



How to Avoid Costly Mistakes: 3 Important Facts About Paying Founders In Equity

By Pat Hammond, The Business Guild

Are you thinking about paying your startup employees in equity?

A lot of startups, particularly technology companies, embrace the practice of offering equity instead of cash to save money on salaries.

It kind of makes sense.

You believe in your future product.

The worker believes in your future product.

Why not save a little money by making them a stakeholder with minority ownership?

It's not like you're forcing them to come to work for you.

Everything should be fine if they're happy with the arrangement, right?

I'll give you a hint, the answer is no.

There are a myriad of state and federal wage laws that

should give you pause and send you running to your attorney before you enter a straight equity-for-work type of arrangement.

If you're one of the thousands of U.S. business owners struggling to find workers right now, you may wonder how startups entice potential employees without the promise of premium pay and bonuses, but it happens.

It's more common in the tech industry where the legend of [Microsoft's Unlikely Millionaires](#) and other success stories run rampant, but it can happen in other sectors as well.

Before I jump into the gotchas and other warnings, I should point out that offering employees equity isn't simply a way for startups to

Is your startup breaking the law? Are you sure?

I'm stepping back from an IRS topic in this issue to address the question of employee compensation and startups.

The idea of saving some money by paying employees with equity sounds good, especially when you know that federal law allows it, but it can be an expensive proposition for both you and your business if you don't have all the facts.

I've put together the top three things you need to understand before you take the plunge and offer your new startup employee equity in lieu of a salary.

As always, I'm a journalist, not an attorney. This content is meant to be informational, not legal advice.

Always consult a lawyer before you make an offer or sign a contract.

save money on salaries. **Equity is also a tried-and-true method of establishing a company culture of inclusiveness**

that motivates early employees to work hard to start and grow the business. There are many benefits for both the business and employees, as long as you follow the rules.

With that in mind, there are three things founders need to understand before they offer equity in lieu of pay.

1. The **Fair Labor Standards Act of 1938 (FLSA)** only exempts **owners who own 20% or more of the company and are actively engaged in management** from standard minimum wage requirements.
2. Many states **require all employees, including full owners, to receive the minimum wage** established by the state.
3. Failure to understand and follow the requirements of FLSA and/or state

Fun Fact: The minimum wage for shepherds in California is \$2,488.97 per month

employment regulations can result in fines and open the door to expensive litigation.

Let's start with the FLSA.

Under federal law, you must pay employees at least a minimum wage of \$7.25 an hour.

As noted above, the two key tests outlined in the FLSA for the founders' minimum wage exemption are that ***the person is actively engaged in management and owns at least 20% of the business.***

But that is just federal law.

In some cases, state law can supersede federal law.

This is where things can get tricky.

Not all states offer minimum wage exemptions for founders

Even if the employee passes the FLSA test for the founders' minimum wage exemption, every state has its own minimum wage laws and regulations.

Sometimes, individual cities and counties within states can set a local minimum wage rate as well.

With 50 states and over 19,400 cities in the United States, you can see how this can get overwhelming.

The thing to remember is that when multiple jurisdictions have conflicting legislation, **the law that most benefits the employee is typically going to take precedence.**

To keep things simple, I'm using Washington State for our examples because their labor laws are easy to find and read for the average business owner. You

should review the labor laws in the state your business is in and the state(s) your employees are in. (See the [US Department of Labor](#) for links to each state's labor office.)

Paying employees with equity is a complex topic that can have serious financial and legal ramifications for you and your business. These examples are illustrations of the differences between state and federal regulations, not legal advice.

As with most other important legal topics, your best option is to **Speak to your lawyer before offering start-up workers equity instead of pay.**

There are too many state and local regulations for a one-size-fits-all guideline, but I can give you a general overview of some things to ask when you speak to your attorney.

- Is it legal to offer straight equity-for-work compensation in your state?
- How about the state where your worker is?
- Do you have to pay a minimum wage, and how much is it?

For example, the state of [Washington offers an Executive Business Owner Exemption](#) similar to the federal exemption, but the [state of New York](#) does not.

Besides the 20% ownership requirement, Washington State has specific criteria to determine if a worker meets the management test of whether they are **“actively engaged in the business’s management”** to qualify for that exemption.

- Can they hire employees?
- Do they have authority over other workers?
- Can they make business decisions or

bind the business to contracts?

If the worker fails to meet the requirements for a founders' business owner exemption, or your state doesn't allow this exemption, you might have to pay your people the minimum wage allowed in that state.

It would still be far below the standard rate an experienced worker could command in the open market, but your company would comply with minimum wage requirements should there be a wage or labor complaint.

Don't forget that local cities and counties could have a different minimum wage than the state or federal government.

Taking another look at Washington State, the current state minimum wage for non-tipped employees is [\\$14.49](#) an hour, but the minimum

Some states require companies to pay *CEOs and founders* at least minimum wage

wage in Seattle is \$17.27 an hour. Both are substantially higher than the federal minimum wage of \$7.25 an hour.

You may also have to pay founding employees overtime.

In Washington State, overtime pay is the standard of 1.5 times regular pay for time worked over 40 hours in a week.

For a minimum wage worker, that would be \$21.74 an hour for time worked beyond the 40-hour threshold.

Based on Washington's state minimum wage, a 60-hour week would cost you \$1,883.70 plus any state or federal taxes and employer contributions.

You could avoid overtime costs by classifying a worker as an exempt

employee, but you can't just give a worker a new title and claim they are exempt.

For an executive employee to qualify for exemption from overtime, they have to pass the duties test and minimum salary requirements outlined in state and federal law.

Washington State's executive job duties requirements

1. The employee's primary duty must manage the enterprise or manage a customarily recognized department or subdivision of the enterprise
2. The employee must customarily and regularly direct the work of at least two or more other full-time

employees or their equivalent

3. The employee must have the authority to hire or fire other employees, or the employee's suggestions and recommendations as to the hiring, firing, advancement, promotion, or any other change of status of other employees must be given particular weight
4. The employee must be paid on a salary basis equal to or greater than the required salary threshold.

Your state's rules may vary.

The federal rate for the executive salary threshold is \$684 per week, but the Washington State rate is 2.5 times the state's minimum wage of \$14.49 X

40 hours. That's \$1,449 per week.

Some states also have special exemption qualifications for different occupations.

In Washington, if the exempt employee is a computer software professional, the salary threshold goes up to [3.5 times the state's minimum wage](#). (That's \$50.72 per hour!)

Putting this in perspective, instead of trading work for equity, you may be obliged, by law, to pay a founding employee thousands of dollars, plus overtime, if they're not exempt as an executive or salaried worker.

What does this mean for your business?

The federal founders' minimum wage exemption sounds good in principle, but may not be legal or practical for your business.

Work for equity is a common practice,

especially for startups in the tech and medical sectors.

People get excited about new ideas and getting in on the ground floor of something with big potential, but what if it takes longer than expected?

How long can people work without pay and what happens when they become disgruntled?

One complaint can open a can of worms that could have long-term effects on both your company's viability and ability to raise funds.

You can circumvent some of this by using contract workers instead of employees, but you better have an ironclad contract and make sure the arrangement passes both the

[federal](#) and state tests for qualifying contract workers.

Don't fool yourself into thinking you can hide behind your business.

Registering your company as a corporation doesn't give you a free pass from litigation. Some states allow employees to pursue business officers and managers and the corporation for wage compensation violations.

As the sole founder and employee, you're not likely to sue yourself, but what if you have a falling out with



a junior partner?

What if they disagree with your decisions or timelines? What are the ramifications of not paying wages if that partner leaves?

Wrap up

Offering equity in lieu of pay is one of those situations where saving a little money now can create a lot of problems later, especially if you're in a state that requires all employees, including founders, to be paid the state's minimum wage.

Exchanging equity for work isn't much of an issue if you also pay the employee at least minimum wage, but it could be a major legal and financial headache if you ask your employees to work for equity with no other remuneration.

If you know some of your team members won't qualify for a founders' minimum wage exemption, consider offering a lower wage with equity and

future bonuses tied to milestones or achievable benchmarks. This will give them the stake they're looking for, as well as the incentive to help build the business without leaving your company vulnerable to labor and wage litigation.

Be sure to **have an open, honest conversation with your corporate attorney about your options, responsibilities, and potential liabilities before you commit to any non-standard compensation package**, especially if it includes an equity for work arrangement.

You may also want to discuss confidentiality agreements, assignment of intellectual properties, and other potential points of contention.

It's not a guarantee that a disgruntled worker or co-founder won't file a complaint, but it should put you in a position where you

have a better understanding of your responsibilities and what you can do to protect your business.✓