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SWEAT EQUITY

17.1 Meaning

Just as ESOPs are a popular tool for motivating employees, sweat equity is a compensation for top management, promoters, technocrats, etc. As the name signifies "sweat equity" is equity or an equity-linked instrument given as a reward for contributing certain valuable technology, efforts, innovation, know-how, etc. Sweat equity was initially not as popular as ESOPs in India, but the last few years have seen it emerge as a key instrument for rewarding the top management. With several companies now having ownership separate from management, sweat equity has found increased favour in corporate India.

17.2 Companies Act

17.2.1 Fortunately, the Companies Act has recognised the concept of sweat equity and has enacted s.79A to deal with the same. The Act defines "Sweat Equity" to mean the following:

- (a) It only covers issue of equity shares;
- (b) They can be issued to employees or directors;
- (c) The shares can also be issued at a discount. S.79A overrides all other sections and therefore, the approval of the Company Law Board/ Central Government will not be required u/s. 79 and consequently, the procedure specified therein need not be followed.
- (d) The shares can be issued as consideration for know-how, intellectual property rights, or value additions, etc. made by the employees or directors to the company. In this case the shares would be issued for consideration other than cash. Thus, they can be issued against any patent, design, trademark, invention, copyright, formula, innovation, discovery, layout, etc., provided to the company. The term value addition is of very wide import and would cover every contribution by the employee which can be deemed to increase the value or worth of the company, its products, its technology, its goodwill, etc.
- (e) The shares can be issued either by a company incorporated and formed in India under the Companies Act and even its subsidiary formed and

incorporated outside India. However, it does not include a foreign holding company of an Indian subsidiary. Thus, an Indian company can issue sweat equity shares to the employees of its foreign subsidiary.

17.2.2 A company which satisfies the above conditions, must follow the following procedure to issue sweat equity shares:

- (a) It must pass a special resolution of its shareholders in a general meeting;
- (b) The resolution must specify, amongst other details, the number of shares, the current market price of the shares, the consideration if any, the class of directors/ employees to whom the shares are being issued;
- (c) At least one year must have elapsed since the date on which the company was entitled to commence business. The date of commencement of business is determined u/s. 149 of the Act. Thus, a newly incorporated company cannot issue sweat equity. It is respectfully submitted that this provision needs a rethink.
- (d) The issue must comply with the SEBI(Issue of Sweat Equity) Regulations, 2002 in case of a listed company or the Unlisted Companies(Issue of Sweat Equity Shares) Rules, 2003 in case of an unlisted company.

17.3 Unlisted Company Rules

In case of an unlisted public company, the issue of the sweat equity shares must also comply with the Unlisted Companies(Issue of Sweat Equity Shares) Rules, 2003. These Rules apply to all unlisted companies, whether public or private. Thus, unlike the Preferential Allotment Rules which only apply to unlisted public companies, these Rules even apply to private limited companies. The key requirements of these Rules are as under:

- (a) The maximum limit of sweat equity shares which a company can issue is 15% of the total paid-up equity capital in a year or shares equivalent to a value of Rs. 5 crores, whichever is higher. In case it wants to issue shares of a higher limit, then it requires the prior approval of the Central Government.
- (b) The shares carry a lock-in of 3 years from the date of allotment.
- (c) The special resolution to be passed must carry certain specified details in its Notice. Important amongst them are the ceiling on managerial remuneration which will be affected by such an issue, the value of the sweat equity, etc.
- (d) In case the issue to identified employees and promoters exceeds 1% of the issued capital during any one year, then a separate resolution is required.
- (e) Practice Pointer: The price of the shares to be issued must be at a fair price which is calculated by an independent valuer.
- (f) Practice Pointer: In case of an issue of sweat equity shares for consideration other than cash, the company must obtain a valuation report of the intellectual property or know-how or value addition which is obtained. The report must contain justifications for the valuation.

- (g) An issue for consideration other than cash is treated as managerial remuneration and included in the ceiling computation u/ss. 198, 309, 310, 311 and 387 of the Companies Act if they are issued to any director/manager and they are not issued against any asset which can be capitalised in the Balance Sheet.
- (h) Practice Pointer: The Company's Auditor or a practising company secretary must certify that the issue is implemented in accordance with the Rules and the Resolution passed in the General Meeting. There is no specified format for the same. A copy of such Certificate must be placed before the General Meeting.
- (i) Practice Pointer: If the issue is for other than cash consideration, then the consideration should be capitalised in the balance sheet in case it is a depreciable asset. Alternatively, it must be treated as an expense. In respect of shares issued during the accounting period, the accounting value of the shares shall be treated as another form of compensation in the financial statement of the company.

17.4 SEBI Regulations

An issue by a listed company must also comply with the SEBI(Issue of Sweat Equity) Regulations, 2002 in addition to the conditions specified under the Companies Act under para 17.2 above. The important requirements of these Regulations are as follows:

- (a) The issue may be to employees and directors who may be promoters as well. However, in case of an issue to promoters, the following additional procedures must be complied with:
 - (i) The issue must also be approved by a simple majority of the shareholders in a general meeting.
 - (ii) Such a resolution must be passed by a Postal Ballot.
 - (iii) The eligible promoters must not vote on the resolution.
 - (iv) Each issue requires a separate resolution.
 - (v) Each resolution is valid for a period of 12 months from its passing.
 - (vi) The Explanatory Statement to the Notice calling the general meeting must contain various specified disclosures.
- (b) The minimum price in case of a preferential issue of shares must be the higher of the:
 - Average of the weekly high and low of closing prices during six months preceding the "Relevant date", or
 - Average of weekly high and low of closing prices during two weeks preceding the "Relevant date"

The "Relevant date" means the date 30 days prior to the date of the General Meeting held for the passing of the resolution. E.g., if the date of the EGM is 31st January, 2006, then the relevant date for considering the above prices

considered would be 1st January, 2006. The prices on that stock exchange must be considered on which the highest trading volume has been recorded during the six months prior to Relevant Date. If the shares are not quoted on the Relevant Date, then the prices on the next trading day are considered.

- (c) The shares carry a lock-in of 3 years from the date of allotment. In case the company makes a public issue after it has issued sweat equity shares, then the requirements of lock-in and promoters contribution specified in the SEBI(DIP) Guidelines would apply (See para 2.6 and 2.7).
- (d) Practice Pointer: If the shares are issued against any intellectual property/ value addition, then a valuation of the same must be obtained from a merchant banker. He must obtain a certificate from an independent CA that the valuation is in accordance with the relevant accounting standards.
- (e) An issue for consideration other than cash is treated as managerial remuneration and included in the ceiling computation u/ss. 198, 309, 310, 311 and 387 of the Companies Act if they are issued to any director/ manager and they are not issued against any asset which can be capitalised in the Balance Sheet.
- (f) Practice Pointer: The Company's Auditor must certify that the issue is implemented in accordance with the Rules and the Resolution passed in the General Meeting. There is no specified format for the same. A copy of such Certificate must be placed before the General Meeting.
- (g) Practice Pointer: If the issue is for other than cash consideration, then the consideration should be capitalised in the balance sheet in case it is a depreciable asset. Alternatively, it must be treated as an expense. In respect of shares issued during the accounting period, the accounting value of the shares shall be treated as another form of compensation in the financial statement of the company.
- (h) The shares would be listed if they are issued in accordance with the Regulations.
- (i) Any acquisition of sweat equity shares would be subject to the provisions of the Takeover Regulations.