

Employment Practices Group

Startup Guide to Hiring and Terminations

This guide provides startups with a basic overview of how to tackle the most important employment issues they will face as they grow and scale: (1) hiring and compensating workers and (2) terminating the relationships with those workers.

Worker Classification

Hiring workers is an important step for startups. Startups engage two main types of workers—employees and independent contractors. It can be difficult to determine the proper classification of a worker, especially since both federal and state law govern whether a worker is an employee or an independent contractor. Also, a worker's classification determines how they are paid and what benefits they receive.

When engaging any new worker, often the most conservative approach is to classify the worker as an employee because improperly classifying a worker as an independent contractor (when they should in fact be an employee) violates tax and employment laws, resulting in legal and financial liability (including potential personal financial liability for officers and directors).

The two main categories of workers:

Employee

- Defined as a worker who provides services to the startup under its direct supervision and control.
- Performs work that is core to the startup's business (e.g., an engineer at a software company).
- Startups withhold taxes from the employee's wages, pay payroll and other taxes to the government, and issue the employee an IRS Form W-2 each year for any wages earned.

Independent Contractor (also known as a consultant)

- Defined as a non-employee worker who provides non-core, highly skilled, and project-oriented services to the startup free from its direct supervision and control.
- Startups do not withhold or pay taxes on behalf of contractors. Instead, startups issue IRS Form 1099s to contractors for any payments and the contractors are responsible for paying their own taxes.

Employee vs. Independent Contractor

Although there are various tests (at both the state and federal level) to determine proper classification as a contractor, the general factors are that the worker:

1. is free from the direction and control of the startup;
2. performs work that is *outside* the usual course of the startup's business; and
3. is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the startup.

Other factors include:

- the duration of the relationship between the contractor and the startup (i.e., the longer the relationship, the more it looks like an employment relationship);
- whether the contractor supplies their own tools and equipment (i.e., startups should refrain from supplying contractors with computers, mobile devices, or other company-issued equipment);
- whether the contractor pays for their own business expenses (i.e., contractors should pay for their travel and other expenses); and
- whether the contractor sets their own schedule (i.e., contractors should have broad latitude to set their schedules).

Contractors are not entitled to fringe benefits, are not subject to wage and hour laws, and do not generally enjoy the same legal protections as employees. However, under the laws of some states (including New York, and in some instances, California), independent contractors are covered by anti-harassment and anti-discrimination laws.

One common misconception is that when startups need help on a temporary (*i.e.*, short duration) or part-time (*i.e.*, indefinite duration, but typically 20-30 hours per week) basis that they should automatically classify workers as contractors. However, in many circumstances, and based on the above test, the workers should be engaged as temporary or part-time employees.

Accordingly, consultants should be used sparingly as they are often misclassified and should be employees. Further, given that the appropriate test to determine independent contractor classification varies—with some states having a more demanding standard than others—it is prudent to consult with counsel when deciding whether to engage a worker as a contractor (including which test applies in a given situation). Startups that misclassify workers as contractors face steep penalties and consequences:

Accordingly, consultants should be used sparingly as they are often misclassified and should be employees.

- Disgruntled contractors can sue startups for wage and hour violations. This can occur even if the worker voluntarily agreed to be classified as an independent contractor or purported to waive their rights to claim they are an employee at the outset of the engagement (such a waiver would be unenforceable, and whether an employer-employee relationship has been created is a legal question and evaluated based on the nature of the actual relationship between the startup and the worker, not what the parties decided to label the relationship). Damages resulting from these lawsuits (which can include the startup being required to pay back taxes and the value of benefits that should have been provided had the worker been properly classified), as well as the attorneys' fees to defend against them, are costly and are typically not covered by insurance.
- Government agencies can audit or investigate startups. Although these agencies can initiate random audits, they often audit startups when a contractor files for unemployment benefits after their contract ends. This is usually done without any ill will or intent to harm the startup; rather, the contractor mistakenly believes that they are eligible for unemployment benefits from the startup. If an agency initiates an audit, it can examine all contractor relationships dating back several years and assess penalties for misclassification as to those workers, in addition to the contractor at issue.
- Misclassification may adversely impact an investment in or sale of a startup since it can be viewed as an undesirable, inherited liability.

Contractor misclassification is a pervasive issue that affects all industries. Since both tax and employment laws favor classification of workers as employees rather than contractors, this will continue to be a significant hurdle for startups, especially gig economy companies that rely heavily on a contractor workforce.

Exempt vs. Non-Exempt Employee

After determining that a worker is an employee, startups must then decide whether the employee should be exempt (paid a salary) or non-exempt (paid hourly). This distinction determines how employees will be paid and whether or not they will be eligible to earn overtime pay. As with contractor classification, exempt versus non-exempt classification is also governed by state and federal law.

Much like the saying “innocent until proven guilty,” employees are hourly (non-exempt) until proven salaried (exempt), and the burden is on the employer to prove exempt status. This is counterintuitive for startups since most want to (and do) hire only salaried employees, especially in the beginning.

Keep the following points in mind:

- While the laws differ by state, the general rule is that employees must be non-exempt and eligible to receive overtime pay, meal and rest breaks, and other wage and hour protections unless they qualify for an exemption.
- Popular exemptions among technology startups include those covering supervisors, workers in the computer professional exemption (e.g., software engineers), administrative employees who handle the day-to-day operations of the startup (e.g., head of human resources or head of finance), and inside salespeople.
- There is no founder exemption to paying minimum wage or overtime, but there is a very limited business owner exemption under federal law that is inapplicable in many states, including California and New York. Each exemption has specific legal requirements that must be met regarding a minimum salary amount, which can be higher for software engineers (including in California), and duties the employee must perform.

While startups must analyze each job individually to determine the proper classification, some commonly misclassified positions include executive assistant, office manager, inside sales representative, and customer service representative.

Like contractor misclassification, employee misclassification can have devastating consequences, including lawsuits by misclassified employees (especially on a class action basis) and government audits, as well as wary investors and acquirers. Accordingly, it is advisable to consult with counsel to ensure that exemptions are appropriately applied in compliance with applicable law.

If the employee does not meet one of the exemptions, they must be classified as a non-exempt (hourly) employee.

Compensation Agreements

An important part of hiring employees is deciding how to compensate them. Because of limited capital, startups often implement equity-only compensation or deferred compensation arrangements in lieu of regular salaries. However, such arrangements are unlawful, even if the founder or employee is a willing participant.



All **employees** must receive at least an hourly minimum wage, which varies by location (including higher minimum wages in cities like San Francisco, Los Angeles, Seattle, and New York), plus overtime as required by state and federal law. If employees are exempt (salaried), they must make a minimum salary amount depending on their exemption, which is also determined by location. Failure to pay wages to employees (or to defer pay) is a violation of employment laws, raises tax concerns, and can result in liability for startups and their founders (as well as officers and directors). Further, it can jeopardize the validity of intellectual property assignment, since employees will not have received proper consideration (i.e., wages) for their assignment. This is especially problematic for technical roles like engineers and scientists.



Unlike employees, there is more leeway for compensating properly classified **contractors**. They can and often are paid a flat rate, only given equity (i.e., no cash compensation), or provided other benefits in lieu of pay that would be unlawful in an employment relationship.

Documenting Worker Relationships and Onboarding

Once a startup has properly classified its worker, it should document its relationship with the worker in order to clearly identify the classification, compensation and benefits (e.g., base salary, bonus, commissions, equity, PTO/vacation, signing bonus, relocation reimbursement, and health insurance benefits), and other terms and conditions of the arrangement.



Contractors should sign a contractor agreement with provisions covering fees, treatment of the startup's confidential information, assignment of the contractor's inventions to the startup, and other basic terms. They should not be formally or informally referred to as employees of the startup or sign documents that the startup normally provides to its employees, including its employee non-disclosure, confidentiality, or invention assignment agreements, as this can affect the nature of the contractor relationship.



Employees should receive more robust hiring documentation, including, most importantly, an offer letter and an invention assignment agreement. The documentation should be presented to (and signed by) contractors and employees before any work begins and kept electronically or otherwise by the startup.

In addition, startups should ensure that they comply with all applicable federal and state requirements related to onboarding new employees, including those relating to employee notices, tax filings, and insurance coverage. The startup may consider outsourcing these issues by contracting with a professional employer organization (PEO), which is a third-party entity that can manage certain human resources functions for the startup.

Termination Process

Worker turnover can be high in startups given their fast growth, changing needs, and uncertain cashflow. Sometimes relationships end naturally, such as the conclusion of a consulting project or an employee's resignation to join another company. Other times, the relationship ends involuntarily due to poor performance or other reasons. While in most cases the startup's employment relationship with the employee will be "at-will"—meaning that either the startup or the employee can terminate the relationship for any reason, at any time, with or without prior notice and with or without cause—involuntary terminations can be challenging for startups and require care and attention to detail to avoid, or at least mitigate, legal liability.

- For **involuntary terminations**, employees must receive their final paychecks on time (based on state and federal law – e.g., on the last day of employment in California, at the end of the established pay period in Washington, and by the regular payday for the pay period when the termination occurred in New York). In addition, startups should provide required state and federal termination documentation (e.g., unemployment insurance notice), as well as shut off the employee's email and systems access and collect the employee's company property and passwords. Moreover, it is highly recommended to offer severance in exchange for a release agreement whenever a startup involuntarily terminates an employee in order to protect the startup from legal claims (e.g., harassment, discrimination, retaliation, or wage and hour violations). However, it is not required and some startups choose to offer severance in exchange for a release only when they think there is a risk that the employee may sue the startup based on the facts and circumstances of the employee's employment and termination. Investors and acquirers like to see signed release agreements for involuntary terminations because this signifies that the startup has controlled its liability. Startups should consider the reason for the termination, any supporting documentation (especially for performance-based terminations), and any risks in terminating the employee (e.g., the employee falls into a protected category based on age, race, gender, disability, etc.). In addition, startups should consult with counsel to assess the risks and whether or not to offer severance in exchange for a release.
- If an **employee voluntarily resigns**, the startup should identify the employee's last day and have the employee submit their resignation in writing in order to have a record of the resignation. Although startups can offer release agreements to employees who resign, this should be considered on a case-by-case basis to determine if it is warranted.
- The relationship with a **contractor should be terminated** based on the terms of the written consulting agreement. Such agreements often require advance written notice of the termination. Startups should discuss the termination of the agreement with the contractor and then follow the required steps in the agreement. Unless otherwise specified in the agreement, written notice can be sent by email, which serves as solid evidence of termination since it is date and time stamped.

Conclusion

Within the first few years, startups grow at an exponential pace, often doubling or tripling in size. This fast growth, coupled with uncertainty regarding funding, underscores the importance of making smart and informed hiring and termination decisions at the outset.

Since this guide only scratches the surface of these topics, please contact a partner in the Employment Practices Group or the Fenwick attorney with whom you typically work.

Employment Practices Group Partners



Sheeva Ghassemi, Practice Area Lead

Mountain View

sghassemi@fenwick.com



Dan McCoy

Mountain View

dmccoy@fenwick.com



Matt Damm

New York

mdamm@fenwick.com