual, quarterly, for the completion of projects, to retain talent that may have competing offers, as a signing bonus, to recognize and reward out-of-the-ordinary accomplishments, to acknowledge an achievement that helps the business, etc., should match the organizational strategy. According to Brandes et al., predictable grants like annual grants can be seen as entitlements and will do little to motivate future performance.

2.6.2.5 What price or ownership?

Since Brandes et al. focus solely on public companies under US law and US tax provisions, their advice on the price and ownership is not suitable for Dutch private startups (Poutsma et al.).

2.7 Conclusion

2.7.1 Summary

An ESOP is associated with many positive effects, more than just attracting and retaining key employees. If incorporated into the company well, considering a number of influencing factors and conditions, it can lead to a feeling of ownership by the employees, increase their motivation, performance, productivity and satisfaction. It is associated with more profitability, competitive advantage, a decrease in absenteeism and it could lead to more solvency due to lower salary costs. Finally, a sense of community can develop where there is less alienation between management and employees. In any case, share options should always be considered part of a fuller picture: without sufficient other (intrinsic) incentives, share options alone will not work in attracting and retaining employees.

The accompanying uncertainty for both employer and employee can be seen as one of the biggest drawbacks of an ESOP, which is why it would not work for all personality types a company may want to attract. A company should also keep in mind that implementing an ESOP takes a lot of time, effort and money while current shares will suffer dilution as well. Finally, one pitfall of ESOPs is that bad organizational performance can decrease or take away the retaining effect.

ESOPs are used in the Netherlands to attract and retain employees mainly by large, financially profitable organizations, yet they have proven to be a good solution and fit for startup companies as well. The typical knowledge-intensive startup company is in need of skilled employees but constrained by cash limitations and poor job security. The possibility to participate in an ESOP can be an extra incentive for employees to start working for such a company and it could even work better than it would in a large company: Stock option schemes “match” the startup culture with regard to a risk-taking attitude and an employee-focus in knowledge-intensive startups. The small employee base in a typical startup makes it easier to involve them in the business strategy and decision-making and individuals generally have a larger influence on company performance which increases their motivation and performance to create value when they have share options. Because the individual’s input in such a company is much more visible, a risk of the ‘free-rider effect’ is minimal.

Aside from share options, other common forms of FEP in the Netherlands include (options on) certificates via a STAK or Stock Appreciation Rights. Differences, upsides and downsides are discussed, however it depends on the type of company and its goals which form with which rights suits an organization best and it is recommended to seek a (fiscal) specialist for advice on the best approach.

2.7.2 The ESOP-Model

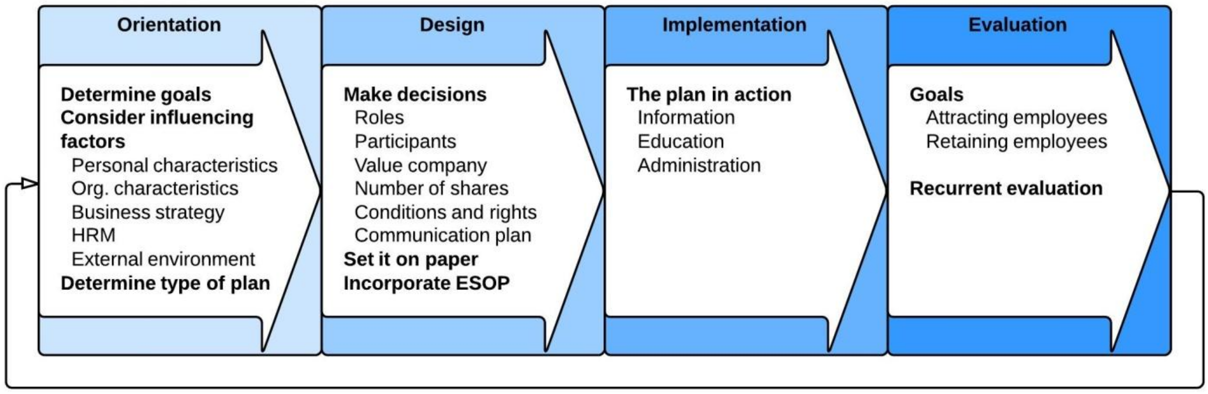
In this chapter a conceptual model is developed that describes the different phases of setting up an ESOP. It distills the guidelines, best practices and experience reports obtained from the literature sources (as comprehensively discussed in this literature review), into a coherent sequence of four phases which need to be followed in order to implement a well-functioning ESOP.

Each of the four phases is comprised of a number of factors that need to be considered and several steps that need to be taken before moving on to the next phase. An outline and reason for each of the phases and the individual steps is given below.

The conceptual model is tested in the interviews to explore how it aligns with the experiences of interviewees of setting up an ESOP in practice (see chapter 4).

More detailed and practical information about every phase of the ESOP model and its components is given in appendix 3 which presents a practical implementation plan and shows how this model would be applied to the specific scenario of Dutch startups who are considering using Employee Share Options as instrument to attract and retain talent.

Figure 4. Conceptual model based on the literature review to design and implement an ESOP



2.7.2.1 Description of the phases

Adopting the guidelines for setting up an ESOP by Nieuwland (n.d.), the model is comprised of four sequential phases: Orientation, Design, Implementation and Evaluation (see chapter 2.6.1).

2.7.2.1.1 Orientation

It has become clear in this research that the design and implementation of an ESOP significantly influences which types of goals a company can attain with the plan. Therefore an ESOP's design needs to start with an orientation phase where the goals that the company sets out to attain (e.g. attracting and retaining employees) are examined.

In addition, several influencing factors need to be considered. These factors (adopted from Kaarsemaker (2009)) include:

- <u>Personal characteristics</u>
  The interests, needs, personal orientation, personality type and experiences of the employees who a company sets out to attract and/or retain and whether they would fit a startup company, this company in particular and share options.

- <u>Organizational characteristics</u>
  Includes the branch, the industry, the organizational phase the company is in, the organizational history, the size and the financial situation. How do these factors influence the design and implementation of an ESOP?

- <u>The business strategy</u>
  The strategy needs to accommodate an ESOP and leave room for employee discretion and practical freedom to act. By sharing relevant and strategic information, employees can be involved and use their functional discretion in accordance with the strategy to increase their share value.

- Human Resource Management (HRM)
  Comprised of participation in decision making, information sharing, financial education, clarity and conflict resolution (see chapter 2.5). These HRM instruments need to match the new ESOP design and communication plan and possibly need adjustment to effectively implement the ESOP.

- The external environment
  All stakeholders need to be considered including possible investors and whether the company would like to operate internationally in the future. This could influence the type and design of the ESOP.

Finally the type of plan needs to be determined. This choice can be based on various considerations such as control, costs or the wishes from the employees themselves. See chapter 2.2.3 for more information of the different forms.

2.7.2.1.2 Design

The design-phase consists of several factors adopted mainly from the Dutch Model by SNPI (2011) in chapter 2.6.1 and the theory from Brandes et al. (2003) in chapter 2.6.2 concerning Stock Option Design.

The design phase begins with several decisions that need to be taken:

- Who will do what: How will the roles regarding the ESOP be divided?
- Who receives them: Which employees will be able to participate?
- What price: How will the company and the shares be valued?
- How many: How many shares to reserve and what to base the division among employees on?
- What terms and how often: Which conditions are placed upon participation and which rights are associated with the shares?
- How to inform: How to set up a communication plan to inform and educate all stakeholders?

The plan needs to be set on paper, preferably by a legal specialist to capture the plan clear and transparently in rules and regulations for all stakeholders (2.6.1) and to cover special situations like what to do when employment terminates of when the company is sold. This ESOP then needs to be incorporated in the existing strategy, procedures and policies.

2.7.2.1.3 Implementation

In the implementation phase, the plan is put into motion and administered, a possible STAK will be formed, employees will be informed and educated following the communication plan and they can enter into the ESOP.

2.7.2.1.4 Evaluation

An ESOP needs to be evaluated at least yearly to discuss the participation rate, if the company still meets its objectives and if the plan still fits the actual situation of the company according to Kuvaas (2003) and SNPI (2011). Companies can reduce the risk of investing in plans that lead nowhere or even have a negative effect by monitoring reactions to the plan. In the evaluation phase it will be assessed whether the goals for the ESOP (in this thesis: attracting and retaining employees) are reached and if the design or implementation needs adjustments.

2.7.2.2 Timeframe

According to Nieuwland (2012), designing and implementing an ESOP generally lasts between 4-6 months but this timeframe can differ for startup companies. Following the literature review, the implementation of an ESOP and the corresponding communication should be easier in the typical startup due to the small number of employees, shorter lines of communication, a flat hierarchy and an innovative culture. Therefore it is assumed that the timeframe for startup companies generally will be shorter.

2.7.2.3 The ESOP-model applied to startup companies

While the ESOP-model can be applied to larger companies as well, the aspects differ for startups:

- <u>The type of plan</u>
  A STAK can cost less money than direct shares or share options because a notary is only needed at the start to set up the foundation, not to transfer the shares. Startups with typically limited funds available to them might favor a STAK for this reason. Because the division of certificates is up to the discretion of the board (in startups usually the founder) without involving a notary, this form fits the volatile nature of a typical startup. See chapter 2.2.3 for more information on the type of plan.

- <u>Influencing factors and implementation</u>
  Employees that would work for startups (less risk-averse) will more easily accept that a part of the compensation is future-based and unsure and are the type of persons who would be attracted by share options or even come to expect it as part of the compensation. This would make an ESOP necessary and easier to implement in startups.

  A typical organizational characteristic of a startup company is that the long-term focus is shorter due to the relatively low survival chance and the highly variable nature of the organization. This makes it easier to implement a share option scheme and within a shorter period of time, because the general resistance to change is lower compared with larger, older companies. The costs of designing and implementing an ESOP is likely to be lower as well due to the typical small employee base. With its typical short lines of communication, a communication plan in a startup company can be less formal and less extensive.

- <u>The design-decisions</u>
  Typical for a startup is to set up a company-wide ESOP at the start for early employees, and narrowing it down to key-personnel only after a certain amount of growth. Finally, the total number of shares to reserve is generally smaller in startups due to the low number of employees and the division of shares in startups is based more on the amount of risk an employee takes by working for a startup.

3. Methodology

This research is qualitative, aimed to provide well-grounded advice for all private limited startups with Oni Labs as exemplary organization. To do so, this thesis extrapolates from the body of pre-existing research literature, which is mainly focused on share options in the US and/or share options in large companies, to a Dutch startup setting by means of desk-research on primary and secondary data.

A conceptual model (the ESOP-model) is created based on this literature review, to guide startup companies through the orientation, design, implementation and evaluation of a suitable share option plan for startup companies in the Netherlands. Building on this model and the results from the literature review, qualitative research is conducted to validate the ESOP-model and to assess the use of ESOPs in practice, by means of in-depth interviews and questionnaires for experts and practitioners (founders and managers of startups in the Netherlands that use an ESOP or have used one in the past). The purpose of qualitative research is to examine and interpret observations in a non-numerical matter, to discover underlying meanings and patterns of relationships (Babbie, 2013, p. 403).

3.1 Operationalization

The goal of this research is to study the effectiveness of share options for Dutch startups to attract and retain valuable talent, yet the attraction and retention effects of share option schemes are difficult to measure directly.

Attraction is defined as the ability of startups and young corporations to attract high qualified employees by providing employees tempting compensations, and retention is defined as tying employees to the company and enjoying ‘their fruits of labour for several more years than regular firms do in short of an ESO programme’ (ten Have, 2013, p. 17).

Existing literature measures these effects in different ways. Smits (2011) asked 640 entrepreneurs and managers if they see a positive effect on attracting and retaining new talent after implementing FEP (in the form of shares, certificates, profit sharing or options). Ten Have breaks attraction and retention down into several interview questions and questionnaire statements for employees within a company. He enquired if ESO was the main reason why they joined the firm, which factors motivate to join a firm, if ESO is an incentive to remain longer with the firm, if they feel like they are part owner of the company, if they would leave if the stock price declines and what would happen with their motivation if stock prices decrease. The statements include several reasons to join a company, including the ESO, the fact that it is a startup, the work environment, intrinsic motivations vs. extrinsic motivations, etc., and several reasons for retention including the ESO, work environment, company culture, etc. Blasi and Kruse (2001) tested attraction by examining the relative growth of the number of employees and retention by examining changes in ‘unnatural’ turnover.

The literature review, questionnaires and interviews of this research are based on these studies and conducted to both inquire on the effectiveness of share options to attract and retain employees and the design and implementation of the ESOPs in several Dutch startups. To prevent the questionnaires and interviews from getting too long and therefore undesirable to participate in, only the main questions about the design and implementation of ESOPs and its attraction and retention effects were asked. The goal of the interviews and questionnaires was to reach a more complete view of the effect of share options for Dutch startups as per theory and experience, to give practical examples of the design and implementation in Dutch startups and to compare the ESOP-model - which is based on literature that focuses on larger, established organizations - with real-life experiences of Dutch startups specifically.

3.2 Interview & questionnaire methodology

The subjects that were interviewed or that filled in questionnaires have firsthand experience with share option schemes in a startup company from a management point of view. The interviews were conducted to gain an insight of how the ESOP was designed and implemented and how the effectiveness of ESOPs is perceived.

To limit the number of questions to ask in the interview or questionnaire, as much company background information as possible - from sources such as the company website, or documentation associated with the company's ESOP - was collected beforehand. The number of respondents is (kept) small due to several reasons. Interviews and the analysis demand a significant amount of time (Elshof & Pieters, 2006; Saunders, Lewis, & Thornhill, 2009) and the number of known experience experts is low. Because generalization is not a goal of this research, the amount is still considered sufficient.

Several measures were taken to increase cooperation and the quality of the answers. The face-to-face interviews were offered to be held at a location of the participant's choice, alternative methods of interviewing over the phone or Skype were offered to increase response and as last option answering the questionnaire digitally was allowed as well. All approached startup managers were informed about the goal and importance of this research in advance and were promised to receive the results of this research upon cooperation, which are means to increase the response rate (Elshof & Pieters, 2006; Saunders et al., 2009). It was a conscious choice to only start this process after having done a significant part of the literature review, to base questions on sufficient knowledge, to demonstrate credibility and to obtain the trust of the interviewees.

'A well informed interviewer has a basis for assessing the accuracy of some of the information offered' - Healey and Rawlinson (1994, p. 336)

The findings derived from these interviews and questionnaires reflect reality at the time they were collected, in a situation which may be subject to change (Marshall & Rossman, 1999). To still ensure reliability however, interview and questionnaire answers are saved in original form on audio file or in documents.

Apart from Dutch startups with ESOP experiences, a fiscal advisor and Employee Participation expert were contacted as well with the request to offer their knowledge and experience on the subject for this research. An interview with the senior manager of accountancy and consultancy firm Grant Thornton (Enschede) was held to complete the literature review regarding the fiscal aspects of ESOP's and to receive information about their role in the implementation process for startup companies that are considering participation plans for their employees. Grant Thornton specializes in growth and has experience in advising startups in financial and fiscal matters regarding share options, certificates via STAK and SAR. Finally, an expert from the SNPI was contacted to receive more information on their 'Dutch Model' and their experiences with Participation plans for startup companies in particular.

3.2.1 Preparation and gathering respondents

A significant amount of effort was spent on identifying a sufficient number of Dutch startups with share options or comparable plans like options on certificates or direct share participation by employees. Via the use of sites like Startupjuncture.com, Dutchstartupjobs.com, Angel.co, Sprout, Youngstartup.nl and by following news regarding startups, a large list of Dutch startups was found to examine. Only the companies from that list that mention share options, stock options, equity or shares on their website or in their vacancies online were contacted and given information about this research. Startup companies with completely English websites and English vacancies were contacted in English and companies with Dutch websites were contacted in Dutch.

Since most companies only provide ways to contact via e-mail instead of phone, all companies were sent an introduction e-mail with information about the research, the request to participate in this research and the offer to share the results upon participation. After 1-2 weeks, a reminder was sent with a short summary of the original e-mail. Last contact efforts occurred by phone when possible. Where possible, the ESOP contract and procedures were requested in advance to minimize the number of questions to ask in the interview or questionnaire and to keep the interviews short. Finally, for all interviews the location, date and time, length of the interview, setting and used language were noted, as well as the immediate impression by the interviewer, to make the interview process as transparent as possible.

3.2.2 Design of the questions for questionnaire and interview

There are several types of bias considered in designing this research.
Interviewer bias is *'where the comments, tone or non-verbal behavior of the interviewer creates bias in the way that interviewees respond to the questions being asked'* (Saunders et al., 2009, p. 318) To avoid ambiguity about the (goal of the) research, the interviews and questionnaires started with a brief explanation of the topic and all questions were formulated in an objective manner to avoid any suggestive tones. *Interviewee or response bias* is when the interviewee may be sensitive to the subject and possibly does not wish- or is not empowered to discuss this with the interviewer. This can result in a partial or wrong picture of the situation via 'socially desirable answering' (Saunders et al., 2009). For this reason, the option of anonymity in this thesis was given to ensure honest answers.

3.2.2.1 Experts in knowledge

Questions for the SNPI included their '*Dutch Model'* for developing an ESOP. Since most literature focuses on large, established companies and various goals of employee participation; the question rose how this model could be adopted to Dutch startup companies in particular who are mainly interested in using ESOPs to attract and retain valuable employees to the company. Furthermore, various claims made in literature written by the SNPI were discussed to reach a better understanding of their research and experiences of ESO in the Netherlands.

Questions for Grant Thornton included the role of the company in the orientation, design and implementation process of ESOPs for private (startup) companies and the fiscal workings of the different forms of employee participation.

3.2.2.2 Expert in experience

The interview questions (see appendix 1) were partly based on the interviews by Kaarsemaker (2009) and ten Have (2013), on the Dutch model and model by Brandes et al., but mostly on the ESOP model from chapter 2.7.2. Design factors like participation, offering, conditions and procedures of the ESOP in question were discussed in relation to the goals set by that company. These goals however can regard various benefits since it was not feasible only to select Dutch startup companies with an ESOP with the only goal of attracting and retaining employees. The interview questions were tested upon several test-persons in advance to ensure objectivity and comprehensiveness. To be able to compare the interview results, the interviewees were given the same main questions after which they could speak freely, which resulted in a semi-structured research method (Saunders et al., 2009).

Most of the questions asked were based on the four phases of the ESOP model. At the start, basic questions about the participant, the company and the ESOP were asked to establish the participant's role and the type of company to get a better understanding of the situation per startup company and the influencing factors from the orientation phase. The questions about the type of company include the sector/industry, size and whether it is listed or not. Secondly the type of plan, the reasons for selecting that plan compared to alternatives and which external parties were involved, were discussed to get a better understanding of the decision-making process regarding ESOPs. The last question from the orientation phase involved the goals that the company wanted to reach by implementing an ESOP. The influential factors Personal Characteristics, Company Strategy and Human Resource Management were excluded in the question list because those are not easily comparable and it helped prevent the question list from getting too long which could discourage or deter potential participants.

Questions about the design phase included the percentage of shares reserved for employees, which employees are able to participate, which conditions are placed, how the shares or certificates were divided and what these decisions were based on. When it involved options, the details about the vesting schedule and exercise period were discussed.
Furthermore, the rights associated with these shares or certificates, the policy on trading or selling shares, offering situation, the determination of the value and communication about the ESOP were discussed.

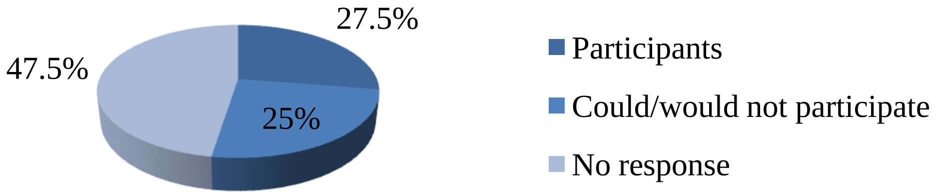
In regard to the implementation and evaluation phase, questions were asked about the communication with employees and evaluation of the ESOP, but most companies were not at a point where the actual results and evaluation could already be discussed. If applicable, experienced challenges, effects of the ESOP and if the targets were reached, passed in review. Finally, the participants were asked to give some advice from their experience to Dutch startup companies that consider using such a plan.

Aside from these main questions, the interviews were mainly non-directive which can help retrieve possible unanticipated opinions and feelings on the matter from the interviewees (Elshof & Pieters, 2006). Follow-up questions were asked in order to obtain more complete answers to the interview questions. Each interviewee answered the questions to the extent that they were able to. The answers were left out whenever their knowledge on the subject proved to be insufficient.

4. Interview and questionnaire results

4.1 Response

In total, 40 Dutch startups that mentioned or offered some form of equity on their website or on vacancies were contacted to participate in this research, out of which 11 (27.5%) participated, 10 (25%) could not or would not participate and 19 (47.5%) did not reply at all. None of the participating companies were listed on the stock market at the time of participation.



Reasons that were given not to participate were that the concerned company had no ESOP in place (yet), did not have time to participate, was not interested in participating or the company policy did not allow it.

The following table provides an overview of the respondents in this research. Names have been left out and were replaced by numbers to ensure anonymity.

Tabel 3: Overview respondents

Nr.	Interviewee Function	Response type	Industry
#1	Chief Technology Officer (CTO)	Interview	Software/IT
#2	Founder	Interview	Leisure, Travel & Tourism / IT
#3	Founder	Interview	IT and Services
#4	Founder	Interview	Internet
#5	Co-Founder & CEO	Interview	Consumer Services
#6	Co-owner & VP Finance & Operations	Questionnaire	IT and Services
#7	Founder & Chief UX Officer	Questionnaire	Internet
#8	Founder & Director	Questionnaire	IT and Services
#9	Co-Founder	Questionnaire	Information Services
#10	Co-Founder & CEO	Questionnaire	IT and Services
#11	Public Relations	Questionnaire	Financial Services

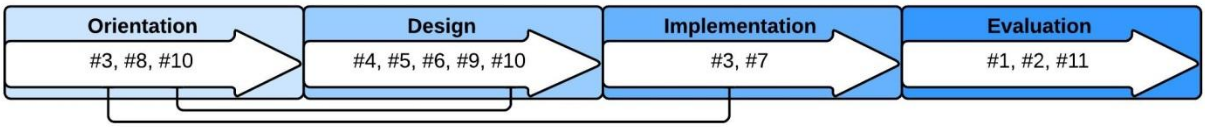
All interviews and questionnaire responses took place between March 21st and April 24th. The interviews and questionnaires were executed in either English or Dutch, at the choice of the respondent. The respondents were able to make a choice between a face-to-face interview at a location, date and time of their choice, an interview over phone or Skype or as last option a questionnaire. The Dutch responses were translated to English to incorporate in this thesis.

4.2 Results

The companies participating in the research were all Dutch startups founded between 2005 and 2012 and having between 3-50 employees (with one outlier having around 175 employees).

As is shown in figure 5, these companies are in different phases of the ESOP model and it can be concluded that in practice, companies do not always follow these phases exactly in the same order and e.g. can have a plan implemented for one (group of) employee(s) and be still in the orientation phase for another group of employees.

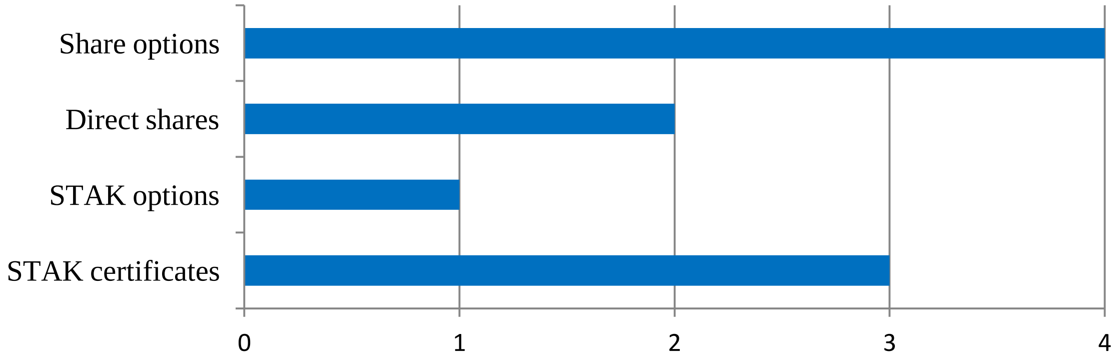
Figure 5. Classification of the stage of the studied companies' ESOPs at the time of research according to the ESOP model



The studied companies are numbered and their corresponding ESOPs placed in the stage they were in at the time of research (April, 2014) according to the ESOP model discussed in chapter 2.7.2. When the same number appears multiple times in the illustration (e.g. #3), it means that the corresponding company had multiple concurrent ESOPs in different stages (e.g. for different groups of employees; see also discussion in text).

Some of the companies employed a combination of different ESO schemes for different groups of employees. An overview is given in chart 1.

Chart 1. Type of plan used by participating companies



One of the participating companies used direct shares and share options for the early employees yet was considering using a STAK with options for all future employees. Two other companies were still in the orientation/design phase and considered either to use share options or STAK options or STAK-certificates or non-voting shares.

The companies mentioned several reasons why they chose to use a STAK or to go for share options, which are listed in table 4.

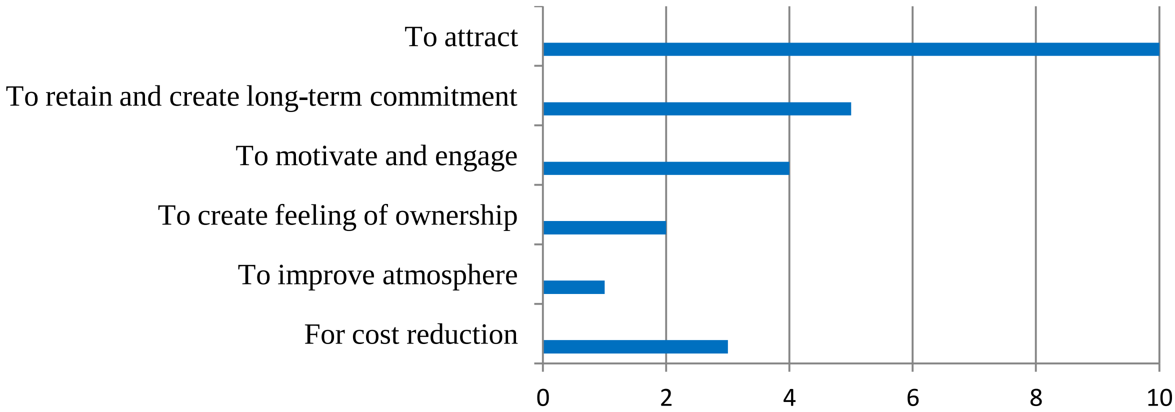
Table 4. Reasons to use a STAK or share options

Form	Arguments
STAK	Option plans are fiscally less attractive in the Netherlands.
	Options bring a large amount of work to keep track of who has what and when and how much it is worth.
	It makes it easy to divide certificates without involving a notary.
	Certificates do not give a right to attend to- and participate in shareholder meetings.
Share options	We're planning to go to the US in the future where options are more known than a STAK.
	The parent company or the company itself is (partly) international.

These arguments are similar to the findings of the literature review on the advantages of the different forms of Employee Ownership. The choice for the type of plan for these startups was monetary, based on control or based on the international nature now or potentially in the future. Whether share options really do cost more time and work than the use of certificates through a STAK is possible but not researched or proven. It is likely however that options, whether it is on shares or on certificates, cost more time than direct shares or certificates due to the vesting schedule and other conditions to the options that companies need to check and keep track of.

The answers provided by the companies to the main survey questions (as shown in appendix 2) align with the findings of the literature survey. The goals that the participating companies in this research set for their ESOP, which are summarized and listed in chart 2, are in accordance with those mentioned in the literature, as well as the percentage of shares that is reserved for employees, the type of employees who are considered eligible and the moment of grant.

Chart 2. Goals of the participating companies for their ESOP

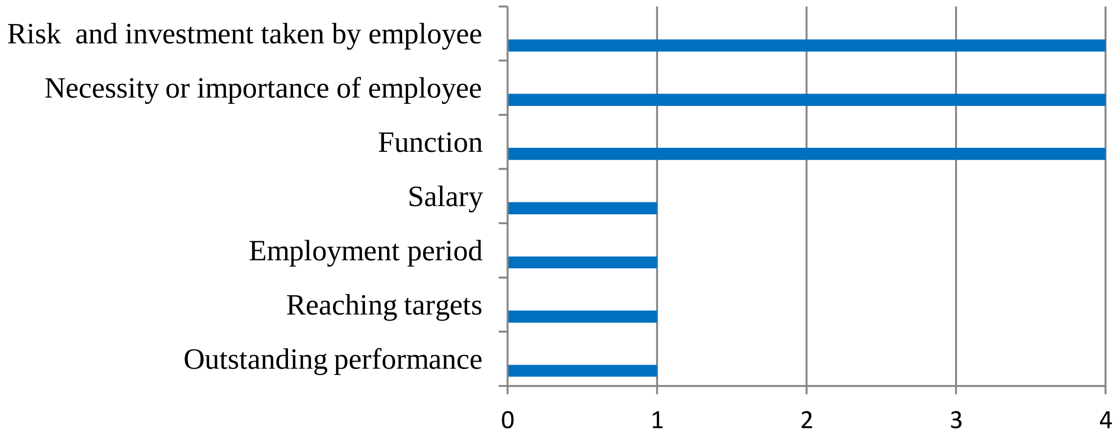


Also in accordance with the literature is that almost all companies from this study chose to grant non-voting shares where only sale proceeds and a right on dividend are associated with the share.

All studied companies with an ESOP implemented required employees to be employed for a certain period of time (between 1-2 years) before they were eligible for membership in the ESOP. This aligns with best practices identified in the literature survey (between 1-5 years) but could be on the lower side due to the changeability and volatility of startup companies. Furthermore, share options would lapse immediately with employment termination.

Chart 3 shows how the studied companies allocated share options among employees. It is of note that several companies chose to allocate share options based on job function; this is a practice that, at least in larger companies, is uncommon. (Kaarsemaker, 2009) did not find any occurrence in his research amongst 2500 companies where the division of shares was based on function.

Chart 3. Basis for division of share options in participating companies



Most of the studied companies offered some form of education to their participating employees, by providing them with documentation or arranging meetings with a tax consultant or lawyer. All but one company got help from financial, legal and/or fiscal advisors or peers who could help them with setting up a proper plan.

In most of the companies, the value of the shares was either based on the value of investments or the original nominal value.

One big difference found with the Dutch Model is that every one of the startups in this study that used a STAK only had a single board member (the founder) controlling the STAK. The SNPI generally recommends having at minimum half of all certificate holders on the board as well.

The few companies in this research that already had an ESOP implemented and evaluated were positive about the effects. They reported that it helped compete with bigger organizations, that it helped sway potential new employees and that they had the impression that employees worked harder because they have a tangible stake in the success of the company.

The participating companies also found setting up an ESOP challenging in practice. The process of pulling it all together is typically lengthy and tax rules in the Netherlands are complex and opaque. A common advice to other startup companies was to obtain ample advice from legal, fiscal and financial professionals while planning and setting up an ESOP.

In two companies there were instances of employees choosing not to participate in the ESOP because they preferred less risk and more salary or because they did not have faith in a positive result.

Finally, when the participating startup companies in this study were asked to give advice to fellow-startups in the Netherlands, they gave the following:

- Only found a STAK when you expand with a minimum of 2 employees because the notary needs to be involved and that can be costly, especially for starting companies;
- Make sure the shareholder agreement is set up by a reputable office that has Mergers & Acquisitions experience (you get what you pay for);

- If you leave room to negotiate the number of shares the employees can obtain, they might realize that the division is not 'fair'. Make sure that the division is considered fair to avoid conflicts;
- Watch the US stock market and see how private companies have gone public or been sold- and learn from what they did right and wrong;
- Options do work for a type of people but for others, it is just one of the 'perks' that come with the job which can be replaced by other perks like offering housing or a good office location.
- And finally: You do not necessarily have to use shares, the important thing in motivating is to show that you really share in everything, including financial profits. The form doesn't matter that much and depends on the situation. See when share (options) is realistic and it does not have to be on day one.

4.3 Conclusion

In conclusion, the results of the interviews and questionnaires are fairly similar to the ESOP-model for startups as described in chapter 2.7.2 and the existing literature on share options in general but they added new insights as well, in the form of reasons to choose a STAK instead of share options and vice versa, experienced challenges and their own advice to other startup companies in the Netherlands.

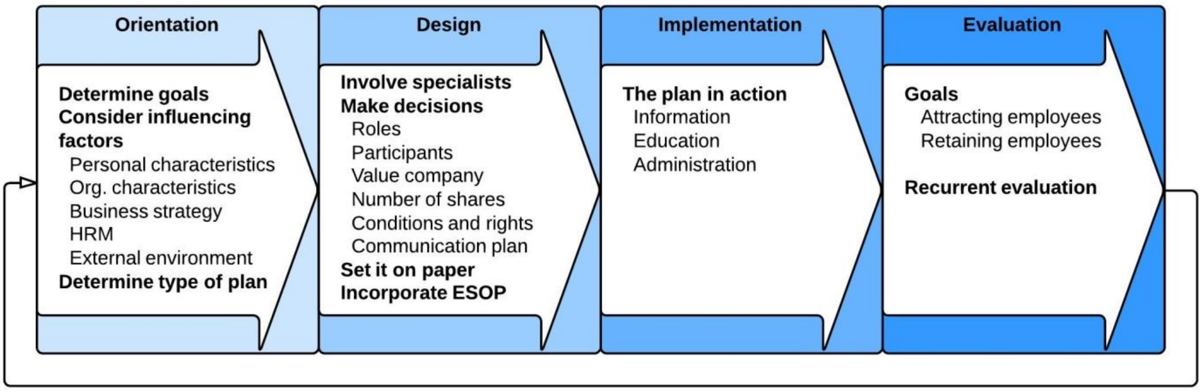
The process of designing and implementing an ESOP can be lengthy and tax rules in the Netherlands are complex and not transparent which is why the responding companies strongly recommend getting legal, fiscal and financial advice in the orientation/design phase.

One clear difference in contrast to the Dutch Model is that these startups mostly have their founder form the board of the STAK while the SNPI recommends having a percentage of employees on the board as well to represent all certificate holders. This way the employees are more involved in the decision-making. The difference can be explained by the finding that the participating companies do not wish to have their employees involved in the decision-making or because the number of employees with certificates is too small to be represented in the board.

When comparing the phases the participating companies are in with the ESOP model from the literature review, it is evident that not all companies follow these phases in the same order and can even be in multiple phases simultaneously, e.g. for different groups of employees. Although the latter can work better for a company to service different kind of employees, the former is not advised. If a company offers shares (implementation) at the start and plans to think about the details and conditions (design) in a later stage 'when there is more time', the employee cannot receive proper information and it can create false expectations for either party. Furthermore, by skipping the orientation phase completely, the form and type of plan can turn out to be a wrong match for the type of company and its strategy which could lead to conflicts with investors and other stakeholders and goals not being reached.

Based on these results, the ESOP-model will be supplemented with involving specialists in the design phase as is shown in figure 6, following the advice of the participating companies in this research. If the situation requires it, this step can be taken in the other phases as well. The other components and the four stages remain suitable to be used by Dutch startup companies for the design and implementation of an ESOP.

Figure 6. ESOP-model to design and implement an ESOP.



5. Conclusion

The main research question of this study is:
Are share options an appropriate instrument for Dutch startups for attracting and retaining talent, and how are they best implemented?

To answer this question, an extensive literature study was conducted and more specific information was gathered from accountancy and consultancy firm Grant Thornton as well as from the Dutch Employee Participation Institute (SNPI). 11 Dutch startup companies in the Netherlands participated in this research to share their experiences with employee participation plans. The participants were asked about the effectiveness of employee participation plans in attracting and retaining employees and the design and implementation of the approach in their company.

Both common forms of share options in the Netherlands were researched: Direct options on shares, and options on share certificates in a so-called "STAK" (Stichting Administratiekantoor). To put share options into a broader context, other forms of employee participation such as stock appreciation rights (SAR) and outright share grants were studied as well.

Following the literature review, share option plans have proven to be an appropriate instrument in US startups and in Dutch larger companies for attracting and retaining talent. Furthermore, ESOPs are associated with an increased feeling of ownership by employees, increased motivation, performance, productivity, satisfaction, more profitability, competitive advantage, a decrease in absenteeism, a sense of community with less alienation between management and employees and it could lead to more solvency due to lower salary costs. Share options however are only one factor contributing to the employee attraction and retention potential of a company. Many other aspects such as the intrinsic attractiveness of the company and the job itself play a large role as well.

There are indications that share options are particularly good at attracting employees with a risk-taking personality type who are willing to accept some job uncertainty in exchange for a potential large future payout. These personality types are also likely to thrive in a startup environment, which is marked by a large amount of uncertainty but also the potential for large growth and change. Therefore, share options should be particularly efficient at attracting the right type of employees for startups. This is backed up by the immense popularity of share options in the US high-tech startup culture. Options work best in attracting and retaining these employees as long as they have faith in the company's success and if their stake is large enough.

For share options to be effective in retaining employees, it is important that the participating employees have enough influence on the performance of the company as a whole to ensure a connection between their individual performance and an eventual share-based payout. The ESOP should be incorporated in the company strategy and HR-policy for this reason, including proper and transparent information sharing and financial education for the participating employees to know when to exercise their options, to have realistic expectations and to increase the ownership and retention effect.

The potential benefits of share options have to be weighed against the complexity and cost in designing and implementing an appropriate plan. One of the main reasons why share option schemes in the Netherlands are uncommon is because there is relatively little legal and tax incentive for ESOPs and having employee shareholders could potentially complicate selling the firm to an outside party both for direct share options (because these entail voting rights) and for shares via a STAK (because this construct is not very well known in other parts of the world).

The literature study was condensed into the ESOP-model. This model consists of four sequential phases: orientation, design, implementation and evaluation, which a startup can follow to set up a well-based and fitting ESOP. In practice, it is found that companies can be in different phases of the ESOP-model at the same time, for different (groups of) employees. The design of an ESOP differs per company and depends on the orientation phase which includes the goals and influencing factors. Finally, recommendations based on this model in the form of a practical implementation plan are given in the appendix. Various aspects of an ESOP that need to be considered with regards to the design and implementation are discussed in order for companies to be able to make well-based decisions.

In conclusion, share options can be an appropriate instrument in Dutch startups for attracting and retaining talent, as long as the ESOP matches the company and its employees in its design and implementation.

6. Discussion and implications of findings

6.1 Implication of this research

The goal of this research was to study the effectiveness of share options as an instrument to attract and retain employees in Dutch startups. Given the lack of similar research on these types of companies, this work could have a contributing effect to current literature.

The ability of ESOPs to attract and retain employees is tested and discussed in existing literature to be significantly effective given the right conditions, design and implementation, in more established companies in the Netherlands. In a startup context, Employee Ownership could work even better due to the advantages the typically small size and potentially high level of growth can bring as discussed in chapter 2.1 and which can be extrapolated to be the case for Dutch startups as well.

The ESOP-model developed in this research is based on several sources for American and Dutch companies and compared with ESOPs of Dutch startup companies specifically. Following this model, an effective ESOP can be designed and implemented by every startup company in the Netherlands to attract and retain valuable talent.

6.2 Limitations and scope of this research

The limited time available for this research made it infeasible to follow the course of potential target companies for a sufficiently long time to evaluate the efficacy of share option schemes quantitatively. Furthermore, the relative unpopularity of share options in this country, and the lack of publically available information about startups in general made it difficult to find a sufficient sample for generalizable research. For these reasons, this study limited itself to a literature review and qualitative research by means of interviews. Because mainly IT startup companies participated in this research, results may differ for startups in other sectors.

A part of the literature on share options is limited to options for senior managers and CEO's only. The effects of these schemes can be different compared to options for employees, inter alia due the higher basic salary an executive typically receives, decreasing the risks of participating in such a scheme.

Since this research was focused on startups aiming to attract employees in general, these research results were left out of this study. Furthermore, there are many benefits of ESO found in the existing literature which are mentioned in chapter 2.3. Since this thesis focuses specifically on attracting and retaining of employees, other benefits are mentioned but not further researched.

Because it is so changeable, complex and depending on specific situations, this thesis does not elaborate on the fiscal and legal side of Share Option Plans or the tax consequences for the company or the employee. It is strongly recommended to get fiscal, financial and/or legal advice on any share-based plan a company is considering.

Finally, there are many other instruments for attracting and retaining employees which are not covered by this thesis. This paper aims to educate about share options in a Dutch startup setting although it might not be the best option for every company to reach the goal of attracting and retaining employees.

6.3 Future research

This research is qualitative and not generalizable to all startups in the Netherlands due the small sample size in the interviews and questionnaires and a limited amount of time. There is still a gap in existing literature regarding this topic and Dutch startup companies in general and it would be advisable to conduct quantitative research on whether share options, options on certificates via a STAK or SAR prove to significantly attract and retain valuable employees to startup companies in the Netherlands (in the long run), how these forms compare to each other and how these plans typically are designed.

Furthermore, personal characteristics seem to play a big part in whether an individual chooses to work for a startup company, whether some form of FEP would sway him and whether a startup company in general would be a good fit in the long run. More research would need to be done in order to know which personality types (e.g. in combination with the anchors from Schein) would correlate with startup companies.

Finally, there is an opportunity to investigate how ESOP-designs differ significantly for Dutch startup companies compared to larger Dutch companies and to American (startup) companies. With the result of this research, the ESOP-model could be specified further to Dutch startup companies to attract and retain employees.

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Appendix 1: Main interview questions

Design and implementation of the ESOP

1. Which goals did/does the company want to achieve with the ESOP and why (e.g. attracting/retaining employees)?
2. What type of shares does it concern and why was this chosen compared to alternatives? (e.g. options, certificates, non-voting shares)
3. Do the shares give voting right or right on dividends?
4. Which external parties were involved in the design of the share (option) plan? (e.g. the SNPI or a financial, fiscal or juridical advisor)
5. What percentage of the total shares is reserved for the employees?
6. Which (type/group of) employees are offered share (options) and what is that decision based on?
7. Can every participant get the same amount of shares/share (options) or are there certain conditions attached?
8. When it involves options:
    a. what is the vesting schedule
    b. How long is the exercise period?
    c. What are reasons for employees to exercise their shares? (e.g. when they can sell them with a profit, when the company is sold)
9. Are there other conditions for employees to be able to participate in the share (option) plan? (e.g. performance or service conditions)
10. What provisions are there for trading/selling shares (e.g. who can they be sold to, are there restrictions on trading)?
11. How is the value of the shares determined?
12. In which situation are the options/shares offered to employees? (e.g. at the start of employment, annual)
13. Are employees in your opinion sufficiently financially ‘educated’ about the plan, what it entails and the consequences in participating in such a scheme?

Goals

14. In what situations are options offered (e.g. as a yearly incentive after positive performance reviews or just at the start of employment)?
15. Are options used as a substitute for bonuses or raises, or in lieu of a higher starting salary?

Results and effects

16. What are reasons for employees not to participate?
17. Are the set goals reached? (e.g. does it help attract employees or increase productivity)
    a. Do you notice any other positive effects from the share (option) plan?
18. Do you experience negative effects from the plan?
    a. If so, how is this handled?
19. Do the employees sell their shares? When? (e.g. right after exercising the options or when they can sell them with profit)
20. Is there a noticeable difference in reaction to the plan and participation..
    a. between Dutch employees and employees from other countries?
    b. between personality types?
    c. between function types?

21. Is the ESOP evaluated on a regular basis? (e.g. yearly, to discuss if objectives were/are met, if the plan still fits/fitted the actual situation of the company)

Finally

22. Would you recommend other startups to use share options? Why (not)?
23. Under what conditions or circumstances do you think a share option plan would/will work best? / do you have any tips/advice for Dutch startups considering implementing an ESOP?

Appendix 2: Interview / Questionnaire response table

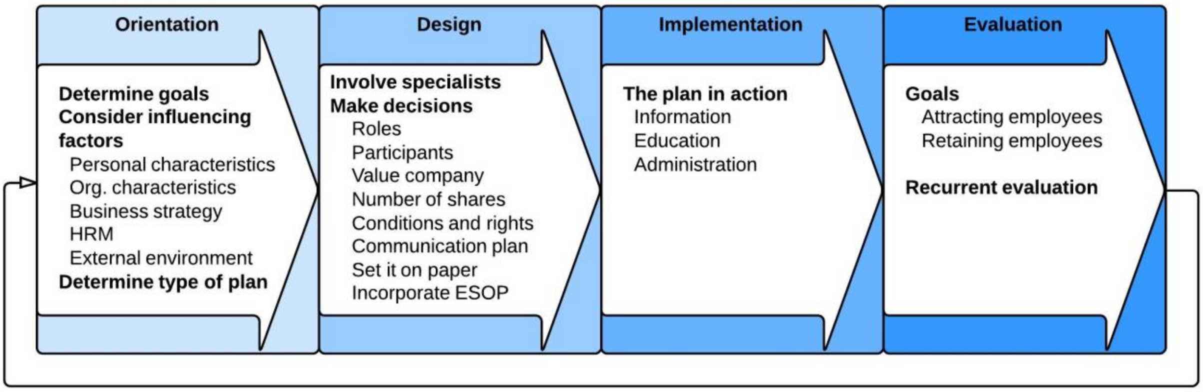
	Type	Goal	% for employees	Which emp.
#1	Share Options	To attract and retain valuable employees, have employees share in the profit	~8%	All technical employees incl. support
#2	STAK certificates	To attract and engage employees	11,5%	Early employees
#3	STAK certificates	Cost reduction, to attract and create long-term commitment	7%	Key employees
#4	Share or STAK (options)	To create a feeling of ownership	5-6%	Key employees
#5	STAK options	To attract without offering higher salary / as compensation for risk taken by the employee by working there	10%	Full-timers + depending on function
#6	Share Options	To create a feeling of ownership, have employees share in profit, create commitment, attract employees without competitive salary	10-20%	Every employee with fixed contract
#7	STAK certificates	To motivate and attract employees	10%	Every employee with fixed contract
#8	STAK certificates or non-voting shares	To attract and retain, create a better atmosphere in the office, involve employees	Unknown	All employees
#9	Options and shares (STAK options in future)	To attract	3% after dilution	Early employees shares, all future employees options on certificates
#10	Shares	To attract and motivate	5-10%	Early employees who they can't pay a competitive salary yet
#11	Share Options	To incentivize, attract and retain	Confidential	All full-time employees

	Division based on	When offered	Vesting	Exercise	Rights	Trade/sell
#1	Risk + function	Start empl. Exc perf.	Partial over 4 years	10 years	Non-voting, non-dividend	Only to company or in acquisition
#2	Risk + salary	Start empl.	-	-	Dividend only	Only to company or in acquisition
#3	N.a.	Start empl.	N.a.	N.a.	Dividend only	Can be sold, have to be offered to current shareholders first.
#4	Investment, employment time, outstanding performance	Differs.	N.a.	N.a.	Non-voting, non-dividend	Only in acquisition
#5	Fixed part (accumulated per month) + possible targets	Start empl. Excellent perf. To retain	1-2 years	1 years	Non-voting No dividends	Only in acquisition
#6	Function and necessity	Start empl.	Partial over 4 years	10 years	Dividend only	Only to company or in acquisition
#7	Importance	Start fixed empl.	N.a.	N.a.	Non-voting No dividends	At acquisition (tag-along/drag-along rights)
#8	Unknown	1 year after employment and after 3 years		N.a.	Dividend only	Only to company or in acquisition
#9	Order of employment and key-position in company	After reaching certain milestones	Unknown	2 years	Dividend only	Via first right of refusal, drag-along and tag-along arrangements
#10	Task and roles; certain functions outweigh others and therefore get a higher percentage	Start empl. Maybe additional later	N.a.	N.a.	Dividend only	N.a.
#11	Position and level	Start empl. Maybe additional later	Confidential	Confidential	Non-voting, non-dividend	Only in acquisition

Appendix 3: Practical implementation plan

This chapter offers practical guidelines and recommendations for implementing a share option scheme for Dutch (startup) companies, based on the literature review and results from the interviews and questionnaires. The plan is based on the ESOP model (see figure 7) and gives concrete steps for implementing a share option scheme following the phases orientation, design and implementation.

Figure 7. ESOP-model to design and implement an ESOP.



When stakeholders are involved in the orientation, design and implementation of an ESOP differs per company and usually depends on the organizational strategy, the stakeholders and the goals for the ESOP. The SNPI suggest however to involve employees, employee representatives, HR, Legal and finance department, the board and administration in an early stage, which can create a transparent and honest atmosphere and can help increase support for the plan by the stakeholders.

Even when this plan or the Dutch Model is followed, it is important that is taken into account that designing, implementing, administrating and maintaining a suitable plan (customized to the type of company and the goals it wants to achieve), plus informing and educating the employees, consumes a large amount of time and money. This impact can be especially large in a small company where time is very valuable.

Furthermore, it is strongly recommended that advice is sought from specialists in deciding which form of participation suits the company and its strategy best and for setting up the ESOP agreements. The SNPI recommends using a lawyer, notary, valuation specialist, accountant and possibly a tax consultant and advisor as well during this process. Not all specialists however specialize in share participation and these functions can overlap as well.

In the average Dutch company, implementing a plan takes about 6 months according to the SNPI. The costs can vary significantly and mostly depend on the number of specialists used and the complexity of the plan. For the average company, the SNPI mentions numbers between € 7.500,- and € 25.000,- but the numbers can be different for startup companies due to inter alia the lower number of employees.

3.1 Orientation

Step 1: Setting the goals

Everything about an ESOP builds on the goals that the company wants to achieve. In this thesis it is assumed that these goals are to attract and retain valuable employees yet as chapter 2.3.1 shows, there could be many more; e.g. to increase profitability. By paying out dividends to employees that have exercised their share options, the profitability of the company is connected to the employee’s performance, giving him the incentive to work hard to reach that goal.

If the main goal is to bind employees to the company, it is suggested to make the employee feel like a part-owner by connecting voting rights and dividends to the shares. Partial vesting increases the long-term commitment even more. Another goal that startup companies could set is to (eventually) sell the company. This usually goes hand in hand with immediate vesting of all outstanding share options, as per options contract. In this situation, dividends, voting rights or an internal trade market for shares are less important.

A reason to involve the employees at an early stage is to align the plan to their wishes and needs; e.g. if they want a say in how the company is run, voting-shares are suitable yet if they are mainly interested in the payout when a company is sold, a STAK might be better suitable.

Step 2: Connect goals to the company

In the orientation phase, several influencing factors (see chapter 2.5) need to be considered, including personal and organizational characteristics, organizational strategy, HRM and the external environment. It is wise to keep in mind that not every type of person will be persuaded by receiving a share in the company and not all people are 'risk-neutral' enough to want to work for a startup company in the first place. Furthermore, usually there still needs to be sufficient salary and other aspects like challenging work and freedom to act to sway employees into working for a company.
Another question to ask here is to which extent to involve the employees concerned in the business strategy and decision-making once they have options or shares. When the goal is to increase a feeling of ownership amongst the employees by granting voting-shares, then they need to be informed on the company finances and organizational performance. Another important question is what information to offer the employees regarding the concept of shares, the company ESOP and its consequences for employees, and finally, which conflicts can be expected in this company and how will this be handled (e.g. employees talking about the differences in the division of shares which could lead a feeling of unfairness).

Step 3: Choose a form of employee participation

The final step in the orientation is choosing the most suitable type of participation plan for the company. This thesis focuses on share options and mentions certificates via a STAK and SAR as alternative yet there are many other ways of incentivizing, motivating, attracting and retaining employees not covered by this thesis. Even in the choice between options on shares or options on certificates via a STAK, getting advice from a specialist can be very helpful to create an overview of the financial, fiscal, organizational and social up- and downsides of these plans for a specific company.

3.2 Design

Step 4: Determining the roles

The next step is to decide and agree upon who will design the plan, manage the administration and communication, who will be the board of the STAK (in case of certificates instead of shares) and what the role of the different company departments will be. In the startup companies interviewed for this thesis, the founder/manager is usually the decision-maker and the board of a STAK.

Step 5: Which employees to grant options

The questions to ask are:

- Do we want to allocate share options to every employee or only key employees?
- Who are the key employees we want to (attract and) retain?
- Do employees need a permanent contract to be able to participate?
- Does the employee need to work full-time or part-time?
- How long does the employee need to be employed to be able to participate?

As mentioned before, startup companies willing to implement an ESOP should consider the type of personalities they want to attract, because not all personalities would fit into the company or be attracted with share options. As mentioned in chapter 2.5.3, the participants should be in a role within the company where they can influence performance and where they have some room for discretion and practical freedom to act, to increase their sense of ownership and responsibility and eventually the retaining effect.

Step 6: Valuing the company

For private limited companies, the value needs to be determined by a financial advisor. This will form the basis (waarderingsgrondslag) for the formula with which shares can be valued yearly. There is no 'best way' so it is advised to proposal a valuation method to the tax authorities to avoid fines and complications. The SNPI has developed a preparation plan for this purpose[7].

Step 7: Determination of the division of shares

How to determine the division of shares: everyone equal or dependent on position within the company, function, salary, the level of risk taken to work for the startup, etc.? As mentioned in chapter 2.2.4.1, the division in larger companies is usually based on the number of years employed, individual performance, company performance or it is based on salary. In attracting employees to a startup company, a division based on risk taken and key-position is common. It should be made sure that the process of determining the division is considered fair by all stakeholders to prevent conflicts.

Step 8: Determining the conditions and rights

Whether to connect voting right or right on dividend to the shares and which conditions to place upon the vesting, exercising, trading and selling of shares depends on the goals of the ESOP and the organizational strategy. It needs to be determined what these goals are and what is expected to be the pay-off for employees, that they only share in the profit when the company is sold, that they can sell their own shares with profit, that they will exercise without immediately selling to gain voting or dividend-rights, etc.

[7] See http://www.snpi.nl/nieuws/actueel/406-goede-voorbereiding-voorkomt-verassingen

Step 9: Creating a communication plan
All stakeholders should receive transparent and clear information on the ESOP and the corresponding opportunities, situations and consequences of participating in the plan. It needs to be decided how to convey that information; on paper, via a fiscal advisor, via meetings, by giving examples, etc.

Step 10: Setting it on paper
Before the ESOP is put on paper, various situations need to be thought out like when the employee wants to sell his shares, what to do when the employment is terminated, what to do with oversupply and demand of shares, when to grant shares to employees, etc. To create a comprehensive plan, a specialist can help set up an ESOP that includes regulations and policies on these situations.

There are several documents needed when implementing an ESOP;

- The Stock Option Agreement: this usually includes the number of shares, the exercise price, when all or part of the options becomes exercisable, the term of the option and a notion of exercise.
- The ESOP itself with general rules, procedures and concepts
- General (clear and understandable) information with examples for employees.

ESOP procedures and rules can be set in the statutes, regulations and/or specified in the individual ESOP contracts. These rules and procedures include vesting- (service and performance) conditions to participation in the plan; the basis for the division of share options to employees and the specifics of the plan including vesting- and exercise period, when options are offered and rules about selling the shares. Typically, a fiscal advisor will give advice on the type of plan and how to set up the ESOP, a lawyer can write the agreements to cover it legally and a notary is needed to transfer shares or to set up a STAK.

Step 11: Incorporating the ESOP in the HR-policy
The current statutes and policies need to be checked and adjusted to the new ESOP. The plan needs to be fully incorporated into the HR policy.

3.3 Implementation

In the implementation phase, a STAK is founded (if going for that type of plan), employees are informed and educated about shares and the ESOP and employees can enter into the plan.

Step 12: Information
Apart from attracting and retaining employees, other benefits of an ESOP – as discussed in chapter 2.3 – rely on information sharing from management to the employees regarding the strategic goals, how their work contributes to these goals and about how the company is doing in reaching those goals. This can be done by connecting the company strategy to financial information to make the employee's influence visible.

Step 13: Education
Overlapping with informing the employees is to 'educate' them about how the program functions. Proper financial education can diminish any confusion and ambiguity of the plan. This means that the employees should be well aware of the risks of ESO, the causes and consequences of value fluctuations and the meaning of certain financial information.

Step 14: Administration
Especially with options, it is important to keep good track on the vesting schedule, expiration dates, which employee is granted what on which conditions, etc.

3.4 Evaluation

Step 15: evaluating the results and suitability of the plan with the current situation
Finally, The ESOP should be evaluated yearly (or more often) so see whether the process runs according to expectations. The plan possibly needs to be adjusted at this point to ensure maximum fit and effectiveness.