Calculating the cofounder equity split – Dan Shapiro

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The only wrong answer is 50/50: Calculating the cofounder equity split

(Note: there are great conversations about this article happening at Geekwire and Hacker News)

The question of equity brings out the most fundamental differences, perceptions, and values in an aspiring startup. In fact the equity question, more than any other, may strangle a young company before it can even get started. **And that's a damn good thing.**

But before we get in to that…

Who's a founder?

As straightforward as this question sounds, it's a tricky matter. The founder moniker is black and white, but the situations are all shades of gray. Setting aside the philosophical question and focusing on the more useful economic one, though, there is a simple approach: founders are people who take a very particular kind of risk.



Facial hair alone proves insufficient to determine founder status

There are, quite roughly, three stages in every company's life:

1. Founding. The only money the company has is what you put in. You are getting no money out of the company. The company will probably fail, and you will lose all the money you put in, plus the lost salary, plus you have to find a new job.

2. Startup. The company has money, either from investors or from revenue, and they give you some of that money every month. Your salary is less than what you'd get at a big company. 50/50 the company fails and you have to find a new job, plus you've lost the difference between your startup salary and the BigCo salary.

3. Real company. You get "market" salary. It's unlikely the company fails, and if it does, your downside is limited to unemployment.

The rule is this: if you're working for a company that's so young it can't pay you, you're a founder. If you are drawing a salary on your first day at work, you're not.

What's a founder worth?

A founder is defined by the inability of their company to pay them (or anyone else) for anything. A founder's primary job, then, is to get their company some money – either by raising investment or by generating revenue. So a founder is valued by two things:

1) Their contribution

2) The market

The first of these is fair. The second is economics. Both are essential.

And now, the formula

Of course, there can be no right answer – but this one's not so terribly wrong. To start out with, give every founder 100 shares.

Somebody's got to get things started (5%)

Some startups are born running, with all founders on board from the beginning. But others come from one leader who recruits the others. You may or may not take the CEO title, but if you're the one who rounded up the cofounders and talked everyone in to getting things done, add 5% to your holdings. If you were previously 100/100/100, you're now 105/100/100.

Ideas are precious, but dwarfed by execution (5%)

It's a lie to say that ideas are worthless and execution is everything... but it's not too far from the truth, either. If you're the founder who brought the original concept to the table, increase your share holdings by 5% (so if you had 105 before, you now have 110.25) Note that if the idea is implemented, or patented, or otherwise has some execution behind it, then...



You know. For kids.

The first step is the hardest (5%-25%)

Creating a difficult-to-replicate beachhead can give a fledgling company direction and credibility. It can help with revenue and with financing. If you bring a concrete start to the table – a critical, filed patent (not a provisional), a compelling demo, an early version of the

product that isn't quite there yet, or something else that means much of the work towards financing or revenue is already done – you get a boost of 5%-25%. The key variation here is, "How much closer does this get us to revenue or financing?"

CEO gets more (5%)

Common situation: the split is 50/50 so that neither party controls the company.

Well, if you don't trust your CEO with the majority of shares, you're founding the company with the wrong person. Market rate for a great CEO is higher than market rate for a great CTO, so the CEO job gets a bit more equity. This isn't fair – the work isn't easier or anything – but it does reflect some market realities.

Fulltime commitment is expensive (200%)

If you're working fulltime while your cofounders are working part time, you're the pig. You're working more, and you're risking a lot more if the project fails. Furthermore, part-time cofounders are a big minus to someone considering an investment. Their equivocating will be expensive. Add 200% to the shareholdings of all the fulltimers.

Reputation is the most precious asset of all (50%-500%+)

If your goal is to get investment, some people make that much easier. If you're a first-time entrepreneur partnering with someone who's successfully raised VC dollars, that person is a lot more investable than you are. In the extreme, some entrepreneurs are so "investable" that their involvement is a guarantee of raising funds. (It's easy to identify them: ask the investors who know them best "would you back them no matter what they do." If the answer is "yes", then they are that kind of super.) These super-preneurs essentially remove all the risk of the "founding" stage, so you should expect that they get the lion's share of the equity from this stage.

This point doesn't apply to most founding teams, but when it does, expect the super-preneur to take 50%-500% or more, depending on just how much more significant their reputation is than their cofounders.

Treat cash like an investment (varies%)

Ideally, each investor contributes an equal amount to the company. That, plus their labor, earns them their "founder shares". It's possible, though, that one founder may put in significantly more. The price for that is high, since it's the earliest, riskiest investment. That founder will get more equity; to determine how much, talk to a good startup attorney about a reasonable value for your company and work from there. For example, they might say that your company could reasonably be valued at $450,000 for investment purposes, so a $50,000 investment would merit an additional 10%.

There are more structured ways to do this, ranging from revolving credit lines with interest and warrants to convertible debt that converts in to common shares. But these all mean increased legal bills and, more importantly, complex cap tables – something that can scare off outside investment.

The final accounting

At this point, you'll have something like 200/150/250. Just add up the shares (600, in this example) and divide each person's holdings by that number to get their ownership: 33%, 25%, 42%.

If you have equal shares, you did it wrong

A couple of years ago I was asked to give a talk at a continuing education series for attorneys. I asked to see the class list, and opposing counsel for a deal I was working on was being there, so I figured it was probably a good idea to do it.

I asked them what to talk about, and they helpfully replied "startups". I pressed for more detail. "You mean like generic startup experiences? Legal issues startups face? Advice for attorneys?"

"Yes, exactly like that!" came the enthusiastic reply.

Clear direction in hand, I started musing on the early days of Ontela. Our company started as just two of us, Charles Zapata and I, brainstorming in a basement. We covered a ton of ground – generating a million ideas an hour, each better than the last, on everything from business concepts to core values to better ways to file expense accounts. No matter what came up, we either agreed, or quickly resolved our differences. Life was good. We split the equity 50/50.

It wasn't until six months later, when we'd quit our jobs and committed our savings, that we nearly destroyed the company with our first real argument.

The advice I gave the lawyers was this: "The most common cause of startup death is founders who can't resolve their differences. Nobody hears about it; they just pack up and go home before the company ever had a chance. If there's one thing you can do to help your clients – really help them – it's to get the hard questions on the table early and help them work through them together."

Mark Suster talks a bit about this in this four minute video clip about "the co-founder mythology".

50/50 isn't a business decision, it's a compromise

You need to get used to hard questions. You need to get used to trusting each other. You need to get used to the idea that you're not all equal. You need to have the difficult discussions about responsibilities, contributions, roles, and compensation. You need to do it before you make commitments to investors and employees. And if you find that the only way you can get a decision made is by compromising – then you need to stop now, before the price of failure climbs higher.



Solomon was unavailable

There's no way around it – you're going to have to split the baby, but it doesn't require the wisdom of Solomon to get it right. Take your time, keep a level head, and remember: this is just the first of the decisions you'll be making together for the rest of your company's life!

PS: Joel, you're awesome, but I couldn't disagree more

Joel Spolsky is one of my favorite authors. He wrote a thoughtful piece about the same subject that reaches very different conclusions. Here's why his article is wrong:

- It confuses "easy" with "fair". If you've had two successful exits already while I'm doing my first startup, it's easy but not fair to split it 50/50. It's fair but not easy to reach a more accurate split.
- It advocates avoiding conflict so you don't "argue yourselves to death". That's exactly the wrong approach: if you're going to argue yourselves to death, do it now when you don't have investors and, worse, employees ("Mom and dad are fighting again").
- It gives too much equity to employees who are drawing salary, at the expense of the founders. The majority of founders work without salary for companies that ultimately fail. Employees are at least guaranteed a salary. The difference in risk is monumental. Nivi provides a lot more detail here explaining why founders should get a lot more stock than employees.
- It doesn't reflect market realities. A typical Series A allocates 20% for the employees. Joel's model has 33% for the employees, which means just 33% for the founding team.
- IOUs are nearly worthless. Most companies don't succeed in raising money or getting profitable. Of those that do, many investors will require that IOUs be waived as a precondition of investment. A $1 IOU has an expected value of nickels. The right solutions are either convertible debt (for investment) or equity adjustments (for anything else).
- It's worth noting that, by the way, Joel is spot on that **founder vesting is required** in any cofounder situation.

Joel's already successful. I believe this is his first startup with cofounders and investors. This looks like a great, idealistic set of ideas – but it's economically unsound, and doesn't reflect the majority of the market out there.

Note: I've only founded two VC-backed companies myself, so I've vetted this analysis with a bunch of folks to access a broader experience base and make sure I'm not out in the blackberry brambles here. That said, a few VCs (including Fred Wilson, one of Joel's investors) have chimed in to endorse Joel's analysis, so perhaps he's not so crazy either.

Thanks to Bill Bromfield, David Aronchick, Galen Ward, Joe Heitzeberg, Rand Fishkin, Sarah Novotny, and Tony Wright for providing feedback on drafts of this. Mistakes, overly broad assertions, and incendiary observations are mine, not theirs.

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