How to Split Equity – Faculty Entrepreneurship Workshop

April 27, 2004

Our April 27 Faculty Entrepreneurship Workshop, How to Split Equity, focused on the crucial and potentially awkward process of determining founders' equity in a startup, as well as how investment impacts that ownership.

Three panelists walked through these processes:

- Eric Silverman, Principal and founder of St. James Capital, LLC; founder and partner of Transitions Capital; and serial entrepreneur
- Alex Laats, Deshpande Center Catalyst and venture partner at Commonwealth Capital; serial entrepreneur; and a former officer at the MIT Technology Licensing Office
- Barbara Johnson, Partner of Testa Hurwitz & Thibeault, LLC's Business Practice Group

Barbara is involved in all aspects of business creation. Alex and Eric (MIT alums) are "serial entrepreneurs" who have started numerous businesses.

"How to split equity – it's one of the first important issues facing a new company," said Deshpande Center Executive Director Krisztina Holly, who moderated the discussion. The panelists unanimously advised faculty entrepreneurs to make decisions about founder's equity – preferably with a lawyer present – as early as possible in the process of founding a company.

The two main purposes of founders' equity, said Barbara, are to compensate founders for work done up to the point of incorporation and to give founders an incentive to contribute to the company's future success.

The discussion looked at four key issues surrounding founders' equity.

Who owns how much of the company at the outset?

It's the *percentage* of what you own that matters, *not the number of shares*, stressed the panel. Misunderstanding can result from confusion over the number of shares each founder owns. The number of shares can change over time, e.g. they can increase with further investment, which results in dilution. That's not necessarily a bad thing. "People accept dilution," said Barbara, because "a smaller piece of a bigger pie is better than 100 percent of nothing."

Forms of equity

There are two forms of equity: stock and options. Founders' purchase of stock should happen early, before there's an outside value placed on the company. This is critical, because once a value is placed – through a term sheet, for example – there are tax implications; founders may find themselves owing hundreds of thousands of dollars in capital gains taxes even though they have not received any cash in their own pockets with which to pay that tax. Founders' stock can be restricted in regards to transfer and reverse vesting (see below regarding vesting). For example, if a founder's business relationship with the company ends, the company has the right to repurchase his/her stock at the founder's original purchase price.

Options – the right to purchase shares of a company's stock in the future at a very low price – are typically granted to new employees and consultants. These vest over time. Sometimes, however, shares from the option pool are given to founders as a way to reward notable contributions by junior team members. "If one student breaks out of the pack as a star, load him or her with options," said Eric.

Vesting schedule

Vesting is a process by which stock or options become available to the employee over time according to a predetermined schedule. Vesting is meant to ensure long-term commitment to the company. The length of a vesting schedule is typically three to five years. Vesting schedules tend to be faster on the West Coast than on the East Coast. There are different types of vesting. For instance, cliff vesting is when a person's business relationship with a company has to continue for a set period of time (e.g. one year) before that person has a right to purchase stock in the company. Vesting can occur on a monthly, quarterly, or yearly basis. Monthly vesting used to be the norm during the late '90s, but recently the schedules have become longer, and annual vesting is once again common. When a company is sold, vesting usually accelerates, and the rights of founders and employees – whose options also accelerate – need to be balanced. The "throttle" to balance this is the percentage of acceleration.

Who keeps what if one founder leaves or the company is sold?

At a liquidity event – the sale of a company, an IPO – who can expect what? Alex offered some rough averages for management:

- CEO – 5%
- Senior vice president – 1-2%
- CFO – 0.5%

"These are the statistics we have," said Alex. "But they're not as cut and dried for founders."

Barbara pointed out, "Not everyone who leaves exercises his options. Those shares go back in to the pool."

With these key areas as background, the workshop turned to the following topics.

First steps for faculty entrepreneurs

"Consult faculty who have done this before," Alex suggested. "Also, talk to other entrepreneurs. Social opportunities for this to happen have grown a lot over the last 10 years."

Of course, you can also consult the workshop panelists, and you should take advantage of the on-campus resources for entrepreneurs.

How can you spend money on a lawyer if your company hasn't received funding yet?

"Some lawyers defer fees until the funding comes. Law firms often have a package for start-ups," said Barbara.

"When it comes to someone who can run the company, find somebody – don't do it yourself – and look for experience," said Eric. You can find such people at the Sloan School, Enterprise Forum, Deshpande Center, etc. Also, consult the Venture Mentoring group, advised Eric. "They have very experienced people, and it's free."

Case studies: calculating founders' contributions

"How do you figure out what people's contributions are, for example a grad student versus a professor?" asked Krisztina.

"First, assume that everyone is at the same level and getting equal equity. Then look at the real situation and adjust," suggested Alex. In a case study, he weighed the contributions of time and expertise of a group of founders: a professor, a postdoctoral candidate, and an outsider brought in to be the company's vice president. In this real scenario:

- Professor – one day per week but a crucial founder. Would retain reputation no matter what happened with the venture.
- Sloan School postdoc – 18-month involvement while attending school. Reputation tied to new company.
- Students with varying levels of involvement
- Outsider – Vice President for next 5-10 years. Reputation also tied to new company.

The outcome: the professor and the postdoc got slightly more equity than the outsider and the other students. "But this could easily have been reversed," said Alex, adding that "norms" of equity don't really exist.

Barbara described another case study, one in which a postdoc and two student founders had varying levels of involvement. Originally they were going to split equity three ways, she said, even though only the postdoc invented the technology. With Barbara's input, the resulting split gave the postdoc 65%, one student 20%, and another student 15%.

One workshop attendee asserted that "as a faculty member, you should feel like you're the driver. Do a 'what if' – how much would it cost to replace me?" Alex noted that "a faculty member's equity in a startup depends a lot on his or her eminence."

"Yes, you [as faculty] have leverage," said Barbara, "but it's a matter of balance. Be careful about saying you're going to maximize what you can get." The panelists agreed that one person trying to maximize the shares at the outset – although it may lead to a higher-percentage ownership early on – may be a big mistake because of demotivated employees and, consequently, a failed start-up. It's a rare case when one founder can keep most of the equity and succeed.

Barbara also suggested faculty consider not only future issues like dilution of the option pool and IPOs but also the risk you're taking personally. Are you leaving MIT and taking a big risk? Or are you tucking your role into 20 percent of your consulting time?

"Remember, when you start a company and raise money, you're only at the second yard line," added Alex.

The TLO's role

Is there potentially involvement by the Technology Licensing Office in any start-up? If the company is based on MIT intellectual property, yes. The way to think of the TLO is as another, but small, founders share. Depending on the situation, the TLO can focus on royalties instead of equity, in which case they aren't in the equity picture.

Avoiding venture funding

"If you don't get venture funding, and run on cash, dilution doesn't apply," said one attendee.

"But the option pool does," replied Barbara. It is important to compensate future key employees, and equity is an important component of that compensation in a start-up.

"Bank money is cheaper than VC money – VCs want at least 25 percent – but you have to be financeable and have cashflow to get bank money. That's the Catch-22," said Eric.

Managing expectations

How do you deal with expectations for people you involve in the company who might or might not stay, particularly students?

"You need to think about founder's equity before you start making promises to people," said Barbara, pointing out that a faculty entrepreneur might entice students to a start-up venture by hinting at a payoff that can't be delivered. "Think through past and future contributions. Unmade decisions will come back to haunt you."

"VCs might be interested in a start-up, but they'll hold back, saying, 'The faculty member has way too much equity,'" said Krisztina.
A VC will look at a situation like that and say, "fix this issue, and then we'll talk," added Eric.

In general, agreed the panel, owning one to six percent of a company is a good deal – over time, with dilution – for a founding professor.