

ISSUE OF SWEAT EQUITY BY UNLISTED COMPANIES



Sanjay Lalit, FCS
Practising Company Secretary, Mumbai
cssklco@gmail.com

Sweat equity is one's contribution to a business or project in the form of an effort as opposed to financial equity, which is a contribution in the form of capital. In a partnership, some partners may contribute to the firm only capital and others only sweat equity. Similarly, in a startup company formed as a private limited or limited but closely held company, employees may receive stock or stock options, becoming thus part-owners of the firm, in return for accepting salaries that are below their respective market values. The term used to refer to a form of compensation by businesses to their owners or employees. Sweat equity shares are equity shares issued by a company to its employees or directors at a discount, or as a consideration for providing know-how or a similar value to the company.

The term is sometimes used to describe the efforts put into a start-up company by the founders in exchange for ownership shares of the company. This concept, also called "stock for services" and sometimes "equity compensation" or "sweat equity" can also be seen when startup companies use their shares of stock to entice service providers to provide necessary corporate services in exchange for a discount or for deferring service fees until a later date, see e.g. "Idea Makers and Idea Brokers in High Technology Entrepreneurship" by Todd L. Juneau et al., Greenwood Press, 2003, which describes equity for service programs involving patent lawyers and securities lawyers who specialize in start-up companies as clients.

Meaning of Sweat Equity Shares :

Sweat equity is commonly considered all the voluntary unpaid work that is often required in the first years of a new business. This work is usually unpaid because the new business cannot afford to pay wages or salaries during start-up. The commitment by members to provide sweat equity is often essential for the success of the business.

Issue of sweat equity shares is governed by the provisions of Section 79A of the Companies Act. Explanation II to the said Section defines the expression 'sweat equity shares' to mean equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing the know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called. It is, therefore, necessary for the issue of sweat equity shares that the concerned director/ employee either provides the know-how, intellectual

property rights or other value additions to the company. Sweat equity for “employees” is usually compensation for “below-market wages” for services performed.

Tips on computation & issuance of entitlement for Sweat Equity Shares from the company’s perspective:

Ownership means owning a portion of the stock of a corporation or a percentage of the membership of a limited liability companies (LLCs). Ownership can be defined in many ways – such as voting and non-voting. Owners expect to share in the future success of the business. For “sweat equity” or “earn-in” situations, LLCs provide more flexibility than listed corporate structures. The rights and responsibilities of owners need to be clearly defined in a written agreement.

Compensation is payment for services performed and should be designed to reward the behaviors that make the business successful. Compensation plans can be designed to include incentives, such as bonuses and profit sharing. Equity (ownership) can be an element of an incentive compensation plan.

The difference between current compensation and market rate compensation gives you the uncompensated “sweat.” With this information, you can quantify the amount of sweat equity – but that’s only part of it! Then you have to decide how it will be compensated – through deferred compensation, profit sharing, percentage of ownership, or a combination of methods.

Sweat equity for “partners” (owners) is much more complicated to calculate. While it is easy to quantify the rupees, euros, dollars invested in the business, contributions of intangibles such as “know how” and customer contacts are more difficult to value. Even more difficult is determining the “value” of individual work efforts in different areas related to developing the business – such as IT, Engineering, Finance, Sales or Marketing. Sales milestones are one approach, but that doesn’t work for all situations.

Regulatory Provisions of Companies Act & related Rules :-

Section 79A of the Companies Act, 1956 and the Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003 authorizes a company to issue Sweat Equity Shares to its employees and directors. This is to enable to help the companies to reward their employees who have contributed for the growth and making available rights in the nature (intellectual property rights or value additions, by whatever name called).

Time limit :

A company which has completed at least one year since "commencement of business" can issue sweat equity.

Quantum :

Company can issue sweat equity only upto 15% of total paid up equity share capital in a year or shares of the value of 5 crores of rupees, whichever is higher. If the ceiling is to be exceeded, prior approval of the Central Government should be obtained. Sweat Equity shares to be issued are shares only of a class already issued by the Company. The Company must also comply with the provisions of Memorandum and Articles of Association of the India and also other related stipulations of the Lenders, Bankers and other Regulatory Agencies, if any.

Lock in period :

Sweat equity shares issued shall be locked in for a period of three years from the date of allotment.

Pricing :

The price of sweat equity shares shall be at a fair price calculated by an Independent Valuer.

Issue of Sweat Equity Shares for consideration other than cash :

If the sweat equity is issued for consideration other than cash, then company shall comply with following:

- The valuation of the intellectual property or of the know-how provided or other value addition to consideration at which sweat equity capital is issued, shall be carried out by an independent valuer;
- The valuer shall consult such experts, as he may deem fit, having regard to the nature of the industry and the nature of the property or the value addition;
- The valuer shall submit a valuation report to the company giving justification for the valuation;
- A copy of the valuation report of the valuer shall be sent to the shareholders with the notice of the General Meeting;
- The company shall give justification for issue of sweat equity shares for consideration other than cash, which shall form part of the notice sent for the general meeting; and
- The amount of Sweat Equity shares issued shall be treated as part of managerial remuneration.

Procedure :

Issue of sweat equity shares is to be authorised by a **Special Resolution** passed by the company in the shareholder's meeting of the Company. This **Special Resolution** will be filed with the Registrar of Companies (ROCs) in Form No. 23.

The Explanatory Statement should include the following details:

- i. The date of the meeting;

- ii. Reasons/justification for the issue;
- iii. Number of shares, consideration for such shares and the class or classes of persons to whom such equity shares are to be issued;
- iv. Value of the sweat equity shares along with valuation report/ basis of valuation and the price at the which the sweat equity shares will be issued;
- v. Names of persons to whom the equity will be issued and the person's relationship with the company;
- vi. Ceiling on managerial remuneration, if any, which will be affected by issuance of such equity;
- vii. Statement to the effect that the company shall conform to the accounting policies specified by the Central Government; and
- viii. Diluted earning per share pursuant to the issue of securities to be calculated in accordance with the Accounting Standards specified by the Institute of Chartered Accountants of India.

A separate resolution should be passed if the shares to be issued (during any one year, to identified employees and promotes) is equal to or exceeds 1% of the issued capital (excluding outstanding warrants and conversion) as stood on the day of grant of sweat equity shares.

After the Shareholder's approval, the Board of Directors of the Company will issue and allot the Sweat Equity Shares to the respective Director/Employees and the Company has to file e-Form-2 and e-Form 3 with the ROC in due course.

Disclosure in director's report :

The Board of Directors, shall, inter alia, disclose either in the Directors' Report or in the annexure to the Director's Report. Disclosure to include number of shares to be issued, conditions for issue, pricing formula, the total number of shares arising as a result of issue, money realised or benefit accrued to the company, diluted Earnings per Share (EPS) pursuant to issuance of sweat equity shares.

Registers :

The company shall maintain a specified register. The register of sweat equity shares issued by the company to be kept in the following format:

S.No.	Folio No. / certificate No.	Date of passing of resolution	Date of issue of sweat equity shares
1	2	3	4

Name of the allottee	Status of the allottee - whether director or employee	Reference to entry in register of members	Number of sweat equity shares issued
5	6	7	8

Face value of the share	Price at which shares issued	Total consideration paid by employee/director	Lock in period till which date
9	10	11	12

Compliance Certificate

A certificate of compliance (with the rules framed by the authorities) duly signed by the auditors or Practicing Company Secretary should be placed before the shareholders at the annual general meeting.

The following are the Specimens of required Board and Shareholder's Resolutions need to be passed by the respective Company, though there can be need based deviations & modifications in the related final resolutions to be passed by the respective Company, as per the requirement of the said issuance of Sweat Equity Shares.

I. Board resolution for issuance of Sweat Equity shares:- (Prior to EGM Resolutions)

The Board was apprised that Section 79A of the Companies Act, 1956 and the Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003 permits a company to issue Sweat Equity Shares to its employees and directors. This is to enable to help the companies to reward their employees who have contributed for the growth and making available rights in the nature (intellectual property rights or value additions, by whatever name called).

The Board was also informed that :-

(i) Time limit :

The Company has completed at _____year since "commencement of business" and therefore the Company is permitted to issue sweat equity shares to the eligible directors/employees of the Company.

(ii) Quantum :

The Company can issue sweat equity only upto 15% of total paid up equity share capital in a year or shares of the value of 5 crores of rupees, whichever is higher otherwise if ceiling exceeds prior approval of the Central Government should be obtained. Sweat Equity shares are shares only of a class already issued by the Company.

(iii) Lock in period :

Sweat equity shares issued shall be locked in for a period of at least three years from the date of allotment.

(iv) Pricing :

The price of sweat equity shares shall be at a fair price calculated by an independent valuer. If the sweat equity is issued for consideration other than cash, then company shall comply with following:

- The valuation of the intellectual property or of the know-how provided or other value addition to consideration at which sweat equity capital is issued, shall be carried out by an independent valuer;
- The valuer shall consult such experts, as he may deem fit, having regard to the nature of the industry and the nature of the property or the value addition;

Thereafter, the Board was apprised that the Company has arranged Valuation Report from M/s _____ in regard to valuation of the intellectual property or of the know-how provided or other value addition by Mr _____ Director or Mr _____ Employees at which sweat equity capital is to be issued.

The Board discussed the matter and thereafter passed the following resolutions:-

“RESOLVED THAT subject to the authorizations by the company in the forthcoming General Meeting and subject to the provisions of Section 79A of the Companies Act, 1956 and also in accordance with the Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003, and also other requisite approvals of appropriate agencies, banks & financial institutions if any, _____ number of equity of shares of Rs. _____ be and are hereby issued for consideration other than cash for providing know-how or making available rights in the nature of intellectual rights or value additions, by whatever name called)per share (or at a discount of Rs. _____) to Mr _____ Director or Mr _____ Employees, as per the detailed statement and Valuation Report of M/s _____ placed before the Board, which is also duly initialed by the Chairman for identification.

RESOLVED FURTHER THAT an Extraordinary General Meeting of the Company be called and held at on day of at for obtaining the approval of the Shareholders for issue of the aforesaid Sweat Equity Shares as per the draft notice and explanatory statement placed before the meeting and duly initialed by the Chairman for identification.

RESOLVED FURTHER THAT Mr. _____ be and is hereby authorised to issue the said notice to the members and others who are entitled for the same, and take all necessary action in this respect.”

II. Shareholder's/ General meeting resolutions for issuance of Sweat Equity shares:-

“RESOLVED THAT pursuant to the provisions of Section 79A of the Companies Act, 1956 and also in accordance with the Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003, and all other applicable provisions, if any, of the Companies Act, 1956, the Memorandum and Articles of Association of the Company and subject to such other approvals, permissions and sanctions as may be necessary of appropriate agencies, banks & financial institutions if any, (including approval of the Central Government, if any, and subject to such conditions and modifications as may be prescribed or imposed while granting such approvals), permissions and sanctions, the consent of the Company be and is hereby accorded to the Board of Directors of the Company (hereinafter referred to as the Board which term shall be deemed to include any Committee of the Board of Directors of the Company which may exercise its powers, including the powers, conferred by this Shareholder's Resolution), to create, issue and allot at any time to or to the benefit of Mr. _____ Director or Mr _____(Employees) of the Company, (hereinafter referred to as the _____) _____ equity shares of the face value of Rs. ___/-each (hereinafter referred to as the Sweat Equity) being not more than _____% of the paid up share capital of the Company as on the date of _____ pursuant to the Valuation Report of M/s _____ in accordance with the Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003 for a consideration other than cash being the value of his know-how provided by him to the Company and valued by M/s _____ vide their Valuation Report on such terms and conditions as discussed **(to be inserted)** and approved by the Board of Directors in its meeting on _____ in accordance with the provisions of the law, rules & guideline issued by the relevant authority.

RESOLVED FURTHER THAT the Share Certificates representing any shares issued to Mr _____ in accordance with the above said Shareholder's Resolution shall contain the following legend:

"The shares represented by this certificate are subject to General Meeting's Resolution passed by the Shareholders on _____ in respect to the provisions of Section 79A of the Companies Act, 1956 & Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003 among other things, imposes restrictions on the transfer, lock-in or other lien or disposal of an interest in, directly or indirectly and whether or not

voluntarily, by operation of law or otherwise, the shares represented by this certificate."

RESOLVED FURTHER THAT such equity shares, upon allotment, shall rank pari-passu in all respects with the then existing equity shares of the Company.

RESOLVED FURTHER THAT the Board of Directors while issuing the said Sweat Equity Shares do ensure compliance with the provisions of Section 79A of the Companies Act, 1956, Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003, and all other applicable provisions, if any, of the Companies Act, 1956 and other guidelines prescribed by the Central Government.

RESOLVED FURTHER THAT the Board be and is hereby authorised to do all such acts, deeds, matters and things as may be considered necessary, desirable, or expedient for the purpose of giving effect to this Resolution."

3. Relevant explanatory statement pursuant to Section 173(2) of the Companies Act, 1956 in respect of resolutions set out under Item Nos. ___ is annexed hereto.

EXPLANATORY STATEMENT/ INFORMATIONS AS REQUIRED UNDER SECTION 173(2) OF THE COMPANIES ACT, 1956:-

Section 79A of the Companies Act, 1956 and the Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003 authorises a company to issue Sweat Equity Shares to its employees and directors. This is to enable to help the companies to reward their employees who have contributed for the growth and making available rights in the nature (intellectual property rights or value additions, by whatever name called).

The Board of directors has accordingly decided to issue _____Sweat Equity Shares to Mr_____Director or Mr _____Employees, for his/ their contribution to the company. The company has complied with the conditions specified in section 79A of the Companies Act, 1956 and the Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003.

In terms of the resolutions of Board of Directors passed on _____, the Company has agreed to grant/ issue _____equity shares of Rs. ___ each fully paid up as sweat equity shares for a consideration other than cash being the value of his know-how provided by Mr _____to the Company and valued by M/s _____vide their Valuation Report. Thereafter the Board of Directors of the Company in its meeting held on _____confirmed, subject to necessary approvals, issue of _____ equity shares of Rs. _____/- each fully paid up to Mr. _____as sweat equity for consideration other than cash being the value of know-how to be brought in by Mr. _____ or Mr. _____in terms of Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003.

Other information regarding the Company is as under:-

- ii. Value of Intellectual Property / Know-How: Fair value of the value addition expected to be generated from the know-how brought in by Mr _____ Director or Mr ____ Employees, is Rs. _____ in accordance with Valuation Report of M/s _____. his/ their
- iii. Value of know-how brought in by Mr ____ Director or Mr ____ Employees, as determined by the Valuation Report of M/s _____ is ____/.
- iv. The price at which the sweat equity shall be issued: The price determined pursuant to the relevant Rules is Rs. _____
- v. Ceiling on managerial remuneration, if any, which will be affected by issuance of such sweat equity: The managerial remuneration shall be subject to approval of the Central Government, if approval is required in accordance with the provisions of the Companies Act.
- vi. Board of Directors of the Company confirmed that the Company shall conform to the applicable accounting policies specified by the Central Government.
- vii. The diluted EPS considering the sweat equity : Rs. _____per share.

Copy of Valuation Report of M/s _____ is annexed hereto.

None of the directors, except Mr. _____ is any way concerned or interested in the said resolution.

The Board of Directors commends the resolution for your approval.

III. Board resolutions for allotment of Sweat Equity shares:- (Post EGM Resolutions)

Allotment of Equity Share Capital to _____

The Board was informed that in accordance with Section 79A of the Companies Act, 1956 read with Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003, Valuation Report of _____ and also Shareholders Resolution passed in the meeting General Meeting on, the Company is hereby requested to issue and allot Equity Shares to ____ for consideration otherwise than in cash, as detailed below. The Board discussed the matter and thereafter passed the following resolutions:-

“RESOLVED THAT in accordance with Section 79A of the Companies Act, 1956 read with Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003, Valuation Report of M/s _____ and also Shareholders Resolution passed in the General Meeting held on _____, the Company hereby issue and allot _____Equity Shares to Mr ____ Director for consideration otherwise than in cash and the entries be made in the Register of Members and Register of Sweat Equity shares of the Company, as detailed below:

Sl. No	Name of Allottee	Shares allotted (Nos.)	Certificate Nos.	Distinctive Nos.
	Total			

RESOLVED FURTHER THAT the Share Certificates for fully paid up Equity Shares of Rs.____/- each bearing distinctive nos. _____both inclusive) be issued under the Common Seal of the Company and under the signatures of Mr and Mr, Directors of the Company with the counter signature of Mr_____ of the Company as per the provisions of the Companies (Issue of Share Certificates) Rules, 1960.

“RESOLVED FURTHER THAT the Share Certificate Nos. representing shares issued to Mr _____ in accordance with this Resolution shall contain the following legend:

"The shares represented by this certificate are subject to General Meeting’s Resolution passed by the Shareholders on _____in respect to the provisions of Section 79A of the Companies Act, 1956 & Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003 among other things, imposes restrictions on the transfer, lock-in or other lien or disposal of an interest in, directly or indirectly and whether or not voluntarily, by operation of law or otherwise, the shares represented by this certificate."

"RESOLVED FURTHER that Mr _____ Director, be and is hereby authorised to file the requisite returns of e-Form 2 and 3 with Registrar of Companies, Maharashtra and to take such other steps as may be necessary to give effect to this resolution."

Conclusion :-

In the start up of a business, it’s common for some people to contribute money and others to contribute time and effort with “an understanding” that they will share in the future success of the business. Sometimes “equity earn-ins” are used as a way for employees to earn an ownership percentage by forgoing some compensation. Sweat

equity has elements of both “ownership” and “compensation” – which are related but distinct concepts that frequently get mixed together.

Sweat equity is important to the successful start-up of a new venture, especially when cash is in short supply. However, it is important to value sweat equity carefully. Sweat equity should be measured in terms of the long term value of the effort, the long term commitment of the participants, and the value-added by the participants to the overall goals of the venture.

To conclude “sweat equity” can be a great way to get a business started and provide incentives to employees. The respective need to have an agreement early on about how the “sweat” equity will be earned and ownership allocated well in advance. For the best results, “sweat equity” and “earn-in” plans should be carefully crafted to ensure that the goals of the participants are aligned with the goals of the business. **The plan needs to include a clear valuation methodology, definition of participant responsibilities and restrictions on ownership transfer and buy-back provisions for the successful completion of the hidden mission of growth of the said Company or Issuer of Sweat Equity Shares.**
