California when do you need to pay a founder in dollars, not just equity?

Urban legend says startups don't have a legal obligation to pay founders in dollars, if the founder is willing to be paid solely in equity. But when it comes to California, this urban legend is wrong.

Founders are often willing to forego a paycheck and work for sweat equity when a business is just getting started, often in the form of restricted stock or stock options. However, in California (and especially for startups in the technology and life sciences sectors), investors and directors should be aware that failure to pay a cash wage to a founder may lead to compliance problems involving wage-and-hour laws – which may in turn have an unpleasant knock-on effect involving tax laws and even fundraising.

Background

Founders don't always have to be paid a cash wage, especially if their work amounts to extra time spent pursuing a hobby or they fall under an exemption.[1] Under the federal Fair Labor Standards Act, an employee who owns at least a 20 percent equity interest in the enterprise and who is actively engaged in its management fits into the bona fide executive exemption and does not need to be paid a cash wage.

That is not the end of the story, however, because most states have their own state wage laws. In some states, a startup may not need to pay its founders. In California, the state minimum wage laws are more rigid. California law does not have a separate distinction for owners or founders, which means that founders who qualify as employees are entitled to a cash wage. A startup that doesn't pay its founders and then later ousts a founder risks a dispute with the departing founder (who may no longer feel so warmly toward the company) over back pay and penalties. These disputes can be costly and may be troubling to investors and future M&A acquirers.

How much to pay?

A founder employed in California is entitled to compensation at minimum wage (currently $10 an hour, but higher in some cities and localities) or above; and:

- Overtime for any time worked beyond 8 hours in a day and 40 hours in a week, unless covered by a statutory exemption. The California professional exemptions require that the employee be paid at least US$41,600 annually and satisfy other requirements, such as supervising two or more employees and carrying out executive functions for the executive exemption. If the founder doesn't fit into the federal bona fide executive exemption described above, note that the minimum amount of pay to be exempt from federal overtime rose to US$47,476 on December 1, 2016.
- Regular payment (at least twice per month, though once per month is permitted under certain circumstances), which must be made in the form of a negotiable instrument (i.e., cash or cash equivalent). Equity doesn't count for this purpose.

Why paying founders matters

Like any other employee, displaced founders can, and do, make California Division of Labor Standards Enforcement claims and employers defend against these claims. However, the California wage laws tend to favor employees and steep penalties may apply. In addition, investors have become very savvy about wage-and-hour law compliance, so unresolved wage issues may impede fundraising.

Practical tip: avoid salary deferral

One potential pitfall is setting a salary and then deferring it. Under California law, it is very difficult to get an enforceable waiver of earned wages unless it's deferred through a qualified employee pension or welfare benefit plan. In addition, there are state and federal tax rules that impose significant tax penalties if compensation is deemed to be deferred, unless a complex set of tax regulations is followed.

More importantly, investors and M&A acquirers aren't looking to invest in back-pay awards! A better practice would be payment of a minimum salary, with a contingent bonus upon funding so long as the founder remains employed with the company.

[1] Please note that the work performed by a founder potentially may be covered by an independent contractor relationship, but for now, we are looking at the case where a California founder is performing as an employee. Independent contractors generally are not subject to employee wage laws. We would note, however, that it may be difficult for a founder to qualify as an independent contractor because required corporate filings may often indicate that they are officer-level statutory employees.
