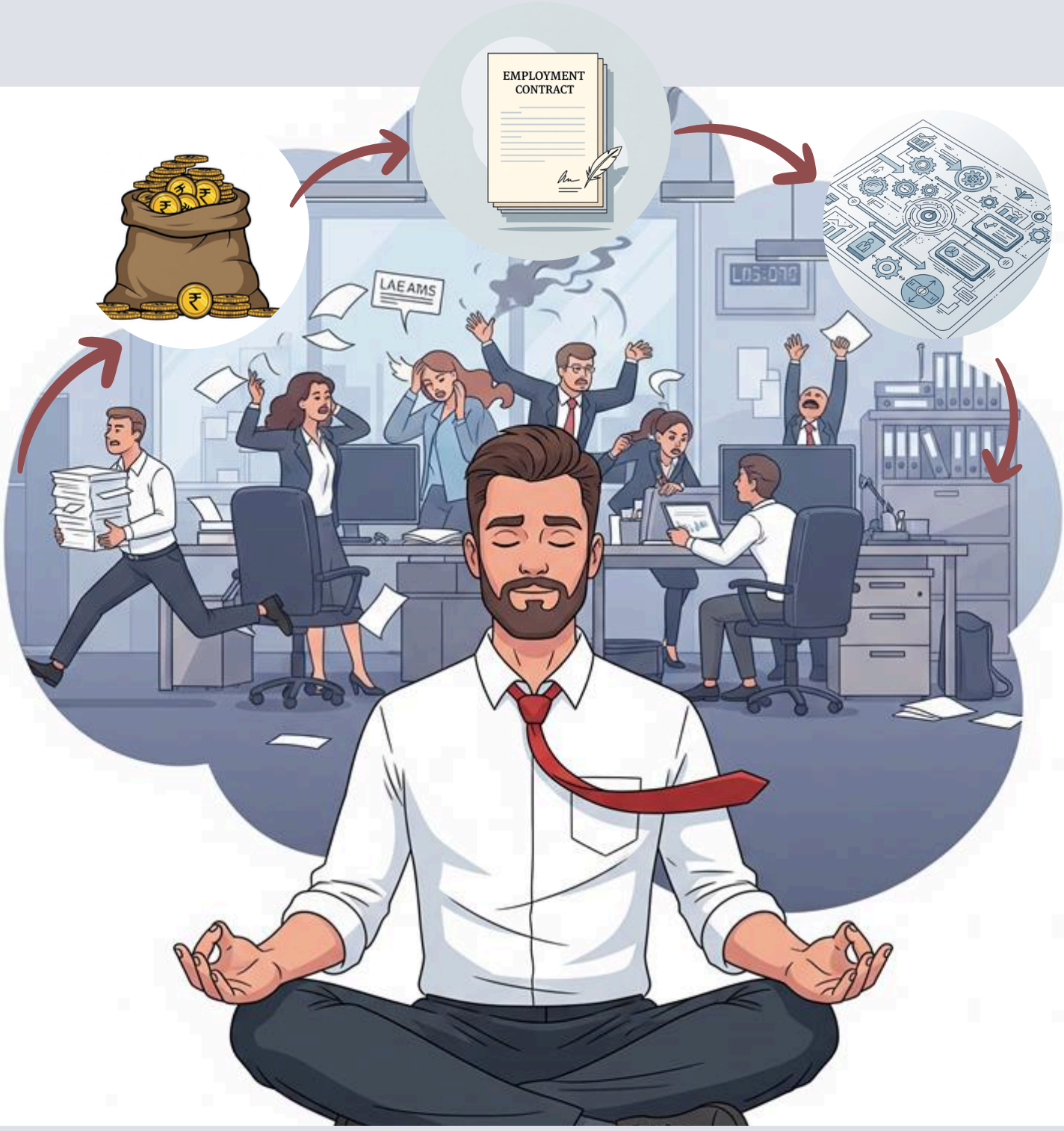
ATTENTION FOUNDERS: AVOID THESE 3 BLUNDERS



WEDNESDAY WISDOM

25-06-2025

Founders of any organization are the main drivers of the business. Most of the business entities' success revolve around the founders. We can consider a classic example of a business formed by a couple of individuals incorporated as a small business to a public listed company. Even considering an example of a private company having seen the success of expanding cross-borders and various investment rounds throughout the process. During the journey, promoters, also being directors of the company contribute to the value of the company in various ways, many a times without a quid pro quo.[1]

Focused on the long-term growth, most of the times, founders who are also directors of the company aren't willing to take compensation in the form of cash, as cashflow generally being a major challenge in the businesses, especially during the development stage. Considering the same it is important that the directors' rights are taken care of.

The Companies Act 2013, provides for certain rights for the directors such as 'Managerial Remuneration'. Section 197 of the Companies Act, 2013 provides for managerial remuneration to be paid to directors of a public limited company, including managing director and whole-time director and managers. Section 197 read along with Schedule V, also provides for the limit of remuneration that can be paid by companies having profit as well as the companies having no profits or inadequate profits.

Companies also may take insurance for the directors of the company. It is important to note that, as per Section 197 (13) If a company takes an insurance policy to indemnify its Managing Director, Whole-Time Director, Manager, CEO, CFO, or Company Secretary against liabilities arising from negligence, default, misconduct, breach of duty, or breach of trust in relation to the company, the premium paid for such insurance shall not be considered part of their remuneration. However, If the director or officer is found guilty, then the insurance premium will be treated as part of their remuneration and would be subject to limits under Section 197.

[1] The article reflects the general work of the authors and the views expressed are personal. No reader should act on any statement contained herein without seeking detailed professional advice.

While the Companies Act, 2013 mainly provides for director remuneration as compensation for standard responsibilities such as attending board meetings and participating in governance, directors who are founders of the company, many a times contribute far beyond these statutory duties. In many cases, they provide critical financial and technical support to the company, which significantly exceeds the scope of what is formally recognized under the law.

Case Study 1:
Unrecognized Contribution of Founders in Product Development

Two co-founders of a private limited tech company had a vision to develop a proprietary software product aimed at automating compliance and reporting for small businesses. With no external funding in the beginning, the founders committed their personal time, skills, and resources over several years to build the product from scratch. These efforts were done before formation of the Company. Thereafter, the Company was formed, and development of product continued, no employees or vendors were engaged for core development at initial stages. Co-founder 1 a seasoned software architect, led the entire coding and system design effort. Co-founder 2, with a background in finance and product strategy, worked on business logic, UI/UX, and market alignment. Neither of them drew any salary, consulting fees, or honorarium for their efforts. No formal contractual arrangement was entered into that valued or recorded their contributions in the company's books of accounts.

Within two years of product development the company began generating steady monthly revenue through licensing and subscriptions. The product's success was a direct result of the years of unpaid work by the two founders. The company's financials began reflecting profits, but only in terms of revenue and costs associated with operations and marketing that occurred after the product development.

Despite the financial success, the founders' efforts during the development stage were never capitalized or recorded as part of Intangible assets (like software under development), Deferred compensation or any other form of remuneration or contribution. The economic value created by the founders through years of unpaid technical and strategic work remained unaccounted in the company's financial statements. This especially created issues while discussing valuation with potential investors.

Workaround:

Recognizing Founders' Contribution through IPR Assignment

The aforementioned problem could be easily avoided by simple solutions. To properly recognize the unpaid contributions of the founders in developing the company's core product, the company can enter into an Intellectual Property Rights (IPR) Assignment Agreement with the founders. Through this agreement, the founders formally assign all rights, title, and interest in the software (including source code, design, and technical know-how) to the company. In return, the company agrees to pay a mutually agreed fee, representing the value of the founders' work. This not only provides legal clarity over ownership but also acknowledges the economic value generated by the founders prior to revenue generation.

Following the agreement, the company can record the assigned product as an intangible asset in its books. The corresponding amount is shown as a payable to the founders, which may be settled in cash or through equity issuance at a later date especially during investment rounds or acquisition of the company.

Case Study 2: Founders' Denied Compensation

Two founders launched an Edu-tech startup, focused on developing an AI-based educational app. While they actively ran the company full-time, handling everything from product development to fundraising, they never executed formal employment agreements with the company. Believing that their efforts would eventually be compensated, they began recording salary and gratuity provisions in the company's books, reflecting their ongoing contribution and aligning with typical employment costs.

Over the time, these entries accumulated into a significant payable under "Founder Salaries and Benefits" in the financial statements. However, when the company secured its first round of venture capital funding, the investors raised concerns during due diligence. The investors objected to the salary and gratuity liabilities on the grounds that there were no board-approved employment agreements, no resolutions authorizing such payments, and no actual disbursements made. As a result, they refused to recognize or allow payout of these amounts, insisting that they be reversed or treated as capital withdrawals. This led to a governance challenge and created friction between the founders and the new investors, highlighting the risks of informal arrangements and the importance of proper documentation in startup management.

Workaround:

Formalizing Founders' Efforts Through Employment Agreements

To resolve the issue and ensure clarity in future operations, the company should immediately execute formal employment agreement with each founder. These agreements must clearly define their designation, roles and responsibilities, salary structure, benefits (such as gratuity, provident fund, ESOPs), and terms of service, including termination and notice periods. The agreements should also include clauses on confidentiality, non-compete, and intellectual property ownership, ensuring alignment with both company interests and investor expectations.

Before execution, the Board of Directors should pass a formal resolution approving the appointment of the founders as employees, including the proposed remuneration. Once executed, the company can begin booking salaries prospectively, supported by proper payroll and HR documentation. As for past entries, a discussion with investors should be held to determine whether those amounts can be reclassified (e.g., as deferred compensation, capital infusion, or waived by the founders). Going forward, this step can establish proper governance, ensures legal compliance, and builds trust with investors and auditors.

On this issue, we connected with Mr. Suyog Narvekar, a chartered accountant. In his view,

"When a company records deferred compensation (e.g., unpaid salary or benefits) for founders or directors in its books, TDS (Tax Deducted at Source) obligations are triggered at the time of accrual, not just actual payment. This means:

- *The company is required to deduct TDS on the salary amount, even if the payment is deferred.*
- *Founders must report this income in their Income Tax Returns (ITRs) for the relevant year of accrual, regardless of whether they have actually received the amount.*
- *Any tax due (beyond TDS) must also be paid by the founder in that year.*

This framework ensures that deferred salary is taxed on a due basis, preventing tax deferral and loss of government revenue. This acts as a deterrent to founders without lack of other incomes/cashflows as they have to pay tax upfront on money not receivable in the near future .

However, when the deferred compensation is eventually paid, no additional tax is applicable on the payout since the income has already been taxed earlier. Thus, while deferred compensation helps preserve cash, it must be legally documented and tax-compliant to avoid complications during audits, due diligence, or investor scrutiny."

Case Study: Anil Govind Ganu V/s Innovative Technomics Pvt. Ltd[2]:

The petitioners, Anil Govind Ganu and Ashwini Anil Ganu, were the founders and directors of Innovative Technomics Pvt. Ltd. They claimed to have worked for the company as employees and drew salaries until their resignation in October 2012 following a Share Purchase Agreement (SPA) through which they transferred 100% of their shares. They later filed for payment of gratuity under the Payment of Gratuity Act, 1972, claiming amounts of ₹94.26 lakhs and ₹27.69 lakhs respectively, based on their alleged employment tenure and last drawn salaries. They relied on pay slips, balance sheet entries, and provisions in the annual accounts reflecting gratuity liabilities. Their applications were rejected by both the Controlling Authority-cum-Labour Court and the Appellate Authority-cum-Industrial Court, leading to the present writ petitions.

The Bombay High Court dismissed the writ petitions, holding that the petitioners were not employees within the meaning of Section 2(e) of the Payment of Gratuity Act. The Court found no valid agreement or contract under Section 4(5) of the Act to support their claim for gratuity in excess of the statutory cap. ***The Court further held that mere entries in the balance sheet, reflecting a provision for gratuity payable to directors, do not amount to an enforceable agreement or create a legal liability.*** *Further, the Court noted that the petitioners, being in full control of the company at the time, self-authorized such entries, and their admission in cross-examination about the absence of any gratuity agreement further weakened their case. The Court also emphasized that while directors can be treated as employees in some cases, in this specific situation, the petitioners acted as employers/promoters and hence were not entitled to claim gratuity under the Act.*

[2] WP-160-161-2024-JR-FC

Case Study 3:

Informal loan by Founder and the Consequences on Equity Conversion

A founder and director of a tech startup personally infused funds into the company to help cover critical product development and team expenses during its early growth stage. He treated this amount as a loan to the company and assumed that, when the company raised external funding, his loan would be converted into equity in a future round. However, no formal loan agreement, board or shareholders resolution, or terms of conversion were ever documented at the time of advancing the funds.

When the company initiated Series A funding the founder proposed converting his loan into equity under the new valuation. However, the legal and financial advisors of the incoming investors flagged the absence of a loan agreement specifying the terms of repayment or conversion any board or shareholder resolution authorizing such convertible debt, and necessary filings with the Registrar of Companies (ROC) under applicable provisions of the Companies Act, 2013.

As a result, the investors refused to allow the conversion, treating the amount as an unsecured loan repayable in cash. The founder was unable to convert the funds into shares or claim valuation benefit, leading to a lost equity opportunity and a dispute over, whether the funds were debt, capital contribution, or something else.

Workaround:

Formalizing Loans with Clear Rights under the Agreement and Legal Compliance

To resolve the issue and prevent such situations in the future, the founder should immediately execute a formal loan agreement with the company detailing the terms of the loan, including the principal amount, interest rate (if any), repayment schedule, and most importantly, the right to convert the loan into equity. The loan agreement must be backed by appropriate compliance under the Companies Act, 2013. Any such financial assistance from promoters or directors intending to convert into equity should be carefully structured as compulsorily convertible debentures or loans, with conversion terms drafted in the initial stage itself. This protects the founder's equity interest and ensures that the company remains compliant with corporate governance and regulatory requirements. Proper documentation not only secures legal enforceability but also builds investor's confidence in the company and its founders.

Conclusion:

The three case studies discussed in this article highlight some of the common but critical oversights founders make during the early stages of building their business. While the solutions provided offer practical workarounds, they are by no means exhaustive in nature. In practice, each company's situation and challenges are distinct and may come with its own set of legal, financial, or regulatory complexities. Founders being the main drivers of a company's future, must ensure that their own rights, and contributions are well-documented and are compliant with applicable laws with appropriate advisory.

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