

BAD

Sweat Equity

vs.

GOOD

Sweat Equity

Compensating with Sweat Equity is a creative way to get early traction prior to raising capital, but it can be fraught with potential issues. Here's an example of a tech startup with a founder/CEO (Company) hiring a senior developer (Consultant) under a Sweat Equity arrangement to build out the tech platform for the Company's vision.

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Vague

DELIVERABLES

Clear

✓

Irrational enthusiasm leads to over-commitment and poor communication

Rational pragmatism leads to shorter engagements with clear timelines and deliverables

Company

I've got a great idea!

Consultant

I can develop the entire app for you!

Company

Let's just wing it!

- Each side over-commits and over-promises
- Vague vision, goals, and timeline
- Poor documentation due to time and expense

Company

I need a specification written up for my app.

Consultant

I can write that specification for you.

Company

Let's agree to a detailed Statement of Work.

- Shorter, smaller chunks of work
- Clear deliverables and timeline
- Well documented using a Statement of Work template

✋

Verbal Promise

AGREEMENT

Iron-Clad Legal

✋

Fuzzy memories of poorly-defined value of the work performed and the value of the compensation to be paid

Well-written, fully-executed legal agreements that define a clearly-negotiated value of both the work performed and the compensation

Company

I'll give you x% of the company!

Consultant

I'll do all of the work for x% of the company!

Company

It kinda seems fair and just feels right!

- The Consultant's time/work is not clearly valued
- The Company's Sweat Equity is not clearly valued
- The value of each can dramatically change over time, but is usually not taken into account
- Cannot easily change the mix of cash vs. Sweat Equity or the type of Sweat Equity over time once a promised % of ownership is locked in
- Poor documentation due to skipping the typical expense of hiring an attorney to structure the deal

Consultant

My fee for performing the deliverables on the Statement of Work is \$x, and I'd like a risk premium of \$x.

Company

Let's discuss the best mix of cash and the best type of sweat equity that works for both of us.

Company

Let's strive to be fair and use market values.

- Open dialog about the value of both sides.
- Avoid overpromising
- Agreed upon timeline for payment and deliverables
- Stay flexible with a different mix of cash and various forms of Sweat Equity over time as circumstances change
- Well documented using the proper legal templates for each type of Sweat Equity

👎

Bad

OUTCOME

Good

👍

Unmet expectations lead to a nightmare and another bad and costly business divorce

Clear expectations and well-defined deliverables along the way with the necessary flexibility

Company

Where's my app? I'm not going to give you the equity after all!

Consultant

You never raised the venture capital you promised and I need to be paid! And don't forget, I own x% of the company!

Company

I'm calling my lawyer!

- The lack of clarity and poorly-quantified promises almost always lead to unmet expectations
- Sweat Equity gone bad will almost always lead to expensive legal battles, even after the company fails

Consultant

I've finished the final phase and the app is ready to launch

Company

Fantastic! Here's your final cash payment and warrants for this phase for a total of x% of ownership

Company

Let's launch and build this company!

- Easily change direction and talent as needed
- Move fluidly from one phase or deliverable to another
- Change the mix of compensation of Cash and form of Sweat Equity as needed for each SOW

