Entrepreneurs' Introduction to
Sweat Equity: Using Equity to Recruit, Retain, and Incentivize the Team

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Introduction

"Sweat Equity" is equity that startups and emerging companies issue to employees and others to attract and incent them, and is almost always "earned" over time (the "Sweat" in Sweat Equity). It has been a defining feature of the high impact entrepreneurship and venture capital universe for more than 50 years. In their efforts to change the world (and create a lot of wealth) entrepreneurs and venture investors alike, working together, have made hundreds of thousands of millionaires out of software programmers, bench scientists, lower and middle-level managers, and even receptionists. And the great thing is, pretty much everyone is happy about it – except maybe some of the folks who turned down sweat equity-laden job offers from risky startup businesses for the too-often nebulous job security promises of larger, more established employers.

As part of the Venture Best® Entrepreneurs' Guide series, this short review covers the basics of what Sweat Equity is, why it is such an integral part of the scalable startup world, and how it works. Far from a comprehensive examination of the world of equity incentives, its more modest ambition is to give entrepreneurs, particularly those new to the world of high impact entrepreneurship and venture capital, a 30,000 ft. view of Sweat Equity in the context of launching, building, and eventually finding liquidity for high impact, risk-capital backed startups. Who should get equity incentives, and why? How much? On what terms? When?

Of particular note, this guide focuses on the use of stock options as the vehicle for implementing Sweat Equity programs. While there are a few references to alternative Sweat Equity vehicles, the fact is, stock options are by far the most common mechanism for implementing broad-based equity incentive programs at venture capital-backed companies in Silicon Valley and across the country.

Just for the record, nothing in this guide should be considered legal advice (or business or any other kind of advice for that matter). Sweat Equity is something every entrepreneur looking to build a substantial company should have a good feel for in terms of the big picture. It is also something entrepreneurs should discuss one-on-one with a good startup lawyer, as well as business confidants and their investors, before setting up any equity incentive plans or making (or promising) any equity incentive grants.

What is Sweat Equity, and Why is it Important?

Sweat Equity involves sharing ownership of your startup with your team, including employees, of course, but also consultants, advisors, board members, etc. For most companies, pretty much everyone who toils in the fields to make your business thrive – a piece of the action, if you will. It's as simple as that.

Perhaps the most obvious question for many entrepreneurs is why exactly they would want to give all these folks a piece of their business? Venture capitalists and other equity investors get equity, of course, but they pay for it.

The "paying for it" part is as critical to understanding the Sweat Equity ownership exchange as it is the investor equity transaction. A good Sweat Equity program starts with the notion that employees and other team members (let's just call all of them "team members") of young, unproven, emerging companies with out-sized ambitions are taking career risks, real and perceived, when they choose to lend their talents to those companies rather than to more established and seemingly more stable businesses. Many take below market conventional compensation as well. Sweat Equity compensates them for taking that risk and making that sacrifice.

Ultimately, Sweat Equity is a tool (a business asset, actually: more on that later) that emerging companies use to recruit, retain, and incentivize the best team members. It does this, in the context of their compensation package, by giving them a stake in the business: a stake that might ultimately be worth a good chunk of change. Not a guarantee, of course, but a believable story that has an ending that includes some serious financial reward for the folks who helped write it – because they owned a piece of it.

There are two other pretty solid reasons for Sweat Equity grants. First, and particularly in the raw startup and very early growth phases, healthy Sweat Equity incentives for the early key players often compensate for below-market cash compensation – cash being something pretty much every startup company doesn't have enough of. Second, a broad-based Sweat Equity program can help instill a business culture characterized by the kind of esprit de corps you get when everyone, from the receptionist to the C-suite, feels like an owner as well as a contributor to the enterprise.

What about other incentives?

Why equity? Lots of companies, even large public companies, use Sweat Equity to recruit and retain employees. At larger and more established businesses, though, Sweat Equity is often reserved for more senior employees, and incentive plans for all levels of employees often include performance bonuses tied to specific business objectives.

High impact, venture-backed startups are the place where Sweat Equity is typically used most aggressively. There are several reasons for this, the three biggest of which are probably (i) these companies are typically cash-poor and thus prefer non-cash incentives, (ii) startups and emerging companies are typically small enough that having everyone in the organization feel that they are part of the "big picture" in terms of their role and the startup's success is realistic and valuable, and (iii) startup operating objectives usually change, often significantly, as the startup grows and evolves, making it hard to define specific performance objectives for long term incentives purposes.

Finally, if you are still not convinced, there is this: wherever you are located, recruiting high-value employees to high-risk businesses pretty much demands it. And, if you are in a place like Silicon Valley, pretty much every employee considering working for a high-risk startup will expect it – and get it, if not from you, then from the entrepreneur on the other side of the parking lot. As much as your venture investors are loath to suffer unnecessary dilution of their own ownership stakes, they understand that incentivizing your team with appropriate amounts of Sweat Equity is part and parcel of building a winning team in today's high impact startup world.

The bottom line is this. Sweat Equity is a critical part of the compensation picture for most venture-backed startups. Sharing ownership across most and often all of the team, when done correctly (more on that coming: stay tuned), is a time-proven part of building and getting the most out of a high impact business team, from startup to – and even in most cases through – a profitable exit transaction. Profitable, that is, for everyone.

Control Issues

Besides ownership dilution, founders may worry that issuing Sweat Equity will dilute founders' voting rights and thus their ability to control their company. It is a legitimate concern, but ultimately not as much of a problem as it might seem at first.

First, the more important negotiation about control will be with investors, who will in pretty much every case have a fair measure of at least negative control (ability to prevent founders from doing certain things with the company) and some level of positive control (ability to influence founder decisions about the company), even if they have well under 50% ownership.

Second, as will be discussed later on, most Sweat Equity plans take the form of options to acquire common stock. Options do not have any voting rights, and are seldom exercised until the company has achieved a liquidity event.

Finally, if a founder is concerned that a particular grant or grants is so large that, upon exercise, it might be significant in a control sense, the grant could include a requirement that the holder enter into a voting agreement with the founders. (While beyond the scope of this Guide, control issues can also be addressed by making Sweat Equity grants in the form of options to acquire non-voting shares.)

If Sweat Equity is good, is More Sweat Equity Better?

The Sweat Equity "Pool" as a Corporate Asset

Hopefully you're convinced that Sweat Equity is a good thing, even if it means diluting your own stake in what you understandably think of as your business. The rubber first meets the road, in terms of thinking about Sweat Equity in practice rather than theory, when you start putting hard numbers on it. That is, when you start measuring the value of Sweat Equity from a team building and incenting perspective against the cost of Sweat Equity in terms of dilution of your own stake and the stake of current and future investors.

Here we want to suggest what may seem at first a peculiar way of looking at that problem. We want you to think of Sweat Equity the way you would think of any other asset; for example, capital – cold, hard cash.

As you grow your business, you are going to need capital. You are going to get capital (at least before you qualify for any sort of debt financing) by selling ownership interests in your business to investors. You are likely going to raise that capital in tranches to accomplish defined objectives so that over time you can raise more capital for smaller ownership stakes; that is, as your business is "de-risked" and grows, you get more capital for every smaller amount(s) of equity.

Sweat Equity works the same way. As you grow and de-risk your business, you will need to "invest" smaller amounts of Sweat Equity in any given team member as that team member – at whatever level in the organization – is asked to take less risk to join the team on the one hand, and becomes a marginally smaller piece of the success of the business on the other.

Viewed in this way, as just another corporate asset, you can think strategically about how you allocate and replenish your Sweat Equity "Pool" over time. Much the same way as you allocate and replenish your capital over time. You can develop a Sweat Equity plan that looks, in many ways, like your capital plan: if everything goes according to the business plan (and the capital and labor markets cooperate), you will find yourself allocating smaller and smaller pieces of ownership to investors and team members for similar contributions as the price of your equity – and thus its value to investors and team members alike – goes up.

The point here is that as important as Sweat Equity is, an ownership stake in your emerging business is a precious asset. An asset that you should invest carefully so that you get the return on it you need, in terms of building and incenting a great team, without spending more of it than you have to. Figuring out the details of that tradeoff, in terms of what individual team members contribute as your business evolves, is our next subject.

Who Gets Sweat Equity and How Much?

We've reached the point where things start getting complicated. Not time for dotting every "i" and crossing every "t" perhaps, but time to start looking at some of the trees rather than just the forest.

The Sweat Equity Pool: How Much Dilution Are We Talking About?

After the founders of a new startup divide the initial equity of the company among themselves, a good exercise is thinking about what additional equity they might want to set aside – if only in their minds – for recruiting future team members.

This is useful for a couple of reasons. First, it forces the founders to confront the notion that building a good team will be dilutive: that while they may own all of the business in a technical sense, they are going to be diluted going forward, even if they never need to sell any equity to investors. Second, when the founders get around to talking with investors, they can be certain that any serious discussions are going to include prospective investors suggesting their own take on how much Sweat Equity should be set aside in a pool for future hires. Founders are in a much better position to "win" that discussion if they have themselves already thought through, and assembled a rational for, their own take on that question.

So, how big should the pool be? There are a bunch of factors that go into that question, and one way to approach the question is to address it from the bottom up; that is, consider each factor in turn and get an answer. We'll get to something like that, but in our experience, thinking about it in terms of where most startups end up in terms of the common ranges of pool size is a good first step.

What About Founder Equity?

The "Founder(s)" of a startup are the folks who own the business at the idea/launch stage, before any investors or other third parties are part of the ownership structure. A founding team can be one or several folks who together own all or the bulk of the initial equity, and sometimes includes early employees or advisors who own much smaller stakes. Founder ownership is usually in the form of shares of common stock rather than "options" to acquire common stock that are typically the mechanism that later-arriving team members get their Sweat Equity.

Founder Equity is in purpose and impact a special kind of Sweat Equity, but in conversations about Sweat Equity, and most particularly the Sweat Equity Pool, Founder Equity is usually not part of the conversation. When people talk about the Sweat Equity Pool they are generally referring to the total available equity stake for distributions to team members after the original equity is divided among the founders and any folks who got equity in the initial distribution of "founder stock" to the founding team.

A quick diversion on methodology. The first "formal" discussion of the size of the Sweat Equity Pool usually takes place during the negotiations with the first serious investors in a startup, and usually asks the question in terms of the size of the pool – as a percentage of the fully-diluted capitalization of the startup – immediately after the closing of the applicable financing.

In this guide we are going to take a step back and first ask the founders to think about whether they will need any key people to join them before the first significant outside investment (we'll see how that works in a fact pattern later on). Having done that and factored it into the "pre-financing" equity split, we will then turn to the more typical question of what the size of the Sweat Equity Pool should be in the immediate aftermath of the first significant financing.

The pre-financing Sweat Equity thinking revolves around whether the founding team is sufficient to attract a quality venture investor on acceptable terms. If so, great. If not, who do you need to add to the team, and what kind of Sweat Equity are you going to have to set aside for that person? The answer to that question can range from a lot (perhaps as much as the senior member of the founding team), to a very small amount (perhaps a couple of points for a glorified office manager), to nothing in the case the founders can raise capital without any other team members on board. Again, we'll go through an example of this kind of decision a bit later on.

In terms of the big picture on the post-financing Sweat Equity Pool, most startups are likely to wind up with a working pool size of somewhere between 5% and 25% of the capitalization of the company immediately after the first significant financing closes. And while it may not seem fair, the investors will, in the large majority of cases, expect the founders to suffer all of the dilution from that set aside. That is, whatever valuation the investors place on the company prior to putting in their capital, it will be assumed to include the shares outstanding before the financing *plus* the shares that will be set aside for the Sweat Equity Pool immediately after the financing closes. The reasoning for this is wrapped up in the earlier discussion of the Sweat Equity Pool as an asset of the business. As such, investors think of the Pool as part of what they are investing in, not something that comes along afterwards. This rational may not convince you, but most investors will insist that you accept it.

5% to 25% is quite a range, and particularly at the high end can give founders some pause. It's even worse than that, because as we will discuss in a bit, depending on how long and uneven the path to successfully selling the business or otherwise achieving a good exit is, and how many rounds of financing it takes to get there, the pool often grows as the company grows. Still, as much as this train of thought can unnerve founders, industry experience suggests that "refreshing the pool" is something most venture-backed companies do at least once.

Who Owns Your Company?

Entrepreneurs and investors typically talk about ownership in terms of the distribution of ownership on a "fully diluted" basis. The fully-diluted capitalization of a startup consists of all of the equity actually outstanding, including any securities (convertible debt, stock options, warrants, etc.) that can be converted into equity, all of the same as if they were by their terms converted into shares of common stock. That much is pretty straight forward, though some convertible securities can be tricky to work through. The less obvious part of the fully diluted capitalization of the startup are any equity securities – typically the "unallocated" Sweat Equity Pool - that have been set aside for future issuance. That is, the fully diluted capitalization includes shares of common stock that are set aside for issuance pursuant to the Sweat Equity Pool whether or not securities in the pool have actually been issued. For example, if there are one million shares outstanding, and the startup has "reserved" up to 200,000 shares for future issuance to employees via a Sweat Equity program, the fully-diluted equity of the startup is 1.2 million shares. That is true whether all, none, or some fraction of the 200,000 shares in the pool are actually outstanding or subject to options that are outstanding.

If the range for the initial pool is pretty significant, what are the factors that drive where your startup fits best in that range? Generally, those factors are contained within the answer to these two questions: How significant are the talent gaps on your team, and how soon will they need to be addressed? If you need to hire a CEO and other C-Level folks, and you need to do it sooner rather than later, you will need to think about a bigger pool. On the other hand, if your needs for recruiting future talent are less significant in terms of quantity and level of talent, and farther down the road, you can think about a smaller pool.

As noted above, whatever the founder's expectations are for the initial pool size, the chances are pretty good that at one and quite often several times down the road, the size of the pool is going to be increased. "Refreshing" the pool often happens when there is a significant new round of financing. Other common "refreshing" triggers include unexpected key hires, or needing to make new Sweat Equity grants to existing team members. The fact is, refreshing the Sweat Equity pool, and who gets the individual benefits of "refresh" grants, can be a routine "non-event" for founders and other team members alike. In other situations, it can also be among the most intense and bitterly contentious events growing emerging companies face (see "Refresh or Reset?" sidebar).

Refresh or Reset?

Most initial Sweat Equity Pools are refreshed, significantly, well before the business achieves a successful exit.

Refreshing the Sweat Equity Pool dilutes everyone who owns equity at the time of the refresh. Founders, investors, and existing holders of Sweat Equity are all diluted when the Pool increases in size. To the extent the dilution is smaller and not unexpected (and the value of the company's stock is going up) a refresher can be a quite benign event, and even a positive signal for the team.

On the other hand, a larger refresh, particularly one associated with the need to bring in significant new talent and/or make a significant new Sweat Equity grant to some founders or existing high level folks but not others, can seriously disrupt a company at all levels. In the extreme case of a "washout" or "restart" or "recap(italization)" transaction, where a new set of investors come in at a much lower price than previous investors, the pool refreshment can be so large that existing holders of Sweat Equity (as well as the founders) that are not a big part of the investors' plans for the business going forward can see their ownership diluted to virtual insignificance.

Let's Put Some Names to the Numbers

While thinking "top-down" about the size of the pool is a good way to get a handle on how big the pool should be, at the end of the day, any such analysis should be followed up with a "bottom-up" analysis, if only as a sanity check. That means thinking about how much talent – quality and quantity – the company will need to recruit over what period of time.

This is probably redundant, but it is important enough that it needs to be said again. The two key factors in determining the size of a Sweat Equity grant are how much value you expect the contributor to make and how much risk (career and compensation) they are taking by signing up. "Day one" folks who join on a full-time basis at significantly reduced compensation levels take the biggest risks, and will generally get an order of magnitude more Sweat Equity than their peers who join when the business offers good job security (whatever that really means in today's business environment), and the business can afford to pay market cash compensation rates.

With that reminder, and recognizing that startups come in so many different flavors in terms of how much talent they need and when they need it, rather than try and anticipate every permutation or alternatively try and come up with a "one size fits all" case study, I am going to work through three hypothetical examples. One that comes out on the high end, one in the middle, and one in the low end in terms of the initial Sweat Equity Pool.

A couple of preliminary points. First, in each example I am going to assume there are two co-founders. This will keep it simple but still allow for covering a range of common situations in terms of how different co-founders can bring very different skill sets, commitments, and expectations to the table – factors that are often overlooked when they set their initial ownership-split. Second, you should assume that the facts represent the mutual assessment of founders and their prospective investors regarding the path forward: i.e. don't be skeptical about the facts, just take them as a given.

First Example: NewCo One is a drug discovery and development company with two academic founders who expect to stay in their academic positions while consulting part-time for the company. They have developed a patent-protected drug discovery "Platform" technology that offers the potential to identify many promising drug targets for a variety of largely unmet medical needs. Two leading molecules have already been identified and have significant pre-clinical data that will need only some "cleanup" testing before expected filings for initial clinical trials within 12 months of an anticipated $3 million of first round funding. The plan is to sell-off one lead molecule shortly thereafter and move towards a second round of financing of $10-15 million while negotiating a strategic partnership around the platform technology within six months of the second closing and taking the second molecule to the clinic "in-house" via a Contract Research Organization.

In this example, the two co-founders will almost certainly need someone on the business side as a co-founder (likely a CEO), either as a condition to getting serious investors to the table or as a condition to closing a significant "A" round of financing. The key facts leading to this conclusion are as follows: (i) the drug discovery and development industry is extremely capital intensive, very complex in terms of the regulatory environment, and it most often takes a very long time to get to the market in any significant way; and (ii) neither co-founder has business or technical private sector experience, and neither intends to leave their academic career and join the company on a full-time basis.

Attracting someone with the right credentials, network, industry experience, or network that will make them credible in the eyes of potential strategic partners from day one (prior to or even simultaneously with the targeted $3 million A round) will almost certainly take more than 10% of the pre-A equity, and quite possibly could take as much as 1/3 of the pre-A equity (i.e. if the co-founders were 50/50 they would be diluted to 45/45 in the first case and 33/33 in the second case). The bottom line is that the initial two co-founders are going to take some significant Sweat Equity dilution even before they start thinking about the post-A financing Sweat Equity Pool.

As for the post-A Sweat Equity Pool, even accounting for already having the key C-level hire on board, it is likely to be in the 25% range. Again, the nature of the industry and the expectation that the initial academic co-founders are going to keep their day jobs (and don't have the drug development, as opposed to early lead discovery, or regulatory chops in any event), means that you are likely going to need at least two early hires to run the company's drug development program. Between them, you probably have 8-10% of the post-A capitalization tied up. Figure another 4-5% for an independent director with significant industry visibility and two to four folks for a Scientific Advisory Board, and you are left with only about 5-8% for everyone else on the team (and a bit of wiggle room) before the first refresh (likely at the planned B round).

Second Example: NewCo Two is an advanced manufacturing company with 3-D printing technology for commercial aerospace applications including corporate and commercial aircraft manufacturers and their suppliers. Valuable IP is coming via an academic co-founder who will consult for the company. The other co-founder is a full-time CTO with significant senior experience and visibility in advanced manufacturing operations in aerospace, at established and emerging companies. NewCo Two anticipates using a first round of $2 million to establish a pilot commercial production capability and land at least one of three pilot customers that already have expressed interest in working with NewCo Two. The plan includes a subsequent $7-10 million B round 12-18 months after the A round, with the funds earmarked to establish commercial production capabilities and initial sales.

NewCo Two is in a business that would look very capital intensive in most contexts, but is still a big step down from the pharmaceutical business of NewCo One. In addition, while NewCo Two may need to bring in a fairly senior manager before the B round (perhaps a business development professional, or if the CTO takes that on, a senior technology person to provide day-to-day management of establishing and running the pilot commercialization facility), the CTO co-founder appears to have the experience and credibility to, in effect, lead the company at least until the closing of the B round.

In this case, I would not anticipate any pre-A or immediately post-A co-founder-like equity needs, and a post-A Sweat Equity Pool of perhaps 15% (perhaps 20% if there is a clear expectation that the CTO will not grow into the post-B CEO role). Assuming 15%, a solid independent director and small business advisory board will likely cost 3-4% and a senior business development or technology manager will likely cost 4-6% leaving somewhere between 5-8% for the rest of the pre-B team including a bit of wiggle room.

Third Example: NewCo Three is developing software for maximizing the efficiency of multiple inputs/multiple outputs small batch continuous throughput manufacturing. Significant, but being software, somewhat problematic as the IP was developed and contributed by a post-doc who will be the CTO. Her co-founder will be the CEO and has significant C-Suite experience at a successful venture backed startup

Regional Differences

This guide is written from the perspective of a venture-backed startup in Silicon Valley or one of the few other regions that enjoy robust venture capital resources and investments. Places where the local startup culture bakes in a general appreciation for, and expectation of, generous allocations of Sweat Equity across all levels of the team.

In regions with limited venture capital resources and correspondingly smaller high impact entrepreneurship communities, the local labor pool may be generally familiar with the Sweat Equity paradigm, in terms of what it is, how it works, and even whether they should be a part of it. This situation tempts some entrepreneurs to be less generous with Sweat Equity than their counter parts in the major venture centers. And that's perfectly understandable: why subject yourself to more dilution than your team demands?

The stingy approach may be understandable and even desirable at the margins. But, we think that it should be employed cautiously. Properly explained, the recruitment and retention and cultural advantages of a robust Sweat Equity program are real and significant. Further, over time if not at the start, pretty much every successful venture-backed emerging company will find itself competing for talent in Silicon Valley or that is otherwise familiar with and expects a good Sweat Equity opportunity. Sure, you can wait until that happens and deal with it at that point, but why wait and have to back and fill? Our advice: get Sweat Equity right, and start reaping its benefits, sooner rather than later.

company as well as Software Development Manager experience at a major CNC company that is a likely customer/partner/buyer of the new startup. A senior salesman from the same CNC company has signed up to join the company on a commission heavy compensation plan. The company expects a $1.5 million A round to take it to and through sustainable cash-flow operations, with a $4-6 million B round in 12-18 months for expansion.

NewCo Three is in a significantly less capital and time-intensive business than NewCo Two. Further, NewCo three's C-level team needs look to be filled until at least the B closing and likely it will be some time after that before significant senior managers will be needed, and then perhaps initially at the director or VP levels rather than in the C-suite. The co-founders of NewCo Three can probably get away with proposing a 10% post-A Pool. Figure say 2-3% points for an independent director and advisory board; say 1-2% for the commission-heavy sales person, and 5-7% for the rest of the pre-B team (again including some wiggle room).

Some thoughts and caveats on our examples:

1. Note how the differences in pool size in the examples are mostly driven by the need for full-time, high-level talent earlier in the startup's life. Part-time folks, independent directors, and business/technology advisors who join early generally get a bit more than those who join late, but the actual awards to those folks, at any given time, are modest and more or less consistent in size across the examples (See "Rules of Thumb" below).
2. Note that one way to minimize significant early awards to very high level talent, say the early CEO hire in the first example, is to put off that hire a bit by hiring a lower level interim person for the role in the early days with the expectation that the big gun will be recruited later on at a lower equity price. That can be a good strategy but it comes with some risk (that the initial person will not get the job done) and, at the end of the day, while you may ultimately get the end-game CEO cheaper, you will have to give some equity to the interim person. Balancing those two factors can be tough, albeit when done well can work out well.
3. As noted earlier, these are three specific fact patterns; patterns that do not include all of the relevant facts and that could be modeled out differently. Then again, in that sense they model the real world, where the one thing that can be said with near certainty about your Sweat Equity plan (and your business plan, for that matter) is that things almost never go according to plan. A good plan is a good starting place, and a good sanity check on your thinking: it is not a cookbook.
4. Note that while each of these examples includes some wiggle room, none of them assume any significant detours on the road to success. Stuff happens and you can't really plan for it. Or, at least, it looks pretty strange if you do.

Rules of Thumb

While getting down to actual numbers in any given situation can be messy and seem at times a bit arbitrary and capricious, there are various rules of thumb that can at least give you an answer – "that's just the way it's typically done" – when pressed to explain how you got to some of your numbers.

Independent Advisors

The first rule(s) of thumb involve Sweat Equity compensation guidelines for important but part-time and ultimately not mission critical team members. For example, independent members of the board of directors (that is, directors who are not founders, or employees or professional investors). Another

common example would be members of business or scientific advisory boards. Let's call all of these folks together "Independent Advisors."

Just as with other team members, the size of the Sweat Equity stake for Independent Advisors will depend on how much risk they are taking (time and reputation) and how much value they are adding (operationally and/or for lack of a better word, branding.)

A generic startup independent director, someone who will provide important senior level advice and come across as suitably experienced and credible to the outside world (notably potential investors, partners, customers, and key hires) will command somewhere between ½ point and two points of the equity, partly dependent on qualification and partly on the industry – the more capital/time/regulatory intense the bigger the number. A comparable person for a business or scientific advisory board will usually command something like ¼ point to one point, with some of the same variables at play.

Now, if your director or advisory board member is the founder and CEO of a tech giant, or a Nobel Prize winner in your startup's technology arena, you will probably need to blow past those numbers. On the other hand, if your prospective Independent Advisor isn't worth even the low end of the above ranges, they probably aren't worth having on board at all.

Percentages or Numbers?

The first dozen hires or so, and thereafter more senior hires, will want to talk about their Sweat Equity stakes in terms of a percentage of the fully-diluted capitalization of the company. That said, it behooves the company to get folks thinking in terms of number of shares rather than percentages sooner rather than later, if for no other reason than the optics of talking in terms of percentages are not very impressive for smaller grants, while the dollar value of those grants (even appropriately hedged) can be more impressive. Certainly by the "B" round of financing, the company should be using some sort of formula, often a multiple (or fraction) of salary, to determine the size of most Sweat Equity grants. This transition contains within it the important implication that while early grants, and more senior grants for some additional time, are negotiated as one-offs, the trend is towards formulaic determinations of who gets how much Sweat Equity as the startup matures.

Founder Dilution Planning: Industry Norms and Evolving Roles

At the end of the day, what kind of dilution should founders and early team members expect to endure over the course of time until they have an opportunity to cash out their winnings? Let's assume, for these purposes, that their deal works and thus their Sweat Equity stakes actually have some serious value when the time comes.

Well, that depends, mostly on three factors. First, how capital- and time- and team- intense the business/industry is. Even a cursory review of IPO filings will show that founders and early team members of most pharmaceutical startups are subjected to a lot more dilution than their peers at the typical software company. Second, refresh scenarios will play out very differently for folks who continue to add new value to the team as the business involves. So, for example, an academic co-founder who keeps her day job is a lot less likely to qualify for refreshes as time goes on than her co-founder who joins the company full-time as a CTO and remains in that position through the liquidity transaction. Finally, it depends on the state of the market, in terms of exit timing and objectives. The rise of the Unicorn necessarily involves additional pre-exit dilution for Sweat Equity holders as companies stay private and independent farther into their life cycle.

The above suggests founders and early team members should think about their initial ownership stakes in terms not just of their size going in, but also how they may, or may not, be significantly

diluted over time. Keep in mind that even as they might be significantly diluted, in terms of how much of the business they own, the value of their stake can be going up.

Final Thoughts

We hope this section has given you a place to start in thinking about who should be getting Sweat Equity, and how much. While the specifics vary across fact patterns, and are subject to differing opinions, the basic rules are pretty simple. People who take more risk add more value, sacrifice more cash compensation, and get bigger ownership stakes, both initially and in terms of the ongoing value add variable, at any refresh occasions.

The Devil in the Details

It is now time to get past the trees and into the weeds and look at some of the messier features of the Sweat Equity forest.

As previously noted, while startup founders typically get their initial ownership stakes in the form of shares of restricted common stock, Sweat Equity usually takes the form of stock options. Options are contracts that give the holder a right to purchase stock in the future at a price set when the options are awarded.

While the concept of options is pretty straightforward, implementing a Sweat Equity Option Plan is rather complicated. This guide is hardly the place for a lawyerly review of the myriad of ins and outs of the various laws governing stock options. Instead, the focus will be on the more than sufficient number of key option issues that most entrepreneurs and Sweat Equity recipients find the most important. Broadly, those are questions around what kind of stock can be acquired, at what price, how, when, and why.

What if my startup is an LLC, or partnership?

First, it probably isn't, or shouldn't be. At least, not if you anticipate accessing venture capital as a source of financing (the reason being that most venture capital funds are prohibited from investing in LLCs and partnership – it's a tax thing, and it just is what it is). That said, if in fact your startup is an LLC or a partnership, you can – very carefully – create "interests" that more or less mimic, for incentive purposes, stock options.

Stock Option Fundamentals

Let's frame our discussion of Sweat Equity Options around a hypothetical grant of an option to Jane Doe; an option to purchase 10,000 shares of NewCo common stock for $0.25/share – or $2,500 if the option is fully "exercised."

A few quick thoughts.

1. The "Exercise Price" of $0.25/share is set at what NewCo believes is the fair market value (FMV) of NewCo common stock on the date the option is granted. This is important for tax and accounting purposes, but there are some exceptions (See "Of ISOs and NQs" below).
2. The FMV of NewCo common stock is typically a fraction of the FMV of the NewCo convertible preferred stock that venture capital investors typically purchase. Over time, as NewCo matures, the FMV "discount" applicable to the common stock will diminish, and in the paradigm case will disappear altogether at NewCo's exit transaction, when the convertible preferred stock shares held by investors are typically converted into shares of common stock.
3. Options have some important advantages for NewCo and its team members. Most particularly, option holders don't typically exercise their option unless and until the underlying shares of common stock are worth more than the exercise price and there is a market for the common stock – so the exercising option holder can sell some or all of the exercised common shares to finance the exercise and perhaps "cash out" some or all of their gains. (See, though, "Option Exercise Period" and "Accelerated Vesting in the Age of the Unicorn" below.)

In the great scheme of things, then, here is how Jane Doe's 10,000 share NewCo Sweat Equity Option with the $0.25 Exercise Price grant is supposed to play out.

Jane gets her option when she joins NewCo, let's say at right around the time of NewCo's A round of venture financing, pursuant to which the investors pay $1.00 for their Series A Convertible Preferred Stock. Some years later, NewCo successfully negotiates an "exit" event (usually selling NewCo to some other company; less often an initial public offering (IPO) of NewCo stock). In connection with the exit event the outstanding preferred stock of NewCo is converted to common stock (share for share in most cases) and all the holders of NewCo common stock have an opportunity, as part of the exit transaction (though sometimes only some time after the actual event), to sell their shares of common stock at a price that is some multiple of Jane's exercise price. Hopefully at least 20x Jane's exercise price if she received her option around the time of NewCo's "A" round of venture financing. At a 20x multiple, Jane would be out $2,500 on the exercise of her option, but hold common stock worth $250,000. Nice work, if you can get it.

More Significant Option Complications

It would be nice, for Jane and her colleagues at least, if the brief overview of the fundamentals of Jane's option told the whole story. Unfortunately, it doesn't. Here is a quick look at some of the more consequential footnotes common in the Sweat Equity Option story.

Option Vesting

As discussed, the goals of a Sweat Equity program are mostly about recruiting, retaining, and incenting team members to put it all on the line (at least career-wise) for NewCo. Just giving someone an option certainly does some of that. However, giving someone an option that they could, for example, keep even if they quit NewCo the day after they got the option would be, from NewCo's perspective, less than optimal.

And so we have the concept of vesting. When Jane joins NewCo and gets her Option, the Option will almost certainly include terms that restrict its exercise until Jane has "earned" it (the Sweat in Sweat Equity) through her work at NewCo. Probably the most common "vesting schedule" for new employees is over four years, such that after one year of employment Jane's Option "vests" as to ¼ of the shares subject to the Option and thereafter, after every month of continued employment over the next 36 months an equal portion vests so that at the end of four years of employment the Option is "fully-vested."

Important Note: For most Sweat Equity recipients (there are sometimes exceptions for very high level folks) vesting stops regardless of whether the employee quits NewCo voluntarily or is let go by NewCo – for any reason or no reason at all. Life can be hard.

There are lots of subsidiary issues around vesting. See "The Finer Print" below for a discussion of some of them.

Option Exercise Period

This is pretty straight forward. Options usually have a ten year life from the date of grant, after which, if not exercised, they expire. The idea is to give the recipient ample opportunity to see the value of the underlying shares of stock grow and reach a point where they can be sold at or shortly after they are acquired on exercise.

The ten year life of the typical Sweat Equity Option can be prematurely cut-off in several circumstances, and in some cases the period can be accelerated even with respect to unvested shares (that is, vesting can be brought forward in some cases). See "The Finer Print" below for a discussion of these important if often overlooked issues.

The Finer Print

The material below takes a deeper dive into some important but more nuanced Sweat Equity issues. While the issues are real and can be important, some readers may conclude that as interested in Sweat Equity incentives as they may be, they would rather deal with those issues in consultation with a professional advisor. Which is all to say … if you want to take a pass on this material, don't worry about it. A fair number of your fellow readers likely feel the same way.

Vesting Formula

In our option example, Jane Doe's option vested over four years, with a "cliff" of ¼ of the option vesting at the first anniversary of employment, and the remaining option shares vesting in equal installments over the following thirty-six months. As noted, this is a pretty common vesting scheme.

Not surprisingly, there is wide variety of vesting formulas for options. Most, but not all, have some sort of "cliff" that require the option holder to stick around for some period of time before any vesting occurs. The point of any "cliff" is to keep the stock ledger from containing a lot of folks who did not stick with the company for any meaningful period of time.

While four years is probably the most common vesting period for employees, periods as short as two years (particularly for consultants, directors, advisory board members, and such) and as long as six years are not uncommon. Likewise, there are option vesting schedules that vest monthly from the start (in fact that is very common for "refresh" grants, where the recipient has already been at the company for some period of time) as well as plans that vest in annual increments, for example ¼ of the option vests at each anniversary of employment.

Finally, for most employees and consultants, the vesting schedule is a non-negotiable detail embedded in the company's Sweat Equity program. Of course, very senior folks can often cut special deals.

The Vesting Start Date

It is not uncommon for a team member to be working for a company for some period of time before a Sweat Equity program is in place, and grants are made. This is particularly common in the earliest phases, before the A round, but can happen at any stage of company development. In terms of the exercise price, not much can be done about this (see, though "Of ISOs and NQs" below): the exercise price will be the FMV of the common stock on the date of the grant. However, the actual date that a vesting schedule is tied to – the Vesting Start Date (VSD) – can be pretty much any date. Most commonly, the VSD for a first Sweat Equity grant will be set at the date the team member engaged

with the company. Even earlier dates are occasionally negotiated by more senior team members or folks who have contributed specific assets – for example intellectual property – to the company.

Accelerated Vesting: Part One

What happens if an exit event happens before a Sweat Equity holder is vested? Or, in a less sanguine case, a team member with Sweat Equity is hit by a bus before they are vested?

Most Sweat Equity plans give the board of directors the option to accelerate any team members vesting schedule for any reason. Perhaps because of that flexibility, and because potential buyers of the company in an exit transaction may want at least some of the company's employees to stick around after the exit transaction (so as to continue vesting – it's complicated), many Sweat Equity programs do not provide for acceleration of vesting in either of these two cases. But some do, and in the case of very senior team members the issue is often ripe for negotiation.

Accelerated Vesting in the Age of the Unicorn

If there is a "gotcha" in Sweat Equity programs it is, in our view, the routine but gradually modified provision that the exercise period ends some period, usually 90 days, after a team member leaves. So, as discussed earlier, if an employee leaves the company after some or all of her option has vested, she must exercise the vested portion of the option, or lose it altogether, within 90 days of her departure. From the company's perspective, this serves to remove certain team members from the ownership table if they are no longer actively contributing to the success of the company. This may not properly compensate the employee for her previous work, however.

The "use it or lose it" rule has always been problematic in so far as no matter how promising the future of the company may look at the time it comes into play, if there is no market for the common shares issuable upon exercise of the option in question, the option holder has to come up with the exercise price for the option shares but has no way to sell any of the option shares to cover the exercise expense. For smaller option grants at lower exercise prices, that might not be much of an issue; but, for larger grants at higher prices it can be quite significant, and - as a practical matter -may in fact be an effective bar to the option holder exercising her option.

"Use it or lose it" has always been an issue, but the rise of the Unicorn – companies worth billions of dollars that are staying private and independent rather than going public or selling out – has really brought the issue to the fore. At many of these companies, there are literally thousands of team members with options that include significant exercise prices – but still well below the apparent "market" value of the underlying shares – that make exercising their options financially impractical.

The good news is that while "use it or lose it" is still very common in Sweat Equity programs, the trend is towards more liberal exercise periods, including to the full ten year period after grant in some cases. Further, so-called "secondary" markets where folks can sell their Sweat Equity shares prior to the exit event, and offers by companies and investors to buy-out vested Sweat Equity Options and shares before any exit transaction, are increasingly common. Stay tuned.

Thoughts on the Exercise Price

For pretty much all employees, and in fact in most cases pretty much everyone else as well, the option exercise price is set at the FMV of the common shares at the date the option is granted. As previously noted, the FMV is typically a fraction of the value of the Convertible Preferred Stock that investors usually hold; a fraction that gets larger as the company matures.

Historically, which is to say until shortly after the dot-com bubble burst in 2000, FMV was determined by the Board of Directors, and was far more an art than a science; an art mostly based on some pro-employee rules of thumb. For example, FMV of common shares at the time of an A round venture financing was commonly about 1/10 the value of the A round convertible preferred stock. While the fraction grew over time, it seldom rose to more than ½ the value of the latest round of convertible preferred financing, at least until an exit event was clearly on the horizon.

For some reason, after the dot-com bubble burst in 2000, the feds decided Sweat Equity pricing was something they needed to make rules about. The result was IRS Code Section 409A. The details of how 409A works are beyond the scope of this guide (beyond this author's somewhat cynical comment that it addresses a problem no one really had, at some material expense to companies and Sweat Equity recipients alike). In practice, though, 409A has led to higher exercise prices for most Sweat Equity programs.

Of ISOs and NQs

Broadly speaking there are two kinds of Sweat Equity Options. Incentive Stock Options (ISOs) and Non-Qualified Stock Options (NQs).

ISOs have certain tax advantages and are generally preferred by recipients and companies alike. However, ISOs can only be granted to employees; they cannot be granted to consultants, or directors or advisory board members and such. Further, the exercise price of an ISO must be at least equal to the FMV of the option shares on the date of the grant. While the Vesting Start Date can be set at a date earlier than the grant, the ISO exercise price must be at least equal to the FMV of the Option shares on the actual date of grant. A final note on ISOs: if for some reason an option labeled an ISO does not meet the criteria for an ISO it is still a valid option. However, it will be treated (and taxed) as an NQ.

NQs can have exercise prices below the FMV, but usually don't. NQs are generally reserved for folks who are not employees, but they can, and rarely are, issued to employees – for reasons that are beyond the scope of this Guide.

Beyond Options

Options to purchase common stock are far and away the dominant form of Sweat Equity in the United States, at least for high impact startups backed by venture and other high-risk equity investors. On balance, Options to purchase common stock are well-suited to serve the goals – recruiting, retaining and incenting employees and other team members – that are the raison d'etre of Sweat Equity programs.

All of that said, Options are not the only way to give employees and other team members a piece of the action; bonus cash compensation programs, profit-sharing, phantom stock, stock appreciation rights, and other vehicles aimed at recruiting, retaining, and incenting the best people are all available. Sometimes, stock purchase plans, where the employee or team member actually purchases share of stock (with vesting terms that allow the company to repurchase unvested shares on an employee's departure) make sense.

Still, if you are thinking of establishing a Sweat Equity program for a high impact startup that will be looking to venture capital investors for financing, you should start by asking yourself "why not an option program?" If you don't have a very convincing answer to that question, go with an option program (even if you supplement it with cash bonuses, commissions and such in select cases). And

find yourself a lawyer who works regularly with emerging companies that have them to make sure that your Sweat Equity program is optimized for your needs.

Concluding Thoughts

Sweat Equity is far and away the most common tool that startups and emerging high impact businesses use to recruit, retain, and incentivize employees and other team members. As potent as it is, and given that it involves sharing something as important to them about their company as ownership, founders should work closely with their advisors and investors to make sure they use it wisely. Founders should also work with their lawyers to make sure they get every “i” dotted and “t” crossed lest they create serious problems that can not only undermine their Sweat Equity goals, but seriously compromise their ability to raise capital on favorable terms - lawyers like the Venture Best Team of Michael Best several of which are listed below.

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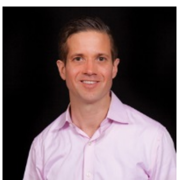

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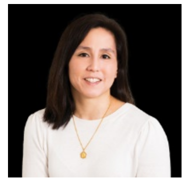

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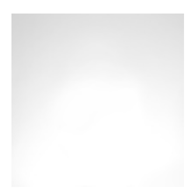

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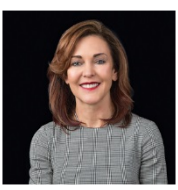

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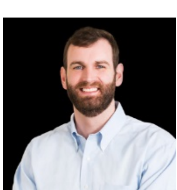

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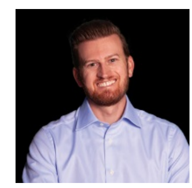

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About Michael Best

Michael Best is a leading law firm, providing a full range of legal services to clients on a global, regional, and local basis. The firm has more than 340 legal professionals, including more than 250 attorneys, serving clients in 13 offices across the U.S. in Colorado; Illinois; North Carolina; Texas; Utah; Washington, D.C.; and Wisconsin.

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Our Venture Best group works closely with entrepreneurs, and with their venture capital and angel investors, to help new, high-growth companies find financial backing and grow their businesses.

We help companies and investors make connections, structure and close transactions, and maximize returns. We also counsel early-stage businesses on their financial, organizational, and regulatory needs as they grow.

We represent start-ups and emerging technology companies in many different industries, including biotechnology, information technology and software, clean tech, pharmaceuticals, medical devices, electronics, and other high-technology sectors. Members of our Venture Best team have themselves been venture-backed entrepreneurs, as well as angel and venture capital investors, giving us great depth of insight on both the legal and business sides of the start-up environment.