Tony Hsieh decided to turn Zappos upside down. His only regret? That he didn't move faster.



THE ZAPPOS EXPERIMENT

THE ONLINE SHOE RETAILER HAS ALWAYS FOCUSED ON ITS PEOPLE AS MUCH AS ITS CUSTOMERS. BUT NOW A RADICAL TRANSITION INTO "SELF-MANAGEMENT" HAS LEFT IT REELING. CAN THE COMPANY REGAIN ITS MOJO?

BY JENNIFER REINGOLD

PHOTOGRAPHS BY BRAD SWONETZ

IT'S JUST ANOTHER WEDNESDAY afternoon at Zappos headquarters—which is to say that it's unlike any other Wednesday afternoon anywhere else in corporate America. The company's "resident artist," who started as a Zappos call-center worker, is painting an enormous chrysanthemum on a canvas near the entrance. Red lanterns festoon the lobby of the semicircular 1970s edifice, which once housed the Las Vegas city government, in honor of Chinese New Year. A few hours later, all 1,500 employees of the online shoe and clothing retailer gather in the nearby MGM Grand theater, home to the Cirque du Soleil show *Kà*, for Zappos's quarterly All-Hands Meeting, an afternoon of progress reports, music, and fun.

The young, diverse staff, heavy on neon-tinted hair and nose rings, cheers when Tony Hsieh, the company's longtime CEO, announces that everyone will get a paid vacation day on Feb. 29 in honor of leap year. They give a standing ovation to a worker in shipping who raps passionately about the company, offer a rousing send-off to a longtime "Zapponian" who's leaving the

company, and take in a surprise Cirque du Soleil performance, complete with a cameo appearance by Zappos's signature box.

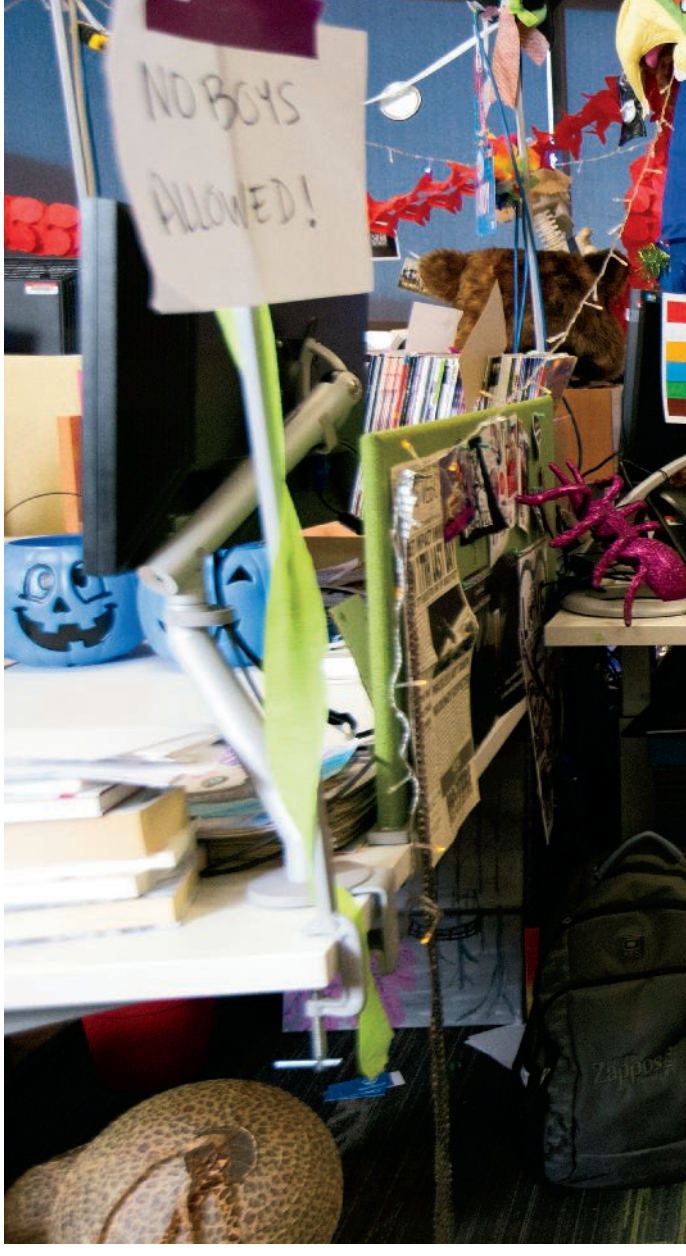
This quirky mix of circus, therapy session, and revival meeting exemplifies what has made working at Zappos so special: an obsessive focus on creating a culture that embraces the idiosyncrasies of each individual. That, and top-of-the-line perks such as free health care. The emphasis on employees—to the near exclusion of the usual metrics used to evaluate business—has made Zappos, owned by Amazon since 2009, a stalwart on *Fortune*'s annual list of the 100 Best Companies to Work For. It has been so celebrated for its 10 core values—which include "Create fun and a little weirdness" and "Build open and honest relationships with communication"—that the company has its own consulting unit to help others emulate the Zappos way.

But this year, nearing the third anniversary of a shift from a traditional management structure to "holacracy," a system that replaces hierarchies and bosses with "self-management," something is different. In between the rapping and the report on the company's "Pawlidayz" initiative to support pet adoptions, Hsieh, 42, takes to the stage to report disappointing news. He announces that scores on *Fortune*'s Best Companies to Work For survey have tumbled on 48 of 58 questions. Indeed, Zappos has fallen off the overall list for the first time in eight years. Two questions that generated particularly dismal results: Do employees think management has "a clear view of where the organization is going and how to get there"? And do managers "avoid playing favorites"?

Yet Hsieh didn't seem particularly rattled. Over the past few months he'd moved beyond holacracy to an even more abstract system he calls "teal." (We'll explain.) "It's just part of the journey," he tells the troops. "I don't think it's going to be all roses. But whatever the top-of-mind things are right now, history has shown that we will get through them."

Still, there's been a lot to get through lately. The shift to holacracy, combined with a wildly ambitious software project called Super Cloud—not to mention a reconceived business strategy—has left employees confused, demoralized, and whipsawed by the constant pace of change. Over the past year, in part owing to a buyout offer, 29% of the staff has turned over.

Holacracy is "a social experiment [that] created chaos and uncertainty," says one Zapponian who left last year. A current employee, who filled out a survey (provided to *Fortune* by the company) following the all-hands meeting, praised Hsieh for openness about the negative feedback but added in a burst of frustration: "I would have liked to hear some actions that may be taken to address how drastically approval of managers and legacy leadership has fallen, and how strongly more and more employees are feeling like favoritism [and management issues



are] becoming a bigger problem…They aren't remnants of legacy structure that have survived despite holacracy; they're things that have somehow found power in it and worsened in the current system."

Zappos has always been a risk-taking enterprise. It was born from an experiment in 1999 (sell shoes via the Internet!) and has, under the deceptively anodyne leadership of Hsieh, embarked on one mold-shattering change after another. He made Zappos the first website to offer free shipping both ways. He moved the company to the suburbs of Las Vegas to build a culture apart from Silicon Valley, then uprooted it again to a gritty area of downtown Vegas in hopes of creating a work-life paradise.

In his mind, the move to holacracy, in which teams are replaced by "circles," and managers by "lead links," is his at-



▲ Derek Noel, once a customer service rep, says Zappos's new system has let his ideas be heard and allowed him to take on a more substantive role.

"MY WORST DAY AT ZAPPOS IS STILL BETTER THAN MY BEST DAY ANYWHERE ELSE," SAYS DEREK NOEL. "I CAN'T IMAGINE GOING BACK TO TRADITIONAL HIERARCHY ANYMORE."

tempt to avoid the eventual fate of most large companies: death. "The one thing I'm absolutely sure of," Hsieh says, "is that the future is about self-management."

The result has been an epic clash between a doctrinaire set of rules and a culture whose very essence has been a tolerance for the unruliness that comes with individual self-expression. Holacracy has empowered some people and hamstrung others. The company's most utopian dreams, which include banishing internal politics, have not yet been realized.

The remaining Zapponians insist the transition, painful as it has been, has turned the corner. They believe in the company, even as they wonder what it will stand for. But at times it feels as if Hsieh, to borrow an old phrase, may be destroying the village in order to save it.



"The structure of the meetings [in holacracy] forces each person to ... say what they want," says Zapponian Danielle Kelly.

TONY HSIEH HAS ALWAYS cared deeply about the human side of work. He wrote a book called *Delivering Happiness,* which asserted that employee satisfaction is the key to business success. Indeed, in recent years workers seemed content, though sales growth had tapered. Turning the company upside down is the last thing most managers would have done. But Hsieh worried that Zappos was becoming more bureaucratic and losing some of its spark.

In 2012, at the Conscious Capitalism conference in Austin, he attended a speech by a software company CEO named Brian Robertson. Robertson argued that it was the messiness of human interactions—the emotional discord, the power struggles—that prevent businesses from achieving their potential. What if, he asked, there's another way to organize—one that doesn't rely on bosses, politics, and power?

Robertson found inspiration in sociocracy, a century-old concept that relies on a sort of Quaker meetinghouse decision-making system. He devised a rule book—an operating system, as he likes to call it—for a bossless organization.

The result was holacracy, in which traditional top-down reporting lines are replaced by work circles that operate next to, and on top of, each other. People don't have jobs; they have "roles." Lead links are the nominal managers—but they have little formal authority and can't force employees to do anything they don't want to do.

All this egalitarianism comes larded with strictures and meetings, particularly in the implementation phase. There are "tactical" meetings, focused on moving the workflow forward, and "governance" ones, which hash out processes and roadblocks. "Holacracy does add structure and rigor and discipline," Robertson says in an interview. "If you don't have parents, you need self-discipline."

Hsieh contacted Robertson—who offers a software system, GlassFrog, that aspiring holacrats may purchase—and signed on. In early 2013 the human resources department became the first group at the company to deploy holacracy. Employees were shocked and frustrated by the numerous mandates, the endless meetings, and the confusion about who did what. Says Christa Foley, an 11-year vet who was a senior HR manager and is now lead link for the Culture—Connecting the Dots circle and the Zappos Insights circle: "I hated all of it, in particular because it was off-the-shelf, so focused on the rules of the game, and it explicitly felt icky without a focus on the people." Foley says she has come to like the system.

Holacracy created new winners and losers—and it sparked

ONE DEPARTED ZAPPONIAN CALLS HOLACRACY A "SOCIAL

fresh ideas. With experience and expertise de-emphasized, less "typical" and more junior types have been able to succeed. Introverts have benefited from the expectation that everybody speak in meetings. Says Danielle Kelly, 25, lead link of the State of Mind circle, the Teal Mappers circle, and the Teal Kit circle: "The structure of the meetings forces each person to ... say what they want. Before I might've thought something and wouldn't have jumped in. Now I have that time to myself."

Another beneficiary is Derek Noel, 30, a onetime customer-service employee. Noel had wanted to transfer to Zappos's culture team but found himself blocked by his manager. "As soon as I found out about how holacracy worked," he says, "I was like, 'Actually, my boss can't tell me that.'" Noel's ideas, which included weekday events where employees watch a movie in the auditorium while working on their laptops, gained traction. Now he works in the Fungineering circle, a kind of events-planning/pep squad. "My worst day at Zappos is still better than my best day anywhere else," he says. "I can't imagine going back to traditional hierarchy anymore."

The biggest shock for Hollie Delaney, previously the head of people experiences at Zappos and now the lead link of the People Ops circle, among others, was that as a career manager, she no longer had the muscle to force anything to happen. Her longtime career goal, to become the VP of human resources, was no longer achievable at Zappos.

As holacracy unfurled, Delaney realized her power was ebbing. "I said, 'I literally have no job.' I was freaking out. That got me to start thinking about why I didn't have other roles. Yeah, I had the big title and the quote unquote power. But was that really fulfilling? The answer was no." In the spirit of self-management, Delaney found "roles" that appealed to her. An avid runner, she became lead link of the Healthy, Happy Zapponians circle, which is starting a race series for employees. But is having an experienced HR executive spend much of her time on a road race really the best use of Delaney—for her and for Zappos?

To get a sense of how some of this works in person, Zappos—which is strikingly open—let me attend, via Skype, a regular meeting of the Pursue Growth and Learning circle. It's the rough equivalent of an employee-training department. There were 10 participants, including one lead link, Chris Peake. It was a hybrid of a governance and tactical meeting. (I agreed not to reveal the topics of discussion.)

The meeting began with "check-ins and checkouts," in which each participant (including me) was expected to speak about how they were feeling—about their work, their personal struggles. One woman talked about her love for her "annoying 13-year-old daughter." It was an acknowledgement that everybody has issues besides work that affect his or her state of mind.

After check-in, which took seven minutes, it was all business. A facilitator cut off digressions (known as "distractions"), and the pace accelerated. The agenda was "made up on the fly," according to Peake. "Agenda items are typically referred to as 'tensions.' A tension is simply the difference between 'what currently is and what it could potentially be.'" Tensions could be anything from practical obstacles to brainstorms, and they proliferated—but were mostly tabled for resolution at a later time.

For all the odd lingo ("I'm making myself an action to send you feedback on that"), it wasn't much different from a conventional meeting. The lead link did almost all the talking. He made requests rather than issued orders (though not without the occasional guilt trip) until someone agreed to take on a task. The meeting lasted over an hour and ended after everybody was asked to name their favorite current TV show.

Holacracy is supposed to slay the demons of politics. It hasn't yet. Some managers tried to consolidate their old power inside the new structure, says Nox Voortella, who came to Zappos in 2014 as a sales planner. "In the beginning I thought [holacracy] was great," she says. "Then I saw the old managers around me grow more and more insecure and try to see how they would restructure management. The people who should've stayed and were leaders and could have rallied people left. And the managers that stayed were just the ones who had nothing else to offer." She recently chose to depart for a more traditional company.

Holacracy also lacks some crucial elements, such as a compensation process. The system doesn't value seniority or the size of your budget. There are no formal performance evaluations. How, then, do you calculate how much to a pay a person, and for that matter, who makes the decision?

Zappos just launched its own method. It has nothing to do with achieving financial results; instead, people are paid according to skills they possess or earn, a system called "badging." Just like Girl Scouts, people can earn, say, a Java Coding badge or a Merchandise Planning badge by fulfilling certain requirements. Zappos says it will pay at the market rate for each skill, but every job comprises many skills. To stave off the anxiety of not knowing what you'll be paid, the company created a Grandfather badge that guaranteed pay wouldn't fall in 2016.

Another big issue is how to determine how much time

EXPERIMENT" THAT "CREATED CHAOS AND UNCERTAINTY."

one spends in the various circles and whether they add up to something approximating a full-time job. Every circle has a certain number of "people points" that together approximate the scope of work. Zappos workers have 100 points each and must distribute them among their circles. If they don't enjoy their circles or feel they aren't doing a good job—or if, as some employees report, lead links don't approve as many points as they need—they must find a new circle.

If they don't, they can end up on "the Beach," a kind of purgatory. "You just sat … in a conference room and talked with the 'why' coaches about what your passions were," says Voortella, who says she landed on the Beach after clashing with a lead link. Today the Beach has been renamed and the path split. You either enter "Hero's Journey," in which a team helps you find a new raison d'être. Or you enter "Transition Support" to help you join another circle. If that doesn't happen in two weeks, you transition out of Zappos entirely.

Meanwhile, holacracy hasn't been the only disruption. In 2014, Zappos reconceived its sales strategy, from one that emphasized volume to one that targets a smaller number of "best customers" who pay full price. Almost simultaneously, the company embarked on a giant software migration—moving its e-commerce system onto Amazon's—a still-ongoing project titled Super Cloud. One result: Zappos's website has barely changed for two years—a lifetime in the world of the Internet. "I wish we had waited until Super Cloud was done," says Manish Honnatti, who leads the Zappos Zero unit and has become an advocate for self-management.

THAT WASN'T ALL. A year ago, as holacracy had finally become law throughout the company, Tony Hsieh issued another decree. It came in a 4,300-word memo entitled "Reinventing Zappos: The Road to Teal." Wrote Hsieh: "We are going to take a 'rip the Band-Aid' approach to accelerate progress towards becoming a Teal organization (as described in the book *Reinventing Organizations*)." Therefore, he explained, "as of 4/30/15, in order to eliminate the legacy management hierarchy, there will be effectively be no more people managers."

Hsieh was referring to a 2014 book by consultant Frederic Laloux, who argues that throughout history people have organized themselves in various ways. Laloux assigned a color to each type: orange for modern corporations such as Walmart, and green for what he views as more evolved operations, like Starbucks. Teal, he wrote, was the next stage of development, characterized by self-management, bringing one's "whole" self to work, and having a purpose beyond making money. "There is something broken about management, something exhausted," Laloux tells me over the phone.

For Hsieh, teal was the logical next step, the state that could be achieved only via a process like holacracy. "Teal is the goal; holacracy is the system," says John Bunch, a former professional poker player and Zappos developer whom Hsieh tapped to lead the move to holacracy in 2013.

Then the low-key CEO injected more drama. He asked everyone to commit to teal—or leave (with extremely generous severance). Hsieh knew he'd lose some good people, but he also thought the nonbelievers were impeding progress.

The logic made sense. Still, the emotional side of it was devastating. Many people who had helped create Zappos and had risen to become leaders were being told they were no longer wanted. It felt like a purge. What unfolded next amounted to a collective wail: *We've only just started holacracy. What the heck is teal?* And, by far, the most common reaction: *Will all this ever end?*

Hsieh says he didn't know how many people would accept the offer. "Whatever the number was was the right number," he says today. In the end, 18% of the 1,500 employees took buyouts, and another 11% left without a package.

ATOMIC LIQUORS is a rare vestige of an older Las Vegas. With its mid-century signage and history as the place on whose roof locals stood to observe nuclear tests, it has the sort of retro cachet Hsieh loves.

Waiting for him are three glasses containing his regular beverages: from left, a Diet Coke, a shot of Fernet-Branca liqueur, and a White Russian. Hsieh has his eccentricities. He's worth around half a billion dollars but lives in an Airstream trailer with two pet alpacas on-site. Unmarried and apparently unattached, he sees his company as his family. I drink a shot of the NyQuil-like Fernet with him, then order a beer. (I can't abide White Russians.)

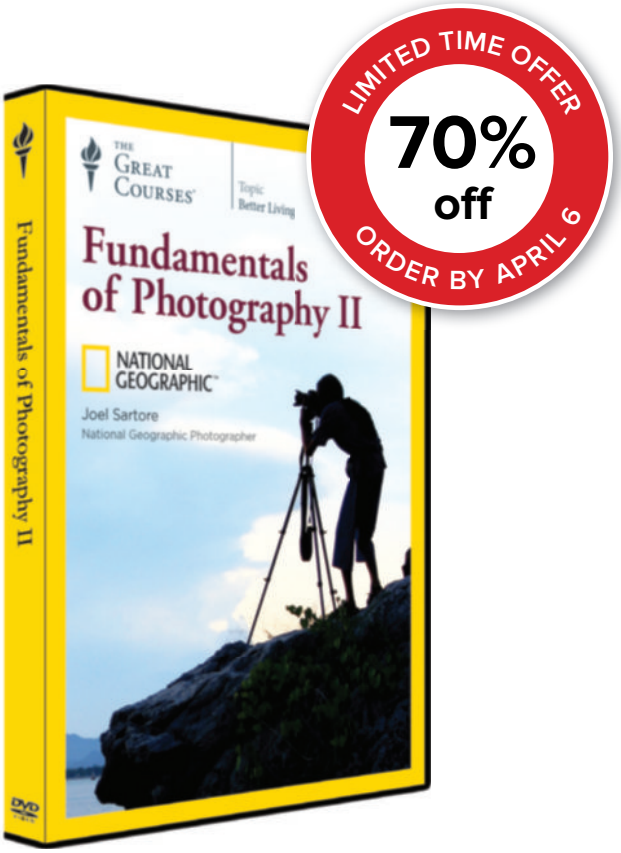
Hsieh turns serious when I ask what he didn't anticipate in the process of implementing holacracy. "I've been surprised," he says, "at how hard it is to let go of the psychological baggage." I ask if he regrets undertaking so much change at once. No, he says: "In retrospect, I would have probably ripped off the Band-Aid sooner."

For Hsieh, self-management is as much a societal strategy as a business one. Having spent much of the past few years building and personally funding—to the tune of $350 million—the Downtown Project, an attempt to build a work-life community in the heart of Las Vegas, Hsieh has ambitions beyond commerce. He likens self-management to the interactions that spring up organically in a city rather than the top-down bureaucracy of a typical company.

Hsieh is thoughtful—a seeker. Yet it's striking that neither he nor other Zapponians make more than perfunctory comments about the company's business. (He did say Zappos has

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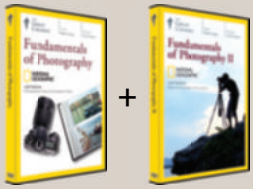
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achieved its highest operating profits ever.)

That's a crucial point. If Zappos continues to make money, Amazon will leave it alone. If it doesn't, Zappos could just as easily cease to exist. The company achieved its 2015 profit goals, but several employees say that it has lowered its 2016 targets. (Zappos declined to comment.) Whether that's due to holacracy, growing competition in the online shoe category, or something else is impossible to tell.

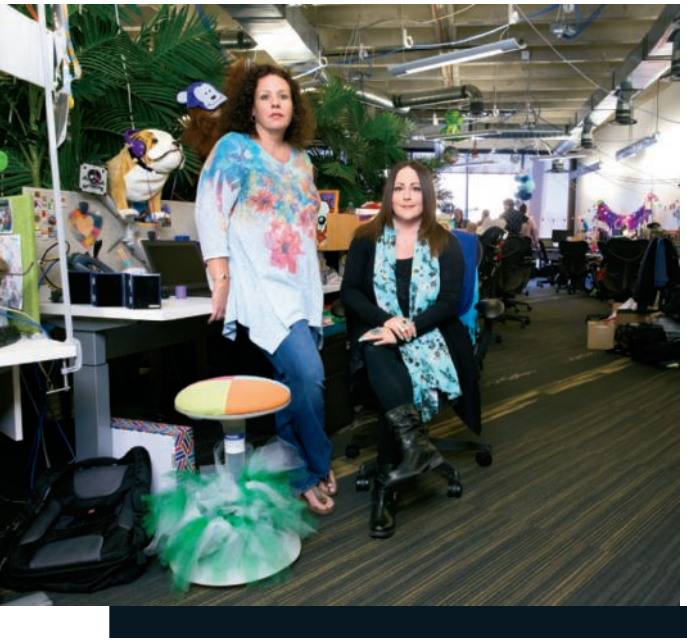
HOLACRACY'S VALUE remains far from proven. Its creator, Robertson, says the process takes five to 10 years to be fully integrated—an eon in business. He seems blasé when asked whether holacracy truly works. "Where I don't measure success is by looking at the actual end results," he says. "I don't put much stock in it, because who knows? For me it's about ease of use."

Some 300 companies use his system—Zappos is easily the largest—and there have been failures. In early March, content site Medium announced it was abandoning it. Bud Caddell, a consultant who has studied self-management systems, says his former firm, Undercurrent, tried it without success. "I found it extremely dogmatic and rigid and overly complex, and it took attention away from our customers," Caddell says. Even Hsieh's own Downtown Project tried holacracy but gave up on it in 2014. ("It was too early to adopt in Downtown Project's time line," says Hsieh.)

When asked for an example of something that couldn't have happened without holacracy, Jamie Naughton, Zappos's chief of staff, cited this: Dogs are now allowed in the office. If that had been proposed earlier, she says, anyone could have blocked it because of allergies, fear, etc. But under holacracy, one of the threshold questions is "Is it safe enough to try?" Now, even though Hsieh was opposed, dogs are welcome, as long as they pass a behavioral assessment. People afflicted by dander have declared "allergy zones" that dogs may not enter. "Self-organization," she says, "allowed one employee to figure it out."

Last spring, while Zapponians were weighing whether to take the offer, one of them invited Caddell to share his own experiences with holacracy in an open forum. He interviewed 15 to 20 employees beforehand, then spoke to a group of about 150. "It felt like a wake," he says. "The people I did speak with expressed a general feeling of loss of control of their own working environment." When Caddell emailed Hsieh suggestions on how to improve morale, he says, he was shut down: "He said I used the word 'leadership' too much, and that I was a biased actor." (Hsieh says that's not the type of phrase he would use.)

Hollie Delaney (left) used self-management to find new roles for herself after her job was reconfigured. Christa Foley says she initially hated holacracy's endless rules.



FOR ALL THE HAVOC, there are signs of optimism at Zappos. Some referred to a book called *The Dip,* by Seth Godin, which argues that in times of great transition, things always get worse before they get better. Now that the employee buyouts are completed, few apostates remain to slow things down.

"We grew up," says Tyler Williams, who leads the Brand Aura circle (a.k.a. marketing). "Now we are getting back to that place where we are being kind and forgiving to people, and people that used holacracy as a weapon are finding themselves getting smaller and smaller islands to work from. We're more policed now as a company based on peer pressure rather than on micromanagement."

Many are pushing to bring culture back to the forefront. One possibility: adding a Culture Check to the agenda at every governance meeting. A six-step conflict resolution process, developed in-house, may help soften holacracy's rigidity. And Zappos is altering its recruiting process to ensure that new hires are wired for self-management.

The day after the all-hands meeting, there were two parties going on at lunchtime: one for Chinese New Year, with women making dumplings, and a Valentine's Day blowout featuring a cruise-themed costume contest and a cookies-and-tattoos setup. Holacracy hasn't reduced the company's social activities. Says Naughton: "We didn't get ranked one of the best companies to work for in America this year, but we're still really a great company. This is my family, and I hope that's what people take away when they see Zappos." Fair enough. Yet that may be true in spite of holacracy rather than because of it.

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New Options in Postgraduate Learning

HEATHER SERRANO WAS AN executive at a California-based financial services firm several years ago when she decided to go back to school. "There were more and more strategy issues coming my way and I didn't feel fully prepared to deal with them," she says. To remedy that, Serrano enrolled in Michigan State University's Eli Broad School of Business, and after 20 months of online classes, she graduated last August with a master of science degree in management, strategy, and leadership.

The program included a weekly videoconference with her classmates and professors, and a course schedule of test dates and assignments. "So much of business is conducted remotely these days, so I felt the online aspect of the degree was actually very helpful," she says. "When your client is on the other side of the world, you're not having in-person meetings, so it's important to know how to use technology to your advantage."

Serrano is among a growing group of executives finding value and fulfillment by returning to the classroom—in person or virtually—to hone their management skills. The chance to network and the added expertise can quickly deliver improved job opportunities and earning power. After completing her degree, for example, Serrano leveraged her new skills from MSU to land a more senior position with another global bank.

Some universities are combining the best features of online and on-campus executive learning to create so-called hybrid programs. At Oklahoma State University (OSU), for instance, candidates in the three-year executive Ph.D. program attend classes at the Tulsa campus for three consecutive days every month; the rest of the degree is completed online. This blended format, explains Toby Joplin, director of the executive doctoral programs, appeals to senior managers who like the networking opportunities of the on-campus classes but need the flexibility of online learning.

Executives who apply tend to be senior managers with 25 years or more of experience, based in the U.S. or overseas, who are tasked with making data-driven decisions. "Unlike an MBA, which is more case study–driven, this Ph.D. program is a true and rigorous research degree," says Joplin, who earned his doctorate at OSU in 2014.

At Villanova University, companies can create custom-designed online certificate programs that address the specific needs of their managers and industry. Brooklyn, New York–based health care provider MJHS, for example, recently put 30 midlevel managers through a Six Sigma certificate course designed and taught by Villanova professors.

Robert Leamer, senior vice president and general counsel at MJHS, says the program helped managers solve complex problems. "Getting the certificate was great," he says. "But the real payoff comes when people can incorporate those skills in their job." ●

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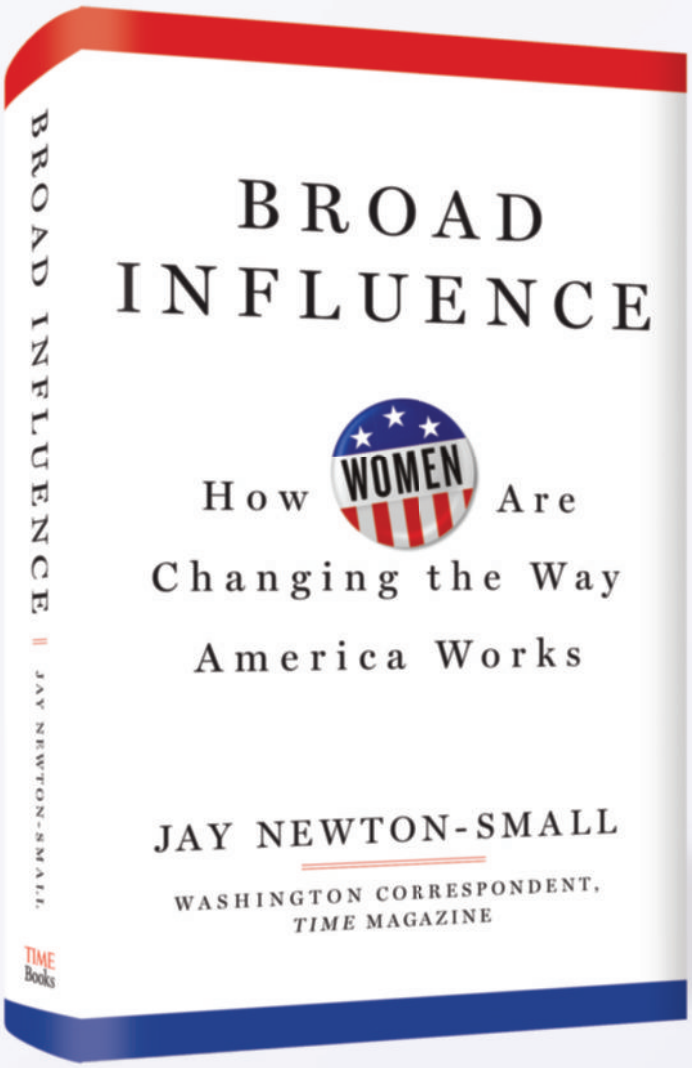
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