Stanford eCorner

Real Lessons in Equity Splits

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Noam Wasserman, associate professor at Harvard Business School, discusses decisions around the timing and structure of co-founder equity splits. To illustrate the dynamics and uncertainties in play in these decisions, Wasserman contrasts real-world examples from Zipcar and Ockham Technologies.

Transcript

So now we are going to take the example that was raised and we are going to do a deep dive into that and contrast it with another team and their decisions. This is going to be the Zipcar team, very prominent now, very well known. But this is back more than a decade ago when they were coming together as a team. Zipcar was founded by two women who knew each other socially. Their kids shared a day-care center, they lived near each other, they would have chats during drop-off and pickup time and were getting to know each other. One of the women had had a vacation to Europe and had seen a car-sharing service over there, liked it as a business idea. The two women also had a very laudable green streak, wanted to do something to help the environment here in the U.S and saw that that great business idea could also help, taking cars off the road, probably all sorts of additional implications for society here. And so they decided, hey, great idea. Let's go and co-found together. Let's go and build this car sharing company.

One of the founders, Robin Chase, had heard a horror story from a friend of hers who had been in a start-up. High potential idea that had gotten derailed by the equity split negotiation. This goes back to hearing the anecdote that leads you down a certain path. What do we think that Robin decided to do? Decided to make sure, hey, let's get this out of our way. Let's make sure that this isn't going to derail us in the same way. What do you think Robin proposed? One over N, the 50-50 split. She reached out, shook across the table, her co-founder agreed and Robin breathed a sigh of relief and said great, now the world is ours to go and conquer. We are off and running, we have gotten that out of the way. Over the next year and a half Robin threw herself into the venture, became the heart and soul of Zipcar, crafting every element of the business model, partnerships with the car companies, parking lot by parking lot, wrestling a parking space to go and put her car. Her co-founder didn't even quit her day job, contributing from the sidelines, barely doing anything at the level that Robin was.

If we're Robin, how are we feeling right now? Resentful. What? Resentful. Resentful. Okay, that kind of captures a little bit of it. I usually have to bleep out the first of the responses that people give me. When Robin came to class to talk about this, you could see the angst eating her up in her face. What she said at that point was that that was the stupidest handshake I had ever made. Who knows about all of the other elements, some of the things that have been highlighted about the uncertainties that we face, about commitment, about skill sets, about strategy, all of these pieces of it, that because we had a divergence from that best-case scenario that I was thinking about, I have had a year and a half worth of angst eating me up, that all of my hard work is going equally to my co-founder as it is to me. One of those perils of doing that early split, putting it in stone, thinking you have taken care of the problem, but it coming back to bite you. Let's go and contrast that to another team and the decisions that they made.

There will be two key ways that this team made a different set of decisions. This team is from the other end of the pie chart. This is the Ockham Technologies team. This was three prior co-workers, people who had worked together professionally, who were coming together to found. There are two key ways that they diverged from the Zipcar team. To me, the second one of them is the most critical. First, in terms of the first dimension, it was relatively obvious that they were not going to be contributing the same amount. One of the co-founders had worked for the other one. Seven years his junior. It was pretty evident one of them was going to be a much bigger contributor than the other one.

So they sat down, they already honed the ability to go and have a real dialogue about these tension-filled issues, and they sat down and hammered out the first element of the difference from Zipcar's, the uneven split. They ended up taking a cut at 50-30-20 as being their best estimate of where things were going to go in that long run. To me, the critical element is the second piece of it. What the Ockham team did was they zoomed in on their uncertainties. They zoomed in on a bunch of these key risks of what they didn't know or where things were going to go and in particular they took the highest ranking of those and did a deep dive into a dialogue about how that might change for the team and how it might cause the Robin Chase problem for them. In particular, the biggest uncertainty that they had was around the involvement of the idea guy, of Ken. They didn't know if Ken was going to be joining the team full-time. Ken had just become a first-time father as they were writing the business plan. Ken had never been a founder before. He had never been a father before.

Are these two compatible with each other? And so he didn't know how he was going to grapple with that. He also had a very nice job that he wasn't sure he was going to want to leave. And so they double-clicked on that set of uncertainties and went through three key scenarios that they did a deep dive into. When I was - this goes back to my computer engineering background, when I took a look at their founder agreement, I saw a series of if, then, else statements. They took the scenario that is the Robin Chase scenario, the best-case scenario, and said if Ken is on board full time, then this is what the equity split is going to be. Else, if Ken is on board only part time, the expected-case scenario, then this is what the split will be, else worst-case scenario, if Ken isn't on board at all, these are the buyout terms for us to reclaim his equity. That key element of going and tackling your biggest risks, your biggest uncertainties rather than avoiding them, rather than punting on them and also when we are looking at these scenarios, which is the natural scenario that, as founders, we go and focus on? Is it going to be the worst-case scenario? Is it going to be the expected-case scenario? The best-case scenario is the key one that we are going to be focusing on, which is very understandable. During those passionate early days when we are brimming with confidence, that's when we are going to be laying the plans that a Robin Chase does. She is going to be as committed as I am. We are going to be contributing our skills.

We are all going to be lifting this heavy rock together as we go and try to pursue this. That's the very natural inclination that we have to fight as founders. We have to also think hard and understand what are the expected-case scenarios, and the hardest of all, what are the potential pitfalls we are going to face? What are the potholes in the road that if we go and architect a very fragile agreement, like what Zipcar had done, when we have one of those potholes, is that fragile agreement going to shatter and come crashing down to earth? Going and tackling the highest of your risks, having that dialogue about how we can mitigate them, how we can go and architect ways to avoid the Robin Chase angst, as being a critical thing. But what also happens in the team when you start teeing up these types of high-tension issues? That's where you are starting to force a bunch of that interaction that will lead to a more productive founding team dynamic and ability to deal with those issues. The equity split is only going to be the first of the high-tension issues that you are going to be facing together. Going and honing it, going and using a whole bunch of these things that we usually would likely avoid, is a way for us to be able to hone the relationship within the team, build the trust and be able to go forward when we hit more bumps in the road because we haven't just punted on those. What's the worst-case scenario if you are not compatible with your co-founder? What is the worst-case scenario about when you are going to find that out? Too late. Way down the road. Far better, we talk about fast fail with products, far better for you to not do the punting that Robin Chase did, far better to tee up those high-tension issues early on and learn then that you are not compatible, that you are not going to be on the same page about these things, rather than going down the road and finding out way at the end of this initial stage that you are in together. And so all sorts of benefits that come from forcing yourself to look at those other scenarios and for being able to see that the uncertainties that we face, we should be matching them with dynamism in our agreements, in our expectations, in the things that we are putting in place early on as a team.

And so that dynamic element, having that match our uncertainties as being a key thing that the Ockham team was doing and that Robin Chase very naturally avoided because of looking at that rosy scenario during those early passionate days.