

Get Them Gators!

A Primer on the Power of Dynamic Equity Splits for Potential Investors, Partners and Employees

- Version 1.0 -

Mike Moyer

Purpose

If you want to skip to the Super-Short explanation, go to the last page...

The purpose of this guide is to make the case for the use of a **dynamic equity split** as outlined in the book *Slicing Pie*. *Slicing Pie* is a short book and it's easy to read, but the concept of a dynamic equity split isn't widely understood. From time to time readers of *Slicing Pie* find that some people need a little convincing that the dynamic model is the best way to divide up equity. So...I wrote this guide for those people to give to anyone they want so others could become more comfortable with the approach.

This is *not* a comprehensive guide to implementing a dynamic equity split. *Slicing Pie* **is** a comprehensive guide. So, if you find yourself with questions about the details please pick up a copy of *Slicing Pie*. For instance, you might think to yourself, "I wondering about the tax and legal implications of this model?" These things are explained, in detail, in *Slicing Pie*. The book is for sale on Amazon.com and can be ordered through most bookstores. If you can't find it or can't afford it send me an email at mike@slicingpie.com and I'll send you a copy for free. As much as I want to sell books, I mostly want to spread the word about the value of dynamic equity splits, so let me know if you need a free copy.

Scan or Click the QR Code to Buy Slicing Pie on Amazon.com

PS: This is a *Beta version*, so there may be a few things that need editing. Please send me your edits and feedback to mike@slicingpie.com



Dynamic Equity Splits

Slicing Pie outlines a straightforward process for implementing a dynamic equity split in an early-stage startup to ensure the most fair equity split possible. It is ideal for bootstrapped startups where time is the primary contribution of founders, but it will well work in any type of company that doesn't have a lot of cash.

It is a universal, one-size-fits-all, self-adjusting model that maintains fairness even as things change. Startup companies change all the time. People come and go, strategies change, they consume cash (when it's available), and every day people contribute more to the company's success. The only thing that doesn't change about startups is the fact that they are always changing.

I wrote this guide to make the case for a dynamic split for people unfamiliar with the model who might be considering getting involved with a company that uses the model. If you have the opportunity to participate in a startup company that uses the dynamic equity system outlined in *Slicing Pie*, you have the rare privilege of getting involved with a group of people who value fairness and want everyone to get what they deserve.

The model in *Slicing Pie* is called a **Grunt Fund** and, if you follow the rules, each person will get *exactly* what they deserve to get—including you. From the moment you start working with a startup you begin to accrue your share of the pie. Your interests will be perfectly aligned with the other members of the team, so if you like the team and the business, you can rest assured that your money, time or other contributions will be handled with perfect fairness. If you don't like the team, you can leave and the termination rules (mentioned below) kick in and everyone is still happy.



A Grunt

The Fairness Equation

Most people would agree that the following calculation is fair:

$$\text{Your Share \%} = \frac{\text{The Value of Your Contribution}}{\text{The Total Value}}$$

So, if you invested \$100,000 in a company that has a post-money valuation of \$1,000,000 you would have 10%:

$$10\% = \frac{\$100,000}{\$1,000,000}$$

This is fair. You get a percentage that is in proportion to what you contributed. Most people would agree that the following calculation is *not* fair:

$$\text{Your Share \%} < \frac{\text{The Value of Your Contribution}}{\text{The Total Value}}$$

In this case your share is *less* than you deserve. This is probably *not* okay with you. If you have *less* than you deserve it means there is someone out there who has *more* than they deserve and they got it at *your* personal expense. The greater the personal expense the more upsetting this will be. You might even try to figure out who got more than their fair share and try to get some back with your posse of highly-paid attorney's (if you can afford them). This happens all the time. (Have you seen the **Facebook movie?**)

Even if you *agreed* to this arrangement in advance, it's still not really fair. The only reason people agree to this kind of treatment is if they had no other choice or if they didn't know any better. This, too, happens all the time. People have a habit of taking advantage of others when they sense desperation or ignorance.

If you've ever been caught on the short end of this equation (as many of us have) you are probably going to try to avoid this situation in the future by making sure you cover your own butt. The greater the pain you endured, the greater your interest will be in covering your own butt even if it means someone else has to lose. This leads us to the other calculation that is also *not* fair:

$$\text{Your Share \%} > \frac{\text{The Value of Your Contribution}}{\text{The Total Value}}$$

In this case you have *more* than you deserve. In many cases the more money, knowledge or power one person has over the other person the greater their share will be at the expense of the other.

This may be okay with you if you are comfortable with the fact that someone else, who deserved more, had to take less so that you could have more than you

deserved. If this is you then a dynamic model isn't for you and you should not participate in one. There are plenty of opportunities out there for you to take advantage of others. Thank you for reading this far. I hope you have a nice day. You can stop reading now.

Personal Soapbox

This is about business, not politics. I'm not a bleeding-heart liberal or a socialist or a communist. I am a capitalist which means I believe in private ownership of the means of production. My goals are to determine the *fair* division of ownership.

I am an advocate of fairness. I believe that every person deserves what they deserve. No more and no less. I don't want to work with people who want to take advantage of me or others, and I don't want to take advantage of others myself. I want to reward the people who help me get to where I'm going.

Given the current startup funding landscape, this goal is hard to achieve. We live in a world where it is so common for people to take advantage of one another that we don't even realize we are doing it!

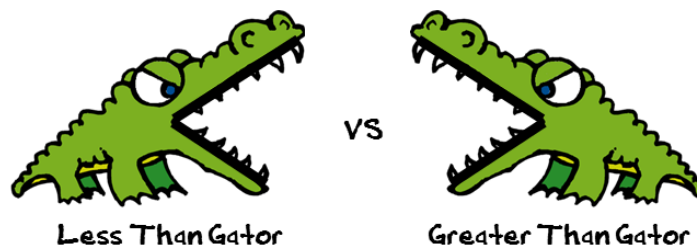
Alligators and Why We Have Them

Today nearly every startup company uses a pre-negotiated *fixed* equity split. In a fixed split equity is doled out to participants based in chunks, based on their potential contribution. This is kind of like paying someone their annual salary on their first day of work because they told us they were going to work hard. If it sounds silly, it is. But it happens all the time.

It's nearly impossible to create a fair fixed equity split. And even if you could, because startups change, the split that was right one day will be wrong the next. This means that in nearly every startup investment there are less-than alligators (<) representing people who have less than they deserve and greater-than alligators (>) representing people who have more than they deserve. In a fixed equity split every deal is an alligator pit.

In an effort to protect ourselves from the snarling alligators that gnash their teeth and swing their tails, we invent concepts like vesting, oppressive liquidation preferences and the dreaded full-ratchet anti-dilution. Our attempts to protect ourselves from the alligator pits are expensive, time consuming and often exacerbate the very problems we are trying to solve.

When we approach the alligator pit we do it with fear, mistrust and a keen instinct towards self-preservation. These are not the best building blocks for creating an



awesome company. The only real way to get them gators off our backs is to use the perfectly fair calculation which, as you may remember, is:

$$\text{Your Share \%} = \frac{\text{The Value of Your Contribution}}{\text{The Total Value}}$$

Of course, now we have a new set of problems. Specifically:

1. What is the value of your contribution?
2. What is the total value?

If it weren't for these two problems this thing would be easy. Because of these problems it's back to the alligator pit. We have to negotiate the value of our contribution and we have to negotiate the total value of the firm. Both of the answers to these questions will no doubt be based on a complex set of assumptions with virtually no grounding in reality. Try as we might, our numbers will be wild guesses at best. At worst they will be overly optimistic fantasies of our meteoric rise to fame and fortune.

Even if we could get the number perfectly accurate we will have to jump back in the alligator pit when something changes with regard to the amount of time, money or other resources that are contributed. It's always a big, bloody frenzy of gnashing teeth and swinging tails.

Get Them Gators!

If you want to create a working environment that is dominated by trust, fairness and cooperation where everyone has aligned incentives you've got to *get them gators out of the equation*.

There is a solution and it's the one you're being offered. It's called a Grunt Fund. A Grunt Fund is a method for implementing a dynamic equity split. There are three primary components to a Grunt Fund:

1. The establishment of a logical set of calculations for determining the numerator (top or left number) and the denominator (bottom or right number) of the perfectly fair calculation.
2. The dynamic nature of the fund, meaning that it changes over time to keep it fair.
3. Termination rules which dictate what to do when someone leaves the fund.

The book *Slicing Pie* describes, in detail, how to implement a Grunt Fund. I'll provide the basics here so that you can decide how interested you are in moving forward.

To be clear, this just a *basic primer* on the topic, *Slicing Pie* goes into much more detail. I won't be covering things like legal issues or tax issues or other nuances of the program. Those things are explained in the book. Remember, the purpose of this guide is to convince you that a using a dynamic equity split is a good thing.

Not All Equity is Equal

Equity is ownership in a company or at least a set of rights to the underlying assets or profits in a company. At different stages in a company's life it has different purposes. In some cases equity is used as an investment tool that can be bought or sold or used to provide cash flow to owners in the form of dividends. In some cases it's used to retain key employees or provide bonuses to valued employees.

All equity represents risk, but in the case of an early stage company it represents something very specific. It represents risk that *you will never get paid* for what you contributed. This risk is high and will be accounted for in the model.

I'm talking about equity in an early-stage company that is bootstrapped. If your company has enough cash to simply buy the things you need and pay people what they deserve, you don't have to use equity. If you don't have the money, and there is a chance you will *never* have the money, equity is your next best substitute.

By the way...

It's important to note, by the way, that an individual's ability to *tolerate* risk doesn't matter, only what they *actually* risk matters. One person, who is financially secure, may be able to work for longer without pay than someone who is not financially secure. Similarly, someone with nothing to lose (like a recent college grad) may be able to work longer without pay than someone with a lot to lose (like someone with a family, home and other responsibilities).

If the person who can tolerate the risk does not take current compensation and the person who cannot tolerate does take current compensation, then the first person is *accepting* a different level of risk and should be rewarded appropriately.

In other words, risk is based on the potential of the company, not on the personal lives of participants.

Use a Proxy

Most startups are worth \$0. Even when you put money into a startup it's still usually worth nothing. Significant investments in exchange for specific chunks of equity will *imply* a valuation, but that's an alligator pit negotiation and most early-stage deals should avoid alligator pits and concentrate on building real value.

The perfectly fair calculation uses Total Value as the denominator (the bottom number). Because you can't divide anything by zero you have to have a proxy for the value. And, because *actual* value is an alligator pit negotiation we need to pick a different value. The answer is *relative* value.

Relative Value

Unlike actual value, which depends on lots of guesses that people call “assumptions,” relative value depends on simply weighing one thing against another.

Let’s say you are an experienced programmer with many successful tech projects under your belt. Your time has a value *relative* to, or compared to, a young whipper-snapper right out of college with no concrete experience doing anything.

Each of you could command a salary on the open market that is commensurate with your skills and experience. Your respective market-rate salaries would account for expected contributions to a firm’s productivity. All things being equal, your ability to add value to a company would be higher. What an experienced programmer can do in a couple of hours might take the recent grad weeks or months.

So, if you’re working in a startup company doing things for which you would otherwise get paid, you are risking your compensation. You should receive equity in proportion to the amount of risk you are taking. (Note that I said “in *proportion* to the amount,” not “in the amount.”)

If the company pays you your full market rate you are not risking anything and, therefore, deserve no equity. If the company pays you less than your market rate then you deserve equity *in proportion* to the amount that you’re not getting paid. The same goes for the recent grad.

If you are contributing cash in addition to or instead of your time you are taking a risk that you will never get your money back. In most cases it is much harder to *save* money than it is to *earn* money. A person who is earning \$100,000 a year would be hard pressed to save that amount in a year- or even ten!

Therefore, the person who contributes money to a company is taking more risk than the person who contributes time alone. Money in the bank is not really at risk, but money that has been spent towards execution of the business plan is at risk. In this case you should receive equity *in proportion* to the amount of your money that is at risk (spent).

Similarly, the relative value of a delivery truck has a lot to do with whether the truck was purchased for the company or if it has been sitting around in someone’s backyard without being used for several years. In the former case the relative value is basically cash spent. In the latter case it has more to do with retail value.

Everything Has a Relative Value

In *Slicing Pie* I provide **descriptions** of how to calculate a relative value for all kinds of possible contributions to a startup company including time, money, ideas, relationships, equipment, supplies and other important resources. Each calculation takes into account opportunity costs and premiums for risk. For instance, in the model I value cash at twice what I value time. In the Grunt Fund calculations included weighting variables that help determine relative value.

So, if we substitute relative value (which is easy to calculate) for actual value (which is impossible to calculate) we have a perfect proxy for our calculation. This:

$$\text{Your Share \%} = \frac{\text{The Value of Your Contribution}}{\text{The Total Value}}$$

Becomes:

$$\text{Your Share \%} = \frac{\text{The Relative Value of Your Contribution}}{\text{The Total Relative Value}}$$

In the book I refer to relative value as “theoretical” value because it’s just used to determine equity splits and has no bearing on actual value created. It’s important to remember that relative value is used as a *proxy* for actual value because the actual value does not exist.

Dynamic vs. Fixed

As time goes by the model readjusts to keep things in balance. This is why it’s called “dynamic.” Every day people put in more time, spend more money and generate new sales. All of these things will impact each person’s contribution and, therefore, should impact their share of the pie. This keeps everyone aligned and properly motivated.

Let’s take a simple example of a fictional company where people contribute money, time, ideas, relationships and other resources. For purposes of simplicity we will assume that each contribution has been converted to a new currency, called a Grunt Nugget (GN) that reflects the relative value of each contribution. There are two partners, Norvin and Anson. In the first quarter they each invest 100 GN (which could be any mix of money, time, ideas, etc.)

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Total	Split
Anson	100 GN				100 GN	50%
Norvin	100 GN				100 GN	50%
					200 GN	

It’s logical that they would each own 50% of this business. And, because their contributions have been converted to Grunt Nuggets, the contribution from Anson is “valued” the same as a contribution from Norvin, even though the company is probably worth nothing at this point. The next quarter Anson invests another 100 GN and Norvin invests nothing. Maybe Norvin was busy with his day job that month. Here is what would happen if the split was fixed to 50/50:

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Total	Split
Anson	100 GN	100 GN			200 GN	50%
Norvin	100 GN	0 GN			100 GN	50%
					300 GN	

In a *fixed* model Anson would have no incentive to invest the extra contribution because their split would stay 50/50. This isn't fair. Anson and Norvin would have to jump in the alligator pit and renegotiate their split. In a *dynamic* model the split would adjust based on the addition of extra contribution:

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Total	Split
Anson	100 GN	100 GN			200 GN	67%
Norvin	100 GN	0 GN			100 GN	33%
					300 GN	

This is fair and both guys are happy knowing that they each have what they should. One might argue that earlier contribution is more risky, but measuring risk in a startup is as impossible as measuring value.

What if, during the second quarter, the company's main client decides to cancel their contract? This would probably mean that the next round of contribution is actually *more* risky than earlier contributions. Considering this Anson is more cautious, but Norvin is not:

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Total	Split
Anson	100 GN	100 GN	0 GN		200 GN	40%
Norvin	100 GN	0 GN	200 GN		300 GN	60%
					500 GN	

In a dynamic model each participant still has the right share. The actual value of the company is still unknown. All that is known is how much each person contributed relative to the other person. Anson has a smaller share, but he is comfortable with it because without Norvin's contribution the company may have failed. The following quarter neither one contributes anything because the company sells for \$1,000,000.

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Total	Split
Anson	100 GN	100 GN	0 GN	0 GN	200 GN	40%
Norvin	100 GN	0 GN	200 GN	0 GN	300 GN	60%
					500 GN	

Anson gets \$400,000 and Norvin gets \$600,000. This is *exactly* what they each should have had. Neither of them could have predicted that their company would sell for \$1,000,000 in less than a year, but they each invested what was needed to move the company forward. The model was always in balance.

In most cases people attempt to negotiate, in advance, how much money, time, supplies, etc., they will need. Next they try to determine what the ultimate proceeds will be. Then they determine a fixed split. It's a nightmare. Without the dynamic feature you will be thrown into the alligator pit forced to renegotiate and renegotiate with gnashing teeth and swinging tails. Nobody wants to jump into an alligator pit.

In the dynamic model if you are investing cash, time or other resources you can rest assured that at any given time you will always have exactly what you deserve relative to every other person who will also have exactly what they deserve.

Saying Buh-Bye

One of the most disruptive events in an early-stage startup company is the departure of team members. These are often emotionally-charged times and the company winds up losing important talent that it might have to replace. It is at these times that equity splits become an issue and the alligators will rear their ugly heads.

The dynamic model is designed to seamlessly handle these situations when it comes to what is fair for both the employee and the company.

There are four different situations under which a person can leave a company:

1. Termination for cause
2. Termination *without* cause
3. Resignation for good reason
4. Resignation for *no* good reason

In some cases, such as termination for cause, the company is left in the lurch and must scramble to replace the employee and make up for lost time. In cases like this the employee bears the cost of departure which provides a *disincentive* to slack off on the job. In other cases, such as resignation for good reason, the employee acted in good faith but the company made decisions that impacted their employment. In these cases the company bears the cost of departure which provides a *disincentive* to the management team for making decisions that adversely affect employees.

Descriptions of these circumstances are outlined in *Slicing Pie*. The dynamic model will easily readjust to accommodate any kind of change so that you, the participant, will always have what you deserve.

Let's say, in our example above, that Norvin decided to bail out because he found a high-paying job somewhere else. This is resignation for no good reason. It may be a good reason to Norvin, but it's not a good reason for the company. In the dynamic model Norvin bears the brunt of the cost. In the dynamic model he would lose the equity he earned for any intangible contributions like time. (Tangible contributions like money and equipment are treated a little differently to mitigate the potential for fraud.)

For simplicity's sake, we'll pretend Norvin only contributed time to the business. When he leaves he will lose his equity. Ouch! This isn't great for Norvin, but by leaving the company must scramble to replace him and this causes a great deal of pain for the company. If he wants to keep his share he should see the project through to the end. After he leaves, Anson owns 100% of the company, but has no partner.

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Total	Split
Anson	100 GN	100 GN			200 GN	100%
Norvin						
					200 GN	

Luckily, Anson is able to find Merrily, who can replace some of the skills that Norvin had. The dynamic model easily accommodates her effort. Her contributions are converted to Grunt Nuggets and the project moves forward.

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Total	Split
Anson	100 GN	100 GN	0 GN		200 GN	67%
Norvin						0%
Merrily			100 GN		100 GN	33%
					300 GN	

It might take a little while longer for that \$1,000,000 sale to happen, but they still have a chance. You might think it's weird to simply obliterate Norvin's time, but it's actually quite logical. The proxy calculations are not reflections of actual value; they are simply ways of creating the formula. The company's actual value is still virtually nothing.

Let's say that Anson decides that the company should move to be closer to their largest client who is 500 miles away. Merrily doesn't want to uproot her family and move and decides to resign. This is resignation with good reason. In this the Anson's decision to move the company puts Merrily in a bad situation for no fault of her own. In this case the company must bear the cost of this departure. Merrily is allowed to keep her shares in the company.

When Anson gets to the new location he hires Anne to do the job that Merrily was doing.

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Total	Split
Anson	100 GN	100 GN	0 GN	100 GN	300 GN	60%
Norvin						0%
Merrily			100 GN		100 GN	20%
Anne				100 GN	100 GN	20%
					500 GN	

Once again the dynamic model adjusts to keep everything fair. Relative to the others, everyone has what they deserve. Merrily still has a piece of the company because it wouldn't have been fair to take it. Anne understands that Anson treated Merrily with fairness and is confident working with him because she knows that she will be treated fairly too. Everybody is happy. Even Norvin is happy in his new job knowing that it was his choice to leave the company and that he doesn't deserve a slice of its success because he left them hanging when they needed him.

Conclusion

The point of this little guide was to pique your interest in dynamic equity splits by acclimating you to the basics of how they work and why they are important.

If you are considering an opportunity with a company that uses a dynamic equity fund I hope that you will see the value in the model and that it perfectly aligns incentives.

Instead of wrestling alligators you can concentrate your attention on building a company with people who want to treat you fairly. Now, if you I've convinced you that dynamic equity splits are worth exploring in more detail scan or click the QR code to buy *Slicing Pie* on Amazon.com



If I haven't... drat!

About the Author

Mike Moyer is a professional entrepreneur who has started companies from scratch, joined start-up companies, helped others start companies, raised millions of dollars of start-up capital and helped sell start-up companies.



He has worked in a variety of industries ranging from vacuum cleaners, to motor home chassis, to fine wine.

Mike has a MS in Integrated Marketing Communication from Northwestern University and an MBA from the University of Chicago. He teaches Entrepreneurship at both universities.

Mike is also the author of *How to Make Colleges Want You* and *Trade Show Samurai*. Mike lives in Lake Forest, Illinois with his wife and two kids, and the Lizard of Oz.

Talk to Mike

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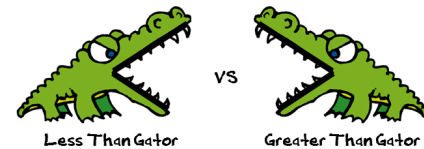
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Super-Short Explanation

Today nearly every startup company uses a pre-negotiated *fixed* equity split. Because startups change, the split that was right one day will be wrong the next. This means that in nearly every startup investment there are less-than alligators (<) representing people who have less than they deserve and greater-than alligators (>) representing people who have more than they deserve. In a fixed equity split every deal is an alligator pit.

When we approach the alligator pit we do it with fear, mistrust and a keen instinct towards self-preservation. These are not the best building blocks for creating an awesome company.

The only real way to get them gators off our backs is to use the perfectly fair equity calculation which is:



$$\text{Your Share \%} = \frac{\text{The Value of Your Contribution}}{\text{The Total Value}}$$

However, trying to negotiate actual value as required by the calculation is an alligator-pit negotiation that is virtually impossible to get right. So, instead of actual valuation we can substitute relative value as a proxy which will get us the same results. So, the new calculation is:

$$\text{Your Share \%} = \frac{\text{The Relative Value of Your Contribution}}{\text{The Total Relative Value}}$$

The book, *Slicing Pie*, outlines relative value calculations for all possible contributions to a company including time, money, ideas, relationships, equipment, supplies and other resources.

The model is dynamic because the contributions are tracked over time keeping the equity split fair, no matter what happens.

Additionally, the book outlines a set of termination rules that apply when people leave the company under different circumstances including termination with or without cause and resignation for good reason or for no good reason. This allows the model to adjust appropriately when someone leaves.

The bottom line is that dynamic equity splits, when implemented properly, are the only way to ensure that the participants in a startup company will get what they deserve. All other methods lead to alligator-pit negotiations that will chip away at working relationships and harbor resentment and mistrust among the team members.

There, that's about as short as I can make this. You now have three choices:

1. Do nothing
2. Go back to the beginning and read the whole document to get a better sense of the model
3. Read *Slicing Pie* for a complete description of how to implement