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Divvying Up Founders Equity? Why Neuroscience Trumps Math

Photo: PatrickSeabird/flickr

I have a confession to make: I once put a startup deal into a tailspin with a stupid comment.

It was more than ten years ago, and we had invested in a technology that was spinning out of MIT. The original inventors pulled in two new partners – young MBA students – and the company was working on raising its series A. Everything was going smoothly so far, and the original inventors had agreed on sharing the founders equity.

Normally an equal split wouldn't raise eyebrows, but I offhandedly asked the original founders how they had decided on equal shares when they had put years into inventing the technology and the others hadn't proven themselves yet. All of a sudden they felt cheated and things ground to a halt.

Why had I said anything? Because I wasn't sure everyone's interests were aligned for the long run. But the way I brought it up put everyone in a suspicious and indignant state of mind, and the whole partnership quickly started going south.

The issue of fairness was quite possibly going to kill the startup, when it was in everyone's best interest to make it work out.

"Fairness seems a bit like air—its absence is a lot more noticeable than its presence," says UCLA psychology professor Matthew Lieberman. Lieberman is at the vanguard of a field called social cognitive neuroscience, and his new book *Social: Why Our Brains Are Wired to Connect* (coming out next Tuesday) shares scientific evidence and anecdotes that demonstrate how our brains are uniquely structured to make us social.

At about three pounds, our brains are three times as large as a chimpanzee's relative to body weight. And, according to Lieberman, this large "encephalization quotient" is not due to our exceptional analytical abilities, as we normally believe, but because of our complex social talents.

This special social wiring is what has made humans so uniquely adaptable and successful in the animal kingdom. But sometimes our social wiring can trip us up in business and in our personal lives, and that is where things get interesting.

Take the Ultimatum Game, for example. The researcher gives one person $10 and asks her to split the money with another person any way she likes. The other person can decide whether the split is fair and whether he wants to accept the money. If he doesn't accept the money, than neither of them receive anything.

Presumably, if person A gives person B half of the $10, the second person would find it fair and happily take the money. That is usually what happens. But if person A decides to keep $9, person B will often choose to take nothing rather than accepting such a low offer of $1. Humans have such a strong sense of fairness that they would rather spite themselves out of free money than to reward the other person for unfairness.

So what does this mean when we negotiate a deal like founders equity? Howard Marks, CEO of Los Angeles startup accelerator Start Engine, often needs to help new startup teams negotiate equity shares.

"I want to invest in a structure where everyone is incentivized to contribute," he says. "I have founders come in with weird equity splits all the time. But if they have 5%, they're not really committed."

For every company that Marks considers bringing into the accelerator, he sits the whole team down together and interviews them. Sometimes one founder invests a lot of money. Or the idea is really one person's baby, with other people contributing significantly less time. The key is to discuss it completely openly and have them come up with the numbers themselves. And, in every case, he makes it a condition that every founder must have at least 20% of the

company if he's going to invest. That way everyone is happy.

Fortunately, according to Lieberman, the human brain is also wired to be generous, and it enables teams of people to do remarkable things together. For most of Start Engine's startups, the founders split their shares equally. And he makes sure that all of the shares vest over time, to make sure everyone is committed long-term.

Going back to the original MIT story, the startup founders settled on a close-to-equal equity split. They agreed on a reasonable vesting schedule, and everyone eventually ended up feeling good about the deal. The raised the series A and within two years they had sold the company and become millionaires.

I learned my lesson the hard way; negotiation can be fragile, and the psychology of the deal can be more important than the math. "I have companies where an engineer has 20% of the company and he's completely thrilled," Marks says. "What matters is how they feel at the end of the day."
