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You can read Margaret's award-winning "Miss Communications" column in the Fort Collins Coloradoan every Friday -- or read her blog at www.MissCommunications.com.

Northern Colorado Entrepreneurs Network Sweat Equity Workshop February 24, 2009, Fort Collins, Colorado.

Notes by Margaret McDonald

The Northern Colorado Entrepreneurs Network met on February 24th for a Sweat Equity Workshop. The meeting's design was to pose audience questions to a panel of local professionals, and to have those professionals – as well as audience members themselves – weigh in on possible answers and solutions.

Event Sponsors: Larimer County Business and Enterprise program, Thorson Rocky Mountain, Texas Instruments, Integrated Computer Consulting.

It's important to note that, although many legal and financial issues were discussed, the workshop was not a forum for formal legal or financial advice.

Peter Olins — Co-Founder of the Northern Colorado Entrepreneurs Network (peter <AT> nocoentre.net)

Peter opened the meeting. The mission of the group is to accelerate the pace of entrepreneurship in the region, by creating a supportive entrepreneurial community. It holds monthly meetings with four business presentations and facilitated networking. Several themes have arisen from the meetings, so a series of workshops is planned to address the needs of the local entrepreneur.

Tim Reeser – Moderator (tim.reeser <AT> colostate.edu)

Tim is an entrepreneur and former technology company executive who now serves as COO of Cenergy, the business operations group for Colorado State University's Clean Energy Supercluster.

The Panel:

Garret Acott – CEO, Tempered Group (garret <AT> temperedgroup.com)

Garret is a serial entrepreneur who currently manages three companies in start-up phase. He has vast experience in sweat-equity relationships and works on both sides of the sweat-equity table.

Anne Togher – CEO, Toghers Inc. (anne.togher <AT> toghers.com)

Anne is an entrepreneur who is using a sweat-equity model to build her online business that supports caregivers. Anne's two most important messages to entrepreneurs who are considering sweat equity agreements are:

- Make sure you have shared values with the team members you attract, whether they're in a sweat-equity or paid position.
- Even when you're using a sweat-equity agreement, hire people as if you were paying them in cash: Sweat equity is just as important.

Susan Schell – Managing Director, Citadel Advisory Group (sschell <AT> citadeladvisory.com)

Citadel Advisory Group in Fort Collins specializes in facilitating many types of middle market corporate finance and M&A transactions which apply to all types of business enterprises. Citadel facilitates debt and equity placements through a variety of instruments. Their client companies are generally \$1M to \$30M in revenue annually.

Denise Juliana – Partner, Sample & Bailey (djuliana <AT> sampleandbailey.com)

Denise provides tax planning and advising for closely held and family businesses. Denise hopes participants take home the message that, “Regardless of the stage of business you're in, you need a team of trusted advisors – somebody who's going to do all the things that perhaps you're not the best at so you can grow and operate your business. It's much easier to plan before you do things rather than after.” In addition, “You need to give your advisers as much information as you possible can. Try to give them too much, in fact, because you never know what you tell them will lead to an answer.” Sometimes you have to pay for expertise, Denise notes, and be aware that you get what you pay for. You can get a lot of problems out of the way if you get advice from trusted advisors.

Jackie Meyer – Partner, Sample & Bailey (jmeyer <AT> sampleandbailey.com)

Jackie also works with tax compliance and planning, and she holds an ABV (Accredited in Business Valuation) certification. As a panel member, she plans to help participants understand what's important when you need a business valuation, and what you can think about ahead of time to make that valuation more accurate.

Kevin Houchin – Principal Creative and Attorney, Houchin & Associates (Kevin.houchin <AT> houchinassociates.com)

Kevin's focus for the group is two-fold:

- How important the relationships are between the people – more important than the money; and
- The #1 goal in any relationship is “how much is it going to cost me to keep driving?” (and never have to go work with that SOB again). Kevin says 95% of the problems you're going to have to deal with are directly related to people wondering “Should I pull out of this relationship?”

Two important TLAs (three-letter acronyms) from Kevin that are important to this meeting: ITI = Inter-Table Interaction; NDZ = No-Drone Zone.

After introductions from the panel, Tim posed some questions that were submitted ahead of the meeting.

Tim: There's a general concern – is it viable, can you get good people through sweat equity?

- Anne: absolutely. I have a leadership team of 8 people – including a CTO and a web developer – very quality people that I found via sweat equity. I also have project people, off the leadership team. Remember, it's important approach sweat equity partnerships from the same perspective as if you were going to pay them on the payroll.

Tim: Denise – what is the long-term impact of using a sweat equity agreement?

- Denise: It depends. You have so many ways to set up sweat equity. It depends not only what type of entity you are, but also what you do, what you restrict, etc. These things all affect the tax decisions.
- Tim: Is sweat equity something you suggest against at a high level?
- Denise: You need to put a lot of thought and structure into it up front, but I wouldn't consider it a bad idea.

Tim: Jackie and Susan – valuation seems to be one of the biggest challenges. Susan says, what would I pay you if I were paying you in cash? What are some of the variables you would use that comprise in an early-stage valuation? What tools you use.

- **Susan:** entrepreneurs typically think that because they put in 10 years of labor into a business and their time is worth \$200,000 per year, that their business should be valued at \$2M. But the business is really worth what it cash flows. That valuation is done according to your financial statements. You really need to get familiar with what valuation is based on – EBITDA [Earnings Before Interest, Taxes, Depreciation and Amortization], or something else. You need to know what to focus on in your financials to create that value.
- **Jackie:** I see people who have brought in the first [sweat-equity] person and no valuation was done, so early structure is not based on something valid. A handshake may not be in your best interest. Even if it's early, think about the financial information, what your projections look like.
- **Susan:** Whatever you set your first value-add at, it's going to set something in concrete that can create problems later on in dilution. And your partners may argue

and dig their heels in the sand, so you have to be very careful up front. Often we think it's valuable to start with some sort of convertible debt.

- **Kevin:** when clients are in the idea phase and they come in, I lean toward a corporate structure instead of an LLC. We discuss doing a buy/sell agreement on whatever stock the person is going to get, but the buy/sell agreement is based on book value – in some ways, that means “everybody gets screwed.” It gives everyone the incentive to turn the car around when they're ticked off, and to go back to work.
- **Garret:** I would echo everything Kevin just said. I often put in 6 to 8 months with no paperwork. The first step let's make sure we can work together, and once it proves itself, that it can be a viable business, let's move forward from there. To me, passion is the key. What will make me run away is, if I don't see passion in the person running the company or in the person putting in sweat equity.

Tim: Kevin – what is the best legal structure?

- **Kevin:** There's no one size fits all. If I have even one person who's putting up money but isn't planning to be there every day, I lean really hard toward a corporate structure. The board minutes and everything else actually assists in keeping things clear. If you have the requirement, in the corporate form, of clear communication on major issues, the odds of keeping things going are stronger.

Tim: Anne – Can we hear an example of how you structured things?

- **Anne:** Toghers is a C Corp. We have an LLC, and the LLC owns stock in the C Corp. We looked at this as “we're building a business.” We built an org chart and decided what jobs we needed to fill – just as if it were for paid jobs. We looked at what needs we had, such as IT and Gerontology experts in the field. We used networking to bring in a lot of people. There were also people who showed up via networking, and the interest and passion was there, so we discovered we needed them, too. It's definitely a part-time model for each member. Everybody on the sweat equity team is earning a number of shares in the LLC.
- **Garret:** I've done a lot in software, and I've done it a lot of different ways. I've traded sweat equity on an hourly rate, for example, \$25 cash per hour and \$75 per hour sweat equity. It can be done in a couple of hundred ways. No way is any better or worse than others. It depends what you're comfortable with, what everybody else is comfortable with, and you need check to make sure it's all legal. Make sure that everybody feels good, everybody feels comfortable.
- **Kevin:** If you're tempted to form your own corporation, please authorize more than one share of stock. Do the hip pocket method – don't issue all the authorized shares; keep some in your hip pocket so you've got several thousand shares sitting around and you don't have to take it out of your pocket and into theirs so you don't have to re-jigger the whole structure.
- **Garret:** The money you spend on a lawyer and an accountant up front will save you a whole lot of heartache and headache, and it's not that much in the big picture.
- **Anne:** It also sets up some confidence with the potential sweat equity partners you don't know – it adds credibility that we've thought this through and we know what we're doing.

A 30-minute breakout session, with groups of 5-6 (joined by members of the panel), allowed everyone to explore their most important issues. One member of each table was selected to present the most important one or two issues raised to the panel.

Next: New questions from participants at the tables.

Q: How do you get the initial investors out?

- **Susan:** the next investors will buy them out, or you'll have a liquidity event.
- **Kevin:** Why are you assuming that you have to get them out? If they want out, you can negotiate ways without necessarily creaming the business – without blocking from a dilution point of view.
- **Tim:** The earlier you can set expectations the better.

Q: When you're setting up sweat equity against future royalties, what signs should you watch out for?

- **Kevin:** Why equity? Because if it's future royalties off a future stream of income, that's easier to set up as a contract. That's just a commission deal and not equity. I may be wanting to invest in this particular stream of income but not everything you do, in which case I don't want the risk of being completely an equity member of everything; just isolate my risk to the things I have control of. If you can keep people out of a sweat-equity structure by putting them into a commission structure, that's a far simpler deal and it's way easier to end.
- **Audience member:** Depending on whether this device goes on, we'd like to figure out how to work royalties (or annuities) in that.
- **Kevin:** As an example: CSU owns the patent, the faculty that made the patent starts the company, CSU licenses it, and they receive a royalty payment and an equity stake, and you just balance those two. You can set it up with milestones, graduated royalties, any way you want.
- **Jackie:** A minority interest is handled much differently from a controlling interest. There are three main methods for valuing a company, and you look at all three before you decide which one to choose. **Asset based** – you don't see used in this context a lot. **Market-based approach** – I look at it a lot but don't rely on it a lot. **Comparables** – this third method, I use 80-90% of the time – income methodology. Cash flows, projections and discount those flows to present value.

Q: Could each panel member please share specific examples of things they know now that they wish they had known before starting?

- **Susan:** I owned a retail business, and when I set it up I thought a 50-50 partnership was a good idea because it would keep us both motivated. I brought financials, my

partner brought expertise and work. Never do anything 50-50. That was a huge mistake in my opinion. No one had control, and nothing got done. And I would never take on a partner that didn't put in some money. Because unless you have something to lose, you don't take it seriously

- **Anne:** The structure we used required that we designate the number of shares we were going to have in the LLC to use for sweat equity. Initially I didn't have as many shares as we needed, so I had to invest more to get enough shares. It's better to have way more than you need and make sure you're thinking big.
- **Garrett:** I've stayed in too long and got out too quick. One of the biggest things that I learned when I was younger was to never expect a partner or someone in that position to work as hard as I do. That's a big mistake a lot of entrepreneurs make: They get involved with someone and the expectation is that they're going to put in the kind of energy that you're going to put in. As an entrepreneur, you have to go in knowing that it's going to be *you*. If you can get 60% of that out of someone else, you're doing pretty well.
- **Jackie:** I would have pushed a client to take the valuation more seriously, and they could have gotten a lot more money and a nicer return.
- **Kevin:** This one's from personal experience: Just because the bank will give you money doesn't mean your idea will work. From a professional point of view, here's another Kevinism: The lessons we remember come in increments of 5 grand. It costs way more to clean your shoe than to avoid the manure.

Q: A lot of companies say they fail due to being under-funded. How do, or should, companies cope with the practical inflection points as companies' needs progress, and sweat-equity players' compensation needs start to kick in? Passion and commitment is there but there's that practical side.

- **Susan:** You can end up in a Ponzi scheme. It's important to set up, up front, when that liquidity will take place, and it's better at a dollar value than at a date. You say liquidity will occur when we're profitable. We are notoriously under-funded because we underestimate not just the initial investment but also the working capital we're going to need and our personal needs. We should double or triple that. You have to be careful that you don't commit to those initial investors too soon.
- **Tim:** What are typical exit events – events where the sweat equity partner gets out, gets in, gets hired – at a high level?
- **Ann:** We consider sweat equity the same investment as cash – long term, no different exit strategy. The goal is that everybody on the leadership wants to be hired.
- **Tim:** What do you do when someone isn't able to continue – do they maintain their equity?
- **Anne:** They maintain, but they stop earning additional equity.

Q: When you're setting up a board of advisers – how do you go about defining what kinds of people you're going to want, find them, and then use them in forming your business?

- **Susan:** You do need legal, accounting, and business org or management advice.

- **Denise:** Find people who are in your industry or have a specific expertise, such as a mastermind group. You need to pay certain people for their specific advice, but that's not the roll of your Board of Advisers. They'll help you operationally, with marketing, etc. When we're working with you, we're going to ask so many questions about where you want to go and what you want now – that's not an appropriate role for a board of advisers. You want people who are in your industry but not a competitor.
- **Kevin:** I get asked for help all the time, and if they have pizza and beer at their meetings, I might show up. If they ask me to do the work I'm going to go on the clock. If it's just some guy off the street, no, I won't work for them for free. Expect to give them some spiffs or trade them some of your expertise through bartering. A lot of people are willing to do that as long as you're honest and are willing to use the advice.
- **Anne:** I would recommend your board of advisers should be people who have connections you don't have into that industry or other industries, and who may add credibility due to their expertise. How do you find those people? I know a lot of people from my field, because I worked there for 20 years.
- **Kevin:** If you feel safe doing it, Facebook and Twitter are speed networking for mastermind groups. You'll find people who, from an ego point of view, are happy to contribute, and you'll get some great advice. You've got to be careful about what you disclose, of course.
- **Audience member:** I would disagree, because credibility is everything. If you farm out your need for a board of advisors and simply take anything that comes along You need to know your board of advisors, and they need to be trusted advisors.
- **Tim:** There's a difference in early stage and later stage. In later stages you've got to have a trusted board of advisers. In early stages I think there's a lot of value to it.
- **Kevin:** Absolutely valid points. You can get great access to people you would never meet in Colorado, who are credible. Then take that offline and get on the phone with them and see if something is going on. The way you get access to some people that you may not normally have access to is so much easier if you are contributing to the communities that are available.
- **Susan:** Check out SBDC and SCORE. You can get spot advice that might get you by for a while. Eventually you're going to need people who are familiar with what you're trying to do.
- **Garret:** To me it really goes back to passion. It's not that hard to find a group of intelligent people from different walks. I've always used a board of advisors to help set the plan of the company from a whole point of view. Develop a strategic plan for the company, then you can go to your strategic providers – the lawyer, etc. – and it doesn't take as much of their time because you already have those questions answered.
- **Audience member:** I had my first board meeting last night. It was such a powerful experience. They're three people in my industry who have had successful experiences and now have some leisure time. It was incredibly powerful having people with a lot of experience who had been through the entire cycle and now had time on their hands.

Q: Garret talked about starting with informal agreements. What kind of handshake agreements can you start with?

- **Susan:** I agree, if you're just testing the water. If you're trying to see whether there's a market, what is the competition. But once you're engaging people to add value to something that has legs, it's time to formalize the thing.
- **Garrett:** I used to have a software company called Ruffdogs. We had some developers working up to 32 hours per week in intern status with the hope that, as a position came open, they would be promoted. One guy was working that way for 7 months waiting for a position to come open. And even when the position came open we weren't paying much, but it all comes back to the passion; what we were doing, the culture we were creating. And they all wanted to be part of it. To me it's silly to formalize things when you're testing the waters. But certainly when it gets to the point that it is serious – we have something here, we can actually make some money here – you have to get the paperwork done and dot the i's, cross the t's.
- **Tim:** It's important to note that your employee understood what the risks were. Both sides knew what to expect, though there were still some risks.
- **Kevin:** If you're the sweetheart in the sweetheart deal, you don't want it in writing. If you're not the sweetheart in the sweetheart deal, get it in writing.

Q: Is it better to do sweat equity over cash flows – promising future salary payments down the road on future cash flows? What are the ups and downs of it?

- **Susan:** It depends on, first of all, the person's willingness to take a deal like that. People want to believe there's a real upside potential when they're doing sweat equity. They want to feel that money they're not earning today is worth more, because they're not getting it until later.
- **NOTE: The following discussion became choppy, fast (!) and difficult for the typist (!) to follow. The notes have been truncated to reflect only the clearer comments.**
- **Jackie:** It depends on the tax consequence. There might still be a tax consequence on the other side. That might be something the other party can't swallow.
- **Susan:** By the way, tax consequences might occur under a number of different agreement structures.
- **Garret:** That's why it's important to have a good accountant.
- **Tim:** Is there a way around saying your basis is 0 because you're working sweat equity? Is my basis zero when I liquidate?
- **Denise:** For the most part, if you get a capital interest you're going to have some compensation currently related to that, which will give you basis. If you have the profit interest – the opposite of a capital interest according to the IRS – you get a share of the profits as you go but nothing in the end game. There is no basis for that – you're getting the income over the years but you're not getting any capital. To get basis you're going to recognize the income now as you provide the services – in general
- **Tim:** Let's say I define my value as 5K per month working for this entity and I'm working 20 hours per week. I'm getting 5K equity, not paying cash. Three years from now I get a cash event of 100k. I haven't paid any tax yet – or maybe I needed to.

- **Denise:** You do have to call it income, with some exceptions.
- **Tim:** If your end game is zero you get nothing.
- **Anne:** If you're accepting payment, it must have value.
- **Denise:** There are some exceptions with adding restrictions to that equity. There are ways to mitigate, but the general rule is if you are getting capital interest for services you will have taxable income whether you see a penny or not.
- **Tim:** Trying to wrap it up – I need specifics.
- **Kevin:** Aren't we talking about, arguably, a higher capital gains rate? So it's not an issue of avoiding tax but minimizing the rate.
- **Denise:** There are things you can do to lessen the amounts of ordinary income.

Q: Instead of taking equity, if you had the options to buy the shares – is that a better way?

- **Denise:** There are all sorts of options and ways to set them up.
- **Audience:** Deferred compensation instead of sweat equity – an angel investor isn't willing to pay that huge debt, when you tell them, "I'm going to use the new investment to pay the people who did all this work last year."
- **Garrett:** It is real hard to find investors – basically everybody gets screwed in a deal like that.
- **Anne:** So be really clear in your agreements that it's based on when it's profitable. We structured our LLC – the contractors work for the LLC, they're contractors for the LLC – and when the LLC dissolves there will be an exchange of value: The contractors will pay me a dollar, and in exchange they'll receive the shares they've earned. It's not a taxable event because of that exchange of value.

Q: Please comment on the pros and cons of the possible structures of issuing equity based on milestones achieved, rather than time.

- **Ann:** We do a combination – hourly/yearly and milestone/goal-based lump sum shares. If you came in at a leadership level and took a management position, all three of those were part of the package. If you did a specific project, you came in hourly.
- **Susan:** Both sides benefit from having milestones. [Under an hourly agreement] the owner has this hourly rate accruing and you can accrue a great deal of salary; whereas if you have it on a milestone basis, it's much more under control.
- **Denise:** Plus, you want to get past that stage when you're getting things off the ground. But beyond that, you only want to pay people if things really get off the ground. That's where your value is, so milestones should be based on that.
- **Ann:** If you were paying in cash, you would have certain milestones they were responsible for.
- **Jackie:** You also want to be able to show investors that you have milestones and a track record of meeting them.
- **Garrett:** It depends on what the work is, more than anything. When you get to the point that it's a well defined project, I like milestones a lot.

Take-home messages from the panel.

Jackie: Keep it business-valuation specific. Think about the reasons you might need a business valuation – litigation reasons, financing purposes, you have kids and you want to give some to them, you think you might have an IPO coming – the SEC can come back and challenge it. The way to start a valuation is, you need to provide the valuator information. The valuator can control what rates they're going to use, discount rates on lack of marketability, etc., but the information you give them is in your control. Do your due diligence on risk factors, potential market share, a new product, existing product that you're improving. You can use the Internet to put research into it so you've thought through a lot of things.

Denise: Clients can get themselves into trouble with respect to the IRS, but pigs are happy and hogs get slaughtered. We all go to parties and seminars and we're told "If I'm a corporation, I can deduct anything." As we were talking about at my table, if you have a business and you have expenses related to that business, they're deductible regardless of whether you're a corporation. The reason for a corporation is not to deduct more stuff. Take good advantage of the tax laws that are out there. If you're an S Corp and you're told you can take all the money out as distributions and not pay yourself wages, that's a myth. Think logically and don't just look for the answer you like – because that's when you're going to get slaughtered. Take advantage, within the law, of everything that's out there. That's our job. I'm not going to break the law, and you don't want to go to anyone who will. Bounce ideas, whether you like them or not, off a few people.

Susan: When you're starting your business, you want to plan your exit. Are you going to manage things so your valuation can be a higher number when you exit? It's important to determine how you're going to manage your business. Just because you're not taking a salary doesn't mean your value isn't affected. Don't risk your business on trusted relationships. Relationships are going to have shaky times, and if you are dependent on a relationship to stay intact, it's probably going to hurt you – so be independent-thinking.

Anne: You don't have to expect that everybody put cash in. Instead, consider what we chose to do with our model: An investment of time is valuable also. Some of our leadership team invested cash and sweat equity; some only invested sweat equity. We would not be where we are today if not for sweat equity. You need both sweat equity and cash, but one person doesn't have to contribute both. Sweat equity is a great bootstrap/startup model. It's not a sustainable model. You want to have a plan that's clear either because the team needs to support themselves or because the business is viable and you're ready to bring people on. But it is a great startup model.

Garret: Run it like a business from day one. Don't be passing out shares of stock like candy. When you get things going, people tend to be a little looser than they would be with cash. Instead, you need to treat it the same as cash and run it like a business.

Tim: Think flexibly. I think a lot of us came into the room thinking of sweat equity as one thing, but there are lots of ways to skin that cat. The other thing I came away with was this: Be afraid if you do it wrong – but perfection is unattainable. The essence of entrepreneurship is that you're running scared without even knowing you're scared.

Closing Remarks:

Lucinda Kerschensteiner: Larimer County has a LCBE (Larimer County Business & Enterprise) resource, and one of the roles we play is to partner with organizations. Find information at www.lcbe.org

Patrick Gill — NoCoEntre.Net Co-Founder (patrick.gill <AT> nocoentre.net)
Another resource in Fort Collins is business librarian Anne MacDonald. You can send her e-mail with your questions: amacdonald@fc.gov

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