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How should we divide the pie? Equity distribution and its impact on entrepreneurial teams☆

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ABSTRACT

Drawing on a multiple case study approach and data on eight entrepreneurial teams observed over six months this article develops a dynamic model of the consequences of equity distribution among team members. Perceived justice of equity distribution emerged as a key variable influencing entrepreneurial team interactions and important entrepreneurial outcomes. High perceived justice triggered *positive team interaction spirals*, whereas low perceived justice triggered *negative interaction spirals*. Teams exposed to external threats drifted from a positive spiral to a negative spiral despite high perceived justice. We discuss the implications of our study for research on entrepreneurial imprints, justice, and exit.

1. Executive summary

While equity ownership is important to entrepreneurs because of the connected financial rewards and the level of power and control within the firm, we know little about the consequences of equity distribution for the interaction within entrepreneurial teams and how these interactions develop over time. Understanding the consequences of equity distribution among team members for team interactions is important because a well-functioning entrepreneurial team is the key to a positive venture development and high levels of performance.

To address this gap we used a longitudinal case study approach and identified eight entrepreneurial teams—four with an equal and four with an unequal equity distribution—as appropriate cases in a multi-stage theoretical sampling approach. We followed these eight entrepreneurial teams over the time span of six months and further tracked them for up to 18 months after the study period to record important events such as team member exit. In total, we conducted 35 semi-structured interviews with the entrepreneurial team members. Additionally, we collected field notes, press reports, and self-report survey data.

We followed an inductive coding strategy and in an iterative process a dynamic model of the consequences of equity distribution among team members surfaced from the data. The key variable emerging in the interviews was the team members' perceptions of justice of equity distribution. High perceived justice triggered positive team interaction spirals consisting of an increase of team

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attraction—the team's experience of being a strong entity—and a reciprocal decrease in team repulsion—the team's thoughts, feelings, and behaviors connected to a process of drifting apart. In contrast, low perceived justice triggered team negative interaction spirals in which team attraction decreased over time, while team repulsion reciprocally increased. Teams which were confronted with external threats in terms of a corrosive impact by investors drifted from a positive spiral to a negative spiral despite high perceptions of justice. The negative spirals escalated over time and resulted in the exit of one team member. In contrast, we observed no team member exit in teams with positive spirals. Moreover, positive spirals were connected to high levels of team and venture performance, whereas negative spirals resulted in lower levels of performance.

Our study provides insights how entrepreneurs' decisions at firm foundation impact the firm's development and thus contributes to the literature on entrepreneurial imprinting. We also contribute to work on distributive justice. In contrast to employees in established firms who can reduce their input to restore justice, entrepreneurial team members still need to sustain their level of effort in order not to risk their venture's performance which creates a frustrating dilemma for entrepreneurial team members. Finally, we contribute to work on entrepreneurial exit by showing how team interactions can trigger exit and how investors initiate turnover via impacting team interactions.

2. Introduction

> "*There are thousands of issues that a startup has to deal with. Equity, the distribution of shares in the company, is the nuclear issue. The X-ray issue. The one that opens things up right to the core. Rolly and I had sweated and toiled and struggled together on this company. But we could work together all we wanted, for as many days and nights and months and years as we liked. Until it came right down to discussing equity in hard numbers, our actual forward going percentages of ownership, we did not really know each other's mind.*"
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> [—(Ashbrook, 2000: 163)]

Tom Ashbrook's reflection on the early days of his Internet start-up demonstrates that the distribution of equity among co-founders is a far-reaching, emotionally-laden decision for the entrepreneurial team. This is hardly surprising, given that equity ownership represents the primary economic reward entrepreneurs receive in return for their efforts and investments into the venture (Hall and Woodward, 2010) and is connected to the level of power and control in their firms (Nelson, 2003). As the split usually takes place within the first weeks of the venture's foundation, Hellmann and Wasserman (2011: 1) refer to the distribution as "the first deal" made by the entrepreneurs.

However, previous research on equity ownership in entrepreneurial firms typically focused on relationships between entrepreneurs and investors and addressed, for example, the investors' interest to monitor the firms in their portfolio (Lerner et al., 1995), the entrepreneur's willingness to grant investors the right to replace the entrepreneur (Hellmann, 1998), and the development of faultlines between entrepreneurs and investors (Lim et al., 2013). Moreover, equity ownership has been considered as an incentive to attract new entrepreneurial team members (Chandler et al., 2005; Wasserman, 2012). However, while there has already been an early call for research on antecedents and outcomes of equity distribution *within the entrepreneurial team* (Kamm et al., 1990), there has been a remarkable paucity of studies on this topic (Hellmann and Wasserman, 2011). Only a study on stock options has shown that stock option dispersion increases team cohesion in top management teams (whereas it decreases cohesion in family firms; Ensley et al., 2007). Studies focusing on the actual distribution of equity among entrepreneurial team members only addressed its consequences for financial firm outcomes (Hellmann and Wasserman, 2011; Kroll et al., 2007), but have not focused on social psychological consequences of equity distribution in entrepreneurial teams. So far, we know little about these consequences for the interaction within entrepreneurial teams and, in turn, outcomes of these interactions, such as team stability and team/venture performance. Investigating these interactions and outcomes is important because it helps to better understand how entrepreneurial teams impact venture development and performance. More generally, there is substantial interest to understand how entrepreneurs' and entrepreneurial teams' decisions and characteristics imprint the firm's development (Baron and Hannan, 2002; Beckman and Burton, 2008; Leung et al., 2013). This gap resulted in our research questions that served as guiding ideas in this study: (i) how the equity distribution in an entrepreneurial team shapes interactions between its members over time, (ii) how the outcomes of these interactions develop for the team and the venture, and (iii) how and why these effects differ between entrepreneurial teams.

Given that no comprehensive understanding of the consequences of equity distribution in entrepreneurial teams exists so far, field-work and grounded-theory "is more likely to generate novel and accurate insights into the phenomenon under study than reliance on either past research or office-bound thought experiments" (Brown and Eisenhardt, 1997: 2). As Eisenhardt and Graebner (2007: 25) point out, "a major reason for the popularity and relevance of theory building from case studies is that it is one of the best (if not the best) of the bridges from rich qualitative evidence to mainstream deductive research." Our major data sources are 35 semi-structured interviews with the co-founders of eight entrepreneurial ventures, which we followed over a period of six months. Our study provides several major new insights.

First, current research on equity distribution within entrepreneurial teams has focused on explaining antecedents (Hellmann and Wasserman, 2011; Kotha and George, 2012) or consequences in terms of financial firm performance (Hellmann and Wasserman, 2011; Kroll et al., 2007) but has neglected its impact on interactions within the team. Our data revealed that the team members' *perceived justice of equity distribution* left an imprint on the entrepreneurial team's interactions. High perceived justice triggered a reciprocal, *positive team interaction spiral* which consisted of an increase in *team attraction* and a decrease in *team repulsion* over time. Low