DARDEN BUSINESS PUBLISHING
UNIVERSITY of VIRGINIA

UVA-ENT

PLEASE DO NOT COPY OR SHARE WITHOUT PERMISSION

OWNERSHIP, CONTROL AND THE ROLE OF EQUITY IN NEW VENTURES

One of the most crucial things for a high-potential startup entrepreneur to understand is how to USE equity in building and growing the new venture. There are at least three reasons for this:

1. Most high-growth ventures grow through equity partnerships. That means equity deals get structured and restructured in a variety of ways as the venture evolves into a stable large corporation – whether public or private.
2. At the same time, most new ventures fail NOT due to bad management, slow market uptake or lack of cash, but because relationships between founding partners and other equity partners become conflicted and impossible to repair.
3. Hence the paradox of equity: You need to share equity to build an enduring high-growth venture. But sharing equity without understanding how increases the probability for the venture breaking up and failing.

Expert entrepreneurs have learned (often the hard way) how to resolve the paradox of equity. But we can learn from their hard-earned experience.

What is equity?

Novice entrepreneurs usually think that equity splits are a one-time decision with some dilution occurring when investors such as VCs come on board. Novice entrepreneurs also confuse equity with at least three other things:

1. Compensation

When deciding how to allocate equity between founding partners, novice entrepreneurs usually come up with a list of resources each partner brings to the venture and have some preconceptions about how to prioritize these resources as the primary criterion for allocation equity. For example, some people believe that the person who came up with the idea should be given the most shares. Especially, if the person has some registered intellectual property rights on the idea – such as a patent or copyrights. Other resources that are sometimes given priority include the amount of time a person spends in actually

---

This technical note was prepared by Saras D. Sarasvathy, Isadore Horween Research Associate Professor. Copyright © 2011 by the University of Virginia Darden School Foundation, Charlottesville, VA. All rights reserved. *To order copies, send an e-mail to* sales@dardenpublishing.com. *No part of this publication may be reproduced, stored in a retrieval system, used in a spreadsheet, or transmitted in any form or by any means—electronic, mechanical, photocopying, recording, or otherwise—without the permission of the Darden School Foundation.*

working in the venture (sweat equity) or the amount of money he or she puts in (capital). Others argue for a premium for industry experience or the personal network of the partner concerned.

However, while equity *can* be used as compensation, it *need not* be. You can easily write in provisions of compensation for each of the inputs listed above. For example, you can consider separate provisions in your operating agreement that sets aside deferred payments of licensing fees (for idea and IP), salary (for time and sweat with a premium for prior experience), interest or non-voting preferred stock (for money invested and even for the powerful rolodesk). None of these inputs need to be compensated with common shares.

2. Profit-Sharing

Similar to the arguments above, another common mistake novices make is to think that equity is necessary to participate in the returns earned by the venture. Put differently, the perception is that the higher the share of ownership or equity in the company, the higher the share of the profits. Again, while this *can* indeed be the case, it *need not* be. You can split equity unequally – say 70%-30% and agree to divide profits equally, or in a varying manner depending on performance or particular milestones achieved etc.

3. Decision Rights

Perhaps the greatest amount of confusion happens in the realm of decision rights. Novices tend to think that ownership automatically gives control – i.e. decision rights – both in terms of day-to-day operations as well as the right to set the overall shape and direction of the new venture. This is simply not the case. Again, while equity *can* be used to allocate decision rights, it *need not* be.

Take the case of bringing on a VC to fund your venture. VCs understand that decision rights are a matter of contract that they can build into the term sheet. Even when they agree to take only a minority stake in the company, say 30% equity, they will negotiate specific rights such as veto rights on: how the assets of the firm will be distributed in case of liquidation, when and where the venture can raise subsequent rounds of funding and even the conditions under which they can fire the founding CEO and member of the top management team. Additionally they will have seats on the board with voting rights on a variety of strategic and operational issues, not necessarily in proportion to their investment.

There are lots of technicalities involved in negotiating a term sheet. But for the discerning entrepreneur these details can be learned as and when needed with the help of good professional advisors such as accountants and lawyers and other members of the new venture's board of advisors. What is important right from the beginning is to truly grasp the fundamental distinction between ownership and control, the distinction that separates equity from decision rights, compensation and profit sharing. A firm grasp of this distinction makes all the difference in growing your fledgling enterprise into an enduring and large success, while at the same time avoiding irreparable conflicts that kill your venture.

What is equity, really?

Answer: Residual Claims

So if equity is not compensation for inputs, share in the rewards or decision rights, what is it, really? Equity consists in residual claims, namely, claims that have not already been predicted and spelled out in the founders operating agreement or in term sheets with outside stakeholders. For example, at the time of liquidation of a company, people holding common shares get whatever is left after paying all other creditors (such as suppliers, employees, investors with preferred shares etc.) who have contractual claims on the firm. If there are assets or cash left over, they will be shared among the common shareholders according to the percentage of shares held. Similarly if there are unforeseen liabilities such

as hazardous waste found buried under land owned by the company, the price of clean up will also be shared among the common shareholders according to the percentage each person holds.

Of Bicycles and Babies

In other words, think about owning a company not like owning a bicycle, but a bit more like being a parent. The point of ownership here is not to use and enjoy and destroy at will. It is much more about nurturing and growing the venture into a productive entity that creates value and thrives and endures in the world. Therefore, when splitting equity or more precisely, *constructin*g the cap table, all decisions must take into account the best interests of the baby rather than the individual interests of each owner/shareholder. In other words, even if you are the founder who came up with the idea for the venture and built the technology and started bringing key stakeholders including the first customers and employees on board, you might still choose to take a minority share and offer the majority to a capable and experienced CEO who has the wherewithal to build your idea and product into a lasting venture. The cofounders of Paypal did exactly that when they brought Peter Thiel on board as CEO.

The Joker in the Pack

A simple analogy may be very useful here. Equity is like the joker in a pack of cards. Depending upon the game you are playing, who you are playing with and the stage you are playing in, you can use equity in a variety of different ways. Equity can be used as compensation in hiring key talent; it can be used to allocate profits among the talent and for things not specifically written down in a term sheet or an operating agreement, voting based on common shares becomes the default way of making decisions. But the crucial point here is that none of this is automatic. It is up to YOU, the equity-holders, to decide when to use equity, how and why. That is why, in addition to deciding how to split equity between founding partners and other key stakeholders, you also want to think through how to compensate each others' inputs and investments, how to share profits down the road and how to make key decisions that are likely to arise in building the venture.

Remember that equity is not only the joker, but also the trump card if you take the trouble to learn to use it wisely. And most importantly, remember there is only 100% of it at any given point in time.

Constructing a High Value Cap Table: Practical Considerations

One of the most important practical considerations you need to keep in mind in constructing your cap table is that it is going to change over time. Therefore, in addition to thinking through the three confounds above (compensation for inputs, share in rewards and decision rights), you also need to consider a variety of contingencies when the residual claims aspect of equity will determine what happens next and thus significantly impact the future of your venture.

Evolution of the Cap Table over Time

Let's begin by taking a quick look at a cap table of an actual venture illustrated in Table 1. As you can see, on Day 1, the co-founders of Effectual Inc invest $1,000 to create 10,000 shares at 10c a share in their venture 100% of which they own. Soon they raise $2,000 in investment from friends and family. At this point how do they decide who owns what share of the company? Although one can make assumptions about the potential value of Effectual Inc using fancy predictive data and through that arrive at what percentage of shares should be allotted to the early investors, the practical fact is that the

company's valuation gets determined by the percentage the early partners are willing to take in exchange for their investment and the percentage the original founders are willing to let go to these early investors. Therefore, the valuation of the company at $12,000 is simply the result of their willingness to invest $2000 for 16.67% of the company.

This process of negotiation continues with later investment rounds as well. Notice here that the actual cash intake of the venture is very different from the market valuation derived from the percentage of shares allotted for that cash at each round. As the company grows and thrives, it becomes easier to value it more "objectively" in terms of actual performance achieved, projected market shares, risk-adjusted future cash flows etc. But a certain subjective assessment of these and a largely *negotiated* inter-subjective agreement on the relationship between cash invested and percentage ownership continues to be important, even when the company gets acquired or goes public and founders and early investors are able to liquidate their shares if they wish to do so.

Also, as you can see from Figure 1, throughout this evolution, the percentage shares of the original founders continues to decline, from 100% to 32%, even as the *value* of their shares grows from $1,000 to $8 Million.

Boosting the Cap Table: Equity and the P/E Ratio

Besides readily marketable assets (such as plant and equipment, inventory etc.) that exceed liabilities on the balance sheet, three broad elements involving the future constitute the valuation of privately held firms – namely, revenues, costs and the P/E ratio. At any given point in time, future revenues are subject to multiple uncertainties including changes in technologies, regulation, market demographics and preferences and so on. Future costs may also be impacted by similar hard to predict changes many outside the control of owners and managers. That is why it is necessary for equity holders to allocate equity with an eye to the health of the venture over the long run than according to the self-interests individual shareholders. As pointed out earlier, this might mean not using equity as compensation for inputs or shares in rewards. Note, however, that as the venture grows and becomes subject to valuation by outsiders, one of the main metrics of valuation includes the P/E ratio – usually estimated using industry comparables.

This ratio amplifies the actual earnings of the firm to provide a practical rule-of-thumb in valuation measures. For example, if a firm books $1 Million in earnings after paying all expenses including employee compensation totaling $500,000, and the relevant P/E ratio comparable is 20, the firm value is $20 M. It is easy to see that by compensating key employees (including founders and key employees) using equity rather than cash (deferred or otherwise) increases earnings. And then the P/E ratio amplifies those earnings in ways that can make a major difference in the valuation of the firm. In the simple example here, if the firm is able to convert even $100,000 of its $500,000 paid in compensation into equity rather than cash, its total market value would go up from $20 M to $22 M. In other words, but moving $100,000 into equity, the firm value is boosted by $2 M.

Once again, a deeper understanding of equity as a joker in the pack is key to winning the game of high growth entrepreneurship. But there are other practical considerations that also need to be taken into account in the design and evolution of the cap table over time.

Contingencies, contingencies, contingencies

Changes in the cap table are not only due to changes in the lifecycle of the venture or unexpected contingencies in its market, technological and regulatory environments. The life events of equity holders in the firm can also play a part. So as you make your equity split decisions in the earliest stages of your venture, even in drawing up the operating agreement of your LLC, consider the following. What if one of

you dies? Or gets married? Or divorced? Or falls sick? Or has to move due to events in the family? All of these can impact how, when, where, why and what you contribute to the venture. Therefore, even if you never plan to bring in outside investors, you still need to consider contingencies and be prepared to redesign your cap table.

How to Construct an Early Stage High Potential Cap Table: Processes and Mechanisms

Now that you know how important equity is and how it evolves over time, we can consider a process through which you can arrive at an initial distribution and a process for proactively making changes over time that will help your venture grow and thrive under conditions of multiple uncertainties.

Woes and Joys of Equal versus Unequal Splits

Most novice entrepreneurs find an in-depth discussion of equity splits among original cofounders uncomfortable and quickly settle in for an equal split or something like a 51-49 distribution. It is easy to imagine why 50-50 splits are usually not a good idea, especially for a new venture that has the potential to grow and thrive into a highly successful company. In his list of 25 entrepreneurial deathtraps, Frederick Beste lists this is as the most serious one. As mentioned at the beginning of this note, his learning from working with a large number of high growth ventures is supported by research showing that most ventures fail due to partner conflicts. Yet the data also show the existence of large numbers of highly successful firms that started out as equal partnerships. This is not a contradiction. All it says is that the distribution is bimodal.

Given this data and the reality of contingencies in life and the evolution of the cap table over the lifecycle of the growing venture, a simple set of rules regarding equal splits might be useful:

- As far as possible, do not split equity equally. Wholeheartedly and consensually, s/elect someone as the "leader" and give him or her a few extra shares to commit to their leadership.
- Even if you decide to split the equity equally, designate a trusted and respected third party to arbiter conflicts and preferably assign some equity and explicit conflict resolution rights to him or her. Steve Jobs and Steve Wozniak did that when they started Apple.
- Finally, put in a Russian Roulette provision. This provision works on the Fair Division principle from philosophy, whereby one person cuts the cake and the other decides who gets which piece to ensure fair division. In the case of a new venture dispute leading to one of the cofounders leaving the venture, this provision allows one of the co-founders to set the price of each share while the other chooses whether to buy or sell at that price.

Also, irrespective of whether you decide to split the equity equally or unequally, create a process and a set of criteria through which you can revisit the equity split and redesign the cap table. For example, you could simply set a date in the future or decide on specific milestones or spell out ways for individual equityholders to call for a revision of the original split.

Constructing Unequal Equity Splits

So, if you decide not to split equity equally, how do you decide who gets what percentage of the venture in the very first round? A simple example with stylized mechanisms can illustrate key points in the process. Construct your initial cap table over two separate meetings of the cofounders. All cofounders

should attend both meetings without time pressure, preferably in a quiet location with an experienced advisor/arbiter to facilitate the conversation.

In the first meeting, talk through in as much depth and detail as possible what it is going to take to build your venture into a successful and enduring firm. Keep in mind that each of you might have very different ideas about what it's going to take and even what will count as success or growth. Some of this might be surprising, even shocking and will likely challenge each cofounders assumptions about the others. That is why it is necessary to hear every voice in the room on all contours of the conversation. Toward the end of this meeting, assuming that all cofounders still want to commit to build the venture, you should arrive not only at some consensus of a common vision of success, but also a numerical estimation of each element that you consider would be necessary to achieve that success. Table 2 provides such an example, albeit over-simplified.

Maybe a week or two after the first meeting, all cofounders (along with the facilitator if possible) should meet to decide something akin to the contents of Table 2. Here each cofounder begins by rating herself and each of her cofounders on a scale of 1-10 on each success factor derived from the previous meeting as set out in Table 1. This conversation may also not be an easy one and might provide with some surprises and shocks to each cofounders self-image and expectations of the others. But assuming the meeting concludes amicably and with a renewed commitment to build the venture, the equity distribution becomes a simply matter or arithmetic.

Equity as a Driver of Effectual Entrepreneurship

In both meetings suggested above, even when the discussions are earnest and real in terms of the vision and methods of building a great venture, it should never be forgotten that most assumptions are likely to be proved false and even heartfelt aspirations are likely to change over a future that cannot be predicted, but can nonetheless be effectually co-created. And in the final analysis, THAT is why understanding and learning to use equity is so important in building successful enduring ventures. If the future were at all predictable, we could simply use other contractual mechanisms to structure relationships. Equity is the most effectual mechanism to structure relationships between self-selected stakeholders seeking to build successful ventures that they themselves cannot fully foresee.

Table 1

Evolving Cap Table of A Typical New Venture

	Price per share ($)	# of shares	Cash ($)	Total # of shares	% of the company	Market Value
Foun-ders	0.10	10,000	1,000	10 K	100%	$1,000
Early Eq Partners	1.00	2,000	2,000	12 K	16.67%	$12,000
First Seed	33.33	3,000	100,000	15 K	20%	$500,000
VCs	100.00	10,000	1,000,000	25 K	40%	$2,500,000
Split	~3.00	(Split 32:1)		800 K		$2,500,000
Public	25.00	200,000	5,000,000	1,000 K	20%	$25,000,000
		Total	**6,103,000**			

Figure 1

Ownership Profiles at Typical Financing Stages of a New Venture

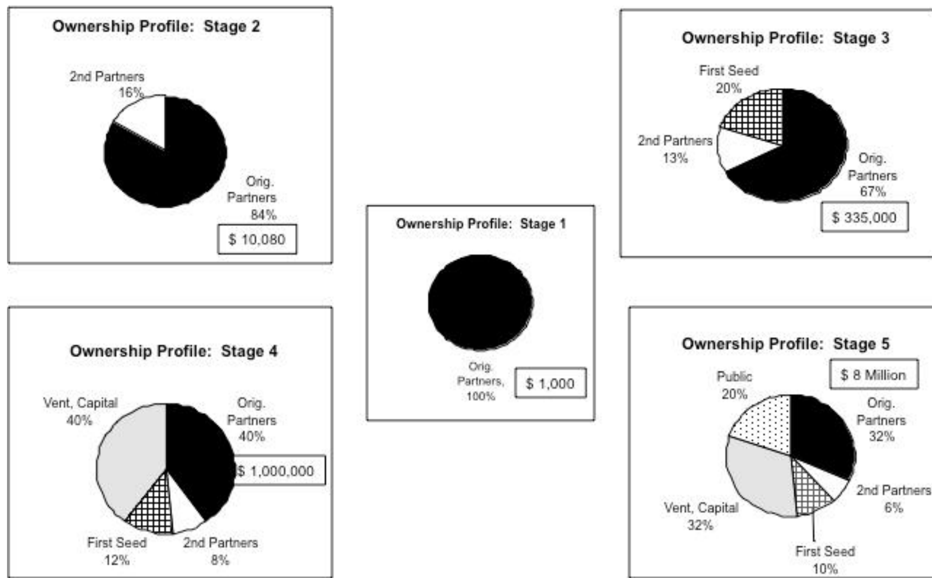

Table 2

Example: Outcomes of First Meeting to Decide Equity Split

(Success Factors/competences arrived at by consensus in conversation between partners and how important each of these is likely to be the survival and growth of the new venture)

Success Factor	**Weights for Venture Success**
Sales	0.4
Technology	0.2
Finance	0.1
Operations	0,1
Total	**1.0**

Table 3

Example: Outcomes of Second Meeting to Decide Equity Split
(Ratings of partners on each success factor and resultant final equity split)

Success Factor	**Weights for Venture Success**	**Each partner rates him/herself and others on a scale of 1-10**						
		Leslie		**Anu**		**Tara**		
		Rating	Weighted Rating	Rating	Weighted Rating	Rating	Weighted Rating	
Sales	0.4	8	3.2	6	2.4	2	0.8	
Technology	0.2	2	0.4	4	0.8	7	1.4	
Finance	0.1	4	0.4	5	0.5	3	0.3	
Operations	0,1	1	0.3	5	1.5	2	0.6	
Average			**4.3**		**5.2**		**3.1**	
Final Equity Split		**34%**		**41%**		**25%**		**100%**