Forming a new software startup, how do I allocate ownership fairly?

I have come up with an idea for a new social networking application. It's not something I *expect* to be hugely successful, but I think it does have some potential. I've approached a few close friends and collegues, all of whom really liked the idea. A couple have offered to come on as partners to help develop the idea into a working application.

I cannot afford to pay them out-of-pocket for their time (nor do they expect that), and we're all approaching this as a project we'll do on our nights and weekends. Since I think the idea does have the potential to turn into a successful venture, I want to go ahead and solve the ownership/payment issue now before it becomes an issue. I'm leaning towards splitting ownership of the idea among the three of us, and letting that determine how any profits are split later on. Is this the right choice, and if so, what's a fair split? I came up with the idea and have already invested quite a bit of time planning it out (plus I'm sure I'll pay any incidental development expenses out of my pocket), so I feel like I should definitely have a larger share of the ownership. Is that reasonable?

I'm also trying to think of some way to reward partners based on effort. I'm not worried about someone signing on then doing nothing, but I do think it's quite possible that one (or more) of us might obsess about the project and put in significantly more effort. If that happens, I think that person should get a proportionately larger share. Any suggestions on how to structure that?

software equity partner

edited Jul 15 '11 at 19:24
Zuly Gonzalez ♦
9,153 5 19 66

asked Jan 21 '10 at 21:07
Matt
1,328 3 6 5

8 Answers

This is such a common question here and elsewhere that I will attempt to write the world's most canonical answer to this question. Hopefully in the future when someone on answers.onstartups asks how to split up the ownership of their new company, you can simply point to this answer.

The most important principle: **Fairness, and the perception of fairness, is much more valuable than owning a large stake.** Almost *everything* that can go wrong in a startup will go wrong, and one of the biggest things that can go wrong is huge, angry, shouting matches between the founders as to who worked harder, who owns more, whose idea was it anyway, etc. That is why I would always rather split a new company 50-50 with a friend than insist on owning 60% because "it was my idea," or because "I was more experienced" or anything else. Why? Because if I split the company 60-40, *the company is going to fail when we argue ourselves to death.* And if you just say, "to heck with it, we can NEVER figure out what the correct split is, so let's just be pals and go 50-50," you'll stay friends and the company will survive.

Thus, I present you with **Joel's Totally Fair Method to Divide Up The Ownership of Any Startup.**

For simplicity sake, I'm going to start by assuming that you are not going to raise venture capital and you are not going to have outside investors. Later, I'll explain how to deal with venture capital, but for now assume no investors.

Also for simplicity sake, let's temporarily assume that the founders all quit their jobs and start working on the new company full time at the same time. Later, I'll explain how to deal with founders who do not start at the same time.

Here's the principle. As your company grows, you tend to add people in "layers".

1. The top layer is the first founder or founders. There may be 1, 2, 3, or more of you, but you all start working about the same time, and you all take the same risk... quitting your jobs to go work for a new and unproven company.
2. The second layer is the first real employees. By the time you hire this layer, you've got cash coming in from somewhere (investors or customers--doesn't matter). These people didn't take as much risk because they got a salary from day one, and honestly, they didn't *start* the company, they *joined* it as a job.

3. The third layer are later employees. By the time they joined the company, it was going pretty well.

For many companies, each "layer" will be approximately one year long. By the time your company is big enough to sell to Google or go public or whatever, you probably have about 6 layers: the founders and roughly five layers of employees. Each successive layer is larger. There might be two founders, five early employees in layer 2, 25 employees in layer 3, and 200 employees in layer 4. **The later layers took less risk.**

OK, now here's how you use that information:

The founders should end up with about 50% of the company, total. Each of the next five layers should end up with about 10% of the company, split equally among everyone in the layer.

Example:

- Two founders start the company. They each take 2500 shares. There are 5000 shares outstanding, so each founder owns half.
- They hire four employees in year one. These four employees each take 250 shares. There are 6000 shares outstanding.
- They hire another 20 employees in year two. Each one takes 50 shares. They get fewer shares because they took less risk, and they get 50 shares because we're giving each layer 1000 shares to divide up.
- By the time the company has six layers, you have given out 10,000 shares. Each founder ends up owning 25%. Each employee layer owns 10% collectively. The earliest employees who took the most risk own the most shares.

Make sense? You don't have to follow this exact formula but the basic idea is that you set up "stripes" of seniority, where the top stripe took the most risk and the bottom stripe took the least, and each "stripe" shares an equal number of shares, which magically gives employees more shares for joining early.

A slightly different way to use the stripes is for seniority. Your top stripe is the founders, below that you reserve a whole stripe for the fancy CEO that you recruited who insisted on owning 10%, the stripe below that is for the early employees and also the top managers, etc. However you organize the stripes, it should be simple and clear and easy to understand and not prone to arguments.

Now that we have a fair system set out, there is one important principle. **You must have vesting.** Preferably 4 or 5 years. Nobody earns their shares until they've stayed with the company for a year. A good vesting schedule is 25% in the first year, 2% each additional month. Otherwise your co-founder is going to quit after three weeks and show up, 7 years later, claiming he owns 25% of the company. It **never** makes sense to give anyone equity without vesting. This is an extremely common mistake and it's terrible when it happens. You have these companies where 3 cofounders have been working day and night for five years, and then you discover there's some jerk that quit after two weeks and he still thinks he owns 25% of the company for his two weeks of work.

Now, let me clear up some little things that often complicate the picture.

What happens if you raise an investment? The investment can come from anywhere... an angel, a VC, or someone's dad. Basically, the answer is simple: the investment just dilutes everyone.

Using the example from above... we're two founders, we gave ourselves 2500 shares each, so we each own 50%, and now we go to a VC and he offers to give us a million dollars in exchange for 1/3rd of the company.

1/3rd of the company is 2500 shares. So you make another 2500 shares and give them to the VC. He owns 1/3rd and you each own 1/3rd. That's all there is to it.

What happens if not all the early employees need to take a salary? A lot of times you have one founder who has a little bit of money saved up, so she decides to go without a salary for a while, while the other founder, who needs the money, takes a salary. It is tempting just to give the founder who went without pay more shares to make up for it. The trouble is that you can never figure out the right amount of shares to give. This is just going to cause conflicts. **Don't resolve these problems with shares.** Instead, just keep a ledger of how much you paid each of the founders, and if someone goes without salary, give them an IOU. Later, when you have money, you'll pay them back in cash. In a few years when the money comes rolling in, or even after the first VC investment, you can pay back each founder so that each founder has taken exactly the same amount of salary from the company.

Shouldn't I get more equity because it was my idea? No. Ideas are pretty much worthless. It is not worth the arguments it would cause to pay someone in equity for an idea. If one of you had the idea but you both quit your jobs and started working at the same time, you should both get the same amount of equity. Working on the company is what causes value, not thinking up some crazy invention in the shower.

What if one of the founders doesn't work full time on the company? Then they're not a founder. In my book nobody who is not working full time counts as a founder. Anyone who holds on to their day job gets a salary or IOUs, but not equity. If they hang onto that day job until the VC puts in funding and then comes to work for the company full time, they didn't take nearly as much risk and they deserve to receive equity along with the first layer of employees.

What if someone contributes equipment or other valuable goods (patents, domain names, etc) to the company? Great. Pay for that in cash or IOUs, not shares. Figure out the right price for that computer they brought with them, or their clever word-processing patent, and give them an IOU to be paid off when you're doing well. Trying to buy things with equity at this early stage just creates inequality, arguments, and unfairness.

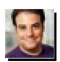
How much should the investors own vs. the founders and employees? That depends on market conditions. Realistically, if the investors end up owning more than 50%, the founders are going to feel like sharecroppers and lose motivation, so good investors don't get greedy that way. If the company can bootstrap without investors, the founders and employees might end up owning 100% of the company. Interestingly enough, the pressure is pretty strong to keep things balanced between investors and founders/employees; an old rule of thumb was that at IPO time (when you had hired all the employees and raised as much money as you were going to raise) the investors would have 50% and the founders/employees would have 50%, but with hot Internet companies in 2011, investors may end up owning a lot less than 50%.

Conclusion

There is no one-size-fits-all solution to this problem, but anything you can do to make it simple, transparent, straightforward, and, above-all, fair, will make your company much more likely to be successful.

edited Oct 3 '12 at 2:52

answered Apr 14 '11 at 3:14



Joel Spolsky ♦
13.2k 9 28 57

13 Regarding **What if one of the founders doesn't work full time on the company?**, what if the founders are roommates and the one with the part time job (or whatever) is funding the housing/food/essentials for the other one? Still not a founder? So essentially there's the same risk for both in some aspects. – Joe Philllips Apr 14 '11 at 3:27

5 After company is *established*, what if *some* founders are working on other things(ideas/startups) too? Should his share decrease? – claws Apr 14 '11 at 6:11

47 @Joel Spolsky - The only problem I have is with your non-full-time founder comment. It is perfectly possible for a founder to hold a day-job and put the rest of his time into the company. A founder can work his day job from 9-5, and then work for the startup from 5-3 (ESPECIALLY if a founder is a developer). This is no less of a risk than leaving your job; the risks are just different (personal relationships and health, rather than money and financial stability). Just my two cents. – Craige Apr 14 '11 at 16:00

9 -1 for "have to be full time to be considered a founder" - nope - sorry. Lots of other good content in that post, but that one is way off. – TimJ ♦ Apr 15 '11 at 14:18

31 Why do you account differently for money inputs from different sources? If one founder does not take a salary he is in effect making money available to the company in the same way an investor makes money available to the company. This money presents the same risk to the founder who is contributing it to the company that money invested in the company presents to the investor. If the company goes under, they both lose their money. Therefore, the founder who is foregoing salary has more skin in the game than the founder who takes salary. – jay Apr 16 '11 at 17:17

I'm sure some folks get by with unequal splits. But I don't think it works for most partnerships. Someone will inevitably be upset because someone is getting more. Find a true spouse or two for your startup. If you can't find people that want to bleed for it like you, than go to bat without partners. Don't bring on people who just care a little now, and you care the most. Most likely that person won't give a shit down the road, and you'll be left with dead weight.

And please, please spend the time crafting a vesting agreement. DO NOT PASS GO, unless you have an agreement in place so that if a partner leaves pretty early they have to forfeit most if not all of their shares back to the company.

See a lawyer to get this done right the first time. It's worth it.

answered Jan 21 '10 at 22:22
Nathan Kontny
1,855 7 9

5 +1 for getting a lawyer and doing it properly up-front. – Steve Wilkinson Jan 21 '10 at 23:05

4 +1 on formalizing an agreement. – JeffO Jan 22 '10 at 2:57

1 Thanks for the feedback. I will look in to a vesting agreement. One thing that is different about this partnership is that we're approaching it more as a hobby-that-might-become-more as opposed to an honest-to-goodness-startup. Still, I think it's better to get this stuff out of the way now before it ever becomes an issue. – Matt Jan 24 '10 at 3:51

1 +1 for legal advice and formal agreement – Spiros Apr 14 '11 at 11:26

I never even knew what a vesting agreement was until a few months ago and now I can't even imagine starting a biz w/ someone else without it. – Nick Apr 14 '11 at 16:58

View your startup as going to war. You will be fighting in the trenches together with the people you bring along.

See the equity split as how you divide the bullets between yourselves.

If there is any chance that one of the founders will take his bullets and shoot you in the back he shouldn't be given any bullets in the first place.

If you believe that one of you won't use his bullets - don't bring him at all.

Everyone else, that is willing to fight with you in the trenches, bring them along and share the bullets equally.

You all bring different things to the table. You might be the one that intitally brings the most. But in a few months it may turn out that someone else have skills that are far more valuable to the project.

answered Apr 15 '11 at 12:37
Niklas
351 3 2

1 +1 - great metaphore – Tomasz Zielinski Jan 22 '12 at 12:59

This type of question been asked often and nobody ever mentions what the other partners expect. If they have given you no indication of what they want, you need start with that discussion. They may just offer a small slice of their time on a specific aspect of this business and only want 5% or they both may want half (I'd like to be a fly on the wall for that one.).

Then I would follow Nathan K's advice and work it out the right way with a lawyer. This may scare your friends off, but better now than later.

answered Jan 22 '10 at 2:57
JeffO
6,139 5 13

Joel's comments are pretty good, but might be potentially a bit large considering the relative scope of many people's ambitions when starting a company.

I normally recommend considering: x% split equally for owners. y% left over for investors. z% for other employees/board members.

Splitting the z% based on seniority or risk equally isn't always the best case scenario. For instance, if I was bringing on Joel to be a board member - he might have very little risk and come in late. But if

I was about to raise money, he might be a valuable partner and I could give him an extra large % comparatively to have him in the room when negotiating terms for VC money.

answered Apr 14 '11 at 13:27
Chris Kluis
1,195 1 4 8

I'm in exactly the same situation as you are and I'm still negotiating. I think you should indeed get some reward from your idea. Currently, I have following proposal on the table: when you license a product you invented to a company, you may get 2% to 7% of the revenues as license fee. The bigger the licensee is, the smaller the number (eg large multinationals won't give you 5%). You could put that in your contract, that you get a % of the revenues (not the profit) and that the remaining profit is equally split.

Alternatively, you could ask for a reserved share of maybe 15% - more than the license fee, because you also share this part of the costs - and equally split the remainder of the shares.

I'm also in the situation that we will not do an equal amount of work, that can also happen to you. I'll reduce my daytime job to 50% while the others will only work during their free hours.I'm trying to compensate that by insisting that they put an equivalent amount of money on the table to cover the first investments.

I think that this deal is more or less equal output for equal input.

answered Jan 22 '10 at 17:59
Luc J

1 The most important is that people should feel that the deal is fair. – BlueTrin Aug 1 '12 at 8:26

As already said there is no one-size-fits-all solution to this problem, and it is definitely case by case.

However, as it is such a common and frequent question, **there are some tools** based on years of discussions with entrepreneurs and co-founders meetups, startup conferences and so on.

Here are two calculators for Funding And Equity on startups:

- **SmartAsset**

- **Co-Founder**

These tools can provide you a starting point for your own analyses.

answered Aug 29 at 3:35
john 4d5
171 3

It does not have to be complicated. Use a dynamic equity split, it will determine *exactly* how much each person deserves. It will protect you from the possibility of someone signing on and doing nothing.

answered Jan 23 at 22:57
Mike Moyer
254 1 3

I find Mike's idea of assigning "contribution points" and only later converting them into exact slices of equity brilliant. It puzzles me why people are still breaking their heads to fix exact percent of X (with X being unknown anything between zero and infinity), when system such simple as Mike's exists. – Dmitri Zaitsev Aug 30 at 2:07

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protected by Joel Spolsky ♦ Apr 14 '11 at 20:51

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