



## **Business Client Advisory (2009 – E1)**

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Thank you to Richard S. Creem, Esq., Counsel to Coleman & Gagnon, P.C., for his excellent work in preparing this Business Client Advisory.

**Topic:**        **Employment Law – A former president and founding shareholder of a start-up company can seek payment of deferred and unpaid salary under the Massachusetts Weekly Wage Act (the “Wage Act”) against both the company and the company’s CEO, who was also an early-stage investor.**

**Summary:**    **In the case of Stanton v. Lighthouse Financial Services, Inc., et al, a U.S. District Court (MA) judge has ruled that, for purposes of the Wage Act,**

**(i) a start-up company’s president is considered to be an employee of the company and, as such, can bring a claim for deferred but unpaid salary arising out of his employment against both the company and the company’s CEO (in this case, his former partner and co-investor in the business);**

**(ii) wage deferral agreements, including the president’s own such agreement, are unenforceable; and**

**(iii) depending on the circumstances, each of the company’s principals may be considered to be both an employee (*i.e.*, a potential claimant under the Wage Act) and an employer (*i.e.*, a potential defendant on a claim under the Wage Act) vis-à-vis the other.**

### **Common Questions/Practical Answers**

#### **1.        What are the facts of the Stanton case?**

Plaintiff Stanton (“Stanton”) was a co-founder of Lighthouse Financial Services, Inc., a sub-chapter S corporation (the “Company”). Stanton invested in the company and recruited defendant Drunsic (“Drunsic”) to do the same. Both Stanton and Drunsic eventually executed employment agreements with the Company, with Stanton agreeing to serve as President and Drunsic agreeing to serve as CEO, each for a term of one year. Drunsic signed Stanton’s employment agreement on behalf of the Company and Stanton signed Drunsic’s.

Each of the employment agreements provided that the relevant employee’s first year salary would be \$144,000 and that payment of this sum (i) might be deferred at the sole discretion of the board of directors and (ii) would have to be made before distribution of any of the Company’s profits. A third investor was eventually brought in who supplanted Stanton as the Company’s second largest

shareholder. Neither Stanton nor Drunsic was ever paid and, as the Company's finances deteriorated, Stanton left the Company and filed a complaint for non-payment of wages with the Massachusetts Attorney General under the Wage Act. The Wage Act claim asserted with the Massachusetts Attorney General enabled Stanton to file a civil lawsuit. He named as defendants in the suit both the Company and Drunsic. None of the Company's other directors or investors were named in the lawsuit.

## 2. What does the Wage Act provide?

The Wage Act requires that every person having employees must pay to each of his or her employees, on a weekly or biweekly basis, such employee's earned wages within six (6) or seven (7) days, depending on the length of the work week, following the end of the relevant pay period. The Massachusetts Attorney General may make a civil complaint or seek an indictment against any person for a violation of this statute, and there can be no valid defense raised in such a proceeding for failure to pay required amounts. Additionally, within ninety (90) days following the submission of a claim to the Attorney General, an aggrieved employee may file his or her own civil lawsuit for (a) injunctive relief; (b) damages, including treble damages for any loss of wages and other benefits; and (c) if he or she prevails at trial, his or her litigation costs and reasonable attorney fees. **By legislative amendment dated April 15, 2009, the Wage Act specifically provides that (i) no person may, by special agreement, exempt himself or herself from the Wage Act, and (ii) "[t]he president and treasurer of a corporation and any officers or agents having management of such corporation shall be deemed to be the employers of the employees of the corporation within the meaning of the [Wage Act]"**.

## 3. What is the legal significance of the Stanton decision?

First, the Court rejected the defendants' arguments that (i) the Wage Act should not apply to co-venturers starting up a business and (ii) Stanton was disqualified from bringing a claim under the Wage Act because he was an "employer". The Court found that, under the "plain text" of the Wage Act and depending on the context, a corporate president could be liable as an employer and yet also be protected as an employee. In other words, a single individual could be considered to have different roles, with differing rights and responsibilities, within the same organization. Having also determined that the Wage Act does not exclude those who are "highly compensated", the Court concluded that Stanton, in his capacity as President of the Company, was an employee who could bring suit under the Wage Act.

Second, although the Wage Act, as interpreted by other courts, may not apply with respect to compensation payable solely upon the happening of a contingency, the Court rejected the defendants' argument that Stanton's deferred base salary comes within that exception. The Court therefore concluded that Stanton's base salary constituted "wages" under the Wage Act.

Third, the Court held that, under the Wage Act, Stanton's agreement to defer payment of his salary upon the board's decision is void as a matter of law. Under the Wage Act, one cannot agree to exempt himself/herself from the provisions of the Wage Act (and including, in this case, to agree to defer one's compensation) regardless of the circumstances. Such an agreement would have the effect of circumventing the Wage Act and, as such, would be unenforceable. The Court cites as its reason for this conclusion the importance of the Wage Act as a matter of public policy, noting that any limitations with respect to the scope of the Wage Act must come from changes to this statute adopted by the state Legislature.

Finally, the Court acknowledged that Drunsic could have asserted his own claim under the Wage Act against both the Company and Stanton had he done so at the outset of the lawsuit.

It should be noted that the judge's decision in this matter is at the trial court level and came about in a pre-trial proceeding (to the best of our knowledge, the trial of this case, barring any settlement, is pending). This means that the judge's decision has less precedential value than a ruling of law by an appellate court (*e.g.*, Massachusetts Supreme Judicial Court, U.S. Court of Appeals, U.S. Supreme Court, etc.). Nevertheless, her decision is noteworthy for the reasons discussed in this Business Client Advisory.

#### **4. What are the lessons of the Stanton case?**

The scope of the Wage Act has become very broad, and, as illustrated by the Lighthouse case, the Act is being further expanded by judicial interpretation. Business entities must, therefore, be structured in such a way that minimizes potential personal liability on the part of, and among, the principals/partners of those entities.

In this regard, we offer the following observations:

A. This case reflects a trend toward a broader application of the Wage Act than might have been anticipated by many companies. While there appears to be a split of authority among Massachusetts trial courts with respect to the question of whether a senior corporate officer should be considered an employee under the Wage Act, the U.S. District Court has opted to follow a line of cases which stand for this proposition. Absent clarification by the state Legislature or an appellate court, we expect this trend to continue.

B. The Wage Act provides for the possible imposition of substantial criminal or civil penalties in the event of a willful violation of the provisions of this statute by an employer. Thus, as the Wage Act is extended to apply to shareholders, a sword is being forged which is both disruptive to the concept of a closely held company, in particular, start-up companies, and potentially detrimental to its principals.

C. The fact that Drunsic was barred from asserting his own Wage Act claim against the Company and Stanton by the Statute of Limitations (he would have had to file a complaint with the Attorney General and then file a civil suit within three (3) years of the alleged violation) serves as a reminder of the need for constant vigilance with respect to the understanding and exercise of one's rights under the law.

D. The best way to avoid these potential results is through careful drafting and competent legal advice.

E. The Wage Act cannot be waived and, as we have seen, is now being interpreted so as to prevent an employee who is a senior officer (as well as, presumably, a sophisticated business person) from agreeing to defer payment of compensation due him or her. This is a common situation with many companies, especially start-up companies, and there are ways founder or partnership relationships can be structured which could minimize the impact of the Wage Act as it now is being interpreted.

F. Finally, the Stanton case demonstrates that, unless proper precautions are taken, duties will continue to be created or implied with respect to shareholders that might never have been intended or desired. This is all the more reason why all business organizations, whether new or established, should avail themselves of sound professional advice before making important business decisions.

Beyond the lessons raised by the Stanton case, it should be noted that, with any deferred compensation arrangement, Internal Revenue Code Section 409A imposes certain restrictions and limitations which must be adhered to in order to avoid potentially adverse personal income tax consequences to affected employees.

## 5. What should I do if I have questions?

Coleman & Gagnon can counsel you in determining the best structure for your business and assist you in developing a comprehensive strategy for minimizing the potential for personal liability under the Wage Act as well as the unfavorable tax consequences of Section 409A.

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