



# 10 Steps for Built-to-Sell Tech Startups to Lock Down Employment Law Compliance

Insights

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You've built a great product, assembled a talented team, and maybe even caught the attention of investors or potential buyers. But your code or growth metrics will only get you so far if your company is not a compliant acquisition-ready business – and your compliance with workplace laws plays a major role in that. This guide will walk you through a non-exhaustive list of employment law best practices every startup founder should implement *before* you begin to position your company for a streamlined acquisition.

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# 10 STEPS FOR **Built-to-Sell Tech Startups** to Lock Down Employment Law Compliance

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## **1. Classify Workers Correctly: Employees vs. Independent Contractors**

Misclassification of workers is one of the most common – and most costly – issues uncovered during due diligence. Where a worker is misclassified, the employer may be liable for a penalty to the state, overtime, missed meal periods, missed rest periods, wage statement penalties and waiting time penalties, among other things. In a startup environment where workers often work very long hours, the damages can be significant.

**Best practices:**

- **Err on the side W-2 employment when classifying workers** – unless you can clearly justify independent contractor status with documentation.
- **Ensure independent contractors meet IRS and state-specific legal tests** (e.g., California's ABC test, which presumes all workers are employees unless proven otherwise). This includes (but is not limited to) analyzing behavioral control, financial control, and the overall relationship between your company and the worker.
- **Provide W-2s for employees and 1099s for properly classified contractors.**
- **Conduct a regular audit of your worker classifications.** Don't rely on old assumptions – review each role carefully as your business evolves and roles change.

## **2. Ensure Offer Letters and Agreements Are Clear and Legally Sound**

Investors and acquirers want to know your employment terms are transparent and enforceable. You also want to ensure that you haven't contractually given away certain rights to your company or promised obligations in the event of a sale.

**Best practices:**

- **Keep digital copies** of all signed agreements securely organized and accessible. Buyers will expect to see a clear paper trail during due diligence.
- **Use Proprietary Information and Invention Assignment Agreements (PIIAAs)** to make sure intellectual property created by employees belongs to the company – not the individual.
- **Provide every employee with a signed offer letter** outlining title, salary, at-will status, start date, and any bonus or equity offers. This ensures transparency and helps prevent later disputes.

## **3. Maintain Compliant Payroll and Wage Practices**

Wage and hour violations can lead to significant liabilities – including penalties, interest, and class action exposure.

### **Best practices:**

- **Pay all wages (including commissions, bonuses, and reimbursements) on time and according to law.** Late or missed payments are common grounds for lawsuits and audits.
- **Track hours, meal breaks, and rest periods for non-exempt employees** in compliance with your state's labor laws. In California, for example, failure to provide proper breaks can result in significant penalties.
- **Ensure employees are properly categorized** as exempt or non-exempt under both federal and state wage laws. Exempt employees are not entitled to overtime or in certain states (e.g., California) meal or rest periods; non-exempt employees are.

## **4. Document Your Equity Grants and Make Sure They're Cap Table-Ready**

Unclear or undocumented equity promises can derail M&A deals and dilute your equity.

### **Best practices:**

- **Ensure equity grants are valued properly under IRS Section 409A** to avoid adverse tax consequences for employees and founders alike.
- **Clearly define vesting schedules, cliffs, and exercise rights in grant agreements.** Misunderstandings about equity can lead to internal disputes or litigation.
- **Use a formal board-approved stock option plan.** Avoid handshake equity promises or verbal understandings, which are unenforceable and risky.

## **5. Protect Company IP and Trade Secrets**

Acquirers will expect full assurance that your company owns its intellectual property. As a result of increased competition and consolidation, talent is already at a premium. Venture capitalists and companies investing in and acquiring startups conduct rigorous due diligence related to key executives, trade secrets, confidential information, noncompetition agreements, and the management of project-related data. For many start-ups, much of their value is derived from their key executives and any proprietary or trade secret information.

### **Best practices:**

- **Develop internal policies for handling confidential information,** including NDAs and internal training where appropriate.

- **Avoid incorporating third-party IP without permission.** If the due diligence process reveals unlicensed software or copying open-source code without proper attribution, it can delay or kill a deal.
- **Require all employees and contractors sign IP assignment agreements *before* beginning work.** This ensures the company owns what's created on its time and dime.
- With regard to noncompetition agreements (in jurisdictions where such agreements are allowed), **acquiring companies should review the structure of their deal and make sure that such agreements are assignable and that the restrictive covenants are enforceable.** Because employees may be located in different states, a state-by-state analysis can be critical. In addition to noncompetition agreements, **acquiring companies should also develop an attractive employee retention plan for key employees.**

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## 6. Develop Proactive Dispute Resolution and Risk-Reduction Policies

Well-drafted policies can prevent minor employment disputes from turning into costly litigation – or at least give you a more predictable, controlled forum for resolution. For many tech startups, this means considering agreements such as arbitration clauses, jury trial waivers, and class/collective actions. These agreements can be particularly valuable in industries where a single misstep can spark a high-stakes class action.

### Best practices:

- **Work with counsel early** to determine whether arbitration agreements, jury trial waivers, or class/collective action waivers are enforceable in your jurisdiction and appropriate for your business model. Laws on these agreements vary by state and change often.
- **Include clear, plain-language terms** that make agreements more understandable and defensible if challenged in court.
- **Ensure agreements are mutual** – binding both the company and the employee – to help with enforceability and fairness.
- **Use stand-alone agreements** (not buried in handbooks) and obtain signed acknowledgments from every covered worker.
- **Review and update annually** to account for changes in state or federal law, and reissue agreements to new and existing employees as needed.

## 7. Implement Basic HR Infrastructure Early



Investors want to see a scalable, professional operation, and performance management practices.

**Best practices:**

- Consider having **at least one dedicated HR professional** embedded in the company as early as is reasonable.
- **Use an HRIS (Human Resources Information System) or secure cloud storage** to keep records organized and accessible for compliance and due diligence. If the company keeps paper records, or if records are stored electronically in a disorganized manner, the diligence will take longer and will be more costly.
- **Provide basic HR training to founders and managers** – even informal training on interviewing, discipline, harassment, and discrimination, leave, and documentation can prevent costly missteps.
- **Audit practices to ensure that the company treats employees fairly** and applies consistent standards to avoid any claims of “disparate treatment” for any unlawful reason.
- **Draft and distribute an employee handbook** that includes anti-harassment policies, benefits, time-off rules, IP security and protecting confidential information, and general workplace expectations—and hold your workers to these standards.

## **8. Be Prepared for Employment- and Benefits-Related Due Diligence Requests**

During acquisition, your buyer will request detailed employment records and policies, as well as a wide range of documentation related to your employee benefits plans. These requests alone can be extremely overwhelming for deal teams, which are typically small, to handle, and there are, of course, many other due diligence categories and pieces of the deal.

You can give a gift to your future deal team by organizing these documents early and starting to assemble a clean data room long before a buyer is even in the picture.

**Best practices:**

- **Keep digital files of:**
  - Offer letters, agreements (e.g., PIAs), and equity grant records;
  - Payroll and timekeeping documentation;
  - Hiring documentation;
  - Termination/severance records; and
  - Employee benefits plan documents, summaries, communications, filings, and more.

- **Be sure to document any prior employment disputes, severance agreements, or ongoing claims.** Transparency in these areas helps avoid deal fatigue or last-minute surprises.
- **Keep an updated employee census** with names, job titles, compensation, and dates of employment. This provides a snapshot of your workforce to prospective acquirers.
- **Maintain a digital folder with offer letters, employment agreements, and NDAs for all employees and key contractors.** These are usually requested early in the diligence process.

## 9. Avoid “Founders First” Compensation Structures

Acquirers want to see fair treatment of your team, not just a windfall for founders. A team that has been treated fairly is more likely to stick around post-acquisition, adding to the value of the company long-term.

### Best practices:

- **Avoid token wages or zero-salary arrangements for employees.** Even if equity is generous, failure to pay fair wages can be a red flag for buyers and regulators and can result in claims alleging significant damages.
- **Benchmark your team’s salaries and benefits against startups of similar size, industry, and geography.** This demonstrates maturity and professionalism to acquirers.
- **Don’t delay paying competitive wages** with the hope of future raises post-acquisition.

## 10. Plan for Clean Employee Transitions Post-Acquisition

Buyers want to retain key talent without inheriting problems.

### Best practices:

- **Avoid making last-minute promises or undocumented agreements during the M&A process.** All employment commitments should be formalized in writing and disclosed.
- **Identify key team members whose retention will be critical** post-acquisition and prepare transition or retention plans for them.
- **Prepare clear transition plans** for all team members, as applicable.
- **Avoid last-minute employment or severance promises** that haven’t been documented or approved.

## BONUS SECTION!

### Understand the “Golden Parachute” Rules As Early As Possible

Tech M&A deals often trigger the so-called “golden parachute” rules under Sections 280G and 4999 of the Internal Revenue Code, and these draconian tax rules can hit tech startups especially hard when they apply.

**Golden Parachute Rules.** The rules under Section 280G are extremely complex, but, in a nutshell:

- They apply when “disqualified individuals” – certain officers, shareholders, or highly-compensated employees – may become entitled to certain “parachute payments” that are contingent on a change in ownership or effective control of the company making the payment (if the company is a C corporation, whether public or private).
- When these rules apply, the individuals receiving those payments must pay a 20% excise tax on any “excess parachute payment” – and the corporation making those payments is banned from taking a tax deduction for that amount. In addition, buyers will absolutely care about potential 280G liability, and these issues can impact or even hold up the deal.
- The “excess parachute payment” amount, if any, depends on how much the parachute payments exceed the individuals “base amount,” which is essentially their average includible compensation over a 5-year base period.

The reason these rules can be even harsher for “built to sell” tech startups is because founders and other key players often take low salaries (or even none at all) during that 5-year base period – and a low base amount makes it much easier for parachute payments to exceed the 280G threshold (3x the base amount) and increases the size of the excess parachute payment (and therefore the amount of the excise tax and deduction loss).

The good news for private C corps is that the excise tax and deduction allowance that would otherwise apply can be completely avoided through by meeting the requirements of the “shareholder approval” exception. However, this involves a somewhat risky, and sometimes contentious, process.

### Best Practices:

- **Learn the golden parachute payments as early as possible** and prepare for how they might apply upon a future sale of your company.
- **Work with counsel to strategize how to mitigate or avoid future 280G liability.** You may be able to make adjustments to salaries and other compensation arrangements to either bump up the base amounts of disqualified individuals who you expect will receive parachute payments or fit within various exceptions to the 280G rules.



- **Once the deal process has begun, keep potential 280G implications top of my mind from the beginning and work with counsel to conduct a 280G analysis.** This will require your deal team to pull a lot of information related to historical compensation, potential parachute payments, your capitalization table, and more. The buyer will likely request this information as well in order to conduct their own analysis (which will likely use more conservative assumptions, so you'll want to have the information necessary to support pushing back on that, if desired).
- **If you qualify for the shareholder approval exception, be prepared for this process to take some time** and likely involve pushback from disqualified individuals and other uncomfortable (or even contentions) scenarios. Note that this process must be completed **before** the closing of the transaction in order for the exception to apply.

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## **Conclusion**

Make sure you are subscribed to [Fisher Phillips' Insight System](#) to receive the latest content relevant to your tech business. If you have questions about employment compliance or preparing your startup for acquisition, please feel free to contact the authors of this Insight, your Fisher Phillips attorney, or any attorney on our [Tech Industry Team](#) or [M&A Practice Group](#) for strategic guidance tailored to your stage and industry.

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