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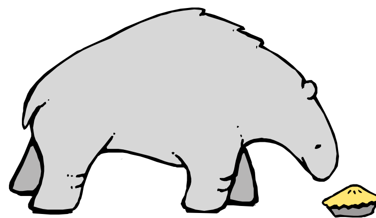

Slicing Pie

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How to Start a Business Without a Lot of Cash

By,

Mike Moyer

Introduction

Not long ago I was a guest speaker at a class in entrepreneurship at Northwestern University. One of the discussions during the class centered on what makes a successful entrepreneur. This is a question that stumped many of the students in the class. And, while they generally agreed it has something to do with money, they couldn't put their finger on it.

I've been an entrepreneur most of my career. I've been driven, for better or for worse, into new businesses or older businesses that want to change their old ways. And, while I am certainly interested in making enough money to choke a heard of wild buffalos, I know deep down that, even without the money there is another important measure of success.

All start-ups eventually cease being start-ups. They usually go out of business but sometimes they turn into companies or are bought by other companies and, thus lose their "start-up-ness". If the team that started the business is ready and willing to jump right back in and do it again, regardless of the outcome, then I think you have success.

Success means you do right by those who believed in you. Hopefully, at the end of your start-up, you all laugh so hard that $100 bills squirt out your nose. But even they don't you can all get up, dust each other off, and do it again. This time older and wiser.

Slicing Pie is short book about doing right by those who believe in you.

The Gap

Somewhere between the inception of your earth-changing idea and the investor presentation to Kleiner Perkins[1] there is a gap. During that gap you are expected to have actually built something that resembles a business enough that the gentle and kind venture capitalist will decide you have your act together and write you a fat check. I call it a "gap" because it's during this time that you can either fill the gap or you can let it consume you and your wonderful idea. Most fledgling business experience the later.

The days of back-of-the-napkin deals are over. In fact, they may never have actually existed. Few investors are willing to provide capital to a company that is little more than a rough idea or, as my mom used to say "a lick and a promise". Nowadays you need to have something worth investing in which often means a management team, a business plan, and, if you're smart, a working prototype. For bonus points get a few beta customers who are actually paying you. Now you have something worth discussing.

Putting those things together takes time and resources and, in many cases, time and resources costs money. And as you are probably aware, money is hard to come by. Sometimes the Gap is small, in

[1] Kleiner Perkins Blah Blah is one of the most successful venture capital companies in Silicon Valley.

other cases it is large. In all cases your idea will either show signs of becoming a business or it won't in which cases your dear friends at the IRS will reclassify it for you as a "hobby" and come a knockin'- but I digress.

Lucky for you, you have a tool that is a great substitute for money when you're in a pinch. It's called equity and it can help you fill the Gap and create a business starting from scratch.

Equity in a start-up company has close has virtually no value. There is no real market for start-up equity trading and you can't buy food or clothing with it. In most cases individuals can't sell it to other individuals and even if you find a willing buyer the government has all sorts of rules who can and can't invest[2]. In spite all of these obvious shortcomings you can use equity to acquire just about anything. Building a business using equity is a powerful and exciting option. It's a beautiful thing.

Equity in your start-up company can be used to pay employees, hire consultants, buy supplies and even pay rent. However, because it has no real value you will have to convince people that it will have a lot of value in the future and provide a logical explanation of how you calculated the amount of equity you are giving them. When you use equity to compensate people you need to make sure you are fair and equitable. It can be a tightrope. Doing it wrong could lead to a quick end to your business and your relationships with those involved. Doing it wrong can also cause irreparable damage your professional credibility and even wind up costing you real money. Do it right and the world is your oyster. I mean it, the world will become a giant oyster and you, my dear friend, will own the pearl.

Interestingly, little has been written about the how to use equity to build a business. It is a process that trips up even the most savvy entrepreneurs. Ask a dozen people and you'll get a dozen answers. There are lots of books about starting companies and bootstrapping and raising money and marketing and all those great things that can help your business grow. But as far as I know there is only one book about how to use equity to get your start-up off the ground and you're holding it.

A Good Business

In a good business everyone wins. The founders win because their vision is realized, the employees win because they gain meaningful employment, customers win because they receive products or services that solve their problems or make them feel good, suppliers win because they get a good client and investors win because they get a return. I think entrepreneurs should strive to create good businesses and citizens should buy from or work for good businesses. Good businesses are good for everyone.

There are other kinds of businesses. And, while I won't refer to them as "bad" businesses, they do not fit the definition of good. In these businesses someone looses. Casinos, for instance, depend on the fact that some customers will walk away losers. It's the nature of certain financial markets to create losers. These types of businesses are legitimate, but they don't help everyone and, therefore, don't fit my definition of a good business.

[2] In most cases only an Accredited Investor can invest in a start-up company.

Still, there are other kinds of businesses that I will refer to a bad. These are businesses that deliberately create losers. Most of the time these businesses are either illegal (like drug dealing) or corrupt (like Enron).

This book is about creating good businesses and, specifically, using equity to pay the brave men and women who create these businesses. Paying with equity requires that you are fair and equitable in your treatment of those who receive it. In my experience, mistreatment of early employees, by design or by accident, is the quickest way to prevent your business from becoming good. When your business' success was built on the failures of people who genuinely tried to help you, your business is not good. So please, as a favor to entrepreneurs everywhere, build your business with the intent of it being good and build a solid foundation from day one.

To do this, let's start at the beginning…

That Little Awkward Conversation

I've seen it before and I'll see it again. A couple of people have a great idea for a new business. They get excited. They start hashing out the details. They build a prototype and speak with a few potential customers. The idea starts taking shape so they put together a business plan and a tidy little investor presentation. Then they start thinking about quitting their jobs and how they are going to spend all the oodles and oodles of cash that is going to start rolling in.

Everything looks great and then, out of nowhere, the topic of equity comes up. It's been on their minds, but they put off the discussions because they don't know what to do. The conversation looks something like this:

"We need to think about how we should split up the company, you know, the stock or shares or whatever," says start-up guy one.

"Uh-huh," replies start-up guy two.

"Well, we need to do it because I'm getting my brother-in-law to set up the corporation for us. He's doing it for free but we need to pay the filing fee," says start-up guy one.

"Um, okay," says start-up guy two. "What do you want to do, I mean, how should we split it up?"

"I'm not quite sure, I thought we could talk about it."

"Okay, yeah, that's a good idea."

"So, what do you want to do?"

"Um, I don't know. What does your brother-in-law think?

And so it goes. Nobody has any idea. It's a weird conversation. Everything "else is great, but this one little conversation seems to create an unwanted awkwardness. A break in the "start-up high," that wonderful feeling you get when you embark on a new venture with people who think like you. You are one with the idea and the idea is one with you. But this little conversation seems to create a chasm that, if you could just get over it, you would be well on your way to acquiring Google in a hostile takeover in year three.

How I Hope You Will Use this Book

This book is designed alleviate that awkward little conversation that, if handled improperly, can create a rift in your little blossoming company that may never be overcome. It is designed to create a common understanding between you and your partners and your early employees. It is designed to help you make the right decisions at the get-go.

I hope, that when you bring on a new person or partner or vendor, you will hand them a copy of this book and say, "here, this is how we're going to get compensated until we raise our first round of financing[3]." Bang- the awkward conversation is addressed and tackled.

Using this book as a guideline for how you will pay people with equity in your company will save you a lot of time and a lot of anxiety. It will reward you and your team for hard work and, in the long run, it will make sure everyone gets what they deserve.

That's it, simple as pie. Boy, I wish someone had handed me this book when I joined or started probably a dozen businesses over the past twenty years. Man; that would have saved me a lot of headaches. I've created this book this book is because *I* want a book *I* can hand to someone before they get involved in one of my businesses. I need this book to solve my own business problems. In fact, as I write, I have two businesses on my mind that are facing *exactly* the issues that this book is designed to address. I figured I can hash it out separately with each one of them or I can write a little book about it and share it with you. You win.

The Disgruntled Millionaire

Not long ago I had lunch with a man who had recently become a millionaire after the company he worked for was sold for hundreds of millions of dollars. He was an early employee and was now rich beyond his wildest dreams.

In spite of his financial gain, the man was complaining about the deal. He said that while he was happy that he now had a nice nest egg, he would have gotten a lot more if he hadn't been *screwed* by the company's owner. While he *only* made a few million dollars the company's owner had made almost one hundred million dollars. His resentment can be traced back to the early days of the business when

[3] Or until the company sells, merges, goes public, builds significant value or other major financial event.

early equity was being allocated. He didn't feel that he receive a percent of the equity that properly reflected his contribution.

Wow, I thought. Here is a man who four years ago was headed towards retirement on social security and a meager pension. He is now a millionaire and can retire in style yet all he can think about is how he resents the man who helped put him there. I'm sure he will get over it and move on, but it's a shame that such a happy time should be sullied by resentment and anger. This unfortunate resentment can be traced back to the early days of the company when the founded misallocated the company's equity to the early members of the team.

This scenario plays out time and time again. A new company hits it big and interpersonal relationships become strained because many people feel undervalued. The biggest wins go to the people with the largest equity stake in the company. And, while not every employee should have nor expect to be granted equity in a company, very early participants often feel entitled especially if they see concrete evidence of their contribution.

After the deal, the participants go their separate ways. Unfortunately, they are the people who should stay and try again. After all, they had one successful deal, why not create another?

As a rule, people expect to be treated fairly. They expect their contribution will not only be valued, but rewarded in a manner that is consistent with the rewards of others. In my experience, nothing causes more damage to business relationships than when there is a perception of unfair or inconsistent compensation and reward practices.

In my experience I've found that it's not *really* about the money. It's frustrating how often people think money is a motivator. It's very difficult to refute, but I know that money is only a part of the equation. People want to know that their contribution is important and valued. And, they want some kind of evidence that that is the case. They want *proof* that they are a valued contributor on the team.

I once joined a technology company as the vice president of marketing. I inherited a team built by the previous vice president. Fair compensation is generally what the market will bear. Most of the members of my staff earned $50,000-$60,000 per year which was what the going rate for marketing managers was at the time. One woman, "Michelle", earned around $32,000 in spite of the fact that her experience and responsibilities were on par, or greater, than the other members of her team. I guess she just didn't negotiate very well when she got the initial offer.

Annual raises were due about six months after I arrived, however, the CEO put a freeze on salaries until financial performance of the company improved. Nobody got raises that year—except for Michelle. I knew that she knew she wasn't making as much as her peers and I could feel the subtle tension; especially as I gave her more well-deserved responsibility. I sat down with the CEO and went over my team's compensation vis-à-vis their responsibilities. He agreed that Michelle was underpaid and we gave her an increase of over 50%. Later, Michelle confided to me that she had been looking for

another job even though she loved her current job. She felt undervalued and her low salary was the evidence. By bringing her compensation more in line with what we both expected, the relationship was saved. She was still paid less than she probably could have earned elsewhere, but her compensation was fair relative to other members of the department.

Another member of the team, “Nina”, was the highest-paid person in the department. She was upset by my arrival because she felt that she should have been promoted into the position that I was hired for. She felt undervalued by the company and decided to “get even” with me by trying to discredit me within the company and convince them that they hired the wrong guy. That behavior, combined with her relatively low level of productivity, led me to the decision to fire her. She wanted a raise and a promotion, but it wasn’t possible. If she had been a productive employee I would have tried to find other ways of showing her that her contribution was valued.

Yet another member of the team, Adam, felt that his efforts were valued and appreciated. Several years later I hired Adam at a company that I started where he was initially compensated using an early version of the model described in this book. The company eventually lost funding and Adam’s equity was worth nothing. However, he felt like he was treated fairly and he and I remained friends. Several years later I introduced Adam to another company I worked for where he was hired on in a good position. I hope he and I can work together again someday I trust him and I’m pretty sure he trusts me. I haven’t made him a millionaire, but I’ve tried and he knows it.

While it’s true that salary information is kept confidential and the above case was no exception. However, people aren’t dumb. They usually have a sense for where they stand. Nina, for example, had more expensive clothes and took cool vacations while Michelle couldn’t afford those things. Michelle could tell that Nina was paid more and she felt justifiably slighted.

A Falling Out

Whenever I hear of two people in a business relationship that have a “falling out” I usually start looking for the answer to the question “who screwed who?” When a falling out occurs it generally means that at least one person in the relationship didn’t feel as if they were treated fairly. And, rather than coming to an equitable agreement they simply stop working. Both leave the relationship angrily justifying why the other person was wrong. Even in situations that the individuals would describe as “amicable”, there is usually anger and resentment.

I recently sat next to a woman on an airplane who, after learning about the concept for this book, spent the next hour telling me about how she had recently had a “falling out” with a business partner. Several years ago she was hired by a wealthy man to start a company. Based on the man’s vision, she designed the technology, wrote the business plan, hired the staff, acquired the customers and operated the company for two years. They were meeting their projections and had a great working relationship. Then, out of nowhere, he terminated her employment with no real explanation. He reneged on her employment agreement and took back all her vested stock. In short, she got screwed by

what sounds like an arrogant bastard. She calls it "amicable" but she secretly wishes that he would die a slow, painful death.

Stories like this make my blood boil. I've been in situations like this before. I've been on the receiving end of blows like this and, if you haven't been there yourself, let me say this: it sucks. A lot. And, if you haven't been there yourself, just wait. I hate to say it, but it will probably happen to you. I hope this book will help mitigate or eliminate your chances.

The reason I'm so angered by the general unfair treatment of fellow entrepreneurs is because of the horrible disservice I believe it does for our way of life. By "our" I mean all mankind.

The life of an entrepreneur, especially a career entrepreneur[4], is exciting and meaningful. Entrepreneurs spend their careers, or at least part of their careers, trying to improve people's lives. Not just their lives of their customers, but also the lives of their employees and, of course, their investors.

Entrepreneurship is a noble profession. According to Carl J. Schramm, president and CEO of the Ewing Marion Kauffman Foundation, "Entrepreneurs give security to other people; they are the generators of social welfare." The country needs entrepreneurs, the world needs entrepreneurs. Without them not much would happen.

In spite of the exciting life and important role of entrepreneurs, most people never become entrepreneurs. To most people the life is too risky. Most people can't handle the ambiguity. Most people are afraid of failure. Every entrepreneur fails more often than they succeed.

Failure is how an entrepreneur learns. In the start-up life there are lessons that help you become a better entrepreneur and lessons that force you to become a worse entrepreneur. *Good lessons* are those that stem from failure related to how you and your team ran the business.

Good lessons improve an entrepreneur's chances for future success. If you created a product that nobody wants, you will have learned to listen to customers in the future. If your marketing didn't work you will learn to communicate better in the future. If your employees leave you, you will learn to be a better manager in the future. If you run out of money, you will learn to better manage cash in the future. If a competitor comes out of nowhere and hands you your ass on a plate, you will learn to be more mindful of the market in the future and create a brand that will insulate you from the competition. In fact, just about any failure that comes in the normal course of creating a business will ultimately make the entrepreneur stronger. They will learn to be better predictors and better responders in the future. In the start-up world this kind of failure begets success. These are good lessons.

Bad lessons, on the other hand, decrease an entrepreneur's chances for success. Bad lessons generally stem from failure related to getting screwed by your partners. "Getting screwed" is a harsh term, but it captures a point that is important to understand. Being an entrepreneur requires a great

[4] A person who starts or works in entrepreneurial ventures, also called a "serial" entrepreneur

amount of trust and confidence. It requires bold moves and big ideas that change the way people think about life. When an entrepreneur becomes less confident and less trusting their effectiveness diminishes. When they get screwed by their partners they do learn, but they learn bad lessons. They learn to spend more time covering their own butts. They learn to spend more time and money writing contracts and agreements. They learn to move more slowly and take fewer risks. They learn to be less like an entrepreneur and more like everyone else.

When an entrepreneur is screwed by people they should be able to trust they are demoralized. It saps their confidence. They feel stupid and become bitter. Worse yet, their families lose confidence in them and become less supportive.

Inasmuch as failure is inevitable for entrepreneurs, getting screwed is also inevitable. However, getting screwed doesn't have to be part of the equation and I believe there are very positive and productive ways to mitigate the long-term damage. In many cases getting screwed is a byproduct of ignorance rather than a product of arrogance.

Entrepreneurship and the Zero-Sum Game

There are people in this world (I've met them and even worked with them) who relish the opportunity to screw another person. They are people who live to play the Zero-Sum Game. Hollywood glamorizes the high-powered businessman who squashes the little guy by pulling the wool over his eyes. Or, they glamorize the little guy who "sticks it to the man" who has been keeping him down. Either way, part of the effort is to gain at another person's expense.

The fundamental problem with this approach is that in there is no value creation, no growth and no expansion. The pie stays the same. I get $100; you lose $100- what good was done? Have jobs been created? Has the net happiness of mankind been positively influenced? Were there positive lessons that took place or did the loser simply learn to trust less, risk less, and cover their butts in the future? Is the winner really better off on their new boat if the loser goes bankrupt? Is that the American way? Does it build the foundation for a healthy society?

Good entrepreneurs don't play the Zero-Sum Game. They play a different game where everyone wins. They will, the customer wins, the employees win, the investors win, and the economy wins. True entrepreneurs aren't so arrogant that they believe they deserve success at someone else's expense. That doesn't mean they don't compete. That doesn't mean they don't play to win. That doesn't mean they don't want to drive their competition out of business. However, completion is fair play. Failure arising from *fair* competition teaches good lessons.

I once hired a salesperson from a competitive company. The salesperson showed up on his first day of work with a thick document that listed all of the competition's customers, contact information, pricing terms and revenue for each. It was information that was extremely valuable. However, I asked to take it out of the office and disregard it. It was okay for him to leverage his skills and relationships, but it was not okay to use confidential information that was essentially stolen from another firm. The reason is

simple- it's not fair. I don't blame the guy for wanting it. He wanted to hit the ground running and impress his new employer. Heck, I wanted it too, but I knew it wasn't right. Good competition is fair competition. Cheating to win isn't really winning. It doesn't teach good lessons.

Equity- A Root Cause

This book is about a fair way to pay people with equity because, in my experience, it is a root cause of unfair treatment and, ultimately, screwing. In some cases founders *deliberately* screw their partners, but in most cases the problem is inadvertent. The founder makes mistakes and it appears as if they screwed their partners even though that wasn't the intent. As in the case of the disgruntled millionaire above, the intent of the founder was to treat everyone fairly. But, due to a few bad decisions early on, there was a perception of deliberate injustice.

Entrepreneurs, even professional entrepreneurs, like myself, who start business after business don't really go through the start-up process that many times—maybe four or five times in a career. Few people have very much experience doing the "equity shuffle" and mistakes are bound to be made, especially unintentional mistakes.

The Fine Line between Greed and Generosity

When dealing with complex business problems. I like to think about how it might be solved on the playground. I'm often struck by the shear brilliance of the way kids divide things, like a piece of pie, for instance. One kid slices the pie in half, the other kid gets to pick his half first. The first kid takes extra care in slicing the pie so that both halves are exactly the same. He measures and eyeballs and slices oh-so-carefully to ensure perfection.

Similarly, the other kid measures and eyeballs and picks oh-so-carefully to ensure maximum enjoyment of his half of the pie. Both parties generally leave the transaction confident that justice and fairness was delivered.

This is a perfect example of a rudimentary business transaction that shows the fine line between greed and generosity. Neither kid wants the other to have more than their fair share. In fact, neither kid wants *either* of them to have their fair share.

Sometimes the slicer makes a mistake and cuts to unequal halves. As long as the difference is small there is no harm done. However, sometimes the difference is significant. Now the onus is on the picker. If the picker acts out of greed and picks the larger share they might feel bad about getting more. If they act out of generosity they may feel bad about getting less. Likewise, the slicer who winds up with the smaller half will feel bad they didn't get more and, if they get the larger half they might feel unfairly indebted to the other kid.

Rarely, will the slicing kid create two unequal halves (if she can avoid it) and rarely will the picking kid choose the smaller half. It just doesn't happen. If the slicing kid inadvertently cuts unequal shares she will feel bad that the chooser took the bigger share.

To expunge himself of this burden, the picker may pick the larger piece, tear off a hunk, and put it on the slicer's plate. In these cases

While it can be argued that acting out of generosity may make the generous person *feel* better. Remember, however, this is a business transaction, not a charitable transaction. If the giver is not fully appreciated for the act by the other party the relationship will deteriorate. I once saw a beggar on the street holding a sign that said "hungry". I gave him a sandwich and he *threw* it at me. I didn't help that guy again.

The more accurately the slicer slices the more likely the transaction won't result in a playground brawl. The same holds true in business. When people involved in a business transaction perceive unfairness interpersonal problems are created that may be difficult, if not impossible, to overcome.

Let's Be Partners!

My first business partnership was formed when I was in the third grade. I started a local newspaper with a friend of mine called *The Moyer Globe*. We didn't talk much about how we would split up the profits and we had no idea what equity even was, we just knew the local community needed a better way to get their news than that silly grown-up paper aka *The Boston Globe*. We both believed this and so we both started working towards a common goal. For the first few months, things were great. Subscriptions sold like hotcakes. Everybody, it seemed, loved our fledging publication and wanted to support us. They often paid more for a subscription than we were asking. Life was good.

As circulation grew so did editorial content. What was once more or less a newsletter was growing rapidly. This increased the complexity of the endeavor and, unfortunately, the costs increased as well. We didn't anticipate the higher costs when we sold early subscriptions so we started running into serious cash flow problems. To make matters worse, our printing vendor (the photocopier at the public library) was way too expensive at ten cents a page. Pressure mounted.

It all came to a head when I found that our next run was going to run over budget- by about $35.00. I called my partner on evening and told him that we had to figure out how to come up with the money. I had about $10 from the subscriptions I sold and I arranged to personally guarantee a loan for another $15.00 which was essentially an advance on my allowance (for a long time). I figured my partner probably still had some money from the subscriptions he sold and might be able to get the rest from his allowance or his grandma who was always, it seemed, flush with cash. I could tell he was nervous. He knew we had gotten in over our heads. I knew I was willing to put it all on the line. The paper was good and I was proud of it. Our circulation was doubling every month. I wasn't about to give up.

My partner told me he would have to get back to me. The next day I saw him. I could tell by his face that he had not been able to come up with the cash. I was prepared for that. But I wasn't prepared for what happened next.

He told me he was out of the partnership and that I had to go it alone. He left me holding the bag. His explanation was simple and curt; "my grandma didn't have any money in her purse. She said maybe next Saturday. I asked my dad and told him what happened. Now he won't let me do it anymore."

I asked him for the money he had from selling subscription. He said he had spent it already and, besides, it was his because he was the one who sold the subscriptions. Even then I understood the flaw in the logic, but as a mere third-grader I lacked a meaningful response. I was in shock. We had spent hours writing articles about Legos and drawing cartoons. Our classmates had contributed movie reviews and columns. How could he just up and leave? How could he make all the problems mine? How he keep the money that I so desperately needed to print the paper? What was to become of my beloved *Moyer Globe*?

The next day I made an appointment with the principle of my school. He was the most powerful person I had ever known. My intent was to see if I could use the photocopier in the library to print my paper. I made my pitch. It fell flat. He hemmed and hawed about printing costs and stencils (whatever the hell those are) and how it wouldn't be fair for a student to make so many copies when most students just made one at a time. I pleaded with him and eventually convinced him to allow me to use the copiers; but I had to turn over my cash—all of it—to my teacher for used on a class project. She used it to buy watermelons (crap.)

I raised more money by selling more subscriptions and I saved on the next issue by reducing the size of the paper. I had over 100 subscribers. I eventually realized that none of them expected me to actually deliver a paper. They thought I was playing a game or something. In the end I ran the paper into the summer and then let it go. I couldn't make any real money and I was getting sick of making all the deliveries. I used the cash to start up a chain of lemonade stands on the 4th of July on my street. I made enough money to buy a sweet bike.

It was tough for my partner and me to remain friends after that. Time passed and we did hang out from time to time, but we drifted apart as most third-grade friends do. I don't even remember what happened to him, but I'll always remember how I felt when he dropped out of the company.

This wasn't the first time I'd been burned in a business transaction. When I was in the first grade me and a friend pooled our money to buy candy- he ate it. Being slighted financially carries with it an extra sting that is hard to forget. As we grow older the stakes get higher and the sting gets stingier. The most stingy stingers of recent years are those of Enron, Worldcom, and that college roommate of mine who still owes me $75 for the phone bill[5].

Since my childhood days I've been involved in many, many different start-ups. In some cases I started the company from scratch and bootstrapped, in some cases I built new divisions or departments

[5] Pay up you bastard!

for existing companies, in some cases I raised millions of dollars. I've also served as an advisor and a coach to countless start-up teams and would-be entrepreneurs. In all that time the most prominent reoccurring theme in damaged relationships has been that of perceived unfair compensation. Just this week I spoke to a friend of mine who had a falling out with another friend of mine. His comment: "that jerk still owes me money."

Partners and Equity

When two or more people form a partnership it is because they want to share the risk of a new venture. If I hire you to clean my house, we are not partners. I am your employer and you are my employee. If I ask you to be my partner it implies we are going to work together in some way to build value and reap the benefits later on. If I need my house cleaned there is no partnership. However, I can partner with you to clean someone else's house and we can split the money somehow. Herein lies the problem.

Because we get paid when the job is complete, we work for nothing until it's over. So, as we clean we are essentially building equity in an asset (clean house) that will eventually be converted to cash when the owner of the house pays us. Now the owner gets the clean house and we get our money. So the question is, how much do we each get?

"How much do we each get?" is the most dangerous question of all business questions. It causes more problems than any other question I have found. It is most dangerous in situations where the contribution of the individual has a material impact on the outcome. Here is what I mean: in the above example, the housecleaning partners have to figure out how to split the money. This decision, more than any other decision they will make, will determine their ongoing success or failure. Doing this right is really hard.

Let's say we decide to "keep it simple" and split the job 50/50. I show up with a bucket full of cleaning supplies that cost me about $10, you show up with nothing. I work my ass off for three hours cleaning the kitchen and the bathrooms and you sweep the hall. The job pays $50. I get $25 which, after I subtract the cost of the supplies nets me $15. You get $25—all profit for hardly any work.

Let's say we decide to determine the split after we get paid. I think I deserve $10 for the supplies, plus $5 for my time in getting the supplies, plus $5 for getting the gig and $10 an hour for my work. So, after three hours of work I think I should get $50. You think that compensating me for my supplies is fair, but it's only worth $1. Plus, you want $10 too because you have more cleaning experience than I do. At the end of the day we have an issue that can't be solved.

So what happens? In either case the relationship deteriorates and we will either have to solve our differences or split up.

Sometimes you luck out. If we both brought our own supplies and we both did our fair share of the work we would both be happy with $25. As long as we keep doing our fair share, life is good. But

what if you get sick? What if I get tired of cleaning houses? What if I stop caring? What if your sister wants to join us? What if, what if, what if?

Partnerships are fragile relationships. Most fail. Many of them fail because of the partners' in ability to answer this question. This week I coached a team of high school students who have a great idea for a great business. They decided to split the business in four equal parts. Since they started two of them have lost interest in the business and two of them are working hard. Now what? They are all equal partners. Should the two that left get to keep their share? It's a shame that they are facing these issues before their company has even had a chance. I hope they can work through it. I've seen a lot of companies that couldn't.

Equity Allocation

Equity is essentially ownership in an asset that produces cash, will someday produce case (hopefully) or can be converted into cash by selling it at a later date. So when you own equity in something you have a right to the future cash it produces. It's pretty simple- right?

The problem with equity is that it is very difficult value because most of us can't predict the future. Some of us are better at it than others, but at the end of the day the future is all based on assumptions. Businesses operate on a complex web of assumptions, some of which are grounded in historical trends. Start-up businesses are pretty much all assumptions.

If I own a lemonade stand how much is it worth? The stand itself and the supplies may have cost $100, but that doesn't mean I can sell it for $100. If it's hot I may be able to sell $100 worth of lemonade, but that doesn't mean it's not going to rain. So, I have to make some assumptions. I'm going to assume that I can sell the equipment and supplies for about what similar stands are selling on Ebay.com- $50 for the stand and $20 for the supplies. Next, I check the weather and it gives a 20% chance of rain. So, I'm going to take that into account and bet that I'll make $80. I'll use up the supplies so they won't be around to sell later. I'll call the stand worth $50 + $80 or $130. That's how much the stand is worth in the next 24 hours. As you can see, there are a lot of factors. If I want you to be my partner, we're going to have to work through these scenarios and agree on which one we like. There are no guarantees. I may not be able to sell on Ebay, it might rain, or I might get robbed- who knows?

Let's say I don't own the stand. You do. Then it doesn't matter how much it's worth as long as I get paid what I earn. But, sometimes you will want to pay me based on the performance of the business which is a combination of my sales skills plus your equipment. You could pay me on commission, but you would rather reinvest the money into the business. One way to get me to work without giving me cash is to allocate some of the equity to me. You are allocating a percent of the rights to the future cash the business generates either by selling lemonade or by selling the stand and supplies.

By accepting equity instead of cash I am assuming the risk that I might never get paid. So, I'm going to accept equity (future cash) that I believe will be worth more than what I would otherwise get paid (current cash). Figuring this out, even for a simple lemonade stand, is complicated.

Slicing Pie

Allocating equity, otherwise known as "Slicing the Pie" is tricky. And, as we've discussed so far, it can not only cause irreparable damage to otherwise important business relationships, but also it can prevent an otherwise good business from even getting started.

In order to understand how to slice the pie, you first need to understand a few things about the pie itself. Unlike apple pies, equity pies can grow and grow and grow.

All Pie is Created Equal

In the beginning, all pies are worth nothing. They start out as just an idea. Some guy[6] is sitting at his desk or on the toilet, or in bed, or in the car, or in the shower, or on a plane, or in the hall, or at lunch or somewhere else and his mind wanders, he thinks about a problem and a clever solution. So clever, in fact, that he begins to think it make a great business. The more he thinks about the clever idea the more convinced he becomes that there is money to be made. He gets excited. And, before long, he is convinced that he is only a few short years away from acquiring Google.

If you remember nothing from this book, remember this: all pies, and therefore equity, are *worth nothing* when they are first created. Pies are essentially ideas and ideas are pretty much worthless. All too often a would-be entrepreneur is so convinced that her idea is going to be "the next big thing" that she locks it away, telling no one from fear it will be stolen. I've seen it time and time again. Someone will allude to a great idea and get all weird a secretive when you ask them about it.

I once knew a guy who kept an idea for a new kind of paintbrush secret for years. Finally, after much prodding, he told me about it. "Cool," I said. I told him that I knew some guys who could help develop it a little further and he agreed to let me talk about it. The next week I came back with a working prototype of the brush and it worked exactly as described. Now all he needed to do was manufacture it, build an inventory, create a fulfillment operation, create a brand, marketing plan, build a sales force, raise money and a million other things that the idea needed in order for it to become valuable. I guess he didn't want to do those things because the idea still remains a prototype, locked in a closet somewhere. By the way, I'm not trying to be critical here. Like most people he has better or more important things to do than build a paintbrush company from scratch.

I knew another guy who had an invention. It was for a new kind of CD case. He built a working prototype and wanted to sell the idea to a CD manufacturer who could turn the idea into something valuable. The company offered him $50,000 for the right to make the cases. Then somebody told the guy that the person who invented the original jewel case made ten million dollars. It was a totally unsubstantiated claim but it was enough to convince the guy to turn down the $50,000 and spend the next two years and about $15,000 getting a patent on the concept. By the time the guy had the patent

[6] Or, of course, some girl

the company was no longer interested. Now the guy has a $15,000 patent that is worth nothing because he can't make it, market it or do any of the other things needed to make money.

But wait! I just said ideas are worthless and now I'm saying that some guy got a $50,000 offer for one? I'm still right, ideas are virtually worthless. My friend had more than an idea, he had working prototypes. He was also quite lucky. If the planets align just right something like this may materialize- don't bank on it—it is the exception, not the norm. Besides, the guy blew it because he thought he could make more. Take my advice, if anyone offers you any money for your thoughts- take the money and run!

When a company offers you money for your idea it is generally in the form of a royalty payment. However, rarely, if ever, does a company pay for a back-of-the-napkin concept alone. The idea has to have a little meat on the bones in the form of a market analysis, prototype, business plan, or patent. In these cases they aren't buying the idea, they are buying the opportunity of which the idea is a part.

Ideas, if you must assign a value to them, are worth about a dime a dozen. They don't become worth anything until they get baked into pies. Next, if after baking the pie, you find that people are willing to pay for the idea and you find that you can produce it for less than they are willing to pay, then (and only then) you have built value.

Sure there are stories about the guy who invented the little plastic thing pizza shops use to keep the box from squishing the pizza that made millions. Or you've heard the one about the woman who invented the "thingamabob" and retired to Hawaii. Those stories are either urban legends or exceedingly rare. Either way odds are they won't happen to your idea. Have fun waiting; I'll be over here baking pies…

How Pie is Valued

Putting a value on a company (pie) is way more art than science. For established companies investors use a variety of tools. The most popular indicators of value have to do with cash flow, revenue and earnings. People buy pies because they are assets or the buyer thinks it will become an asset. An asset is something that produces income. The value of the pie is based primarily on the amount of income it is able to generate. Because the future is uncertain there is a lot of speculation with regard to future income generation so the value of a pie can vary dramatically based on who is looking at it.

Cash-Out

At any given time, your company is worth whatever you can sell it for. If I have a lemonade stand that consistently generates $1,000 profit per year I may decide that, rather than waiting a year to get the $1,000 that I'd rather have some money right now. So, I find someone who thinks that they would like to run a lemonade stand for a living and take home $1,000 per year or more if they think they can hawk lemonade better than I can. So, I tell them that the company is worth $5,000 because I think the market will not change much or even improve (global warming) over the next five years so profits

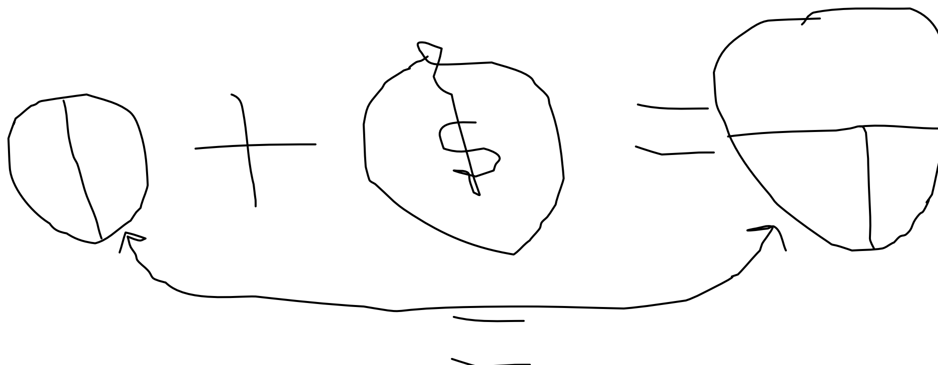
should stay the same. They think the market will change (Jamba Juice down the street) and so they offer $3,000. I say okay. They just bought my pie for $3,000. I take the money and run. In this case they just bought the whole pie from me and I cashed-out meaning I took the money out of the business. The pie now belongs to someone else. My share of the pie is 0% and the buyers share is 100%. This transaction is also known as an “exit”. Investors are always looking talking about exit strategies because they want to know how they are going to cash out of the business and take a return on their investment. In fact, all equity owners want to know the circumstances under which their equity will be cashed out.

Sometimes you can estimate a resale value on the underlying assets of a company such as buildings, machines, inventory, etc. This is useful when the company doesn’t currently generate income or if the owners think the income is less than the resale value. For instance, if my lemonade stand business owns the property on which it stands then it may be worth a lot more than $3,000.

Cash-In

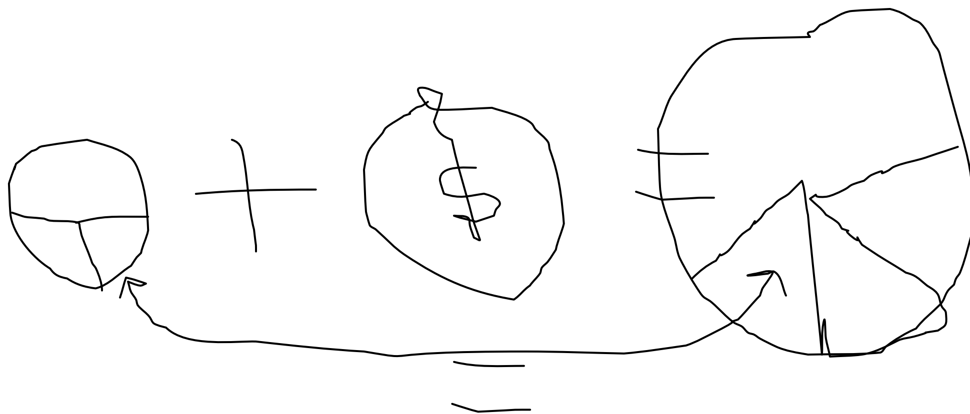
In many cases a company will want to raise working capital. In this case they want to sell a part of the pie but keep the cash in the business and retain part of the ownership themselves. This is a very typical scenario and when you put cash in a business in exchange for equity it helps set a benchmark for the company’s value. Whatever the investor paid for equity is a pretty good indicator of what the rest of the world will say it’s worth.

For instance, if an investor buys 50% of the pie for $1,000,000 the pie is now worth $2,000,000 as long as the money stays in the business opposed to being passed on to the original shareholders. So, now the pie is bigger. The original pie was worth $1 million, the investor put in another $1 million so now it is worth $2 million- get it? If you had half of the original pie your piece was valued at $500,000. Now you have 25% of the pie and it is still worth $500,000.



If a few months later someone buys half the company for $3,000,000 in the next round of financing, now the whole pie is worth $6,000,000. The original pie, before the investment, had grown to be worth $3,000,000. Now your share, which was 25% of the original pie or 12.5% of the new pie is

worth $750,000. Your equity stake has dropped from 25% to 12.5% but the value has grown to $750,000. At the end of the day, the cash value of your equity is much more interesting than you percent ownership.

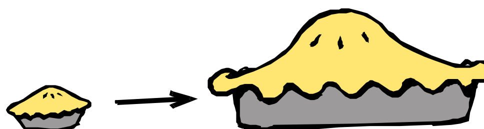


It is funny how often people lose sight of this simple concept. Pies get bigger and bigger as value grows. Equity grows and grows. People who think equity is a finite resource are wrong. I once worked for a guy who was so paranoid about giving up "all the equity" that he couldn't sleep. He was a fool.

As long as a people are willing to pay more and more for your company's equity the value of your shares will also grow- regardless of what percent ownership they represent.

Of course there are situations where companies lose value in which case you lose value too. If the next guy invested $1,000,000 for half the company instead of $3,000,000 the company would be worth $2,000,000 and your 12.5% share would be worth $250,000. Sometimes the company issues different "classes" of equity that might dilute the value of your shares. There are a number of possibilities that are beyond the scope of this book. There are people who make a nice living figuring out stuff like this- I'm not one of them.

The moral of the story- concentrate on building value and don't worry about percentages. Don't get hung up on it. Pies can grow beyond your wildest dreams. If you don't think so think Google or Microsoft.



Sometimes pies grow- this is good.

Paying with Pie

Using pie during the Gap means you will have to convince people that the pie has value before there are any real benchmarks. To do this you will have to be able to convince people that you business ideas is great and that you (with their help) will be able to turn it into some cold hard cash in the not-too-distant future.

It is important to note, before we continue, that while paying with pie can be a great way to get your business off the ground and through the Gap you must be careful not to make too many slices. In general, investors want to invest in a pie that is relatively intact. If it's not, it will be less attractive. Investors want to see that all of the shareholders are actively involved in the business. While this is not always possible when you pay with pie, we will go over some ways to keep the pie relatively intact.

The other thing you will have to do is find people who are willing to work for pie instead of cash. Not everyone is willing to assume the risk that they will never get paid. However, I think you will find that a lot of people will take pie over cash if they think they are going to be part of an exciting new venture. There is a word for people who will take pie instead of cash.

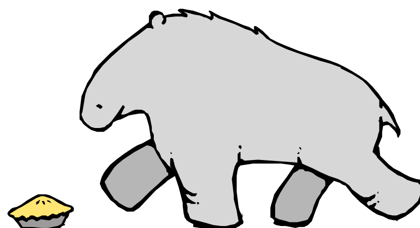
Grunts

Grunts are people who are willing to forgo cash compensation in exchange for a piece of the pie. Grunts do the work necessary to turn an idea into a reality. They will do the fun work and the dirty work. They are as comfortable licking stamps as they are building a strategic plan.

Grunts ask for little in return- usually just pie. They can generally survive in sub-standard habitats. They have been known to thrive in garages, basements and spare bedrooms. They can be found lurking in coffee shops, college campuses and even within the cubicles and offices of a day job.

Grunts don't need much. They are highly resourceful. The can act on scant little information and turn mountains into molehills. They are motivated by the dream of success.

Grunts are pack animals. They travel in herds. Rarely can a Grunt do all the work themselves so they offer some of the pie to other Grunts. If you can win the heart of a good Grunt your idea will become a reality as long as you treat the Grunt with respect and fair play.



Grunts come for the pie

Baking Pies

In order to make tasty pie you need the right ingredients. These will be provided by Grunts. You, by the way, are a Grunt too. While type of ingredients and amount of each will vary depending on the flavor of pie you are baking the basic ingredients are as follows:

- **Time**- probably the most significant ingredient that a Grunt has to offer. Many Grunts don't have a lot of money, but they have time, especially early in their career or if the previous pies they helped make didn't sell or grow they way they had hoped. Grunts dedicate time into turning ideas into pies. Not all time is created equal. The time of the experienced CTO is worth more than the junior programmer. However, both Grunts need to be treated fairly. If you have the right Grunts in the herd you will be fine.

- **Ideas**- Grunts are a fountain of ideas. Ideas for products, ideas for marketing, ideas for sales, ideas for operations. Good Grunts come to the table with lots and lots of good ideas. Remember, however, that an idea by itself has little or no value. It has to be made into pie first.

- **Relationships**- all companies need relationships. Sometimes relationships are built through the operation of the business and sometimes a Grunt brings pre-existing relationships with him or her to the table. Existing relationships can really accelerate the process and finding Grunts who have these relationships is an important part of the process.

- **Intellectual property** such as patents, trademarks and ways of doing things. As long as the Grunt has a legal right to use these assets they can be an important part of a fledgling business, especially when it comes to creating strategic advantages.

- **Cash** in the form of early working capital or covered expenses for which reimbursement is not expected. This is different than a significant angel or venture capital investment. This is money that helps get the business off the ground.

- **Loans** from the Grunt to the company that they expect to be paid back.

- **Credit** in the form of personal credit card debt or company loans that a Grunt had to personally guarantee.

- **Business-*facilitating* supplies and** equipment such as pencils, paper, personal computers or other items that make the business easier to operate efficiently. The test here is whether the business could operate at all without them. Many Grunts, for example, use their own personal laptops during the formation-stages of a business. This is an example of equipment that facilitates the business.

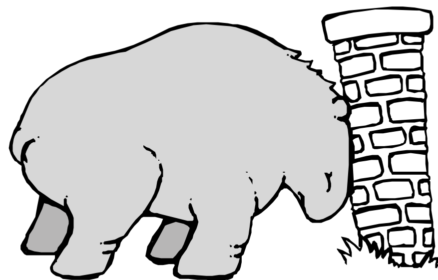
- **Business-*enabling* supplies and equipment** such as data servers, printing presses, delivery vans or other items without which the business would not be a business. For instance, if a couple of Grunts are starting a pizza shop and one of them provides a pizza oven that would be an

example of a business-enabling piece of equipment. There is often a fine line between whether supplies and equipment is business facilitating or business-enabling. It's often a judgment call. Chairs, for instance. A Grunt shouldn't expect her $1000 Aeron chair to be a business-enabling piece of equipment even though you need chairs. In most cases a $25 used office chair will serve the same purpose.

- **Facilities** that would otherwise generate income for the owner. This would include an office building, retail location, studio space or other facility that the owner would typically rent out if the start-up wasn't using it. In this case the owner has an opportunity cost of dedicating the asset to baking the pie. If all the Grunts work out of a spare room in one of the Grunt's houses this wouldn't count because the Grunt probably isn't planning on renting out the spare room in his house.

While some ingredients are more productive than others, all should be treated as if they build positive value. Why, you might ask, should I treat them all as if they build positive value? Simple- it's not fair not to. If you are paying with pie you have to be fair. If a Grunt does work on behalf of a company and that work depends to be a waste of time you still got value. Specifically, you learned that that particular activity was a waste of time and you can avoid it in the future.

A friend of mine (a Grunt), grunted away for a guy for almost two years and followed the direction of the controlling partner. One day, on a whim, the controlling partner decided to abandon the original strategy in favor of another one. He fired my friend one day and took back all the equity that my friend had earned because my friends work was not related to the new strategy. How could my friend have known? Ask yourself: is this fair?



Not all effort is productive, but it is all valuable

When a heard of Grunts agrees to dedicate their time, energy and resources towards a problem it is impossible to tell, in advance, if it is going to work. It is not fair to judge the value of the input using the benefit of hindsight. Start-up companies are risk-taking entities. By devaluing an individual Grunt's input based on hindsight you are asking that Grunt to assume the risk on behalf of the herd. You cannot allow a single Grunt to bear the burden of risk for the herd- it's not fair.

When there is a pie, Grunts will show up and help make the pie grow. A Grunt is happy sharing the pie with other Grunts as long as he or she was treated fairly in the process. In the end there will be enough for everyone if things go right. After all there is virtually no end to how big the pie can grow. If your company fails the Grunt will try again someday as long as they were treated fairly.

If you have been an entrepreneur or worked for an early-stage start-up filled with Grunts, you know there are few places on earth with more excitement, energy and passion. A heard of Grunts is a sight to be seen and a force to be reckoned with. When a Grunt is not in a herd they are often pre-occupied with trying to find one or trying to build one. Sometimes Grunts join a number of herds. Herds of Grunts are great.

The Proper Care and Feeding of Grunts

As I said before, Grunts don't ask for much. You can pay them in pie or at least partly in pie. They also need to feel as if they are part of the herd. Grunts thrive on their inclusion in the herd. That means their opinions are taken seriously their contribution is valued.

It is important to feed a Grunt the right amount of pie. If you don't feed a Grunt enough pie, they will feel undervalued and they might leave the herd. If you feed one Grunt too much pie the other Grunts may feel undervalued, give up and leave the herd. Or worse, they will feel undervalued, give up and *stay*. When Grunts give up and stay you host an environment that is plagued with resentment and low morale. Trust me when I say that these emotions are start-up *killers*.

Using equity to compensate Grunts, or slicing pie, can be one of the most important tools for attracting and maintaining a healthy herd of hard working Grunts when it is done right. When it's done wrong you will have a lot of disgruntled Grunts.

As a Grunt myself I've been the member and, in some cases, the leader of many herds. I have been in very few herds where all the members of the herd were fed properly. I have been in herds where I've been fed more than my fair share and I have been in herd where I have been fed less than my fair share. In all cases the relationships I had with other Grunts was strained.

When people slice pie they usually do it wrong. It happens for one of two reasons. They either slice the pie *before* they bake it or they slice the pie *after* they bake it.

Before

The most common mistake entrepreneurs make is slicing the pie before it is baked. In my experience this is what about 90% of people do. They "do the deal" with one another up front that way there won't be any arguments later on. This is rarely the case. There is always an argument. It may be one-sided and you may never hear about it because the Grunt left in a huff.

I was recently coaching a team of high school students who were involved in a summer camp for future entrepreneurs. There were four of them. They sliced the pie *before* they got started. Two of the

members were gung-ho about the company and two of the members developed other interests. So, two of the members did all the work and neither of them liked the fact that they had an equal share as the non-working members- would you?

I was once in a business with a guy who didn't understand the concept of growing pies. He thought equity was a finite resource as many people do. So, he set out to slice the pie for every possible Grunt that might come along. He was the worst slicer I have ever come across. Needless to say, I don't work with him anymore and I won't ever join a herd with him in it. He is a successful guy, but he just doesn't understand start-up pie very well.

The reason that slicing pie before baking pie causes so many problems is that start-ups change fast—really fast. You never know what is around the corner and it is impossible to anticipate what will happen. In order to bake and grow the pie you need the right Grunts. If you don't have the right Grunts you will have to entice them with pie. If you have already sliced the pie you will have to take pieces from the other Grunts who will think it is unfair. If the pie grows enough there is more to feed new Grunts. If it has not grown then you have to take from existing Grunts.

I've made the slicing before mistake more than once in my life and I've always regretted it. Several years ago I had an idea for a web site that was destined to change the world. I was over-eager to get it started so I made the mistake of slicing the pie before I baked it. I gave a developer 75% of the equity to build the site. I kept 25% which was fine with me because I had planned on being a silent partner. Now it's built. In order for it to have any value, however, we need to market it. I'm a marketing guy; but, as a minority shareholder I have little motivation to dedicate my time to the project. I screwed myself by slicing the pie in advance. The developer is unfairly burned too. He's a great developer, but he doesn't do marketing. Now, if we want to hire another Grunt to do the marketing work what do we do? Should I spend time finding someone and paying them out of my pocket? Should I put additional time in? Should he? Our ownership is fixed. Maybe we can give him a chunk of the equity but who will give up their pie? Remember, the pie is pretty much the same size as when we started. We have a web site, but without paying customers it's not worth much. Should I give up more of my pie or should the developer give up his? Should we each give up the same amount of pie or do we give up in proportion with our shares? It's a tough question and a tough conversation. Even if we can work though it, it will take its toll on the relationship and it will certainly come up again before we're done. I could suggest, for instance, that we start over and reallocate the pie. He will undoubtedly have less which will be at least annoying for him even though he knows that his current stake is worthless anyway. At the end of the day, the momentum and excitement has been sucked out of the business because of bad pie slicing.

You think I would have learned from this mistake. Not long after I had another idea for a new company and bounced it off a few developers. I tried to entice them into doing the development work by offering them pie. They are Grunts so they happily agreed. Again, I made the mistake of slicing the pie before the pie had been baked. When I realized that the technology component was much smaller than I had anticipated I realized I had offered too much pie. Now I have developers who think they own a huge hunk of my concept and neither of them have done any work whatsoever! That project is now stalled for

two reasons. First, I sliced the pie in advance and now I have to renegotiate with them and, second, I stopped working on the project because it gave me the idea for this book!

Vesting and Options

Vesting is a popular hedging method for those who slice the pie before baking it. Vesting is a structure under which your equity is granted according to a certain schedule. For instance, the company may give you 2,000 shares in the company with 100 shares vesting at the end of each month. At the end of the eighth month you would own 800 shares if you quit your job.

They figure if they slice up the pie and then allow it to vest over time they create a safety net if the Grunt doesn't work out. The problem is that you have to predetermine the amount of pie a Grunt will receive which means you are also trying to predetermine the value of that pie. This just doesn't work during the Gap phase of a start-up. As a company matures the value is more concrete and a vesting program can work nicely.

Companies like vesting because they think it helps retain employees. The employee has to stay a certain number of months, for instance, before their equity vests. If the employee leaves they stop vesting.

Along with vesting, it is customary for businesses to use options rather than actual equity. Options allow the Grunt to reap the financial rewards associated with equity, but avoid some of the tax implications. When you use options you are essentially keeping track of how you will slice the pie when it's time to eat. It keeps the pie whole and it keeps your knife clean.

After

Sometimes entrepreneurs anticipate the problems with slicing pie before baking the pie so they decide to slice it *after* they bake the pie. This is even worse than doing it in advance. Now that the pie is baked and has some value there will be a Grunt feeding frenzy with every Grunt trying to get the biggest piece they can get. And, to make matters worse, they are starving! They haven't been fed yet!

Some friends of mine once started a bike shop while they were in college. They all put time and energy into it and, low and behold, they made money! So, now they had a pile of cash and none of them knew what to do with it. Who did it belong to? Did they keep it in the company or split it up? Some guys did more work than other guys, plus some had spent some of their own money for marketing materials. One guy owned all the tools and the stand. One guy was a member of the bike club and a lot of the members were customers. After much ado, they chickened-out and split the money evenly. They all felt screwed. The business was over.

When you slice a pie after it is baked you are forced to make judgment calls on each other's contribution. You have to recreate what worked and what didn't work while you were baking the pie. Everyone has a different point of view so nobody agrees.

Sometimes a herd of Grunts will do a little bit of work, like writing a business plan, before they start thinking about slicing the pie. So, the pie starts baking and they start seeing the value and they all want their piece. Again, you get a feeding frenzy and a herd of disgruntled Grunts.

Whether you're slicing pie before or after it's baked you run a high risk of getting screwed or screwing someone else. It is a tightrope, even if you have the best intentions. Sometimes entrepreneurs find the right answer because they have enough experience to know what they will need, sometimes they luck out, and sometimes the pie grows so big so fast that nobody cares (like during the dot-com bubble).

However, you can't always count on these things to work in your favor and good companies with good Grunts often ruin their chances for success when they make the inevitable bad choice.

We Need a Solution

The fundamental problem with using equity as compensation is that equity (pie) has no actual value. It is highly subjective so, lacking a concrete model, entrepreneurs try to assign an actual value. This is virtually impossible at the start-up stage- anything can happen. If actual value is so unclear what is clear? The answer is *relative* value. While it's impossible to calculate actual value, it is easy to calculate relative value.

So, we Grunts need a solution. In order to solve our problem we must find a method for slicing pie that is easy to understand in addition to providing:

1. Both rewards Grunts for the ingredients they have provide and motivates them to continue to provide more ingredients
2. A fair and equitable way of slicing the pie given the *relative* values of ingredients that different Grunts provide over time
3. Flexibility in the face of constant, rapid change

Good news. A solution exists. It is called the *Grunt Method of Equity Allocation.*

The Grunt Method

Rather than slicing pie *before* the pie is baked or *after* the pie is baked and risk creating a herd of disgruntled Grunts, the Grunt Method allocates equity *while the pie is being baked* by allocating equity based on the relative, theoretical value of the ingredients at any given time[7]. Yes, this means that on any given day the pie could be sliced differently- the equity during the Gap phase remains fluid and changes from day to day. Some people think this is weird. The reality is, however, that most equity markets are relatively fluid. The stock in public companies changes every minute!

When you use the Grunt Method you allow Grunts to essentially earn equity over a period of time based on the theoretical value of the ingredients they provide. So, at any given point in time the allocation among Grunts will vary. This fluidity reflects the ever changing needs of the business as it grows.

To implement the Grunt Method, follow these simple steps:

Step One: Appoint a leader

Step Two: Assign a *theoretical* value of the ingredients provided by the various Grunts

Step Three: Calculate the equity whenever you need to based on the percentage of value contributed by each Grunt

As the pie grows, early Grunts can "harvest" some of the value they created in excess of the value they contributed by "calibrating" the pie which will allow them to invite new Grunts to join the herd or bring on an outside investor.

The Grunt Method makes some people uneasy. They like to know what they're getting into and they like the I's dotted and T's crossed. That's fine. Don't use the Grunt Method- get a job instead. A job will pay you a fixed salary and you can be around other people like you. Those who can't handle the risk and ambiguity that comes with a start-up are better off in a predictable career with a predictable salary. There's nothing wrong with that. I myself have opted for the job option more than once.

If you are a Grunt, however, you will see that the Grunt Method is the easiest and most equitable way of slicing the pie.

The Discovery of the Grunt Method

In spite of all my business and start-up experience as well as my business education, I have never heard of anyone using the Grunt Method or even something similar. I discovered pieces of the Grunt Method when I started a company several years ago on a shoestring budget[8]. I had spent almost a year as a lone

[7] Ta-da!

[8] Vicarious Communication,Inc. It *was* cool, but it's gone now (sniff)

Grunt trying to get the business off the ground. I briefly make the mistake of trying to slice the pie before it was baked when I teamed up with a classmate at the University of Chicago to enter a business plan competition. My teammate went on to other things after the competition (we won).

Before long, it became clear that I needed help baking the pie and had to find some Grunts. I had no money to pay anyone and I had no idea when I would be able to pay them. So, I made an agreement with each of them that laid the foundation of the Grunt Method.

I told each Grunt that I was trying to raise money for the business and I was making a case for a $1,000,000 pre-money valuation. I wanted to sell 50% of the company to investors for $1,000,000. I told them to keep track of the hours they spent working at the company and we agreed on an hourly rate. When I finally raised the money I converted the hours they worked into equity as part of the $1,000,000 valuation. In other words, if an employee worked 100 hours and we agreed to a $100 hourly rate, they would be given equity worth $10,000 of the $1,000,000 or 1%. For the most part, it worked. Everyone got their fair share. It wasn't perfect because I had allocated an unfair percentage to myself but the company lost the funding about a year later so it ultimately didn't matter.

In all of my experiences, that method worked the best. It was an early building block of the Grunt Method.

The Grunt Method Explained

In order to get a better grasp on how the Grunt Method works here is a little more detail on the steps and how to calculate the theoretical value.

Step One: Appoint a Leader

One of the worst ways to start a business is to split it 50/50. Businesses need leaders who are ultimately responsible for making the tough decisions. When people go in 50/50 they have to make all sorts of joint decisions and, in a tie, they waste time and damage the relationship. Someone has to call the shots. This doesn't mean they don't listen carefully to the other Grunts, it just means they need to step up to the plate and make decisions when no one else will.

Most of the time picking a leader isn't that hard. Many businesses start because one person got an idea and shared it with others. The person who cares enough about the idea to go out and take action is a good choice. I'll refer to this person as the founder. However, if the founder is smart and knows their shortcomings they may choose to assign leadership to someone with more experience or someone who can dedicate more time to the business in the beginning.

When you pick a leader you will have someone who can manage the Grunt Method and, if needed, get rid of unproductive Grunts.

A LA Mode- LLC vs. Corporations

To learn how the your legal structure can impact the Grunt Method go to SlicingPie.com and click on the Pie a la Mode.

Step Two: Assign a theoretical *value of the ingredients provided by the various Grunts*

If you've been paying attention, you will notice that I have emphasized the word *theoretical* when it comes to assigning a value to the ingredients provided by the various Grunts. This is important- very important. The contributions that Grunts make have no actual or real value, they only have theoretical value.

One reason this is important is because there is a very good chance your business will be worth diddley-squat in spite of your best efforts and those of other Grunts. However, the most important reason is because if you imply that there is an actual value of the ingredients you may find some of the Grunts want their money- even if you don't have it.

When I was using the early version of the Grunt Method in the company I described above I hired a programmer that logged about 160 hours at $50 per hour. The slacker then stopped coming to work. Several weeks later he sent me a bill for $8,000. That's a lot of money for a company that has no money. I had people who had worked for months without expectation of getting paid in cash. I had gone without an income for over a year and invested the bulk of my life savings.

To make matters worse, we couldn't find any evidence that the guy did any real work. It seemed like he was working but he wasn't there long enough to deliver anything. We found a couple of bugs on the bug log with his name on them but that's it.

He wound up pursuing the matter with the Illinois department of employment. I had to go to arbitration to settle the matter and it was a big hassle. In the end we didn't have to pay, but the lesson was learned. Make it clear that Grunts, including you, are not creating actual value, it is only theoretical and used for the purposes of calculating a percent ownership. Get it? Good.

A LA Mode- Slacker

To see some of the actual documents dealing with the employment arbitration case including a nasty email from the slacker's wife, visit SlicingPie.com and click on the Pie a La Mode.

Determining Value

Ingredients provided by Grunts have different values. It is important to have a standard method for determining this value and keep it consistent for all Grunts. If the other Grunts find out that one Grunt is being favored it will appear unfair. Don't worry; incentives for special talent are built into the methodology.

Use the following calculations to determine the *theoretical*[9] value of the following ingredients:

Time

Time is pretty much the main contribution of Grunts. It is also the most important contribution. Ideas are nothing without people willing to put the time in to turn it into a company with paying customers. Determining the value of a person's time, however, can be difficult because people often think they are worth more or less than they actually are. Getting the number "right" is less important than making sure it's fair relative to other Grunts.

Different people are worth different amounts. Clearly, the junior developer straight out of college is has a different value than a form SVP of sales for Oracle. However, depending on your company, you may need a junior developer more than you need a hot-shot sales manager. It is up to you to decide who you want to bring on board. Don't make the mistake of taking on more than you need in terms of Grunts, especially high-profile Grunts who may think they are doing you a favor by joining your company. If you choose to slice the pie before or after baking it, it's easy to over-allocate to these kinds of people.

Using the Grunt Method, the value of an individual's time is based on whatever salary you would have paid them if you had the cash *times two*. You double the amount because is assuming risk by joining an early-stage start-up. Next, divide the number by 2000 which will help you calculate the Grunt Hourly Resource Rate (GHRR!) I use 2000 hours which is 40 hours per week times 50 weeks per year. This allows for a couple of weeks vacation and it gives you a nice, round number to work with. Most Grunts work longer than 40 hours per week but it doesn't really matter. What is important is that you keep it consistent from Grunt to Grunt.

Speaking of consistency, it's okay to round the GHRR up to the nearest $10, $50 or $100. If you and your partners had similar earnings levels at your previous jobs you should consider agreeing to the same GHRR for each of you. This isn't a good time to split hairs. Come up with a rate you are comfortable with.

If the job you are hiring a Grunt work is typically paid on an hourly basis you can simply multiply their previous hourly rate times two to determine their GHRR.

[9] This is the last time I'll use italics on this word as long as you promise not to forget its importance.

Make sure you're the base salaries you use for calculations are realistic. If your company doesn't need a $300,000 CEO then don't hire a $300,000 CEO because their base rate will be too high. Additionally, don't think that just because it's you're the founder that you should earn the same GHRR as your partner who has 20 years of experience if your partners is doing a similar level of work. If I joined a company started by a high school student I would expect to have a higher GHRR. After all, I have lots of experience starting companies plus a college education and two master's degrees. It wouldn't be fair to expect me to take the same rate.

Another rule of thumb is to use a base salary that is commensurate with the job. I may be worth a six-figure salary, but if you hire me to clean the toilets (and I agree) then the base salary should be closer to that of a toilet-cleaner (albeit an experienced toilet cleaner I hope).

Summary: the theoretical value of a Grunt's time is calculated using their Grunt Hourly Resource Rate or GHRR. The GHRR is the salary you would be willing to pay if you had the cash times two divided by 2000[10]

All Grunts need to keep track of their hours on a regular basis.

If a Grunt travels a lot for the company you should calculate the travel time as ½ GHRR.

A Note about Base Salaries

When you negotiate the base salary that you will use to calculate the GHRR make sure it is a salary that you would be willing to pay if you had the cash. This is important because someday you may want to convert the Grunt to cash compensation and you don't want to pay too much or too little. In the early days founders either tend to be too generous because they desperately need the help or they tend to be too stingy because they are afraid of the future. To get it right, pretend that you have raised enough money to get your company comfortable past your breakeven point and set salaries that would make sense.

A la Mode: To see a sample offer letter used to hire someone under the Grunt Method visit SlicingPie.com and click the Pie a la Mode.

Wages and Grunts

Not all Grunts can forgo salary and may require at least a nominal amount to make ends meet. In these cases you should deduct the amount paid to the Grunt in case from the base salary and use the remainder to calculate the GHRR. For instance, if a Grunt made $100,000 in their last job their GHRR would be $100,000 x 2 ÷ 2000 which equals $100. If the company paid them a $50,000 salary you would subtract that amount from the base so the new GHRR would be $50,000 x 2 ÷ 2000 which equals $50. In other words, your equity payout is based on whatever compensation is put at risk.

[10] Yes, I know, you can also just divide by 1,000 (smarty-pants)

Let me qualify this with a quick note: *not all Grunts will earn equity in your business*. Sometimes you'll hire a Grunt, pay it a salary and everything is fine and fair. These "mercenary Grunts" are generally more entry-level or with skills that are relatively easy to replace. For instance, a receptionist, a junior web developer, a customer service rep, an entry-level sales rep and any number of other positions that offer tactical, but probably not strategic, value to the firm. These people may become pie-seeking Grunts in the future and, although they are still part of the herd, they are happy with money instead of pie as long as you pay them a salary that is commensurate with their experience. If, however, you choose to lower a mercenary Grunts salary and pay them with pie to make up the difference.

Consultant Grunts

If you want to hire a consultant on a short-term basis then their GHRR is equal to their normal consulting rate times two. Make sure they read a copy of this book so they will understand the Grunt Methodology. You should reserve the right to "buy them out" within one year of the last day they render services. You may have to pre-negotiate the buyout rate but never pay more than twice their rate. Remember, you need to compensate them for not only the work they did, but also the risk they take.

One way to negotiate a buyout with a consultant is to offer them a sliding scale that will build to twice their rate over one year. The scale looks like this:

Month 1	108%
Month 2	116%
Month 3	124%
Month 4	132%
Month 5	140%
Month 6	148%
Month 7	156%
Month 8	164%
Month 9	172%
Month 10	180%
Month 11	188%
Month 12	200%

So, if you received financing nine months after you stopped working for a contractor you could settle-up with them for 172% of their original bill. This is a pretty nice return for the contractor. However, after twelve months they receive an equity grant that they can keep. You can always offer to buy it back after a year, but they should not be required to sell it to you.

The buyback option should have a one year protection clause that allows the consultant to receive the full value of the shares if the company sells or goes public within 365 days after the

buyback occurs. This will prevent the company from buying back the equity at the last minute before a liquidation event to turn a quick profit at the expense of the Grunt. That would be a dick move.

Absentee Owners

The buyout right is important when dealing with people who are not employees. Anyone who owns equity or options in your business who is not an investor or an employee is known as an absentee owner. Prospective investors will be wary of businesses that have too many absentee owners. They are generally difficult to manage and may have rights and make demands that can distract the business. The ideal number of absentee owners is zero. However, if you are in the Gap and have no cash then equity may be your only option. The right investor will respect that kind of tenacity but they will still appreciate being able to buyout the absentee owners.

Money

If a Grunt pays for services (like corporate formation), covers material out-of-pocket expenses for which no reimbursement will be received or provides working capital the business the theoretical value is the value of the cash or credit used *times four*. People are much more likely to provide other ingredients, like equipment or time, rather than money so an extra incentive is preferable for those who provide cold, hard cashola.

If the Grunt personally guarantees credit for the business which the business will pay off the theoretical value should be the value of the credit used *times two*. Credit is important, but it receives a smaller multiple if the company is paying if off because the Grunt is assuming less risk. However, if the company can no longer pay it off the Grunt who provided the credit must pay it off themselves. In these cases the payments are treated as cash contributions. Similarly, if the Grunt uses personal credit and does *not* expect it to be paid off by the company it is treated as a cash contribution equal to the credit used.

Cash contributions are weighted heavily in a formation-stage company for several reasons. First, it is much harder for a Grunt to replace the cash or pay off the credit when he or she is in the process starting a company. Unless they have money to spare[11] (and most Grunts don't) the Grunt must either keep a day job or find consulting work to pay the bills in the short term. Starting a business and trying to earn a living at the same time takes a lot more energy that doing one or the other.

Next, all businesses need cash to survive. No cash = no business. Grunts like pie and if they can buy a big slice for putting in a little cash everybody wins.

[11] A Grunt with money to spare is often called and Angel Investor

Lastly, weighting cash heavily allows founders to buy and maintain a big chunk of their own business during the early days. Many founders want to retain ownership of their company and tend to be stingy about slicing pie. The best way to retain equity is to simply pay in cash instead of equity. If you don't have the cash you can use equity, but you can't expect to keep most of the pie yourself.

To recap, the theoretical value of a cash or cash-equivalent contribution a Grunt makes is the amount of the contribution times four. And, the theoretical value of credit provided with a personal guarantee is the amount of credit used times two if the company makes the payments. If the Grunt makes the payments the amount of the payments is treated as a cash investment so it's the amount of the payment times four.

Supplies and Equipment

Although supplies and equipment are important ways to offset cash expenses, their cash-value is often difficult to assess. If the supplies and resources facilitate the business, meaning they help make running the business easier (pens, paper, temporary office space, personal computers, etc) their value may be incidental to the value of the business and should not be taken into account. Despite the expense incurred by the individual participant, the act of accounting for such inputs may cause more damage to the relationship than it is worth at an early stage. Think about it. If a Grunt shows up with a box of pencils should they really expect to receive *equity* in exchange?

A potential investor will likely place little or no value on access to personal computers or supplies. Such expenses should be ignored during the early days of a fledgling business. Eventually such expenses could be covered by the business. However, it is rarely advisable to reimburse past expenses from an early-stage investment fund. The expenses are sunk and offer no future value to the company. Investors loathe using their investment dollars to pay off debt and will pass on deals that have too much. Especially when the debt is to employees who could otherwise take equity.

Old laptops and pencils are one thing, but if a Grunt is going to the office supply store on a weekly basis and spending hundreds of dollars on supplies that's a different thing. In those cases the purchase of supplies should be treated as an expense for which reimbursement is not expected which is equivalent to cash. Note to Grunts: save your receipts!!!

In some cases, equipment and supplies *enable* the business. Without them the business would not exist and having access to them is material to the value of the business and would be valued by potential early-stage investors.

If the asset was acquired by the Grunt specifically for the business then it should be treated as an out-of-pocket expense for which no reimbursement is expected (cash). If the Grunt has owned the asset for less than a year it should be valued at the price the Grunt paid. For instance, the Grunt may have a few servers leftover from a previous business that are less than a year old and still in good shape. If the supplies or equipment are older than a year the value should be set to the same

amount as it would have cost the company to acquire the asset from a third party. If it's a car, for instance, you could use the value listed in the Kelly Blue Book or take it to Car Max to see what they might give you. The value of most items can be assessed with a quick glance at other items selling on Ebay. Ebay sets the standard for what people are willing to pay for just about anything.

It's okay to err on the side of generosity because the Grunt providing the asset is assuming the risk that they may not get it back.

To summarize, calculate the contribution of supplies and equipment as follows:

- Zero if the contribution simply facilitates the business
- If the contribution enables the business:
    - Treat as a cash equivalent if it was acquired specifically for the business
    - Use the purchase value if it is less than a year old
    - Use the resale value if it is more than a year old

Grunts who contribute business-enabling supplies and equipment should for which they do not receive payment can be compensated fairly with equity.

Facilities

Office space, warehouse space, retail space and other facilities that enable the business has value, especially when the Grunt could otherwise rent or lease it to a paying customer. If the facility is appropriate for the business it is fair to value the facility equal to the amount the Grunt could otherwise lease or rent the space. An appropriate facility is one that the business might otherwise rent or lease in order to run the business.

Sometimes the facility will work, even though it's not ideal. For instance, if you need small office space and the Grunt in your herd offers use of an entire floor in one of his or her buildings you probably have access to more than you need. In such cases your fledging company shouldn't be expected to provide equity to cover the entire value. The fair value is proportionate to what the business needs in order to grow and prosper. Also, space in someone's house probably shouldn't be exchanged for equity unless the person would otherwise rent the space to a different business. In general people don't rent their garages to start-up companies.

I once started a company and was able to negotiate some office space from a friend of mine who owned a marketing agency. My team and I took over a few cubes in the corner of the office. It worked out nicely. We only paid for the space we used and had free Internet access and use of the phones for a nominal price. This is ideal. Ask around, situations like this are sometimes easy to come by.

Intellectual Property

Ideas and business concepts are undoubtedly important and valuable to a business. However, ideas without action are relatively valueless, no matter how good the idea is. In the start-up world, a dozen ideas will cost about a dime less the cost of the lunch over which the ideas were generated. Generally, ideas should *not* be taken into account in the Grunt model unless they fit two criteria:

1. the idea must have existed before the inception of the business

2. the idea must be "baked" as opposed to "half-baked". A "baked" idea often comes in the form of a thoughtful business model or legal protection. Baked ideas usually represent the investment of considerable time, money and creativity and are often business enablers.

If it fits the criteria above then there is value that should be taken into account. Generally the value is set equal to the amount of time it took to bake the idea times the originator's GHRR plus the costs of any research or legal protection which would be treated as unreimbursed expenses. So, if I spend 500 hours developing a business plan around my idea, 200 hours writing and researching a patent and $10,000 hiring a lawyer and filing my patent then the idea would be with 700 x my GHRR plus $10,000 or $80,000.

GHRR	$100
Business plan hours	500
Patent research hours	200
Time Rate	$70,000
Legal fees	$10,000
Theoretical Value of IP	$80,000

Ideas developed during the course of business, for instance, would not be taken into account no matter how good the idea is. It's the nature of business to generate new, good ideas and it is part of the job of a Grunt to come up with the most awe-inspiring new idea that ever existed.

Calculating the value of intellectual property can be a challenge because inventors tend to really overestimate the value of their ideas. People tend to say things like "Michael Dell stole my idea for building computers in my dorm room! That crook made billions! He owes me." It's ridiculous.

Don't get me wrong, ideas are critical to a business' success. But turning the idea into a reality is where the value is built, not in coming up with the idea in the first place.

Relationships

The last input that requires discussion is relationships. Sometimes Grunts provide access to certain relationships that the company needs, but might not otherwise have access to. The right relationships can turn into sales or partnerships as well as professional services or a reliable vendo. A well-connected Grunt can do wonders for a company and that value should be taken into account.

However, be careful not to be too bullish about the prospect of a Grunt's relationship actually materializing as relationships with the company. I've been in more than one situation where a start-up has over-paid for a Grunt based on the quality of their relationships. Once the Grunt was on board, the relationships failed to turn into anything substantial. In many cases even if the relationship does materialize it is difficult to quantify the value in any meaningful way.

Relationships are kind of like intellectual property, the relationship has low value unless you put the time and effort into making it work. However, a notable exception is a relationship that turns into a sale. Few things are more important in the early days of a start-up's life than an actual customer that actually pays. A business needs customers and, as obvious as it sounds, many start-up companies don't have customers. They're too busy building products, designing slick web sites, writing ads, creating business plans, negotiating legal contracts and talking to each other.

The best way to translate relationships into value is simply by applying the GHRR to the hours spent cultivating the relationship after the Grunt joins the herd. If the relationship has the potential to turn into a sale you should set up a quasi-commission structure for the Grunt that would reward them for successfully landing the sale. The Grunt should receive a theoretical value of *twice* the rate of commission they might otherwise earn if they were getting cash.

Summary Calculations

The following table summarizes the theoretical value of the various ingredients:

Ingredient	Calculation
Time- Grunt	Grunt Hourly Resource Rate (GHRR)= Negotiated Base Annual Salary x 2 ÷ 2000
Time- Grunt with Comp	GHRR = (Negotiated Base Annual Salary – Current Comp) x 2 ÷ 2000
Time- Consultant	Hourly Rate x 2 (reserve the right to buy back)
Money- Cash	Amount of Money x 4
Money- Personal Credit, Paid Off by Company	Amount of Credit Used x 2

Money- Unreimbursed expenses	Amount of expenses x 4
Supplies and Equipment- Business Facilitating	Nothing
Supplies and Equipment- Business Enabling	Treat as a cash equivalent if it was acquired specifically for the business Use the purchase value if it is less than a year old Use the resale value if it is more than a year old
Facilities	Equal to rent or lease amount of appropriate for business Equal to cost of more appropriate facility
Ideas & Intellectual Property	Development hours times GHRR plus costs as unreimbursed expenses
Relationships	Value earned at 2 times the cash commission rate

Allocating Equity Using the Grunt Model

Now that you have determined the value of the various ingredients into the pie you now have a simple way of calculating everyone's share. You simply add up all the theoretical value that has been contributed to the making the pie and give assign a percent equity to each Grunt based on their input. The total theoretical value is called the Theoretical Base Value (TBV). To determine ownership percentages divide the theoretical value of each Grunt's inputs by the TBV.

Individual Grunts should keep track of the hours they spend on the business and how they spent the hours. Keep enough detail so that it's meaningful, but not so much that it is aggravating. Keeping the balance is up to you. I once worked for a man who tracked his time in 15-minute increments—probably an overkill for the average Grunt. Still, it is nice to know how Grunts spend their time in a start-up business. A simple time sheet could look a little like this:

Date	Hours	Notes
1/5	9	Worked on business plan, lunch with potential client, interviewed printing vendors
1/6	8	Discussed plan with Frank, prepared investor presentation, met with Joe about web site, reviewed and edited specs

1/7	4	Edited web site specs

Grunts should also keep track of the other ingredients they provide and discuss them regularly with the founder or lead Grunt. You can use whatever format you are comfortable with, but make sure you keep track of the different inputs.

A LA Mode- Tracking Forms
To see some sample tracking forms for various ingredients visit SlicingPie.com and click on the Pie a la Mode

When to Calculate Equity

For the most part, you will want to calculate it on a regular basis, say monthly, to see where everyone stands. More importantly, however, you will want to calculate it if you anticipate that someone, like a potential investor, will ask about it.

I started a business a few years ago where I wound up pitching the business dozens of times to potential investors. If I was using the Grunt Method I would have needed to have the equity allocation numbers handy, just in case I needed them. Investors often want to know about ownership. In some cases you can tell them the current equity allocation but explain to them that you are using this system and let them buy their own copy of the book. It will be good for them to know how you are calculating it and they will think you are a fair and wise person. It will also help me sell more copies so it's a win for you, a win for the potential investor, a win for me, a win for my publisher and a win for mankind.

Calibration

In a perfect world the value of equity would go up in excess of the theoretical value of the various inputs. This is called "the point" of a growth-oriented business. Often, when you pitch a potential investor you are trying to sell them on a base value that is hopefully more than you and the other Grunts have put into the business. Successfully negotiating a high valuation is *highly* motivating for Grunts and it breaths more life into the business.

However, you can set a new TBV earlier in a start-ups life with a slightly different purpose: adding Grunts to the herd. Sometimes, if you and other Grunts have worked hard on the company for a period of time, you may want to "harvest" a little of the value for yourselves before allowing others into the herd. This is fair, early Grunts take on more risk than later Grunts. I call this *Calibration*.

Pretend that you and two other Grunts have each put in $30,000 worth of theoretical value into a company. You have been working for six months and you need to bring on more people. The company has a little traction now so you would like to reap some of the benefits for your hard work. You allocate the equity at 33% each on a TBV of $90,000. If you think the company is now worth $300,000 you can

move the base to $300,000 and move forward *as if* you had all contributed $100,000 each. On paper your investment of time and whatever else you put in has grown threefold.

Now, when other Grunts enter the herd they will be earning against a base of $300,000 instead of $90,000. So, if they contributed $100,000 in value and the rest of you did nothing, they would have earned 25% of the company ($100,000/$400,000) instead of over 50% of the company ($100,000/$90,000). This allows early Grunts to keep a higher percent for themselves. Keep in mind, however, that the new work the original Grunts contribute will be calculated against this new TBV.

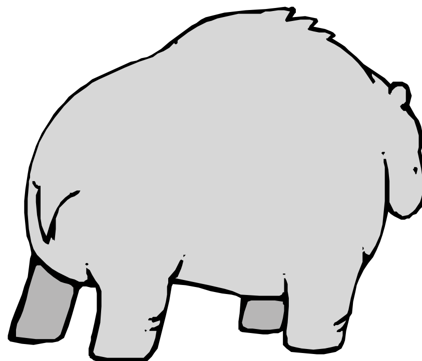
The other thing to keep in mind is that if you calibrate too high you run the risk of exceeding the value you can sell to an investor which would mean that when you do find an investor newer Grunts will actually realize less value than they contributed which is a good way to anger a good Grunt. I could tell myself and the other Grunts that the company is worth $1 billion but if I can only convince an investor it's worth $1 million I will have disappointed my Grunts.

It's best to calibrate only when enough value has been built that an early herd deserves to benefit from the higher-risk work.

Also, as time goes by, the Grunt Method may have to be replaced with a different method of allocation. As a company grows it may take on a more formal structures in place to handle equity sharing.

Subtracting a Grunt

Few events take their toll on a start-up company that when a Grunt leaves. It is highly disruptive. Sometimes, however, Grunts leave. Sometimes they are no longer interested in the project or no longer share the vision. Other times they have other obligations, such as family, that forces them back in to day jobs and sometimes the Grunt isn't a good fit with the herd and has to be asked to leave.



Sometimes you have to ask a Grunt to leave the herd.

When a Grunt leaves the herd either by choice or by force, great care must be taken to treat the Grunt fairly. Even if the Grunt is being fired for being a total jerk there is still a proper and fair treatment. If, as the herd's leader, you treat a departing Grunt unfairly, you will do damage to the entire herd. Again, the last thing you want is a herd of disgruntled Grunts.

Besides treating a Grunt with dignity and respect, fair treatment includes what a departing Grunt is or is not entitled to as well as what the company is entitled to in terms of non-competition. When a Grunt leaves and keeps his or her equity they become an absentee owner which, as mentioned before, is something to avoid if possible. There are worse things than having absentee owners. One worse thing would be a defunct business, for example.

Determining who is entitled to what will depend largely on the circumstances of their departure. There are three main reasons a Grunt will leave the herd. One, they might resign, two, they might be fired and three, they may no longer be able to work because they are disabled or dead.

Resignation

When a Grunt resigns, or quits, the motivation to do so falls into two buckets. The first bucket is called "Resignation without cause" the second is called "resignation with good cause"

Resignation without Cause

Sometimes a Grunt loses interest in the company or sometimes they have external pressures that prevent them from being able to contribute to the company in a meaningful way. So, the Grunt resigns. In the case of Resignation without Cause the Grunt has broken its commitment to the company and should not expect to retain the same equity position as they would have as an employee. It's a free country and there is no reason why a Grunt can't move on to what they feel are greener pastures. But, you can't have your pie and eat it too!

Sometimes a Grunt loses interest in the company

When the Grunt resigns without cause they will forfeit part of the equity earned under the Grunt Model including equity earned through the time they contributed to the company. The company should recalculate the theoretical value of the Grunt's contribution without the multipliers. This means

the GHRR calculation no longer multiplies the negotiated salary by two and no longer multiplies the cash contributions by four. Additionally, the company should reserve the right to buy back the equity at a price equal to the theoretical value.

If possible, pay back any cash contributions the Grunt has made especially if the Grunt is leaving for financial reasons. You may want the Grunt back for a future herd—treat all Grunts fairly.

Leaving the herd in the lurch has consequences and it should. When a Grunt resigns and maintains its original equity the Company will have lost a piece of itself that they may need in order to provide incentive to a replacement Grunt.

In the movie Startup.com the president of Kozmo, a defunct dot-com, has to negotiate a buyout of the stock owned by an early partner who had left the company. He wound up paying $800,000. Ouch. This was money that could have been put to better use that paying off a former employee who left on a whim! This guy, as it turns out, was pretty much the only guy who made any money off Kozmo stock!

The other issue is non-competition. In the case of resignation without cause the company should secure a non-compete agreement in exchange for letting the Grunt keep equity in the company. This will provide a deterrent to Grunts who want to take what they learned with you and start a competing business. Many states won't support a non-compete, but some will. Make sure you have been clear that the Grunt was never promised any cash from the business and make sure the equity grant to the leaving Grunt is written into the agreement as consideration for the non-compete clause.

Resignation with Good Cause

In some cases a participant is "pushed-out" of a company or compelled to leave for no other reason than the other Grunts have decisions that are no longer supportive of their participation. In some cases the decisions are unavoidable, in other cases the decision seemed more important than the negative impact it would have on the affected Grunt. Such decisions would include:

1. Adverse change in title or responsibilities. If the Vice Grunt of Marketing was demoted to the Director of Marketing the Grunt would have a good cause to leave. They wouldn't *have* to leave, but the role is clearly no longer what they signed up for.

2. Adverse change in compensation that does not affect other participants at the same level. If the other Grunts cut the Grunt's GHRR by 50% but the other stayed the same.

3. Relocation of the company more than 50 miles from its original location. The Grunt may not be able to manage the commute. Extending the commute puts an unfair burden on the Grunt.

Sometimes the company chooses to change their strategy or they take on a new Grunt that is has a particular set of skills that make another Grunt redundant. Or, perhaps they just don't like a Grunt even though the Grunt has worked hard and made a positive contribution. Companies, especially start-

up companies, change fast and that means the herd must adapt and change as well. When this happens, however, you must still act fairly when dealing with the departing Grunt. Whatever the reason, if the participant resigns with good cause, they *should* have an expectation of remuneration or equity that is more in line with their theoretical contribution. In these cases the Grunt should be able to maintain ownership of their equity less the amount of any severance payments made. The company can choose to maintain a buyback option that would allow them to buyback the equity at the theoretical value or fair value, whichever is *higher*. The buyback option should have a one year protection clause that allows the departing Grunt to receive the full value of the shares if the company sells or goes public within 365 days after the buyback occurs. This will prevent the company from buying back the equity at the last minute before a liquidation event to turn a quick profit at the expense of the Grunt.

With regard to non-competition, the company is not entitled. The Grunt should be free to compete. If the company is concerned about this they should be more careful not to provide good cause for resignation.

This is fair treatment for a departing Grunt who left for circumstances outside his or her control. It is not fair to penalize a Grunt when they dedicated their time, energy and resources in good faith to the company. While it may not be ideal to have an absentee owner, it is much better than screwing the Grunt and risking damage to your relationships with other members of the herd.

I was once knew a startup where the CEO short-changed a Grunt who was terminated without cause. The Grunt had been faithful and had worked side-by-side with the CEO who had given him a lot of positive feedback for the Grunts work. However, the CEO was not a seasoned Grunt and he began to panic that the company wasn't an overnight success. He woke up one day and decided to let the Grunt go for no apparent reason. The nasty CEO took back the equity the Grunt had vested by taking advantage of a loophole in the operating agreement even though it was clearly against the spirit of the contract. Next he withheld promised severance payments and slapped the Grunt with an oppressive non-compete agreement. The Grunt was mistreated and the other Grunts noticed. Morale sank, the company moved sideways for many months and they never got back on track. The other Grunts saw the true colors of the leader and they began to question whether they would someday be treated as unfairly.

The CEO was unfair and selfish. He didn't understand that pies grew and he let greed steer his thoughts. By mistreating a Grunt in this manner he sent a clear message to the other Grunts that he didn't care about honoring the letter or the spirit of contracts and that he only cared about himself.

There is nothing more important than fair treatment. At the end of the day, all the money in the world won't make you a better person. One of my favorite quotes is:

> *Money can't buy happiness, but if you have money you can buy a boat and wave at happiness as you sail by!*

I don't know where this quote came from, but I realize that sailing is a lot more fun when you are surrounded by people who care about you.

Termination

When it's the company's decision to fire a Grunt it is called termination. Like resignation, termination can be with our without cause.

Termination without Cause

These days business must change and adapt quickly. It is the job of the management team to make sure the right Grunts are in the right places. From time to time, however, the strategy changes and good, hardworking Grunts are no longer needed.

Several years ago I started a company and hired a staff of four to handle outbound telemarketing. I thought that telemarketing was the way to sell the product. It wasn't. The telemarketing Grunts worked hard and did their job but I had to let them go. The company changed its strategy and no longer needed a herd of telemarketing Grunts. It wasn't their fault, it was mine.

When you terminate a Grunt without cause they should be treated the same way as if they left for good cause. This means they can retain their equity and even compete with you if they want. While it might be more convenient for you if the Grunt didn't compete it wouldn't be fair. If you are concerned about competition then you should find a way to keep them in the herd.

Termination with Cause

Sometimes the leader of the herd must fire a Grunt. Generally speaking "cause" means one of the following:

1. Serious misconduct such as theft, dishonesty and assault. Absenteeism, lateness and poor performance is usually not serious misconduct unless there has been some form of progressive discipline (such as a series of warnings).

2. Habitual neglect of duty or incompetence. For this to be cause, the participant has to clearly understand the requirements of the job, the requirements have to be reasonable given the resources of the company and a reasonable time period must be given for improvement.

3. Conduct incompatible with the employee's duties or prejudicial to the employer's business. Engaging in activities during the workday that interfere with employment obligations or that compete with an employer's business is generally considered cause.

4. Willful disobedience. When a clear instruction has been given by a manager and the instruction has been challenged or disobeyed by an employee, in certain situations this can be cause.

If the Grunt is terminated for cause, they should be treated the same as if they had resigned without cause. The company should recalculate their equity without the multipliers and the company should get

a buyback right. Additionally, they should be required to sign a non-compete agreement in exchange for keeping their equity. Of course, if the Grunt embezzled money or otherwise sabotaged the business you may have a different set of legal problems. Even in these cases, fair treatment will keep you out of trouble.

Death and Disability

If a Grunt becomes disabled they should be treated as Grunts who resigned for good cause. If the Grunt dies, their family should receive the full benefit of their contribution to the firm and they should be treated with as much respect as the Grunt themselves.

Debt

Sometime your fledgling company will rack up some serious debt and, before you know it, you are all underwater. Unless your company is generating enough cash to service the debt you will need a way to come up with payments. This is a job for Grunts.

As I mentioned before, when a Grunt personally secures debt on behalf of the company it will translate into equity at a theoretical value of twice the credit used so long as the debt is being serviced by the company. However, if the company cannot cover payments the individual Grunt who guaranteed the credit is now responsible for covering the payment himself. In these cases the payments are treated as cash contributions for which the theoretical value is four times the amount of the payment.

However, if the company has secured the credit on its own and cannot cover the payments it must look for cash contributions. In some cases, members of the herd can come to the rescue. In other cases you can invite an outside investor. Unfortunately, outside investors rarely want to bail a start-up company out of debt. This is a pretty bad use of funds.

It would be tempting to "pass the hat" or allocate the debt across Grunts according to their share of equity. This is a bad idea. Grunts don't want to be put in a position where they have to cough up their own money. Grunts work for pie. Pie is equity. Grunts do not work for liabilities. If they think their job is turning into a liability they will resign.

This is one of those cases where the leadership of the organization will have to take the hit. They will have to cover the company's debt and their payments will be treated as cash. If leadership is not willing or not able to cover the debt and neither are the other Grunts you may have to close the business. When you close the business you would sell whatever assets you have, pay off the debt and distribute what is left to Grunts in the following order:

1. Grunts who put in cash or cash equivalents should be paid back in an amount equal to their contribution. This payback will not diminish their equity holding, however.
2. Other Grunts according to their percent of equity (if there is anything left over)

If the company's debt exceeds any cash they were able to generate through the sale of assets the company will still owe the creditors. If you anticipated taking on the debt you should have set up a legal structure, such as the aforementioned LLC, to protect the herd's personal possessions. It is likely that the creditors will come after you directly but you should be okay if you structured the company legally. If you did not set up a corporate structure the creditors will come after you and, in an ideal world the debt would be spread proportionality over the equity holders. In the real world, however, the creditors will sue the Grunt with the most cash.

Good luck with this. Let me know how it works out for you…

Grunt Method Summary

The Grunt Method is a fair and equitable to allocate equity in an early-stage start-up company. To employ the method simply track the theoretical value of the various ingredients that Grunts contribute in order to bake the pie. Ingredients include:

1. Time
2. Money, in the form of cash or cash equivalents
3. Supplies and equipment that enable the business
4. Relationships
5. Intellectual property

Under the Grunt Method, Grunts are allocated equity in proportion to their contribution to the overall theoretical value.

Ultimately, the company will go raise outside funds by developing a Magic Number which is the amount of money that is high enough to motivate the Grunts to keep working and low enough to motivate the investor to invest. If the Magic Number is higher than the theoretical value of the contribution by the various Grunts everyone should be happy!

Occasionally early Grunts can "harvest" some of the value they have created by calibrating the theoretical value to a higher number. The new value becomes the base against which they will earn additional equity as well as new Grunts entering the herd. Care must be taken to ensure that the new, calibrated amount does not exceed the Magic Number. If it does, the Grunts will be unhappy.

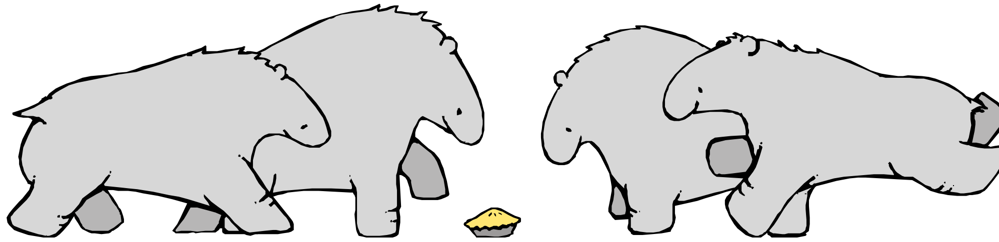
When a Grunt resigns without cause or is terminated with cause they should not expect to maintain equity at the theoretical value of their contributions. At best they should be entitled to equity based on a theoretical value that is set equal to the actual value of cash or cash equivalents. The company should be able to maintain a buyback provision for the equity.

When a Grunt resigns with good cause, is terminated without cause, becomes disable, or dies, the Grunt should expect to keep their equity at the theoretical value less any severance payments. The company can choose to maintain a buyback provision at an amount equal to the theoretical value or the fair value, whichever is higher.

The Grunt Method is, at the core, about treating fellow Grunts fairly. While most entrepreneurs are motivated by money at some level, they are also motivated by being part of the game, working as a team (herd) and building something from scratch. Being a Grunt takes dedication and commitment. It's a hard life but the rewards are great—even if the company isn't successful. The evidence is that many Grunts jump right back in to start-ups after leaving failed start-ups. They can't get enough.

The most common mistakes entrepreneurs make when allocating equity is slicing the pie before it is baked or slicing the pie after is it baked. Neither way takes into account the ever-changing needs of a fledgling business.

It is possible, and indeed common, for entrepreneurs to bite the hand that feeds them by screwing hardworking Grunts. Sometimes this is intentional and sometimes it's because they lack the tools and the understanding to execute a fair model—now they have one.



If you bake it, they will come…

Part III: The Grunt Method in Action

The following case studies are designed to help enlighten you with regard to the practical application of the Grunt Method. In some cases I will show the shortcomings of other methods to help you see how the Grunt Method solves problems created by traditional models. All the examples and case studies are *fictional* unless otherwise noted.

John's Bicycle Attic

> *John loves bikes and wants to start a bike repair service. He tells his friend Doug and they decide to start a bike repair shop in their basement and call it* John's Bicycle Attic[12] *and use the Grunt Model for equity allocation. The only other job that either of them had was when they were dish dogs at the local country club. John, who was a dish dog longer than Doug, earned $10.00 per hour and Doug only earned $9.00 per hour.*
>
> *They appoint John as the president of the company because it was his idea and he has the most bike-repair experience. John provides a repair stand and a killer set of tools that enable the business. The resale value of the stand and tools is $1,000. Over the next month John works 100 hours in the shop and Doug works 100 hours talking to bike owners and generating business. He spends $1,000 on flyers and ads for the company and he brings $100 in snacks for the shop from his home. He does not expect to be reimbursed.*

Using the Grunt Method the first step is to figure out John and Doug's Grunt Hourly Resource Rate (GHRR). Because they were hourly workers before, it's okay to double their previous rate for their GHRR. This would give John a GHRR of $20.00 and Doug a GHRR of $18.00. Doug and John, however, are smart guys. They realize that fixing bikes isn't the same as washing dishes and they agree they have complementary skills. So, they agree to take an equal GHRR. You don't have to split hairs with the Grunt Model. Keep it real.

[12] If you ever tried carrying bikes into the attic you would understand why they used the basement.

Next, we have to take John's equipment into account. Because the equipment enables the business it should be assigned a theoretical value. John didn't buy the tools specifically for the business so they looked up a comparable set of tools on Ebay.com and found some for around $1,000. So, the theoretical value of the business enabling equipment is $1,000. Doug also contributed to the business with supplies consisting of flyers, for which he paid $1,000, and snacks, for which he paid $100. The snacks, which he brought from home, are business facilitating supplies and should not be assigned a value. They are nice to have, but not critical. The flyers, on the other hand, were a business expense for which Doug does not expect to be reimbursed. They theoretical value of that contribution is the amount of money times four.

So, at the end of the first month John would own 33% of the business and Doug would own 67%

	John	Doug	
Time @ $20	2,000	2,000	
Equipment	1,000	-	
Cash (x4)	-	4,000	
	$3,000	$6,000	$9,000
	33%	67%	

In the above example, the Grunt Model has properly divided the equity of the business among the two partners. Over the next month the partner's commitments change.

> *Doug gets a new girlfriend and starts spending a lot of time over at her apartment. Over the next month he only spends 50 hours promoting the business and spends no money on advertising. John spends 75 hours in the shop and 75 hours generating business. He also spends $500 on advertising.*

At the end of the second month, John has committed 175 hours, $1,000 in enabling equipment and $500 on advertising. His total theoretical value has grown to $8,000. Doug has committed 150 hours and $1,000 on advertising. Hit total theoretical value has grown to $7,000. At the end of the second month Johns equity share is 53% and Doug's is 47%.

	John	Doug
Time @ $20	5,000	3,000
Equipment	1,000	-
Cash (x4)	2,000	4,000

$8,000	$7,000	$15,000
53%	47%	

As you can see, John's equity share grows to reflect his dedication to the business. If John and Doug had simply split the business 50/50 in the beginning there would no doubt be hard feelings among the partners. In this model the allocation is fair based on the choices of the two participants.

Doug continues to spend time with his girlfriend instead of building the business so they decide to add a third partner, Sam. Sam ran a bike shop for many years before selling it. His experience will add a lot to the business. His last salary at a bike shop was $50,000 per year. Sam agrees to the Grunt Model and starts work. Over the next month Doug spends 20 hours promoting the business, John spends 150 hours in the shop and Sam spends 50 hours in the shop and 50 hours calling his old customers and generating a lot of business

Under the Grunt Model, Sam can slip right in and start earning equity. At $50,000 per year his GHRR is $50.00. John and Doug think this is fair given the fact that he has far more experience than either of them. At the end of the third month the equity split is as follows:

	John	Doug	Sam	
Time @ $20	8,000	3,400	2,500	
Equipment	1,000	-	-	
Cash (x4)	2,000	4,000	-	
	11,000	7,400	2,500	20,900
	53%	35%	12%	100%

The Grunt Model has provided a method for adding another partner in a fair and consistent manner. The theoretical value has grown and all parties have a fair share.

Removing a Partner

In the above example, it is clear that Doug's commitment is waning he may be on his way out. At such an early stage, it would be impractical for Doug to maintain an equity share in spite of his contribution. Investors don't look favorably on absentee-owners. While, Doug has added value to the business and it should not be overlooked, it is clear that the young company has a long way to go and unless Doug sticks with it, he may not be entitled to the gains. There are three scenarios in which Doug can depart the business. Each one creates special circumstances that need to be considered if he is to be treated fairly. The three reasons are:

1. Doug can quit, also called resignation without cause
2. Doug can be "pushed out", also called resignation with good cause or termination without cause
3. Doug can be fired, also called termination with cause

Starting a new business is precarious and commitment of the partners is important. Half-hearted commitment can damage a business beyond repair. An understanding, in advance, of expectations can help pave the way to a successful transition without hard feelings.

Resignation without Cause

If Doug quits for personal reasons then he should have no long term expectations to holding equity because he is breaking his commitment to the company. At very early stages partners who leave on their own accord must be willing to leave their equity position behind. Even cash contributions, such as Doug's purchase of advertising, must be forfeited. If the investment is substantial and creates a long-term asset on the balance sheet the cash should be treated like an angel investment. In most scenarios this is not the case for an early-stage bootstrapped start-up. When Doug quits without cause he no longer has rights to equity nor does he have rights to any inputs including cash or enabling supplies and equipment. Under the Grunt Model Doug's contribution will be ignored and equity will be allocated to the other owners according to their investment. If Doug leaves after the third month the equity allocation would look like this:

	John	Sam	
Time @ $20	8,000	2,500	
Equipment	1,000	-	
Cash (x4)	2,000	-	
	11,000	2,500	13,500
	81%	19%	100%

The Grunt Model has fairly re-allocated the equity between John and Sam. It is important to note that the actual value of the business may have been diminished with Doug's departure so even though their equity percent has grown, it may be a smaller pie. The calculation reflects a decrease in theoretical value.

Resignation with Cause or Termination without Cause

In some cases a participant is "pushed-out" of a company or compelled to leave for no other reason than the other managers or other participants have made decisions that are no longer supportive of their participation. In most cases it is as a result of unfair treatment or broken commitments by the other participants. Typically, a participant can resign with cause for the following reasons:

4. Adverse change in title or responsibilities
5. Adverse change in compensation that does not affect other participants at the same level. For instance, if John and Sam told Doug that his GHRR was dropping to $10 or that theirs was increasing.
6. Relocation of the company more than 50 miles from its original location. Doug may not be able to do the commute.
7. Material breach of other agreements between participant and the company

Termination without cause means the other participants have decided they no longer want to work with a person. The person may have made a valuable contribution, but perhaps the business vision has changed and that person's skills are no longer important. Whatever the reason, if the participant resigns with good cause or terminates without cause they should have an expectation of remuneration or equity.

In these cases, it would be fair for the company to either do a buyout or allow the individual to keep their equity with or without a buyback option. If the company chooses to do a buyout, the individual would generally be entitled to the actual amount of cash invested, the current value of enabling supplies or equipment and *half* of the GHRR times the number of hours worked. The time investment is paid out at half in a buyout scenario to reflect the fact that there is no longer any risk of nonpayment.

If John and Sam decide that they don't need Doug they could terminate him without cause. They could allow him to keep his current equity with a fair cash buyout option of

Termination with Cause

In early-stage start-ups most of the work is done as a team. However, there is usually one person who is spearheading the operation in some way or another. In the current example, John is clearly the leader. He had the idea, convinced Doug to join and is dedicated to building the company. John should be considered the de facto manager or president of the organization. John would have the "power" to terminate a participant with cause. Generally speaking "cause" means one of the following:

5. Serious misconduct such as theft, dishonesty and assault. Absenteeism, lateness and poor performance is usually not serious misconduct unless there has been some form of progressive discipline (such as a series of warnings).

6. Habitual neglect of duty or incompetence: For this to be cause, the participant has to clearly understand the requirements of the job, the requirements have to be reasonable given the resources of the company and a reasonable time period must be given for improvement.

7. Conduct incompatible with the employee's duties or prejudicial to the employer's business: Engaging in activities during the workday that interfere with employment obligations or that compete with an employer's business is generally considered cause.

8. Willful disobedience. When a clear instruction has been given by a manager and the instruction has been challenged or disobeyed by an employee, in certain situations this can be cause.

In all start-up situations decisions are made as a team and rarely according to clear-cut contracts or rules. In fact, times spent on such activities during the bootstrap phase may be a waste of valuable resources. You must always find reasonable partners that you can trust. However, if you trusted the wrong person and they behave in a way that is not constructive to the business then you may have to terminate for cause. In such cases, the employee should not expect to keep equity or receive compensation. In some cases you may need to provide some sort of compensation to prevent lawsuit or other negative backlash.

PhoneMatcherator.com

Sally was a successful businesswoman who made her fortune selling helicopters to other successful businesswomen and men. She also had a short stint as the CEO of an online company that sold cell phones during the dot-com bubble and did quite well. She had gone back into the helicopter business when she heard a business plan presentation that reminded her of an idea she had while working at the cell phone company. The idea was to match people with the right cell phone after they answered a few questions. The idea wasn't terribly original, but Sally thought it was and wanted to give it a shot.

Sally put together a little PowerPoint outline of his idea and shared it with Frank, a career entrepreneur who had a lot of experience with online companies and, although he had started several tech companies, he hadn't been as fortunate as Sally who could retire if she wanted to.

Frank, who didn't have a big nest egg, told Sally he was interested in helping her start the company but he would need to earn a salary in addition to equity. Sally agreed and offered him $100,000 (which was half what he was paid in his previous position) plus 10% of the equity vesting over five years. He asked Frank to sign a complicated non-compete and non-disclosure agreement along with an employment agreement that provided severance payments and accelerated vesting of shares in the event that Frank was forced out of the company.

Sally also took $100,000 in salary but agreed to let the money accrue instead of being paid. Her previous income was commission-based in a different industry so she needed a benchmark. She often reminded the other staff members that she was not being paid current compensation- she mentioned this in hopes of motivating them.

Over the next few months Frank worked 60-70 hours per week and relocated his family so he could be closer to the office. Sally worked part-time on the business and invested about $250,000 of her own money He brainstormed with Sally, wrote the business plan and the software specification, hired the staff, and began to execute. Sally took the business plan and pitched it to all her helicopter customers and was able to raise several million dollars to fund the company.

She set aside a small chunk of the equity for other managers and doled it out in small increments. She offered less than 1% to the vice president of marketing who, with no good reference for the value of 1% took the offer.

With Frank at the helm the company successfully launched the site on time and within budget. Sally was very happy with Frank and gave him plenty of positive feedback and relied on him for most of the execution while she played more of a strategic role. They were a good team and built a good company.

PhoneMatcher.com grew steadily over the next two years and was meeting its projections; however, Sally grew frustrated that the company didn't perform as well as the company she ran during the dot-com bubble. She didn't realize that it was a different time and her company was the only company that sold phones online. Today there were hundreds or resellers. To make matters worse, a competitor had launch shortly after them and were growing neck-and-neck.

Sally was still selling helicopters on the side and many of her customers were now her investors. She began to worry that the company wouldn't be the overnight sensation that she had dreamed about and, on a whim, she terminated Frank without cause. Frank was shocked. He had received excellent feedback and had trusted her completely. She offered little explanation to her action other than she had "lost confidence" in his abilities.

Under the terms of his employment agreement, Frank was entitled to severance payments and accelerated vesting of part of his equity. Sally held out on the severance payments and, taking advantage of a small loophole in the company's operating agreement, she took back all the equity that Frank had earned over the past two years including the shares that vested under the employment agreement leaving Frank unemployed. After making Frank sign a broad and oppressive separation agreement, Sally paid him the severance payment that she owed.

Over the next few months the company's growth turned to a plateau. They continued to burn through their start-up fund and the other employees, who missed Frank, began to lose their passion for the business. After seeing how Sally treated Frank, a loyal employee, they began to look for other jobs fearing that they would meet the same fate.

The company eventually sold to a competitor but all of the proceeds went back to the investors.

The above example shows what happens when entrepreneurs don't use the Grunt Model. Sally makes a number of important mistakes that, ultimately, cost her company. The first mistake is that she didn't fully understand the opportunity before jumping in. She figured that the company would explode in popularity just as her old company did during the dot-com boom. Sally is essentially a helicopter salesperson. She knows this and hires Frank to do most of the work.

The next mistake Sally made was trying to slice the pie before it was baked. She carved off 10% and allocated it to Frank whom she hired on a half salary. Frank, seeing her wealth and past success, figured she knew what she was doing. Plus, she is a good salesperson and made Frank believe. It's okay to get Grunts to believe, that's the job. It's not okay to take advantage of them.

Sally, who also took a deferred salary, often brought up the sacrifice she was making to the other Grunts on the team who were taking a salary. She thought they would work harder knowing how much she, herself, had on the line. However, because she had unfairly allocated the equity and kept the

lions share for herself everyone thought she sounded like a total prick. After all, she had already accumulated enough wealth to retire and she was still in the helicopter business.

Frank did his job, better than could be expected. He launched on time and hit the numbers. Sally was grateful to Frank and told him so- this is good treatment of a good Grunt. However, Sally got cold feet. She raised too much money and drastically overestimated the market. Times have changed so despite Frank's best efforts the company didn't have a chance of performing up to Sally's unrealistic expectations. She panicked and found, in Frank, a scapegoat.

She screwed Frank by reneging on her deal. She pulled the rug out from under him by not expressing her concerns earlier and giving him a chance to correct. He was doing what she had asked and working hard. He deserved more warning. Next, she took back the equity that he had earned fair and square. Because he was terminated without cause, Frank had no choice in the matter and should expect to keep what he earned. Sally, who doesn't understand that pie grows, felt there was a finite amount of pie and that she needed to take it back so she could give it to another Grunt. Otherwise she might have to give up hers (greed) or dilute the other Grunts, which is fair in these circumstances.

Lastly, she forced Frank into an oppressive non-compete. In the event of termination with cause or resignation without cause a non-compete is appropriate. Companies should not provide incentive for a person to leave and create a competing firm. However, in the case of resignation for good cause or termination without cause there should not be a non-compete. The Grunt has to find new work and they should not be hampered by a non-compete especially when the industry in which the company operates is likely to be the industry in which the Grunt has the most contacts. If you decide to cut a Grunt loose for no reason you have to be willing to accept the consequences of doing so. Like I said before, you can't have your pie and eat it too. Non-competes are commonplace these days and largely unenforceable. However, just because companies use them doesn't make them right. They are only fair in certain circumstances.

Let's take a look at how this same story would have been told if Sally used the Grunt Model:

> *Sally was a successful businesswoman who made her fortune selling helicopters to other successful businesswomen and men. She also had a short stint as the CEO of an online company that sold cell phones during the dot-com bubble and did quite well. She had gone back into the helicopter business when she heard a business plan presentation that reminded her of an idea she had while working at the cell phone company. The idea was to match people with the right cell phone after they answered a few questions. The idea wasn't terribly original, but Sally did some research and decided that her idea had some real merit. The current sites had somewhat similar filters on their sites, but they always pushed people to higher priced phones of a specific brand. Her site would be agnostic and present all phones in a way the buyer could understand. She decided not to sell the phones directly, but to refer them to other e-commerce sites and take an affiliate commission on the sale.*

Sally put together a little PowerPoint outline of his idea and shared it with Frank, a career entrepreneur who had a lot of experience with online companies and, although he had started several tech companies, he hadn't been as fortunate as Sally who could retire if she wanted to.

Frank, who didn't have a big nest egg, told Sally he was interested in helping her start the company but he would need to earn a salary in addition to equity. Sally agreed and told Frank about the Grunt Model and bought him a copy of this book which he really, really liked. They decided to pay Frank a salary of $100,000 and used the following calculation to set a GHRR for Frank at $150 per hour:

Negotiated base salary	*$200,000*
Less ½ current compensation	*-$50,000*
Subtotal	*$150,000*
Times two	*$300,000*
Divided by 2000	*$150*

Under the Grunt Model a company is entitled to buy back certain shares in the event of termination without cause or resignation with good cause. Sally agreed to severance payments that would buy back the equity based on how long Frank worked. Frank understood that he would lose rights to equity if he left for no reason or was fired.

Sally also took a salary of $100,000 but she agreed to defer it. In this case she is covering an expense for which she expects to be reimbursed. Therefore it is not treated as cash. Frank and Sally agree to a 10% annual interest rate on the deferred salary. Sally's GHRR is the same as Frank's

Her previous income was commission-based in a different industry so she needed a benchmark. She often reminded the other staff members that she was not being paid current compensation- she mentioned this in hopes of motivating them.

Over the next few months Frank worked 60-70 hours per week and relocated his family so he could be closer to the office. Sally worked part-time on the business and invested about $250,000 of her own money He brainstormed with Sally, wrote the business plan and the software specification, hired the staff, and began to execute. Sally took the business plan and pitched it to all her helicopter customers and was able to raise several million dollars to fund the company.

She set aside a small chunk of the equity for other managers and doled it out in small increments. She offered less than 1% to the vice president of marketing who, with no good reference for the value of 1% took the offer.

With Frank at the helm the company successfully launched the site on time and within budget. Sally was very happy with Frank and gave him plenty of positive feedback and relied on him for most of the execution while she played more of a strategic role. They were a good team and built a good company.

PhoneMatcher.com grew steadily over the next two years and was meeting its projections; however, Sally grew frustrated that the company didn't perform as well as the company she ran during the dot-com bubble. She didn't realize that it was a different time and her company was the only company that sold phones online. Today there were hundreds or resellers. To make matters worse, a competitor had launch shortly after them and were growing neck-and-neck.

Sally was still selling helicopters on the side and many of her customers were now her investors. She began to worry that the company wouldn't be the overnight sensation that she had dreamed about and, on a whim, she terminated Frank without cause. Frank was shocked. He had received excellent feedback and had trusted her completely. She offered little explanation to her action other than she had "lost confidence" in his abilities.

Under the terms of his employment agreement, Frank was entitled to severance payments and accelerated vesting of part of his equity. Sally held out on the severance payments and, taking advantage of a small loophole in the company's operating agreement, she took back all the equity that Frank had earned over the past two years including the shares that vested under the employment agreement leaving Frank unemployed. After making Frank sign a broad and oppressive separation agreement, Sally paid him the severance payment that she owed.

Over the next few months the company's growth turned to a plateau. They continued to burn through their start-up fund and the other employees, who missed Frank, began to lose their passion for the business. After seeing how Sally treated Frank, a loyal employee, they began to look for other jobs fearing that they would meet the same fate.

The company eventually sold to a competitor but all of the proceeds went back to the investors.

Mark had an idea for a technology that would facilitate market research using online user panels. He and his wife (Martha), who is an attorney, filed a provisional patent application for the technology, called *Rapid Research*.

Over the next few months Mark researched the concept, hammered out a business model and even spoke to a few potential clients who agreed to try the solution when it was ready. Mark decided that, while the concept was good, he wasn't ready to quit his day job. He also decided that he needed a little help putting some legs under the new company. He reached out to a colleague, Ted who has a background in data technology as well as experience in operations. He and Ted found three other guys: Scott and Chad who have experience in development and Joe who is a solid sales person. Each member of the team invests time into the organization as well as $2,000 cash.

As the team works together they get closer to launching a prototype and start thinking about formally organizing the company. Before too long, the question of equity comes up. Using the Grunt Model of Equity Allocation they assign a GHRR to each member of the team. Remember, the Grunt Hourly Resource Rate (GHRR) is equal to the most recent salary × 2 ÷ 2,000. Mark earns $100,000 in his day job so he gives himself a GHRR of $100. Ted was also assigned at GHRR of $100 even though his current salary is $90,000. Mark, recognized that they would be peers in the new business and that their earnings history and management level were basically on par. Scott and Chad, who were more junior-level, each earned around $50,000 per year so they received a GHRR of $50 and John, who earned a base salary of $30,000 plus commission of 10% of sales was given a GHRR of $30 plus a commission of 20% payable in equity. Additionally, they did not forget Mark's wife, the attorney, whose regular billing rate is $200 per hour. Her GHRR as a consultant was set to $400. (If she was an official part of the start-up team with the intent of joining fulltime she would have had a GHRR that was based on her salary, not her billing rate.) Mark and Martha decide to allocate her ownership to Mark to keep things simple.

Each Grunt contributed $2,000 to the company, but Mark also paid for the costs of the provisional patent. The costs included the filing fee plus some out-of-pocket costs for a designer to create some diagrams for the document. The total costs were $1,000. Because the provisional patent expenses are not going to be reimbursed, they receive the same treatment as a cash investment (cash × 4).

Based on the GHRR, they calculated a theoretical value of $85,350 at the end of the first six months and built an equity table that looks like this:

	Mark	Martha	Ted	Scott	Chad	John
Hours	*192*	*23*	*24*	*20*	*25*	*10*
GHRR	*100.00*	*400.00*	*100.00*	*50.00*	*50.00*	*30.00*
Time	$ 19,200	$ 9,200	$ 2,400	$ 1,000	$ 1,250	$ 300
Cash	$ 8,000	$ 8,000	$ 8,000	$ 8,000	$ 8,000	$ 8,000
Credit	$ -	$ -	$ -	$ -	$ -	$ -
Expenses	$ 4,000	$ -	$ -	$ -	$ -	$ -

Total	$ 31,200	$ 17,200	$ 10,400	$ 9,000	$ 9,250	$ 8,300
	37%*	20%*	12%	11%	11%	10%

**Mark owns 57%*

Mark, as the company's founder, owns 57% when he adds in Martha's equity. He can be pretty happy that he has built a solid team with a lot of potential and his total investment, besides time, has been only $3,000.

Moving Forward

Over the next two months Ted and Mark both work 80 hours. They decided that Scott and Chad have been splitting up work that could be done by one person and decide to ask Chad to leave. He has done a good job, but they just don't need two developers and Scott has shown more dedication to the company. They also lose John who took another job and relocated. So, Chad was terminated without cause and John resigned without good reason. Therefore, John will lose equity he earned with his time commitments, but retain equity earned through his cash investment with a provision that allows the company to pay back his $2,000 within one year. Chad, on the other hand, will be allowed to keep his equity. Over time his % will diminish as other Grunts continue to earn, however, the underlying value of the equity should continue to grow. The company could offer to buy back the equity, but Chad should *not* be obligated to accept the offer. Mark understands that when an employee is terminated at no fault of their own it is not fair to revoke their hard-earned equity. However, if an employee simply does not perform or quits on their own and leaves the company in a lurch, the company should have the right to reclaim equity earned and buy back equity purchases.

At the end of the eight month the company's theoretical value is $103,050 equity table looks like this:

	Mark	Martha	Ted	Scott	Chad	John
Hours	*272*	*23*	*104*	*60*	*25*	*-*
GHRR	*100.00*	*400.00*	*100.00*	*50.00*	*50.00*	*30.00*
Time	$ 27,200	$ 9,200	$ 10,400	$ 3,000	$ 1,250	$ -
Cash	$ 8,000	$ 8,000	$ 8,000	$ 8,000	$ 8,000	$ 8,000
Credit	$ -	$ -	$ -	$ -	$ -	$ -
Expenses	$ 4,000	$ -	$ -	$ -	$ -	$ -
Total	$ 39,200	$ 17,200	$ 18,400	$ 11,000	$ 9,250	$ 8,000
	38%	17%	18%	11%	9%	8%

Note that the company loses theoretical value when John left, but maintains theoretical value after Chad left. This makes sense logically. When John leaves the company loses a good employee so the company is worth less than before. When Chad leaves because the company determined his efforts were redundant the company is not worse off, it is better off. Therefore, the value created by Chad is maintained.

Two more months go by. Mark and Ted decide to buy back John's equity for $2,000. They decided to use $1,000 from the company's account and they each put in $500 of their own money. This will remove the theoretical value of John's contribution and increase the theoretical value created by their $500 each. John, in effect, is wiped clean from the equity table. It is important to note that equity calculations are not accounting calculations.

Each of the existing employees works another 100 hours on the business. At the end of the next two months the company's theoretical value is $124,050 and the equity table looks like this:

	Mark	Martha	Ted	Scott	Chad	John
Hours	*372*	*23*	*204*	*160*	*25*	*-*
GHRR	*100.00*	*400.00*	*100.00*	*50.00*	*50.00*	*30.00*
Time	$ 37,200	$ 9,200	$ 20,400	$ 8,000	$ 1,250	$ -
Cash	$ 10,000	$ 10,000	$ 8,000	$ 8,000	$ 8,000	$ -
Credit	$ -	$ -	$ -	$ -	$ -	$ -
Expenses	$ 4,000	$ -	$ -	$ -	$ -	$ -
Total	$ 51,200	$ 19,200	$ 28,400	$ 16,000	$ 9,250	$ -
	41%	15%	23%	13%	7%	0%

Now, after ten months, the team thinks they have created value in excess of the theoretical value. They all decided the company concept is a winner and they quit their day jobs and commit full

time. At this time they decide to calibrate the business. This would increase the “base” of $124,050 to $500,000. Now, when they invite new team members, they will maintain a higher percent of equity that was earned early in the business when the risk was highest. The calibrated value divides the new base value ($500,000) by their respective ownership percentages.

	Mark	Ted	Scott	Chad
Ownership	57%	23%	13%	7%
Theoretical Value	$ 283,757	$ 114,470	$ 64,490	$ 37,283

Note that I’ve combined Martha and Mark. All the participants should be happy with this arrangement; even Chad, who was let go, has seen a nice theoretical return for his contribution. Now they decide to hired a new sales person to replace John. They replace him with Mike. Mike is earning a salary of $100,000 in his day job as a director of sales plus 10% commission. They give him a GHRR of $100 plus commission on sales at 20% payable in equity.

Over the next two months they each work 100 hours and Mike makes the first sale for $20,000! He earns a commission on this sale of 20% or $4,000 payable as time equity. They are all working from their home offices. At the end of the first year the company has a theoretical value of $539,000 and an equity table that looks like this:

	Mark	Ted	Scott	Chad	Mike
Base	$ 283,757	$ 114,470	$ 64,490	$ 37,283	
Hours	*100*	*100*	*100*	-	*100*
GHRR	*100.00*	*100.00*	*50.00*	*50.00*	*100.00*
Time	$ 10,000	$ 10,000	$ 5,000	$ -	$ 14,000
Cash	$ -	$ -	$ -	$ -	$ -
Credit	$ -	$ -	$ -	$ -	$ -
Expenses	$ -	$ -	$ -	$ -	$ -
Total	$ 293,757	$ 124,470	$ 69,490	$ 37,283	$ 14,000
	55%	23%	13%	7%	3%

Note that I’ve added a new line called “base” that was added after the recalibration. Older employees will have this base, newer employees, such as Mike, will not. This is okay with Mike because he realizes that risk is much lower now that the company has some traction.

It is clear that the company needs to get some office space and build out the team by adding sales, marketing and development staff. They find an angel investor, Anne, who offers to invest $1,000,000 for a 50% ownership stake in the company. They are all happy. They create a new equity table that reflects the investment. The base value for the teams shares goes from $539,000 to $1,000,000 as they all, collectively own 50% of a business valued at $2,000,000. The equity table *before* the investment looks like this with a theoretical value of $1,000,000:

	Mark	Ted	Scott	Chad	Mike
Ownership	55%	23%	13%	7%	3%
Theoretical Value	$ 545,003	$ 230,928	$ 128,924	$ 69,171	$ 25,974

When Anne, the angel investor, put in her $1,000,000 the new equity table looks like this:

	Anne	Mark	Ted	Scott	Chad	Mike
Ownership	50%	27%	12%	6%	3%	1%
Theoretical Value	$ 1,000,000	$ 545,003	$ 230,928	$ 128,924	$ 69,171	$ 25,974

The $1,000,000 is an angel investment and its theoretical value calculation is equal to the amount of equity the investor receives. You will note that the total theoretical value of the other shareholders is equal to $1,000,000

At this point the company decides to use some of their cash to buyout Chad. The give him a call and offer him $20,000 for his equity. Remember, the equity is still high risk and even though they just received a nice investment there is no guarantee that they equity will ever be worth anything. The *theoretical* value of Chad's shares is almost $70,000 but the actual value is still virtually nothing. Chad now has the opportunity to decide if $20,000 is a good offer. He is not obligated to accept it. Chad counters with an offer for $30,000 and they settle on $25,000. The theoretical value is now reduced by Chad's value. The transaction has the following impact on the equity calculation:

	Anne	Mark	Ted	Scott	Mike	
Ownership	50%	29%	12%	7%	1%	
Theoretical Value	$1,000,000	$ 545,003	$ 230,928	$ 128,924	$ 25,974	$1,930,829

Remember, we're still talking in terms of theoretical value. You should always try to convince a bank or investor that the company is worth more than the theoretical value.

As time goes on the company will grow. And investors and will start implementing more formal equity programs and option program. However, in the above case the Grunt Method helped this company build their business using equity in a fair and equitable manner.