Sweat Equity

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Introduction

A critical factor to the success of any company is its ability to attract top talent while retaining those already working within the company. Losing employees can have a significant impact on a company's morale, productivity and overall profit.

One of the ways in which companies attract and retain key employees is by rewarding them with equity shares. Traditionally, the issue of equity shares took two forms: employee stock options scheme (ESOS) and employee share purchase scheme (ESPS). Now, a new form has been recognised by the Companies Act, 1956: the issue of sweat equity.

When employees own stock in their company, there is an opportunity for employees and the company. Employee ownership of shares is believed to result in a positive, team-oriented atmosphere that attracts and retains top personnel, where people work together to secure a bright future for all. Knowing that the work they do makes a difference, every day—that they are not just working for someone else but contributing to the success of their company and their own. Ownership makes sense to the average Indian. We generally believe it is better to own a house than to rent; the same thinking extends to business.

Definition

A sweat equity share is an equity share issued by the company to its employees for a non-cash consideration. This non-cash consideration may be in the nature of intellectual property (copyright, patent, or design) or development of know-how.

Formally, sweat equity shares are defined as:

> Equity shares issued by a company to its employees or directors at a discount or for consideration other than cash for providing know how or making available rights in the nature of intellectual property rights or value additions, by whatever name called[1].

Issue of sweat equity shares in India is regulated by the Companies Act, 1956

[1] Explanation II to Section 79A (1) of the Companies Act, 1956.

(particularly Section 79A). Listed companies are required to comply with Securities and Exchange Board of India (Issue of Sweat Equity) Regulations, 2002. The Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003 are to be followed by unlisted companies.

Sweat Equity V. ESOPs

Companies offer various rewards to attract and retain talent. Issue of sweat equity and offer of stock options are few of such rewards. Sweat equity and offer of stock options share a number of common features; however, there are significant differences.

The objective of sweat equity is to compensate the employee for his past performance, which may have resulted in creation of intellectual property in the form of copyright, patent, or design; or in the development of know-how.

The objective of issuing employee stock options is, to put it crudely, offer bait to the employee to stick in the company. The employee can exercise stock options only if she works for the company for a given number of years (called vesting period). For this reason, employee stock options are also called as 'golden handcuff'.

Sweat equity is not linked to routine performance but to the value of intellectual property or know how created by the employee. Unlike stock options, sweat equity is normally a one-time grant and not repetitive.

Legal Provisions

The following prerequisites are mandated by the Companies Act, 1956[2]:

The issue of sweat equity shares is required to be authorised by a special resolution passed by the company in the general meeting. The resolution should specify the number of shares, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued

A company cannot issue sweat equity shares unless one year has elapsed since the date on which the company was entitled to commence business.

Additional Requirements for Listed Companies[3]

Listed companies are required pass separate resolution if they wish to issue sweat equity shares in excess of one per cent of the issued capital as it stood on the day of issue of sweat equity shares.

The notice sent to members for the meeting convened for considering the issue of sweat equity is required to be accompanied by an explanatory statement. This explanatory statement should contain prescribed particulars.

Ceiling on Quantum of Issue

For unlisted companies[4], the total sweat equity shares issued during the year should not exceed 15 per cent of the total paid-up equity share capital in a year or shares of the value of Rupees 5 crores, whichever is higher. If the ceiling is to be exceeded, prior approval of the Central Government should be obtained.

Valuation

Sweat equity shares are issued for a non-cash consideration; thus, the valuation of non-cash consideration (intellectual property, know-how, or other value addition) becomes imperative.

Listed companies are required to get the valuation carried out by a merchant banker. The merchant banker may consult

[2] Section 79A(1).

[3] Listed companies are required to comply with the Securities and Exchange Board of India (Issue of Sweat Equity) Regulations, 2002.

[4] Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003.

such experts and valuers, as he may deem fit having regard to the nature of the industry and the nature of the property or other value addition.

The merchant banker is required to obtain a certificate from an independent Chartered Accountant that the valuation of the intellectual property or other value addition is in accordance with the relevant accounting standards[5].

Unlisted companies may get the valuation of non-cash consideration done by an independent valuer[6].

Pricing

Listed companies are required to issue sweat equity shares at a price that shall not be less than the higher of the following[7]:

The average of the weekly high and low of the closing prices of the related equity shares during last six months preceding the relevant date; or

The average of the weekly high and low of the closing prices of the related equity shares during the two weeks preceding the relevant date[8].

Lock-in period

Sweat equity shares issued by listed, as well as unlisted, companies are locked in for a period of three years from the date of allotment[9].

Issue of Sweat Equity Shares to Promoters

The Companies Act contemplates issue of sweat equity shares to employees and directors. However, SEBI has gone one step further and has allowed issue of sweat equity shares to promoters too[10]. The following safeguards are prescribed to ensure that this additional facility is not misused by the companies.

Issue of sweat equity shares to promoters should be approved by the company by passing an ordinary resolution[11].

The above ordinary resolution should be passed by voting through postal ballot[12]. The promoters to whom sweat equity shares are proposed to be issued shall not participate in such resolution[13].

Each transaction of issue of sweat equity is required to be voted by a separate resolution. The resolution for issue of sweat equity is valid for a period of not more than twelve months from the date of passing of the resolution.

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[5] Regulation 8 of the Securities and Exchange Board of India (Issue of Sweat Equity) Regulations, 2002.

[6] Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003

[7] Regulation 7 of the Securities and Exchange Board of India (Issue of Sweat Equity) Regulations, 2002.

[8] Relevant date for this purpose means the date which is thirty days prior to the date on which the meeting of the general body of the shareholders is convened, in terms Section 79A (1) (a) of the Companies Act.

[9] Regulation 12 of the Securities and Exchange Board of India (Issue of Sweat Equity) Regulations, 2002.

[10] Regulation 6 of the Securities and Exchange Board of India (Issue of Sweat Equity) Regulations, 2002.

[11] SEBI has used the term ‘simple majority of the shareholders’.

[12] The rules regarding passing of resolutions through postal ballot are contained in the Companies (Passing of the resolution by Postal Ballot) Rules, 2001.

[13] The validity of this provision is doubtful. The basic framework of company law does not allow putting any fetters on the rights of shareholders to vote in the general meeting.