Cutting Up the Founders' Pie

By Frank Demmler

Two friends decide to start a business. "We'll go 50-50," one says to the other.

Three graduate students have worked on a research project that they want to commercialize. "Just like the three musketeers; all for one; and one for all. We'll split the company three ways equally."

Four neighbors share passions for baking. "Let's start a catering business," says one. "That's a great idea! One hundred divided by four means 25% each," responds another.

That's a story that repeats itself multiple times every day. IT'S ALSO ONE OF THE MOST COMMON MISTAKES FIRST-TIME ENTREPRENEURS MAKE. In fact, my friend, Fred Beste of Mid-Atlantic Venture Fund, attributes two of his famous, "Twenty-Five Entrepreneurial Deathtraps" to this issue.

You did see the word, "deathtraps," didn't you? As in, the company crashes and burns. As in, best friends become vicious enemies. As in, a family's net worth goes down the drain.

Within thirty seconds of deciding to start a business, the seeds of its destruction are sown.

IN THE BEGINNING, THERE WERE THE FOUNDERS

When a company is first launched, the founders own 100%. As already indicated, the often-used method for dividing that 100% is to divide it by the number of founders. "It's fair," is the common explanation.

Have you ever heard, "The road to hell is paved with good intentions"? This is a prime example.

WHAT IF…

Before I discuss what should be done, let's look at a few "hypothetical" situations. What if:

- You put in 10 hour days, six days a week and your "partner" shows up at 10:00 a.m. and leaves at 3:00 p.m., except on days when he's got an earlier tee time.
- You quit your job, forego salary, while your "partners" stay in their jobs "to help fund the business" until it can afford "to pay them."
- Every time you try to do something that you consider important, but costs some money, your two "partners" veto it.
- You want to raise investment to help the company realize its potential, but your "partners" don't want to take the risk. "We're doing just fine the way we are."
- The company is running through cash flow raindrops and can't cover payroll, so you draw down your savings to make the checks good. Your "partners" can't

come up with their "fair share," but they assure they will when they can, but never do.

I could go on and on, but I think you get the picture.

THINGS TO CONSIDER

You need to consider the past, current, and future contributions that each of the founders will be bringing to the company.

Idea

The company wouldn't exist if it weren't for the original idea, and that is certainly worth something, BUT there's a lot of truth in the saying, "A successful business is 1% inspiration, and 99% perspiration."

Business Model Creation

The development of an initial business model is a surprisingly difficult and time-consuming effort. To pull together and organize all the thoughts of the founding team, filling in the blanks, identifying and reconciling the differences, and producing a pitch that captures the essence of the business and helps persuade banks, investors, board members, and others to support the company is a mammoth undertaking, as anyone who has done it will attest.

Again, getting the business model right is a necessary element of starting the business, BUT execution is where the real value lies.

Domain Expertise

To what degree do you and your partners have meaningful experience in the business of your business? Knowing the industry, having relevant experience, and having a Rolodex full of accessible contacts can greatly improve the company's probability of success and speed its growth rate. Otherwise, it will take longer to get commercial traction and you'll have to pay for these assets, usually by hiring someone and including equity in their compensation package.

Commitment and Risk

You've probably heard the old saying that "a chicken is involved with a breakfast of bacon and eggs, but a pig is committed." Similarly, the founders who join the company full time and are committed to making it a success are much more valuable than founders who are going to sit on the sideline and cheer you on. In addition, the opportunity cost of joining the company rather than pursuing an existing career is not trivial.

Responsibilities

Who is going to do what? Who is going to stay up at night when you can't make tomorrow's payroll?

As an aside, it is my very strong recommendation that someone has to be the "boss." Your primary strength against your competition is the speed with which you can act.

Don’t neutralize that by debating every decision among the founders. Usually, any quick decision is better than the “right” long and drawn out decision. Even if you ignore all of this unsolicited advice and decide to be “equal” founders, I encourage you to make one of your team a “little more equal” than the others.

Management by consensus is rarely successful.

RELATIVE IMPORTANCE OF THE ELEMENTS

For each company, the relative importance of these elements is likely to be very different than that for another company. A company based upon new technology is highly dependent upon the “idea.” On the other hand, a new restaurant is not likely to be so unique that the “idea” is a major contributor to the restaurant’s ultimate success. If we were to evaluate the ideas on a scale of 0-to-10, the technology company’s idea might be a 7 or 8, while the restaurant may be only 2 or 3.

Similarly, the relative importance of the business model will vary. A company that has to raise external financing will need a pitch deck that will support fund raising efforts.

I believe the same analysis can be productively applied to the other elements. Not only can the absolute evaluations be made (0-to-10), but they can be compared to one another to make sure that their relative values are reasonable as well.

	Weight
Idea	
Business Model	
Domain Expertise	
Commitment & Risk	
Responsibilities	

RELATIVE CONTRIBUTIONS OF THE FOUNDERS

Each of the founders can be evaluated on these elements as well. Who did what to come up with the idea? Who contributed what to conceiving the business model? Who has the industry connections? Who is joining the company full time? Who is accepting responsibility for raising investment capital? Who is responsible for bringing the product to market?

		Founder 1	Founder 2	Founder 3	Founder 4
Idea					
Business Model					
Domain Expertise					
Commitment & Risk					
Responsibilities					

AN EXAMPLE

Let’s 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 internationally as the technology leader in his domain.
- The “business guy” who is bringing business and industry knowledge to the company.
- The research associate or post-doc 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.

If these were all first-time entrepreneurs, it’s very possible that they would each get 25% of the company’s stock, because “it’s fair.”

Let’s take a look at what the Founders’ Pie Calculator says. First we evaluate each of the factors on their relative importance and each of the founding team member’s contribution to each on a scale of 0-to-10.

	Weight	Founder 1	Founder 2	Founder 3	Founder 4
Idea	7	10	3	3	0
Business Model	2	3	8	1	0
Domain Expertise	5	6	4	6	4
Commitment & Risk	7	0	7	0	0
Responsibilities	6	0	6	0	0

Next, we multiply each of the founder’s values by the factor’s value to calculate weighted scores. Add up the numbers for each founder, sum those totals and determine the relative percentages. Do a sanity check to see if those numbers seem to make sense, and adjust them accordingly.

	Founder	Founder	Founder	Founder	
Idea	70	21	21	0	
Business Model	6	16	2	0	
Domain Expertise	30	20	30	20	
Commitment & Risk	0	49	0	0	
Responsibilities	0	36	0	0	
Total Points	106	142	53	20	321
% of Total	33.0%	44.2%	16.5%	6.2%	100.0%

I am not suggesting that these specific numbers should be used to allocate the Founders' Pie. They should, though, provide relative positioning and value of each of the founders.

I am often asked, "I don't feel comfortable asking these questions and attempting to define relative importance of each founder. What if we can't agree? What is someone's feeling get hurt? Why should I subject myself to the potential backlash when I don't have to?"

My response is to walk the entrepreneur down the path of a likely outcome, "OK, let's say we're 9 months down the road. You've been working 80-hour weeks and everyone else is on the sideline waiting until you can raise money. How 'fair' will you consider your 'piece to the pie' then? What will happen when you propose that you should get more stock, or stock options, because of your sacrifice and contribution to the company as compared to the others?"

Mostly likely at least one, and probably more, of the co-founders will go ballistic. You might be labeled "greedy" or worse. Emotion, not logic, will drive those discussions. Animosity among the founders is very likely. It could get very ugly.

If you address those considerations today, the discussion is likely to be courteous and rational. You can use the Founders' Pie Calculator as an agenda for a meeting. People's opinions will be presented. Some opinions are likely to be in direct opposition to one another. Talking them out so that the different opinions are understood and discussed. Agreement on that issue may not be resolved, but understanding one another's viewpoints is likely to defuse an argument in the future.

Not addressing the issues now is like the ostrich burying its head. The situation is likely to get worse, not better. DO IT NOW!

ADVICE TO ENTREPRENEURS

- Splitting up the founders’ pie is an extraordinarily important, but little understood or appreciated, set of decisions that may have set the stage for future crises.
- Rarely should it be split evenly, even though that’s what many startups do.
- Consider the past, current, and future relative contributions of the founding team members to the ultimate success of the company.
- Employ the Founders’ Pie Calculator to create a quantified scenario of how the pie might be divided based upon these elements.

Caution: while I have convinced myself that this is a brilliant tool, and that the scenarios that I’ve run through it have had logical outcomes, use this tool for guidance only. Do not depend upon it exclusively.