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**Notes from the Northern Colorado Entrepreneurs Network seminar on
“Sweat Equity”**

Disclaimer: The seminar moderator made a clear statement that none of the opinions expressed were intended as legal advice. The same goes for this summary!

Sweat Equity – should you do it?

The general opinion was “Yes, this can work.”

Deal with Sweat Equity (SE) staff as if they were on the payroll in all other respects. They are just getting equity instead of a salary.

Do an organization chart and then go looking for SE people to fill the positions.

But get professional help, attorney, CPA, before getting into any agreements. Do it yourself LLC filings only cost \$50 but they can cause problems. Also there are tax traps for SEs. They can get stuck with phantom earnings where the IRS deems that they have earned “equity value that is taxable” but no funds have been paid out. If the company fails, the SE is left with a loss on their efforts.

Company structure

This needs professional advice.

One novel set up was a C corporation where part of the equity was owned by an LLC. The LLC equity was convertible to the C corp. SEs received stock in the LLC.

Think about having a Buy/Sell agreement to cover the actions when ownership of the SE’s rights may change, eg death, relocation.

Some start-ups do OK with unwritten agreements as the process gets worked out. But if one brings money and is not present day to day, there should be a written agreement and the company should keep formal records and books.

Valuation

Entrepreneurs often over-value the years that it took to get an idea to the point where other people and new money can be brought in.

One measure of value in the company is “What is the cash flow and projected cash flow, worth to the next equity buyer?”

If the company has expectation of being a hit, it may be worth getting a formal appraisal to set the basis for bringing in SEs. Valuations are an art, assessing comparable value from the sale of similar companies, assessing the value of future cash flow, assessing the risk of the company being around to generate future cash flow (discounting the forward value for this risk and for the value of money, can be 5% to 50%.) Valuation is also discounted if the equity being considered represents a minority position. In this case the owner is vulnerable to decisions that do not favor him/her. Valuations can cost \$10K.

Similarly, assess the value of the contribution from an SE guy as “What would this capability cost? But add value for unique skills or intellectual property that the SE may bring.”

There was one faction that thought that a very early stage company should be valued on book value, ie the cash that each brought to the deal or other tangible assets that were contributed. This was disputed for considerations such as an SE bringing a solution to a problem, or a unique skill that was critical to the success of the company.

Advisory board

The best people to bring in as an advisory board are those who have industry knowledge and credibility.

Do not expect specialists such as attorneys, CPAs or marketing people, to work for free. They can be expected to give general guidance but not deliver work-product.

One opinion was to use Twitter to get guidance on specific issues. The challenge to this was that many correspondents lack credible information.

Traps to avoid

Be careful with valuation of the contribution of the first SE you bring in. It sets a precedent for later recruiting. Do the valuation with thought to the needs you will have over the next three years.

Failure to authorize enough shares in the company at foundation, or issuing all the authorized shares at the beginning. This leaves no room to issue shares for later participants and could lead the founder to have to put in cash to maintain equity control. A big percentage of stock should be left “On the shelf.”

Beware of partnering with an individual who has zero, or negative, net worth. This will cause problems if trying to get a bank loan.

You may need to be able to get early investors to leave. VCs do not like to have 30 angel investors as equity owners. The solution is to define how the early investors are compensated but obliged to leave. One way is to state that early investors will be cashed out at the next finance event.

Avoid SE obligations coming due without the availability of funds to pay what is owed to them. Solution is to make the payout date to be the time when free cash flow reaches an agreed amount. It is a problem to have this payout linked to the next round of finance because new investors want their money to achieve some tangible growth event, and not go to pay off debt.

Stock options are only available to employees and cannot be offered to contractors.

Do not enter into a 50/50 ownership. If the two disagree, no decisions can get made. Do not partner without the other party bringing some skin to the game, either cash or an asset.

By David Cunningham.

If you have recently spent time sorting through a pile of resumes in pursuit of a new employee, give me a call. (970) 988-4080.