



Lowenstein Sandler's Executive Compensation and Employee Benefits Podcast: Just Compensation

**Episode 50:
Employment Considerations for Early-Stage Companies**

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- Megan Monson:** Welcome to the Lowenstein Sandler podcast series. Before we begin, please take a moment to subscribe to our podcast series at Lowenstein.com/Podcasts, or find us on Amazon Music, Apple Podcasts, Audible, iHeartRadio, Spotify, SoundCloud or YouTube. Now let's take a listen.
- Jessica Kriegsfeld:** Welcome to the latest episode of "*Just Compensation*." My name is Jessica Kriegsfeld and I'm an associate in Lowenstein Sandler's Executive Compensation, Employment and Benefits Practice Group. I'm joined today by Amy and Adam who I'll let introduce themselves.
- Amy Schwind:** Hi, my name is Amy Schwind. I'm counsel in the Executive Compensation, Employment and Benefits Group. Happy to be here today.
- Adam Dickson:** Hey, I'm Adam, and I am counsel in Lowenstein's Emerging Companies and Venture Capital Group, and I'm honored to be a guest, and thanks for having me.
- Jessica Kriegsfeld:** Today's episode will discuss key employment considerations for early-stage companies. Being compliant with applicable employment laws will help companies build a strong foundation to grow and attract talent. We will discuss some high-level considerations related to hiring employees and general compliance with employment laws.
- As always, this is not intended to be an exhaustive discussion, and we encourage you to consult with your legal counsel to develop and maintain compliant employment practices. Amy, before a company hires employees, what are some considerations for a company to be thinking about?
- Amy Schwind:** First, a company will want to consider how it intends to facilitate payroll. The company will need to keep track of wage rates and hours worked for

employees who are non-exempt from overtime, as well as manage tax withholdings, including for Social Security, Medicare, and state and federal taxes.

There are a lot of external payroll providers, so the company doesn't have to perform these payroll functions in-house. There are also other HR-related functions related to onboarding employees, so some companies may look to outsource those obligations as well and may explore using a professional employer organization abbreviated as a PEO to assist with this payroll and benefits offerings.

Companies should also consider whether the state where the company is located requires the company to have workers' compensation coverage or be approved for self-insurance, and whether the state requires the company to have short-term disability insurance or paid family leave insurance.

New Jersey and New York are examples of states that require employers to have all of those. The company should also consider the legal requirements around providing health insurance. There are nuanced requirements under the federal Affordable Care Act, and some states have state-specific mandates including New Jersey, California, and Massachusetts among others.

This is unlikely to come into play with hiring initial employees, but it will as the company grows.

Jessica Kriegsfeld: Adam, from the perspective of an early-stage company, what are some items to consider before hiring employees?

Adam Dickson: First, consider what type of positions the company needs filled, including whether to hire a specialist or a generalist who can wear multiple hats. Oftentimes, specialists and more senior talent have more expertise, but they may demand higher salaries. Second, consider how much funding the company has and whether it has enough cash flow to hire employees.

As we'll discuss in a bit, all employees need to earn at least minimum wage. We can help companies with financing like raising debt, convertible notes, and traditional price rounds like series seed, series A, B, C, D, et cetera, to ensure that companies have enough cash for their workforce. And third, companies should consider whether to hire full-time employees, part-time employees or independent contractors.

Amy Schwind: And just to jump in here from an employment perspective, whether to classify a worker as an employee versus an independent contractor isn't a business-level choice, but rather it's a legal test, which varies by state and based on other nuances.

Employees typically are under the direction and control of the company and perform work directly within the scope of the business, whereas contractors may be engaged to perform a specific and discrete project.

This is a simplification, but again, I want to stress that the proper classification depends on application of a legal test to the facts and circumstances and not on preferred tax treatment, whether the entity's preference or the worker's.

This is an important distinction to get right at the beginning to avoid future penalties. Companies can also consider engaging temporary workers, and we will discuss engaging temporary workers in more detail in an upcoming episode of this podcast.

Jessica Kriegsfeld: Once a company has a plan and internal mechanisms to hire employees, what are some considerations when recruiting, interviewing, and offering employment?

Amy Schwind: There are various considerations when an employer first makes a job posting and is in the initial interview stages. For example, job postings can't contain language that is discriminatory based on a protected class such as age, sex, race, religion, national origin, et cetera.

An example of a hiccup there could be is an employer putting in a job posting that they are seeking a young professional that would be viewed as discriminatory on the basis of age, whereas terms like entry level convey level of experience, and a person of any age would be eligible for an entry level position.

Some states have laws requiring job postings to include a salary range to promote pay transparency, including California, New York, Colorado, and Washington, among others. Some states also have salary history bans, which prohibit employers from requesting, requiring, or seeking a job applicant's or current employee's wage or salary history as a condition of employment or continued employment.

So, a question in an interview, like, "How much did you make at your last job?" would be prohibited. Many states also prohibit employers from asking about criminal history on a job application and require delaying inquiry about an applicant's criminal history until a conditional job offer is extended.

Employers that are going to run background checks will need to engage a background check provider and ensure appropriate disclosures and authorization in accordance with the Federal Fair Credit Reporting Act and applicable state and local law.

If an employer elects to conduct a drug test, the employer should ensure that it complies with applicable state law. And just to note, some states do protect off-duty cannabis use. Before making a job posting and interviewing candidates, companies should ensure that they check the requirements in applicable states.

Once an employee is hired, an employer should document the employment arrangement, and this is often done through an offer letter or an employment agreement. We typically see offer letters for rank-and-file employees and more nuanced employment agreements for more senior employees or executives. A minimum offer letters or employment agreement should outline pay, the term of employment, or more commonly that employment is at will and the opportunity to participate in benefits offerings.

Companies should also consider restrictive covenants agreements. These agreements can contain restrictions such as confidentiality obligations, assignment of inventions, non-solicitation and non-competition obligations. However, the laws and enforceability regarding non-solicitation and non-competition obligations vary widely by state and should be tailored in scope.

For instance, in some states like California, non-competes are generally not permissible. At a minimum, consider having employees sign a confidentiality and invention assignment agreement and then think from a business perspective what other protections are desirable.

Jessica Kriegsfeld: When a company is starting to grow its workforce, what are strategies that you see companies use to continue to recruit and retain talent?

Adam Dickson: Often in early-stage companies, they may elect to pay the management team less cash compensation than they would get from larger companies, or founders may even take no salary. These companies may incentivize employees with equity grants instead, and it's important that an equity plan and applicable award agreements are directed correctly, properly incentivize employees, reflect the company's intent, and to comply with applicable laws and regulation.

Companies should keep accurate records of outstanding equity grants and applicable vesting schedule. There are a variety of equity management tools that companies use such as Carta, that are great for this purpose. Companies should also ensure proper corporate governance practices, including, for example, executing board consent or properly documented board minutes for all equity grants.

And to value equity, companies will have to determine the fair market value of each share of common stock, and this is done by engaging an outside and independent advisor to appraise the company's value.

This is called a 409A valuation. The 409A valuation can only be relied upon for equity grants for up to 12 months, or if earlier, until a material event that affects company's fair market value, whether a good event or a bad event. So, it's important that companies have timely 409A valuation before granting equity.

And we're going to discuss 409A valuations in more depth in another episode titled, "Why is a 409A valuation important?" We also see companies paying a lower base salary until the company raises a certain level of funding, and that's part of the trade-off of working for a young company, lower salary for higher upside when the equity becomes valuable.

Amy Schwind:

Even though employees are often incentivized with equity, it's important that generally all employees are paid at least the minimum required by applicable law. So, this is important to keep in mind. For non-exempt employees, that is at least minimum wage for every hour worked. There is a federal minimum wage, and state and local minimum wages that may be higher.

For exempt employees in general, it is a required salary threshold to maintain exemption. Again, there is a federal level there and then some states have higher thresholds. The test for whether an employee is exempt or non-exempt from overtime is, again, a nuanced one, but in general depends on the salary level and the duties of the position. They have to meet a certain legal test.

Also, I do want to note that there are certain instances in which it may be acceptable for founders to not pay themselves as employees. This would depend on whether what is called the business owner exemption is available, which is a special rule for business owners who own at least a bona fide 20 percent equity interest in the enterprise and who are actively engaged in its management.

This exemption, while available under the Federal Fair Labor Standards Act, is not recognized in every state. It's a good idea, particularly when just starting up, to consult with counsel regarding proposed compensation arrangements or lack thereof. Employees can also be incentivized with bonuses and commissions.

Any compensation arrangement should be properly documented to avoid any disputes with employees. In particular, if there's commission, there should be a separate commission plan.

Jessica Kriegsfeld: If an early-stage company were to have employment-related compliance issues, when do they commonly come to light?

Adam Dickson: Employment issues often arise in the deal context. For example, if a company is being acquired, the buyer will do diligence of the selling company, which involves looking to the company's business, including with respect to employment practices. So, examples of this are that buyers often look for relief to term employees who have been involuntarily terminated, and they look for offer letters or employment agreements for each employee or consultant that the selling company claims those work for the company.

This shouldn't be a surprise, and worker classification, onboarding processes, et cetera, are heavily scrutinized in the diligence process and, depending on the scope of a potential issue, could have an impact on the transaction.

Amy Schwind: Another place that employment issues often arise is when a worker is terminated. If the worker tries to claim unemployment benefits but the worker was classified as an independent contractor, this could raise scrutiny into the company's worker classification practices and employment practices more generally.

Employment compliance issues could also be raised by the worker themselves, or by an audit, by a governmental entity such as a Department of Labor, either state or federal, or a taxing authority.

Jessica Kriegsfeld: What are other best employment practices for an early-stage company to adopt early on?

Amy Schwind: One best practice is to create a personnel file for each employee. Another good idea is creating an employee handbook and having employees sign or acknowledge receipt of the employee handbook. It would cover company policies and workplace expectations.

The employee handbook typically includes paid time off policies. A growing number of states require paid sick time and the number of states requiring paid family leave insurance is on the rise. Some states require having anti-harassment policies, and it is generally a best practice to do so anyway.

Companies should draft and review their handbooks for state-specific compliance. Consider where each employee is located, particularly if it's a different state than where founders are located. A growing number of employees work remotely in different states. Employers must comply with state law where the employee is located.

Note that there are also a host of tax withholding and business registration requirements with respect to remote employees. Employers will want to provide any legally mandated training, such as any state-required anti-harassment training that's required, for example, in New York and California, and employers will also want to provide any required job notices.

There are also business expense reimbursement statutes in certain states like California and Illinois, which may require reimbursement for expenses like mileage, home internet, and data plans. Employers need to have a system in place for I-9s to verify employees' identity and eligibility to work in the United States, which is a process required by federal law within three business days of the employee's first day of employment.

Another consideration is that upon termination, depending on the circumstances, companies may want to consider asking employees to sign a release of claims in favor of the company. So, this typically includes offering the employee something over and above that to which they're entitled, like severance in exchange for the release.

Adam Dickson: And from the corporate side, get a law firm involved early on with equity grants. Get an electronic stock ledger, Carta, for example, or Pulley, or one of their peer companies, to keep track of these grants and don't rely on your memory or Microsoft Excel or similar things. You'll be cruising for a bruising if you do that.

Self help usually costs more in the long run. And remember to keep everything current with employee and consultant termination dates, so equity doesn't keep vesting after they've been terminated.

Jessica Kriegsfeld: As you heard today, there are a variety of employment-related considerations that early-stage companies should be aware of, including considerations before employees are even hired. Companies should carefully adopt employment practices that are compliant with federal and applicable state law.

With proper planning and consultation with legal counsel, early-stage companies can set themselves up for success and prevent future issues. This is intended to be a high-level overview and is not an exhaustive discussion. Thanks for joining us today. We look forward to having you back for our next episode of "*Just Compensation*."

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