SWEAT EQUITY

Understanding Sweat Equity

– By Prof. *Simply* Simple™

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For the last couple of months, the term ‘ sweat equity’ has been in the news. In the recently concluded IPL3, this term acquired immense news coverage. But what does it mean? How is it arrived at?

Let me try & simplify…

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According to the Companies Act, sweat equity are equity shares that a company issues to an individual in consideration of his/her services, knowhow or any other value addition that the company has benefited from. In other words, it is the equity given to a company's executives to reflect the value the executives have added and will continue to add to the company.

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For instance, if a person works for creating patents for a company, then the company can issue equity (shares) to him, instead of paying cash.

It could be issued for many other things too such as the person providing technical know-how, brand rights or similar value additions to the company.

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All the limitations, restrictions and provisions relating to equity shares are applicable to such sweat equity shares.

These equity shares can be issued free of monetary consideration or at a concession to their prevailing value.

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A company may issue sweat equity shares if the following conditions are fulfilled:

- **(a) the issue of sweat equity shares is authorized by a special resolution passed by the company**
- **(b) the resolution specifies the number of shares, current market price, monetary consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued**
- **c) not less than one year has, at the date of the issue, elapsed since the date on which the company was entitled to commence business**
- **(d) the sweat equity shares of a company whose equity shares are listed on a recognized stock exchange are issued in accordance with the regulations made by the Securities and Exchange Board of India (SEBI) in this behalf.**

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Are "sweat equity" the same as "stock options"?

Not exactly. They are similar to the extent that both are means of providing non-cash incentive or compensation to individuals. However, sweat equity, as widely understood, are real shares allotted to individuals upfront.

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Stock option, on the other hand, is merely a right given to an individual to acquire shares of the company at a future date at a pre-agreed price.

Aware of the inherent differences between the two, SEBI has issued separate guidelines for sweat equity and stock options.

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Also, the Companies Act allows an unlisted company to issue up to 15 per cent, or worth up to Rs 5 crore, in a year under sweat equity allotment.

If the allotment is more than 15 per cent in a year, then it is not treated as sweat equity, unless the central government approval is taken.

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In a broader sense, sweat equity can be issued to anyone who has rendered services to the company. Sweat equity can be issued to an employee, consultant or a vendor. That is the reason start-up companies use sweat equity as currency to pay for services that they cannot pay for in “hard” cash.

However, in India, as per SEBI regulations, sweat equity shares can be issued only to employees or directors.

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But what about the IPL?

How did sweat equity acquire so much significance?

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The Indian Premier League (“IPL”) has been mired in controversies over the award of certain franchises.

Firstly, it was claimed that one of the members of the consortium had received 25% free equity. This was against the ordinance of Companies Act that allows an unlisted company the to issue only up to 15 per cent, or worth up to Rs 5 crore, in a year under sweat equity allotment.

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Secondly, the Companies Act also states that a company may issue sweat equity shares only after completing a year since its incorporation. According to press reports, one of the companies was incorporated only in August 2009 and therefore a year has not elapsed.

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Finally, issue of sweat equity needs to be passed by a special resolution; however, there is no confirmation that such a resolution was passed.

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In a nutshell, sweat equity shares are typically used to encourage entrepreneurs to form start-up ventures. However, there are specific regulations in India which must be followed regarding the issuance of sweat equity shares. It seems that these guidelines were not adhered to while awarding the rights of ownership to certain franchisees.

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Also if you wish to demystify any other concepts, do write to me about them.

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