

# How to Divide Equity Among Founders an a Startup Company

One of the first tough decisions that startup founders have to make is how to allocate or split the equity among co-founders. The easy answer of splitting it equally among all co-founders, since there is minimal value at that point, is usually **the worst possible answer**, and often results in a later startup failure due to an obvious inequity.

Another common “failure to start” situation I see is one where the “idea person” insists that the idea is 90% of the value (and 90% of the equity). In the real world, the "idea" is a very small part of the overall equation. A startup is all about "execution" - meaning the equity should be allocated based on the value that each partner brings to the table.

As an attorney, I regularly counsel entrepreneurs, investors, emerging and established companies, and associations on a broad range of domestic and international corporate and commercial legal matters. I have also funded, managed, and sold businesses of my own in highly competitive domestic and global environments. Two approaches we can take in allocating equity are:

## **First, the layperson approach of evaluating five areas:**

**1/ Experience running a startup business.** Running a new business starts with building a solid and credible business plan, working the investor funding process, and building an organization from nothing, with minimal resources.

**2/ Domain expertise and connections.** If you are recognized as an expert in the business area of your startup, with a good reputation, and you know all the key vendors and customers, your value is huge. Building a product doesn't get it distributed and sold. Expertise can be marketing, technical, financial, or sales.

**3/ Pre-existing intellectual property.** Ideas are not intellectual property, until they have been converted into patents, trade secrets, trademarks, or copyrights. In many cases, one founder has started earlier and brings an important completed piece of work to the table, and that can have great value.

**4/ Sacrifice and time commitment.** A part-time commitment, while holding down a “real” paying job, is obviously not the same as a full-time executive role, especially if the cash compensation is nonexistent, deferred, or at high risk.

**5/ Funding.** Providing the major funding source for an early-stage startup is a totally different dimension, but it usually trumps all the items above in demanding some equity. For purposes of commitment and business decision making, I always recommend that execution partners retain control of at least 50% of the equity.

An arbitrary, but perhaps rational equity factoring approach would be to assign each of these five items as 20% of the total, and allocate equity based on each partner's relative contribution to each. For example, if your rich uncle is providing all the initial funding, but has no active business role, it might be smart to offer him a 20% slice of the pie. Equity allocation is usually the first point in a startup where outside help should be considered (legal counsel, potential investors, startup advisors), as they may be able to provide experience and more importantly, an unbiased view that the entire team can trust.

An important note is **DON'T DODGE** the discussion up front, come to some agreement quickly, and write it down. If you and your potential partners can't get through this discussion in a timely fashion and come to agreement, then it's unlikely that your startup can ultimately survive anyway. Startup decisions only get harder later, never easier.

## Second, the non-layperson approach of evaluating is five steps:

While performing these legal and consulting services, the most common question that is almost always asked of me is *“How should we divide the equity among the Start-Up founders, investors, directors, advisors, and employees?”* The correct answer usually surfaces if you confront the question systematically.

### Step 1—Dividing equity within the hierarchical organization.

The first and most guiding of all steps is how to divide the equity within the hierarchical organization; that is, what are the allotted percentages for the Founder Group, the Investor Group, and the Option Pool Group (for the directors, advisors, and employees).

From the conventional wisdom of many reputable American private equity firms (such as Advent International, Madison Dearborn Partners LLC, and Austin Ventures) who like to establish a collaborative partnership with management teams, and have a close involvement with overseeing strategy of emerging companies, a typical allotted percentage of the equity within the hierarchical organization is:

<b>Hierarchical Organization</b>	<b>If One Phase of Investments</b>	<b>If Multiple Phases of Investments</b>
Founders	50% -- 70%	20% -- 30%
Investors	20% -- 30%	50% -- 70%
Option Pool	10% -- 20%	10% -- 20%
<b>Total:</b>	<b>100%</b>	<b>100%</b>

### Step 2—Dividing equity among Founders.

Founders receive equity for what they bring to the table. A founder may contribute in many ways. Some bring capital. Some bring patents or product ideas. Some bring knowledge, experience and competence that have been acquired through a consistent track record of successful projects accomplished in various domain areas (i.e. “Domain Expertise”). Some bring network connections.

Thus, how do we then quantify what the founders bring to the table? We use the “Founders’ Pie Calculator”.

L. Frank Demmler, an Associate Teaching Professor of Entrepreneurship at the Donald H. Jones Center for Entrepreneurship at the Tepper School of Business at Carnegie Mellon University, invented an interesting way to divide equity among founders in a way that is both logical and fair — the Founders’ Pie Calculator.

Professor Demmler’s calculator provides a way to quantify the elements of the decision making process, which are 1) Idea; 2) Business Plan Preparation; 3) Domain Expertise; 4) Commitment and Risk; 5) Responsibilities.

The idea behind the Founders’ Pie Calculator is to come up with a weight for each of these five elements and then assign a value to each founder on a scale of 0-to-10. Then you take the weight and multiple it by the founders score to come up with the weighted score. From there you can get the percentage of equity.

Let us look at a hypothetical example. Assume that we have a high technology Start-Up spinning out of a university with four members of the founding team.

The inventor who is recognized as the technology leader in his domain.

The “business guy” who is bringing business and industry knowledge to the company.

The technologist who has been the inventor’s “right hand man.”

The research team member who happened to be at the right place at the right time, but hasn’t and won’t contribute much to the technology or the company.

From this hypothetical example, the Founders’ Pie Calculator would determine the allocation of the Founders group’s equity in the Start-Up:

*Absolute Scores (1-10)*

	Weight	Founder 1	Founder 2	Founder 3	Founder 4
<b>Idea</b>	7	10	3	3	0
<b>Business Plan</b>	2	3	8	1	0
<b>Domain Expertise</b>	5	6	4	6	4
<b>Commitment &amp; Risk</b>	7	0	7	0	0
<b>Responsibilities</b>	6	0	6	0	0

*Weighted Scores (1-10)*

	Founder 1	Founder 2	Founder 3	Founder 4
<b>Idea</b>	70	21	21	0
<b>Business Plan</b>	6	16	2	0
<b>Domain Expertise</b>	30	20	30	20
<b>Commitment &amp; Risk</b>	0	49	0	0
<b>Responsibilities</b>	0	36	0	0
<b>Total Points</b>	106	142	53	20
<b>% of Total</b>	33.0%	44.2%	16.5%	6.2%

and thus, allocation of the Founders group's equity in the Start-Up:

	Hierarchical Organization	If One Phase of Investments	Percentage of Equity
<b>Founders</b>			55.00%
Founder 1		18.16%	
Founder 2		24.33%	
Founder 3		9.08%	
Founder 4		3.43%	
<b>Investors</b>		30.00%	30.00%
<b>Option Pool</b>		15.00%	15.00%
<b>Totals:</b>		<b>100.00%</b>	<b>100.00%</b>

**Step 3—Dividing equity among Investors.**

The basic formula is simple: if you need to raise \$3 million, and investors believes the company is worth \$10 million, you will have to give them 30% of the company for their money.

To get a \$10 million valuation (or for that matter, any meaningful valuation of a start-up), you need a great idea; a really good elevator pitch; a compelling product prototype that has been independently verified by a third-party; a niche, significant market with potential of capturing meaningful market share; and an effective business plan with a clear, concise executive summary of your business, which also addresses the execution of your idea, your business model, your management team, financial projections and your exit strategy, and questions such as: “How large is your target market? How fast is it growing? Where are the opportunities and threats, and how will you deal with them?”

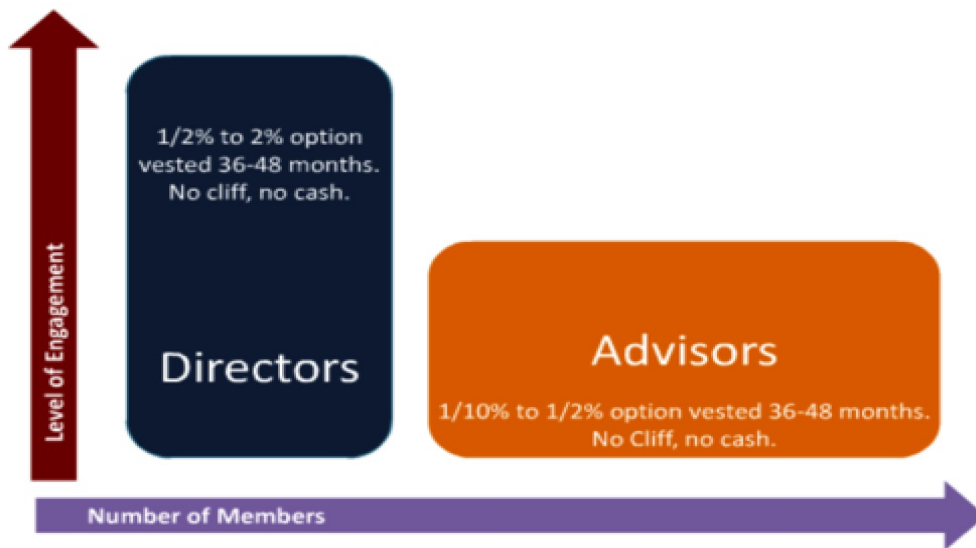
Note that under this discussion, ownership by the investors does not imply any additional obligations or liabilities. Once an equity stake is purchased, or “vested”, it belongs to the investors, perhaps forever. It also entitles the investors to vote for the company's board of directors, its governing body.

**Step 4—Dividing equity for Board of Directors & Other Advisors.**

When figuring out how to provide equity to the board members and other advisors of a start-up, you can use as a

guideline the chart developed by R. Michael Crill, Managing Director of Atlas Accelerators, who has been providing valuation services to early-stage companies since 2006.

Typically for a Board of Directors, it ranges from 1/2% to 2%, and for and other advisors, it ranges from 1/10th of percent to 1/2%. See below Guideline more detail and additional explanation:



Source: Mike Crill, Atlas Accelerator

### Step 5—Dividing equity for Employees.

The goal is to incentivize early employees to have an emotional ownership with your great idea, and its compelling product, along with the company you are asking them to grow.

For your first key hires, two to five key employees perhaps, you will probably not be able to use any kind of formula; it is more of an art and most certainly not a science. Still, a rule of thumb for those first few hires is that they will probably looking to be granted some points of equity (i.e. 1%, 2%, 5%, 10%). To be clear, these key employees are hires we are talking about, not founders.

Once you have assembled a core team that is operating the business, you need to move from art to science in terms of granting employee equity. Most importantly, you need to move away from points of equity to the dollar value of equity because granting equity in terms of points is very expensive.

In light of the above Step 4 and Step 5 discussions, the Option Pool Group (for the directors, advisors, and employees) will have many factors that affect option allocations including the quality of the existing team, the size of the opportunity, and the experience of the new hire. Invariably the equity splits are not equal (generally, the top end of these ranges is for proven elite contributors); but hopefully each of the participants will come away comfortable with their ownership and the reasoning behind it.

In the final analysis, the Option Pool Group will generally have equity ownership shared as demonstrated below:

<u>Title</u>	<u>Range (%)</u>
<b>Board Member</b>	<b>0.5 – 2</b>
<b>Advisors</b>	<b>0.01 – 0.5</b>
<b>CEO</b>	<b>5 – 10</b>
<b>COO</b>	<b>2 – 5</b>
<b>VP Advisors</b>	<b>1 – 2</b>
<b>CTO</b>	<b>0.5 – 1</b>
<b>5+ years experience Engineer</b>	<b>0.33 – 0.66</b>
<b>Manager or Junior Engineer</b>	<b>0.01 – 0.33</b>

Finally, when determining how to allocate the equity in a Start-Up, percentages matters, the number of shares is meaningless and the price of shares is meaningless. Even still, regardless of the initial equity split, you should seriously consider vesting your founders shares over at least two years. This means they will be metered out month-by-month, and a partner who changes his mind or defects early will not walk away with half the company.

The next big challenge for a multi-partner startup is the allocation of roles. Who will be the CEO, CFO, and CTO? The same five areas or five steps apply, but here skills and experience are paramount. If you are an inventor and have the key patent in hand, that doesn't mean you should be CEO. Of course, holding key assets and money always provide leverage to management rights as well as economic rights.

All partners should never forget that their allocated shares are only the beginning, and will be diluted proportionately when outside funding is later required from angels or venture capitalists. Investors will be quick to remind you that a small percentage of something is worth more than 100% of nothing. The same logic applies to splitting equity with co-founders.