THE LAW FOR FOUNDERS

CANADIAN EDITION

A Guide to
PROTECTING
YOUR STARTUP

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DEDICATION

Dedicated to my father, David Wires, a (retired) litigation lawyer who paved the law path for me and made this book possible.

"There is, in my view, no doubt that Mr. Wires and his firm have performed heroically. Over seven years, Mr. Wires did battle with one of the most powerful American regulatory agencies [the Federal Trade Commission], an agency with virtually unlimited legal resources and ably represented by the largest law firms in Canada, first BLG and now Gowlings. He eventually succeeded "against almost insurmountable odds" in setting aside the ex parte orders, getting a damages inquiry on the plaintiffs' undertaking, and having the 2002 action stayed – and did all of this without being paid by his clients. This is surely a testament not only to the fortitude of the senior defence counsel, David Wires, but to his commitment, indeed passion, for justice."

- Justice Belobaba on David Wires in United States of America v. Yemec, 2009 CanLII 61418 (ON SC).

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INTRODUCTION

This book is for founders, not lawyers.

If you are a founder, or an aspiring founder, this book is to help you wade through the trenches with practical legal tips and information for building and protecting your business.

Consider this book as a legal guide to implementing your business idea and understanding the legal framework around your business. Using case examples and examples from my own practice the book covers core legal issues every start-up should consider.

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Entrepreneurship is alive and well in Canada. More and more Canadians are capitalizing on their dreams of operating their own businesses. The success of organizations like Victoria Lennox's Start-up Canada are a testament to the growing popularity of becoming an entrepreneur.

Somewhere along the line, entrepreneurship not only became an option in university programs, but it actually became "cool". As college students started making money online and building business empires like Facebook and Google, fewer hockey players were born in Canada. Now more than ever, teenagers and young adults are aspiring to become founders.

In the early 2000's, as tech entrepreneurship grew, so did the support systems for founders. From educational institutions building a host of incubator and accelerator programs to crowdfunding sites like Kickstarter giving a funding boost to new ventures and products.

However, one support network that lags is the legal services industry. Start-ups are lean and lawyers are expensive. This leads to a legal knowledge gap for founders and often a failure to fully consider how the law impacts a founder's business.

Many founders fray from meeting with a lawyer until they view it as absolutely necessary or there is some existential crisis. I see it frequently, where founders wish they met with a lawyer sooner to understand the implications of decisions they made, agreements they signed or risks they took. Decisions which, unwittingly, can materially impact the success of a business.

Starting in 2011, I practiced corporate litigation. I came to realize that many businesses fail or face setbacks as a result of not having completed important legal processes early on. From not entering contracts with third parties and founder disputes tearing a business apart, to government regulators seizing assets and shutting businesses down. In some cases, it was hard to watch.

With an interest in tech, I decided I would pursue a career helping founders build businesses, rather than tear them down. So, in 2013 I started my own corporate law firm and for the last 11 years I've enjoyed working with founders. Their personalities are positive and optimistic, unlike many lawyers (especially litigation lawyers).

Yet, founders often face a blind spot for the law. I realized that part of the lawyer's role becomes not just giving advice and drafting contracts, but educating clients on the legal issues and legal framework around the decisions they make. As I found myself educating clients on common topics, I decided to sit one night and map out a table of contents with all the things a founder will wish they knew about the law when they started.

And so, my motivation in writing this book became filling the legal knowledge gap for Canadian founders. To enable founders to make more calculated decisions about their business and operate from a position of confidence and strength. With the knowledgebase from this book, you will make more informed decisions about protecting your business and stick-handling legal challenges you will undoubtably face.

There are known risks and unknown risks that lurk in the future for every founder. This book intends to shift some of the unknown risks, the ones you might not have even contemplated, and make them known risks for you to navigate on the way to success.

Enjoy.

CHAPTER 1: LIFT OFF

We've all experienced that spark—the brilliant business idea that consumes our thoughts. Maybe it's a new app, a custom GPT, a SaaS platform or a unique online store. It's an exciting feeling. The idea becomes your passion, keeping you up at night as you envision its potential.

Maybe you are bold enough to go one step further, beyond just an idea, to forming a start-up. For many, the start-up decision is about more than a great idea. It's about exercising your creativity and taking joy in building something. It's a decision to escape the 9-5 employment grind and a path to escaping what Tim Ferriss calls the "deferred-life" where people work, slave, save and retire. It's about taking initiative and giving purpose to your day.

I understand the thrill, having launched businesses myself and witnessed my clients' enthusiasm over the years. Yet, I've also seen the sobering moments when doubt creeps in—concerns about viability, money, lawsuits and even your own perseverance.

If your business fails, whether or not you sought legal advice may seem inconsequential. But as success grows, so does the likelihood of legal challenges. Nothing attracts greater legal risk and the threat of lawsuits than a business that sees success.

I've seen it all. Co-founders who walked away popping back up claiming ownership of shares, intellectual property, domain names and other assets. Contractors claiming they were promised equity or a share of profits. Employees claiming they were wrongfully terminated. Regulators wanting to investigate the safety of your product, or compliance with privacy laws. Customers claiming defective products. Investors demanding larger dividends. Competitors trying to cut you off from a supplier or claiming you breached their intellectual property rights. Foreign entities stealing your technology or copyrighted works. Past employees taking your client lists or trade secrets. I could go on and on.

I joke with clients that if your business fails, or you lose the passion and abandon the idea, it may not matter whether you understood the legal framework and mitigated legal risks. But if you believe you are on a path to success, you will wish you stopped for a moment and carefully thought about protecting your business and its assets from the get-go.

In a fast-paced start-up, the opportunity to mitigate legal risks, before they come to fruition, passes by quickly. This book aims to help you take a pause, look at the horizon and pre-emptively address legal issues.

Founders typically aim for one of three outcomes: a profitable exit, building retirement capital, or creating a legacy (i.e. passing a business on to the next generation). To achieve one of those aims, you must not only succeed in business, but also in protecting your start-up from legal risks.

To set your business on a solid path, we'll initially focus on choosing a business name and domain name, with examples of how things can go horribly wrong from the get-go.

From there, the book covers seven main topics:

1. Corporations, since corporations are the main vehicle used by Canadian founders.

2. Negotiating founder and shareholder agreements.
3. Raising capital from investors and issuing shares.
4. Protecting intellectual property rights.
5. Hiring contractors and employees.
6. Special considerations for web-based businesses, like SaaS and e-Commerce companies.
7. Selling your business.

Let's go.

CHOOSING A BUSINESS NAME: WHY GETTING IT RIGHT IS IMPORTANT

Your trading name is an asset. From a business perspective, many entrepreneurs put a lot of stock in the name. Some believe, that from a branding perspective, your name can make or break your business. Good names are easy to understand yet unique and memorable.

The problem, of course, is that there are not many names left to choose from that are short, catchy, and descriptive which stand out at the same time. This makes finding the right name an often long and tedious project.

While the laws governing trademark and trade name disputes are much more nuanced, the number one rule is simple - don’t be a copycat. From a legal perspective, choosing the wrong name can be devastating. Choosing a name that is too similar to an existing name or trademark opens your new business up to the threat of a lawsuit before you even leave the gate.

While the law differs based on jurisdiction, the general rule of thumb is to not pick a name that creates confusion in the marketplace between you and an existing business or trademark.

To avoid selecting a similar name, the first step is the good old Google test. Do a quick Google search to see if existing businesses are listed in Google search results. Google is a good preliminary indicator for whether a name might be confusingly similar to existing businesses or brands. It also helps ensure that when you start competing for that keyword on search results, acceptable results show up. That said, not all businesses have websites and not all businesses have a public facing component to them, so the Google test is by no means determinative.

If you plan on building a business that sells internationally, it's a good idea to consider search results in those jurisdictions as well. Perhaps more importantly, ensure your name does not have a different meaning in other jurisdictions. For example, "Pee Cola" (which means very good cola in Ghana) might be a difficult sell in Canada.

Next, using a tool like ChatGPT is another great way to do a preliminary search for confusingly similar names. As an example, I prompted ChatGPT with:

Prompt:

I want to start a business called "Wires Law", search the Web and see if there are confusingly similar names that already exist.

ChatGPT:

The name "Wires Law" is already in use by an established corporate commercial law firm founded by John Wires. This firm provides legal services to entrepreneurs and businesses across Canada, with a focus on technology, SaaS, and e-commerce clients.

You could even go one step further and do:

Prompt:

Is there a trademark registered in Canada for "Wires Law"? Search the web, including the Canadian Intellectual Property Office website to find out.

ChatGPT:

> The trademark "WIRES LAW" is registered in Canada under Application Number 2041784, as detailed on the Trademark Elite website. The mark is categorized under Class 045 for personal and legal services.

If your name passes the Google and ChatGPT test, use a domain registrar (like GoDaddy) to see if a suitable domain name is not only available, but also not easy to confuse with different domain extensions. For example, if my father wasn't the one who owned http://wires.law as a domain name, I'd consider suing, given I own the "Wires Law" trademark and the .law domain extensions are intended for legal related businesses.

The next step is the CIPO test. CIPO is short for the Canadian Intellectual Property Office, a government entity. CIPO has a public database on their website with a list of all registered trademarks. You can search the database for free to see if the same or confusingly similar names appear in search results.

To highlight the importance of the CIPO search, when I type in "Wires Law" to the search bar, it comes up with more than 10 pages of search results. While there may not be trademarks that have the exact name, it might show other marks that use "Wires" in the title that I may want to consider if I was registering a new business.

Keep in mind that just because there is not an exact match does not give you a free pass to use the name. Speak with a lawyer or trademark agent for an opinion on whether it can be registered given the particular laws, rules and regulations in your jurisdiction. Your lawyer will be impressed, and you'll save him or her time, if you arrive having already done the above searches.

The NUANS Name Search

The final step, at least for Canadian federal and Ontario corporations or businesses is a NUANS name search. A NUANS name search report lists similar existing business names and trademarks registered in Industry Canada's database. The federal and most provincial governments require all new businesses to complete a NUANS name search report as part of registering a new business.

While the search report is intended to show all similar business names and trademarks registered federally and in certain provinces, the search process is subject to a number of flaws. For various reasons, there may still be similar names in existence that are not disclosed in the NUANS report. This makes the Google, ChatGPT, GoDaddy and CIPO searches that much more important.

While it is your job to ensure that the new name does not create confusion with existing names, the Federal government registration agents will often review your NUANS report to determine whether you can register the name. In some cases, the agent will ask you for more information and research about an existing business, asking that you provide evidence as to why a name displayed in the report is not confusingly similar to your chosen name.

That is, in assessing possible confusion, "Corporations Canada looks at all circumstances, including a comparison of the goods, services and operating area of your proposed business with those of existing businesses. While name approval from Corporations Canada does not guarantee that you are not violating the rights of another firm or individual, it reduces your risks."

In Ontario, the registrar often provides less scrutiny, and unless there is a business with the exact same name, typically the Ontario registrar does not question, review or scrutinize the name registration.

In either case, whether forming a Canadian federal or provincial corporation, the fact that the registrar permitted you to proceed with the name should not be seen as an indication you have chosen a name for which you cannot be sued. The NUANS report only shows names and trademarks registered in Canada and does not consider foreign jurisdictions you may want to enter at some stage.

Again, your own due diligence (searching for names outside of the NUANS process) is important to try to ensure you are not choosing a name that is confusingly similar to an existing business.

Distinctiveness

The *Canada Business Corporations Act*, for federal companies, also requires your name to be distinctive from other businesses that carry on the same or similar activities. Your name will not be distinctive if it merely describes your business activities. For example, the name "Coffee Bean Roaster Inc." lacks distinctiveness since it just describes the activities of all coffee roasters.

You can achieve distinctiveness in several ways. One of the most common is to add an element to an otherwise indistinct name. "Jonny W’s Coffee Roasting Inc." for example, is distinctive. New words also give a name distinctiveness. They can be a combination of two dictionary words such as "Infotech" or something completely new. Unusual highly distinctive names are given greater protection because they are unique and more obvious when a competitor chooses to compete with a similar name. Unique names will also likely be easier to trademark.

Consequences of Creating Confusion with Other Names or Trademarks

If your name is too close to an existing corporate name or trademark the owner of that name may commence legal action to force you to stop using your name and even to pay damages for its unlawful use.

One of the types of damages a plaintiff may claim is an accounting of profits. That is, they may seek to recover any profits you made as a result of using the name, along with handing over all marketing materials. This can be devastating for a new company.

Apple's Name Battles

One example of a company running into name issues involves Apple. Apple Corps was established in 1968 and owned several businesses, including a record label. In 1978, when Apple Inc. (formerly Apple Computer, Inc.) was founded, Apple Corps sued the new tech company for trademark infringement due to the similarity of their names and logos. The parties reached a settlement in 1981, with Apple Inc. agreeing to pay an undisclosed sum and to not enter the music business.

However, with the launch of iTunes and the iPod in the early 2000s, Apple Inc. found itself once again embroiled in a legal dispute with Apple Corps. Apple Corps claimed that Apple Inc. had breached the 1981 agreement by entering the music business. In 2006, the courts ruled in favor of Apple Inc., stating that the company had not violated the agreement by producing and selling music-playing devices and software. The judge clarified that the agreement only prevented Apple Inc. from operating a record label or releasing music under the Apple name.

In 2007, the two companies announced another settlement, with Apple Inc. now owning all Apple-related trademarks and licensing some of them back to Apple Corps. The terms of the financial agreement were never disclosed, but the resolution allowed both companies to continue using their respective names and logos without further legal issues.

Given not all companies have the same resources as Apple, this case highlights the importance of thoroughly researching and choosing a unique business name to avoid potential trademark infringement lawsuits and confusion in the market. However, the difficulty in Apple's case was not even knowing that one day, they would enter the music space with their now famous iPod and Apple Music. If you know you have plans to expand your business into different industries, it is worth considering those other industries as part of your naming process, and whether that expansion will impact the calculation as to whether your name is confusingly similar to an existing business name or trademark.

Legal Element

All corporations in Canada are required to add Limited, Incorporated or Corporation, or contractions such as Ltd., Inc. or Corp. to allow people you do business with to identify your business as a corporation.

Section 2 of Ontario's *Business Names Act* prohibits an individual or corporation from carrying on business under any name other than their legal name unless the name is registered under the *Act*. For example, neither John Wires nor John Wires Inc. would be permitted to carry on business as "Wires Plumbing" unless they registered "Wires Plumbing" as a business name under the Act. Failing to register a business name can result in fines and a prohibition from commencing a lawsuit.

CHOOSING A DOMAIN NAME AND NOT GETTING SUED

Choosing a business name that has a suitable domain name was becoming increasingly difficult. There was some relief in 2013 when the Internet Corporation of Assigned Names and Numbers ("ICANN") announced a series of new top-level domains (TLD's). TLD's are the extensions that specify a website type and location; .com or .ca for example.

2014 saw another 1400 TLD's become available; from .venture, .inc, .ltd and .llp to .enterprises, .law and .lawyer. While the new domain name expansion will help businesses find a suitable domain name, there will be growth in name and domain name disputes along with other hurdles for business owners.

It is important to tread cautiously and know the domain name dispute rules to ensure you do not find yourself on the wrong end of a domain name dispute. Contrary to popular belief "cybersquatting" where someone buys and holds domains of an existing business and trademark with the sole intention of selling them for a profit can be unlawful.

For example, The *Anti-cybersquatting Consumer Protection Act* (*ACPA*) was enacted in 1999 in the United States. The *ACPA* specifically addresses the issue of "cybersquatting" and provides legal recourse to trademark owners against individuals or entities who, with a bad faith intent, register, traffic in, or use a domain name that is identical or confusingly similar to a distinctive or famous trademark. The *ACPA* allows trademark owners to seek legal remedies including injunctions, damages, and the transfer or cancellation of domain names that infringe upon their trademarks.

The ACPA has been an important tool used by big brands in the fight against the misuse of trademarks in domain names.

Not just as a result of the *ACPA* but even in Canada, where someone registers a domain name that is confusingly similar to a trademark of an existing business, the trademark holder may have legal remedies. This is particularly the case where it is clear that, (i) the domain holder only registered or acquired the domain to fool people into thinking that the registrant is associated with that business, an act called passing off; or (ii) the domain holder bought the domain for the purpose of selling it to a person who has a legitimate business interest in the name.

What a Gongshow

One example is the Canadian hockey apparel company Gongshow Gear and the disputed domain www.gongshow.com. The domain had lawfully belonged, for more than 10 years, to a blogger whose last name was Gong. In November 2012, the domain was sold in a closed auction, however Gongshow Gear was not invited to bid. Instead, the new purchaser of the domain, an individual located in Dubai, tried to flip the domain and sell it to Gongshow Gear for $18,000.

Instead of paying for the domain, Gongshow filed a complaint with ICANN, the international body that regulates website addresses and won the domain without paying a cent. To do so, Gongshow Gear had to prove three main items under the ICANN rules at the time:

1. That the domain was confusingly similar to Gongshow's trademark;
2. That the current owner of the name does not have a legitimate interest in it (i.e. he or she is cybersquatting); and

3. The owner is using the domain in bad faith.

Gongshow, who had been building their brand in Canada and around the world for the previous 11 years was successful on each point.

While there may be separate causes of action that parties may be able to bring in various courts around the world, often the most effective route is an arbitration proceeding, which may be available depending on the type of TLD domain (for example, a .com or a .ca domain). For a .com domain, dispute resolution may be available under the Uniform Domain-Name Dispute Resolution Policy (UDRP) an arm of ICANN. The Canadian Internet Registration Authority ("CIRA") has its own Domain Name Dispute Resolution Policy for .ca domains. Both ICANN and CIRA use a private dispute resolution setting where disputes are usually carried out in writing and resolved by one or more arbitrators.

Who Registered and Owns your Domain Name?

It is also important to ensure you know who is registering the domain name and who has ownership of it. Only as recently as 2011 did the Ontario Courts confirm that domain names are property in the eyes of the law (*Tucows v. Renner*). As property, domain names can be owned by any legal entity. An interesting issue arises under most hosting providers terms of use as to who owns or who can claim ownership of the domain name.

With many start-ups, the domain name is registered in the personal name of one of the co-founders. This can cause a number of problems, particularly where there is a co-founder dispute and the registrant of the domain leaves the business.

Take the Ontario dispute in *Mold.ca Inc. v. Moldservices.ca* argued by my friend John Simpson. In that case, two co-founders ran a mold inspection and removal business, with co-founder 1 being responsible for start-up costs and managing the business and co-founder 2 being responsible for operations, including the registration of the website. Co-founder 2 purchased a number of domain names for the business, using the company credit card, but putting his own name down as the registrant.

When co-founder 2 left the business about a year later, he took the registrations and passwords with him. Unfortunately for co-founder 1, the CIRA dispute resolution proceedings, to have the domain names transferred from co-founder 2, to the company were unsuccessful on the grounds there was no evidence the domain names had been registered in bad faith by co-founder 2, or that they were being used illegitimately.

While the domains were ultimately recovered by the operating company in (expensive) court proceedings, the lesson learnt is to consider if the operating company should be the entity that actually owns (and registers) the domains and website, and not an individual associated with the business, who one day may part ways. If the company is not the registrant, careful thought should be given to who owns it, and what rights the company has to use the domain name.

CHAPTER 2: CHOOSING A BUSINESS VEHICLE

Selecting a business vehicle turns on two main issues; tax and liability. In many cases the corporation makes the most sense on both fronts. It can be used as an effective tax planning vehicle whether by retaining earnings in the corporation, taking advantage of lower corporate tax rates, or using your lifetime capital gains exemption when you sell your shares.

However, from a lawyer's perspective, the corporation is by far the most effective means of reducing personal liability for the debts and obligations of the business. For that reason, we will focus primarily on the corporation, with just brief attention on sole-proprietorships, partnerships and franchises.

THE CORPORATION

Corporations are an amazing creation. They are the essence of any capitalist economy for one simple reason; they allow entrepreneurs to risk their capital, but (in most situations) contain the risk to the amount invested in the venture. In essence, they create a separate legal entity from the individual owners (i.e. shareholders).

Think about what that means for a moment. Without a corporation, the alternative would be that every business venture you undertook, including with a group of other owners, could result in each owner being responsible for the debts of the company, including where the company failed, went insolvent, or was sued for causing damages or harm. Would you passively invest money in a business knowing that the management team could fail and creditors could come knocking on your door? Probably not.

One of the early uses of the corporation was to pool money to set sail and explore foreign lands from England. The Hudson's Bay Company is the oldest commercial corporation that operated in North America, originally incorporated in 1670 as, “The Governor and Company of Adventurers of England Trading Into Hudson's Bay”. Yes, that name is taken, sorry.

However, the first corporate law case taught to law students is the case of *Salomon v. A Salomon & Co. Ltd*. from 1897. It was a case in which the House of Lords, the UK’s highest court, would define the future of corporations by sealing their recognition as separate legal persons, distinct from their shareholders. While the law has been refined since 1897, with a few exceptions, the case stands for the idea that shareholders cannot be liable for the debts or other obligations of the corporation.

In the case, Mr. Salomon formed a company and transferred his boot-making business to it. He held most of the shares, with the rest held by his family members. When the company faced financial difficulties and went into liquidation, creditors sought to hold Mr. Salomon personally responsible for the company's debts. However, the House of Lords ruled that the company was a distinct legal entity, separate from Mr. Salomon. This meant that he was not personally liable for its debts beyond his investment in the company’s shares.

The main exception, where shareholders can be liable, arises in the event of fraud. However, in Canada, individuals involved with a corporation (including as directors) can also find themselves liable for things like unpaid wages, unpaid corporate taxes, environmental liabilities and other matters, depending on the circumstances.

And of course, shareholders or directors who personally guarantee the debts of the company (as frequently requested by banks, lenders and landlords) can be forced to fork over personal assets to cover the company's obligations.

Granted the right to be viewed as a separate legal "personality", corporations have seen a steady rise to dominance and influence since the formation of the Hudson's Bay "Adventurers" and the House of Lords decision in Salomon. They have increasing pull in politics, culture, world affairs and pretty much every aspect of our daily lives (perhaps too much). However, they are used by most start-ups today for three main reasons.

Why Incorporate? Three Big Reasons

1. Reduce Exposure to Personal Liability

The main reason most founders incorporate is to protect their personal assets against the claims of creditors and lawsuits. Without incorporating, sole proprietors and general partners in a partnership would be personally and jointly responsible for the liabilities of a business including loans, accounts payable and legal judgments. In a corporation, however, shareholders are not liable (with some exceptions) for the company's debts and obligations.

2. Tax Benefits

The second reason founders incorporate is tax related. Corporations, like individuals, are subject to both federal and provincial income taxes. However, corporations are taxed differently when compared to individuals. While individuals are subject to various income tax rates, corporations are subject to flat rates of tax.

At the time of writing, the corporate tax rate for Ontario companies, is structured as follows:

- Federal Corporate Tax Rate: The basic federal corporate tax rate is 15%.
- Ontario Provincial Corporate Tax Rate: Ontario has a general corporate tax rate of 11.5%.
- Small Business Deduction: Canadian-controlled private corporations (CCPCs) benefit from a reduced federal tax rate of 9% on the first $500,000 of active business income due to the small business deduction. In Ontario, the small business rate is 3.2% on the first $500,000 of active business income.

So, for small businesses in Ontario, the combined federal and provincial tax rate on the first $500,000 of active business income is 12.2%. For income above this threshold, the combined rate is 26.5%. Of course, these rates may change, so it's advisable to consult the latest information from the government and a professional tax advisor.

Keep in mind, if you plan to extract profits from your corporation you will also be taxed on the employment income or dividends you take out, in effect, being double taxed. So, careful tax planning with a qualified tax advisor is a must.

Incorporating certainly won't make sense from a tax perspective for everyone. It is important to even consider the added cost of incorporating (legal fees, additional accounting and tax filing expenses etc.) when weighed against the benefits of incorporating (reduced personal liability exposure etc.).

If you have no profits in the early days of your start-up, the tax rates won't matter. Many start-ups operate at a loss in the early stages, and therefore tax is not as big of a concern from the outset. That fact may drive certain founders to operate as a sole proprietor, taking the personal liability risk.

For many of my clients, they choose to incorporate right away based on the nature of the business they are operating and the potential risks that go with that business, even if the costs to form the entity are greater and there is no real tax benefit, in the short term, to doing so.

That said, every founder should consult with a good tax advisor right away. Tax will be one of the largest (if not the largest) expenses you have in your entire life. As Canadians we are taxed at every corner in life; income tax, sales tax, land transfer taxes, capital gains etc. Making sure you understand the tax implications of the various decisions you make for your business, along the way, is crucial. Your accountant can advise you on things like:

- The tax implications of incorporating;
- The benefits of having Canadian Controlled Private Company status;
- The payment of dividends vs employment income;
- Capital gains taxes and the lifetime capital gains exemption; and
- GST/HST filings, input tax credits and other tax credits.

3. Raising Money to Finance a Business

The corporation is also a great vehicle for raising money. It allows founders to give up various types of securities (shares, options, convertible debt etc.) to finance the business. Keep in mind that as a start-up, you can't head out into the world and issue shares to whoever you want. There are strict laws and regulations for issuing shares and other securities in Canada - more on this later, see the section below on "Raising Capital and Issuing Securities".

Aside from the three main benefits, other benefits of incorporating include:

- ***Transferable ownership.*** Ownership in a corporation is easily transferable to others by selling all or part of your equity. In other structures, such as a sole proprietorship, you are limited to selling the assets of your business (like the domain name, software code, inventory, goodwill etc.).
- ***Durability.*** A corporation is capable of continuing indefinitely. Its existence is not affected by the death of shareholders, directors, or officers of the corporation.

The Importance of Ensuring Your Corporation Really Is a Separate Legal Entity

Even though corporations have been deemed to be separate legal entities, it is crucial that you treat the corporation separate from your personal assets or the assets of other businesses you are involved in. Where you co-mingle the assets and liabilities of your corporation with your personal assets and liabilities a court may find that you are one in the same for the purpose of establishing liability.

For that reason, the formalities which come with running a company are important. The corporation should have separate bank accounts, separate credit cards, issue separate invoices (with its name and HST number clearly listed), enter contracts and be paid separately. If the corporation has a website and marketing materials, they too should make it clear to readers who they are doing business with by listing the exact corporate name.

In the legal profession, going after the personal assets of a shareholder or director is referred to as "piercing the corporate veil". One of the grounds for piercing the corporate veil is the "alter ego" doctrine. Courts may look behind a corporate structure through the alter ego doctrine to find a director and/or shareholder liable, where it can be shown that:

1. The alter ego (the individual director or shareholder etc.) exercises complete control over the corporation; and
2. The corporation is being used as a shield for "fraudulent or improper conduct" or in some cases "oppressive" conduct.

Take for example the case of *Chan v. City Commercial Realty Group Ltd.*, where the corporate veil was pierced to find two owners personally liable for over $100,000 in company debts. In that case:

- Corporation 1 owed over $100,000 to the plaintiffs;
- Shortly after the debt arose, Corporation 1's owners wound down their business and started Corporation 2, which was in the exact same business and run by the same two individuals.
- The judge found on the evidence that Corporation 2, "engages in the same business, occupies the same premises, uses the same furniture, phone number, business name, signage and some of the same personnel." In essence, they were the alter ego of Corporation 1 largely because their assets were co-mingled.
- The court found that Corporation 2 was therefore incorporated for an improper purpose, namely avoiding paying the debts and obligations of Corporation 1.

- The trial judge found that the rule that a corporation is a separate legal person would not be applied if its result would be, “too flagrantly opposed to justice”.

As a result, the two individuals behind both corporations were held to be personally liable for Corporation 1’s debts. Understanding the scenarios where you may be personally liable, whether as a director or shareholder are important for reducing your risk exposure and keeping you on track to manage your business properly.

The Framework of a Corporation

In Canada, we are somewhat boring when it comes to the various types of for-profit companies we can form. For the most part, founders in Canada have the option to choose between Canadian federal corporations and provincial corporations, with the difference not being substantial.

Canadian federal corporations are governed by the *Canada Business Corporations Act*, and for example, Ontario corporations are governed by the Ontario *Business Corporations Act*. The difference between federal and provincial corporate legislation is, at least in my view, not material in terms of the protections to shareholders, tax matters, shareholders rights and the day-to-day management of the corporation.

In the United States, they have different types of entities, such as limited liability companies (LLC’s), C Corporations, S Corporations and others. Each has various pros and cons, mostly revolving around the tax treatment of the entity. There are also various benefits to incorporating in certain states, with Delaware being a popular state (at least before Elon Musk started a campaign to encourage entities to leave Delaware) due to its well establish corporate law.

Other states market certain benefits, Wyoming, for example, is sometimes marketed as a jurisdiction with favorable privacy laws in terms of requirements around disclosure of who the shareholders (or members) of the business are.

That said, even with only having to choose between federal and provincial corporations, corporate law in Canada leaves lawyers with a lot of room to be creative in terms of how corporations are structured, how they are managed and operated, how profits are shared and the rights shareholders have within the company.

The Articles of Incorporation

The articles of incorporation are arguably the most important legal document for your company. Think of the articles as your company's constitution. They set out the individual shareholders' rights, broken down by different classes of shares.

Start-ups can create as many different classes of shares as they desire, with different rights attached to each class. Having different classes of shares can be used for a number of different purposes, but more often than not, they are used to manage two main elements:

1. The amount of control (i.e. voting rights) shareholders have in relation to their ownership of the company; and
2. The priority in which they receive their money back if the company is dissolved or goes insolvent.

Your company may want to have different share classes depending on the nature of the business (for example is it an operating company, or a holding company) and whether it has, or plans on having:

- A sole founder;
- Co-founders;
- Co-founders & their family and friends acting as investors;
- Employees who will be issued stock options or vesting rights;
- Outside investors, such as accredited investors (angels, venture capital funds, private equity funds etc.); or
- Equity crowdfunding investors.

The various kinds of preferences, rights, and conditions that may be attached to shares are vast and can impact the value of the shares (i.e. what an investor is willing to pay for them).

For the sake of ease, it is not uncommon to see companies formed with only one class of shares, which are usually designated as “Common” or “Class A” shares. The decision to create (and make available for issuance) other classes of shares hinges on the company’s circumstances; particularly whether the founder intends on raising outside financing from other investors or offering employee stock options or other equity incentive plans.

The articles of incorporation, setting out share classes, can be amended to add another class of shares where required. As certain investors will want different share rights, sometimes it makes sense to keep things simple on incorporation and amend the articles of incorporation as needed. However, to do so, you will need the approval from the existing shareholders to cause the amendments. For that reason, in some cases, it is better to predict the type of shares you will require in the future than rely on your ability to amend the articles.

Rollovers

Special share classes may also be required for certain circumstances. One of the most common examples is where a tax ‘rollover’ is required on incorporation. A rollover serves as a means for individuals and companies looking to transfer assets into a corporation to defer immediate tax liabilities.

For example, if you operated a sole proprietorship for a few years, had sales, a website, domain name, trademark, inventory, intellectual property, a client lists or subscribers to your software product, and you wanted to incorporate and transfer those assets to the new company, that would likely be a taxable disposition of the property from you personally to the new corporation.

Because the transaction is, in essence, you transferring the assets to a company that you will have ownership of, provisions of the *Income Tax Act* can be used to defer taxes on the transaction (when you dispose of the assets to the new company).

There are tax filings required (an election form), and a rollover agreement should be entered specifying what assets are being transferred to the new company, their fair market value (which you should get advice on determining) and the shares that the new company will issue to you in exchange. These documents and filings should be prepared by an accountant and lawyer, along with the corresponding board and shareholder resolutions for your minute book.

The shares issued in exchange for the assets can then be issued as a special class (often called redeemable shares), with a fixed value equal to the fair market value of the assets transferred to the company. Once the company has the cash to redeem (or buy back) the shares, the share terms can specify that the company can do so, at will.

In short, the special class of redeemable shares can be made available to facilitate a tax deferred transfer of the assets to the new company. Depending on the circumstances (for example if there are co-founders and other investors) it may make sense to have the redeemable shares have no voting rights, with voting control of the company managed in another class of shares issued previously to the founders.

Share Terms

Of the various rights and restrictions a company can attach to its shares, founders need to consider, in respect of each class of shares:

- The voting rights that attach to each class, for example, do the shares have no voting rights, one vote in respect of each share, or multiple votes in respect of each share (i.e. super voting rights);
- Whether they can receive dividends and if so, on what terms and conditions;
- Whether the shares of each class will rank equally, in terms of the return of capital invested, or whether the company will have preference shares. Preference shares can permit the repayment of capital in priority to other classes of shares, for example, in the event of dissolution, liquidation or insolvency;
- Whether a class of shares will have rights to convert into shares of another class, for example, in the event of an initial public offering; and
- Whether the class of share is redeemable (i.e. can be bought back by the company for some stated value) or retractable (i.e. the shareholder can tender the shares for sale back to the company on specific terms).

Where a corporation has only one class of shares, the rights of the shareholders are equal; including the right to vote at any meeting of shareholders of the corporation and to receive the remaining property of the corporation when it is wound-up. All shareholders will also be entitled to the same dividend per share when dividends are declared.

In some cases, shareholders can assign or contract themselves out of the rights they would otherwise have. For example, some companies have their shareholders sign a voting trust agreement assigning their voting rights to someone (such as a founder) or another entity.

In addition to the rights attaching to each share class, the articles will need to specify the maximum number of shares, of each class, that can be issued. In some cases, corporations elect to cap the number of shares in a certain class and create different rounds or series of investment. In many situations, companies simply permit an unlimited number of shares, in each class to be issued.

If investors want restrictions on new shares being issued, they can often negotiate those restrictions in a shareholder agreement. For example, they could negotiate to require that ¾ of the voting shares are needed to pass a resolution permitting the new issuance. Or they could require that the board vote unanimously or by a certain majority, to approve a new share issuance.

Restrictions on the Transfer of Shares

It is generally recommended (and sometimes required to comply with securities laws) for private companies to include restrictions in their articles of incorporation regarding the sale or transfer of shares by shareholders. Typically, the articles contain a clause stating that shares cannot be transferred or sold without obtaining approval from the directors and/or shareholders. Such restrictions in the articles not only aid in compliance with securities laws but also play a crucial role in preventing the acquisition of shares in the company by an undesirable shareholder.

If there were no restrictions, and the board didn't need to approve a transfer, your 49% co-founder could go sell their shares and bring on-board someone you have never heard of to be your new 'partner'.

You Incorporated, Now What? Corporate Governance & Management Basics

When I started my law firm I was surprised how many founders did not understand basic corporate governance. Corporate governance refers to the system of rules, practices, and processes by which a company is directed and controlled. It encompasses the mechanisms through which companies, and their directors and officers, are held accountable to stakeholders, including shareholders, employees, customers, and the community at large.

Understanding corporate governance requires knowledge of four simple points:

1. Shareholders invest money (and in some cases time, resources and other property (including intellectual property). They are granted rights not only by default in the legislation, but more particularly their rights are set out in the articles of incorporation where their share classes and terms are established. They may also negotiate certain rights and obligations in a shareholder agreement.
2. Voting shareholders then appoint the directors who manage the company.
3. Shareholders also appoint auditors to scrutinize the company's management and financial records. Many founders are surprised to learn that auditors are required for all companies (at least under the federal and Ontario corporate statutes), including privately held companies. This

requirement exists unless all shareholders agree to waive the audit for each financial year. A waiver is often granted for small companies to avoid the cost of an external auditor reviewing your books. However, the audit requirement is often used by disgruntled shareholders, or shareholders who believe management is not acting in good faith or properly keeping the company's accounting books and records. For example, a shareholder who believes the company's expenses are inflated, or there are arm's length transactions benefiting one shareholder or director over another, may want an auditor appointed.

4. Directors can then delegate management functions to officers of the corporation such as a CEO, president, vice-presidents, corporate secretaries etc.

Given all governance flows from the shareholders of the company, in your own start-up the most important first steps, following incorporation, is to actually issue shares to the founders.

I see so many situations where founders incorporate using an online service provider and never actually issue shares, create company by-laws (that set out a framework for holding shareholders and board meetings etc.), hold shareholder and director meetings or enter shareholder agreements. While it seems trivial at the time, this section will help you understand why corporate governance and the above formalities are so important.

First Meeting – Directors

The party, or parties, responsible for incorporating the company, the "incorporators", will have named the initial directors of the company when it comes into existence. Those directors are listed on the articles of incorporation. To formalize their roles, the initial directors are then required to sign a “Consent to Act as Director” form.

The corporation is then required, under the federal statute, to hold a first meeting of the directors where they typically pass resolutions to:

- Enact the company by-laws;
- Adopt the forms of share certificates (if share certificates will be used);
- Allot and authorize the issuance of shares;
- Make banking arrangements;
- Appoint officers;
- Adopt any pre-incorporation contracts (if any); and
- Create shareholder ledgers and registers.

Holding the first meeting of the board is not a difficult process but is essential to the proper management of the business and staging off disputes about share ownership (more on that in a moment). Depending on the articles of incorporation, for most companies, director resolutions are passed where a majority of the directors vote in favour of the resolution.

However, for newly incorporated companies, the meeting is typically held ‘in writing’ with all initial directors consenting to various board resolutions in writing (via signature), rather than voting on matters in person. This is because typically on incorporation the division of the first tranche of shares will have been agreed upon in advance, and therefore not contentious. At the same time, share subscription agreements can be signed by the new shareholders and share certificates issued.

Directors Duties and Responsibilities

The directors of a corporation are required to manage or supervise the management of the business. The directors' power to manage the business can only be restricted by a unanimous shareholder agreement, or in some cases, the company's by-laws or articles. There are two main obligations imposed on directors in connection with their management of a corporation. Directors have:

- A fiduciary duty to act honestly, in good faith, and with a view to the best interests of the corporation (and its shareholders); and
- A duty to exercise the care, diligence and skill of a reasonably prudent person in comparable circumstances.

Where a director's duties are breached, they will likely find themselves on the wrong end of a lawsuit or a government fine. Under the federal corporate statute, the scope of the duty to act in good faith includes the duty to disclose a material interest in any transaction the corporation undertakes.

For example if the company is going to sign a contract with a third party, and a director is a shareholder in the third party who stands to benefit on both sides of the contract, the interest would need to be disclose to the board. He or she would also likely have to abstain from voting on the transaction. Fiduciary duties can also have implications on the ability of a director to compete due to conflicts of interest.

The scope of a director's duties makes it necessary for the director to be on top of the company's financial situation and ensure that taxes and salaries are kept current. For example, although there are conditions to the imposition of the liability, section 119 of the federal statute (the *Canada Business Corporations Act*) says, "Directors of a corporation are jointly and severally, or solidarily, liable to employees of the corporation for all debts not exceeding six months wages payable to each such employee for services performed for the corporation while they are such directors respectively.”

There are also provisions in the *Employment Standards Act*, *Occupational Health and Safety Act* and the *Environmental Protection Act* in Ontario (and other provinces) which can give rise to director liability.

Given the exposure directors have, it is often advisable to have the corporation agree to indemnify the directors where they are carrying out their duties in good faith and to purchase director liability insurance.

Second Meeting – Shareholders

Once the initial board meeting has been held, it is time to hold a meeting of the voting shareholders.

Just like with an initial board meeting, the initial shareholder meeting is typically held ‘in writing’ and with the unanimous consent of all the shareholders. This is because prior to incorporation there is often an agreement on all the matters that the initial shareholders would decide on at the meeting. This saves the formality of having to hold a meeting in-person. If a formal meeting is held, it would typically include each of the shareholders, directors, and the auditor (if appointed). The meeting (or unanimous resolutions instead of the meeting), would be used to:

- Confirm the by-laws passed earlier by the directors;
- Appoint the auditor (if one is going to be appointed) or waive the audit requirement;
- Appoint the directors for the remaining fiscal year.

Every shareholder is also entitled to (but not required to have) a share certificate. The certificate is evidence of the number of shares of that class or series held by the shareholder and registered in the shareholder ledgers kept by the corporation. For small companies, my practice is to typically not issue a share certificate as generally they end up getting lost. Instead, in some cases a 'notice of uncertificated shares' can be issued (unless or until a share certificate is requested by a shareholder). If the shares are ever transferred you can issue a certificate at that time (which can be endorsed for transfer), or use another instrument of transfer.

After the first shareholders' meeting is held, the company is required to hold at least one shareholder meeting each year; the annual general meeting or "AGM". Under the federal corporate statute, at the close of each AGM, the company is required to inform Corporations Canada of the date of the meeting and update the list of registered directors if new directors have been elected. Where the annual filing is not submitted, there is a risk, after a period of default, that Corporations Canada may administratively dissolve the company.

There is a similar requirement for Ontario corporations as well. While it would be rare (at the time of writing) for Ontario corporations to be administratively dissolved for failing to file an annual information return, they can face other consequences, including the inability to commence or defend lawsuits. This means that for both federal and Ontario corporations, it is crucial to stay up to date on your annual information return filings. Keep in mind that these filings are separate from the company's tax return.

While typically most shareholder resolutions require the voting approval of a majority of the voting shares, in some instances, for more substantial changes to the corporation, a "special resolution" is required. A special resolution is one passed by a two-thirds majority of the votes cast by the voting shareholders.

The Corporate By-laws

Separate from the articles of incorporation, most companies (especially in Ontario and federal corporations) have a set of corporate by-laws. Company by-laws serve as a fundamental governance document. Unlike the articles of incorporation, which focus mainly on the rights that attach to various share classes, by-laws delve deeper into the company's organizational framework.

To be effective, the by-laws and any amendments must first be approved by the directors, then confirmed by the shareholders at their next meeting.

By-laws can set out how the company will be governed on virtually any matter of importance. By-Law number 1, for most corporations, is a general by-law dealing with:

- How and when shareholder and director meetings will be held;
- Whether shareholder and director meetings can be held electronically;
- How notice of the meetings will be given;
- Quorum for meetings;
- The appointment of officers;
- The rights of shareholders to have proxies;
- Banking and account signing authority;
- How documents will be signed (and contracts entered) on behalf of the corporation;
- The date for the corporation's financial year-end;
- The roles of the officers of the corporation (CEO, CFO etc.).

In some cases a company's by-laws may also deal with voting rights on the board of directors. For example, some companies with two directors permit the chairman of the board to have a deciding vote in the event of a tie-vote. That said, deciding votes in the event of a tie are more typically addressed in a shareholder agreement.

The Indoor Management Rule

Even though the by-laws or internal company documents and policies will dictate who can sign documents and enter contracts on behalf of your company, it is important for founders to be cautious of the indoor management rule.

The indoor management rule means that a third-party dealing with your company is allowed to assume that the employee, director or officer (or other representative) they are dealing with has valid authority to bind the corporation to contracts. That means that even if the employee or company representative didn't, in fact, have the authority to sign a big contract for your company, the indoor management rule can be used to enforce the agreement against your business.

So, it is important for founders to be very careful with employees and company representatives to advise them clearly on the scope of their authority and what (if any) contracts they can enter on the company's behalf and representations or warranties they can make. It is for this reason you will notice that some employment agreements (and many contractor agreements) have provisions stating that the person is not allowed or permitted to enter contracts on behalf of the company without managements express written approval.

It is equally important not to put employees in situations where they may be held out as though they had the authority. For example, giving a low-level employee a fancy title, just to appease them, or make them feel important, could result in others assuming that employee has more authority than they actually do.

Record Keeping and Minute Books

Legislation in Canada requires that certain records be kept by the company including, for example:

- A copy of the articles of incorporation (and any articles of amendment);
- All by-laws;
- A copy of the company's shareholder agreement;
- Minutes of meetings and resolutions of the directors and shareholders;
- A register of directors;
- A securities register;
- Accounting records; and
- A register of share transfers.

These documents form the basis of your corporate minute book. Traditionally, corporate minute books were compiled in large binders and stored either at a lawyer's office or at the company's head office. However, some law firms in Canada, including mine, moved to maintaining digital minute books.

Maintaining a minute book is required by law for all corporations in Canada. Aside from the legislation, keeping your minute book updated is important for a number of reasons, including:

- If you are issuing new shares it serves as a clear record of all existing shareholders, the number of shares outstanding (i.e. a cap table), when each shareholder acquired their shares and for how much.

- Your accountants, the Canada Revenue Agency ("CRA") and other government agencies may need (and may have a right to demand access) to review your corporate minutes in connection with tax and audit matters.
- Your bank may require certain records in order to open accounts and grant credit.
- If you ever sell your business, the purchaser will review your minute book to ensure the company is in good standing, confirm who the shareholders are and how many shares they own.

Properly updated minute books also avoid shareholder disputes, as without them, there can be confusion or ambiguity on (i) who is and is not a shareholder (or the number of shares issued and outstanding); and (ii) how board and shareholder meetings can be called to impact control (i.e. voting to add or remove directors).

Minute books also hold a record of all annual return filings by the corporation. Canadian corporations (both federal and provincial companies) are required to file annual information returns either with Corporations Canada or the corresponding provincial Minister.

In Ontario, the failure to file the annual return can result in the company being unable to defend or commence lawsuits (among other consequences). At the federal level, failing to file annual returns can result in the company being administratively dissolved (i.e. cease to exist). Annual return filings are typically prepared in connection with the company's annual shareholder meeting.

ISSUE THE SHARES AND AGREE ON IP RIGHTS (THE SNAPCHAT CO-FOUNDER DISPUTE)

In this chapter we have looked at not only why corporations are such powerful and important vehicles for carrying on business, but also the formalities necessary once you incorporate. Those formalities, like preparing a proper minute book, seem unimportant to many founders, especially when you haven't raised money or started to earn revenue.

As a lawyer who sees clients in this situation frequently, the failure to keep proper records and have a clean record of ownership with the appropriate agreements can often lead to disputes. Those disputes can not only be costly, but they can destroy the business itself.

One example of where that almost became the case, and which serves as a cautionary tale, is Snapchat. For those unfamiliar with Snapchat, it's the company that famously rejected a $3 billion acquisition offer from Facebook. Snapchat's CEO, Evan Spiegel, told Forbes that short-term gains were "not very interesting."

Not many people would dismiss $3 billion as uninteresting. Whether the decision was brave or crazy is up for interpretation, but Snapchat did manage to raise $50 million from investors at a $2 billion valuation and an additional $20 million in August 2014 at nearly a $10 billion valuation. At the time of writing, the company had gone public and has a $23 billion dollar market cap, so jokes on … "Zuck", I guess.

But the following story of Snapchat's early days, drawn from court records, illustrates a common error that founders often make when launching a company: neglecting to formally issue shares to founders and establish agreements to protect intellectual property rights. It also highlights that had a minute book been properly kept, a major dispute could have, perhaps, been avoided.

In 2009, Evan Spiegel and Bobby Murphy, students at Stanford University, collaborated on a start-up called Future Freshman LLC, aimed at assisting high school students with college applications. The pair agreed to divide the business's equity evenly, but their venture never took off, and they both moved on from the business.

In 2010, Reggie Brown, a friend of Spiegel, had an app idea for self-destructing messages. He shared this idea with Spiegel and Murphy. They invited Brown to Los Angeles that summer to develop the app. Rather than forming a new entity, Spiegel and Murphy chose to repurpose their existing corporation, Future Freshman. They renamed it Toyopa Group, LLC. However, they did not issue shares, or formalize a minute book.

Spiegel and Murphy took the position that Toyopa owned the code and all intellectual property related to the Snapchat app. However, Brown, who conceived the idea, assumed he held equity in Toyopa since he had been working with Spiegel and Murphy on the project in various capacities in the early days, such as marketing and business development. Spiegel and Murphy, on the other hand, believed they owned 100% of Toyopa (since they formed the company and came to a 50-50 understanding) and, consequently, 100% of the app and its associated intellectual property.

In short, Brown had the expectation that he owned something, because he had the general idea for disappearing messages and contributed work in the summer of 2010. Spiegel and Murphy assumed they owned the company and the copyright in the code used to develop the app (regardless of who had the idea for disappearing messages).

During court proceedings, Murphy was asked if he thought Brown knew he had no equity in Future Freshman. He responded, "I don't know what he believed. All I know is that, again, he was invited to join us that summer, do some work."

His statements highlight that there was no deal ‘papered’ (or attempted to be papered), no shares issued, no certainty on what exactly Brown owned, whether shares or a portion of the intellectual property.

To gain leverage, Brown eventually filed a patent titled "Timed, Non-Permanent Picture Messages for Smartphone Devices" which listed his home address and contact information as the sole contact and named Murphy, Brown, and Spiegel as co-inventors. This led to a dispute and Spiegel subsequently forced Brown out of the company.

Brown later sued and argued that he was at least a one-third owner of the company and the intellectual property outlined in the patent. He claimed credit for the original idea and the design of the ghost logo now used in the app's branding. Spiegel and Murphy argued that since they had developed the software and app, they were the sole owners of the company and its assets (i.e. the app).

Years of disputes and litigation, likely costing hundreds of thousands of dollars, finally culminated in a settlement in September 2014. In connection with their listing to go public in 2017, Snapchat disclosed that the settlement had Snapchat pay Brown $157.5 million.

So, what’s the lesson? I joke with clients that if you don’t plan on the business being successful, you’ll have nothing to worry about, because a claim from someone against a company worth nothing and with no real assets, is likely fruitless. But as all founders do, if you believe your start-up has legs, there are two major considerations from the Snapchat case:

1. ***Negotiate and set expectations right away:*** That is, when Spiegel and Murphy invited Brown to come work on the app, it should have been made clear what Murphy was going to receive in return. Was it equity? If not, was it a fee to help them build out and market the app that summer?
2. ***Document the agreement:*** Without setting expectations, there was no clear agreement to document. But assuming the three 'founders' had the discussion on ownership of the company and the IP in the app, it would have been easy for a lawyer to document those agreements by issuing shares, formalizing a minute book and having the founders enter agreements to assign all IP rights to Snapchat.

In Snapchat's case, making it clear to Brown that he either owned no equity (which was the expectation of Spiegel and Murphy), or would be paid for his contributions in some form of employment or consulting agreement (perhaps compensating him with stock options) could have saved Snapchat hundreds of millions of dollars.

In Snapchat's case, it might have been hard, even awkward to discuss equity, control and IP ownership among friends back in the summer of 2010, but it's a conversation that all founders need to be willing to have.

Although Brown made his argument as a co-founder, companies often face similar issues with employees and independent contractors who claim ownership of intellectual property, domain names, and the like. We will talk about this more in subsequent chapters. We will also discuss how stock options and vesting agreements can be used to protect companies from granting too much equity to co-founders, employees, or consultants before they make significant and meaningful contributions to the company. This approach can also help prevent potential disputes and ensure that those involved in the business are fairly compensated for their efforts.

Before we turn to negotiating founder agreements and the intellectual property considerations, a quick note on sole proprietorships, partnerships, joint ventures and franchises.

SOLE PROPRIETORSHIPS

Sole proprietorships are easy to form. In effect, as a sole proprietor you are doing business as yourself, either in your own name or a business name you register with the relevant government authority.

While sole proprietorships are quick and easy to set up, they have two major disadvantages. First, sole proprietorships expose the personal assets of the owner to claims by creditors; whether trade creditors or lawsuits.

Exposure to personal liability for the debts and obligations of the business is often the main consideration for businesses who decide to incorporate. That said, various insurance policies can help mitigate your exposure to certain types of claims against a sole proprietorship.

The second main disadvantage of a sole proprietorship is the inability to raise equity financing. While you can take on loans, as a sole proprietor you cannot sell shares in their business.

Likewise, when the day comes to sell the business, you will be restricted to selling the assets; whether physical assets or intangible assets like goodwill and intellectual property, to the new owner.

You may also miss out on tax saving opportunities that are available to shareholders of a Canadian controlled private corporation. For example, you may miss out on the lifetime capital gains exemption when you go to sell your business. More on that later.

For founders who are more risk averse, and for high-growth start-ups or start-ups who will seek to raise equity financing, the sole proprietorship is not the business vehicle of choice.

That said, some founders choose to start out as a sole proprietorship and later convert to a corporation, when the time is right. Keep in mind that converting a sole proprietorship (or a partnership) to a corporation does not rid of personal liability. For example, the sole proprietor could still be liable for claims against the business arising from events that took place, or contracts that were entered, pre-incorporation.

It also adds a layer of complexity to the incorporation process. When a sole proprietorship sells or transfer the business assets to the newly incorporated company, it may create a taxable transaction (i.e. a disposing of assets of proprietor A to company B). Under Canada's current *Income Tax Act,* with the appropriate legal steps and tax filings, it may be possible to convert your sole proprietorship into a corporation in a tax-efficient manner, deferring taxes until the shares you obtain in the corporation (in exchange for transferring the sole proprietorship's assets) are eventually sold. This mechanism can ensure a smooth transition without immediate tax consequences. Whether this process will be necessary (or possible) for you is something you should seek tax advice on.

PARTNERSHIPS

Provided this book is intended for founders, and assumes you are not starting an investment fund, or have another reason to using a partnership, we will only cover a very high-level overview of partnerships. The overview may be relevant if you ever seek private equity and need to understand how the private equity fund, if it is a partnership, is set-up and managed.

Partnerships can also be relatively inexpensive to set up. Aside from registering the business name (see above), the registration process is quite simple. In Ontario, partnerships are governed by the *Partnership Act* and in some cases the *Limited Partnerships Act*. What is more complicated, and often more costly, is negotiating and entering the partnership agreement.

Partnerships and Personal Liability

There are three types of partnerships recognized in Ontario with different consequences on the issue of liability:

1. General Partnerships. In a general partnership, which can be formed under the *Partnerships Act* in Ontario, each partner is jointly liable with the other partners for all debts and obligations of the firm. In a general partnership you could have both individuals or corporations acting as 'partners'.

The *Partnerships Act* says that a general partnership is formed where there is a relationship between "persons carrying on a business in common with a view to profit". So, there are three main elements to a partnership:

- A "business" as defined in section 1 of the *Act*;
- Which has "a view to profit" (i.e. not a charity or not-for-profit); and
- Which has an intention to share profits between the partners.

This means that a partnership can be found to exist even where there is no formal partnership agreement or registration. In fact, unless amended by a written partnership agreement, a number of default provisions apply to partnerships by operation of the *Partnerships Act,* including for example that profits will be shared equally between the partners. For this reason, careful thought should be given to entering a partnership agreement, and the terms of that agreement.

Likewise, founders need to be careful to ensure they do not inadvertently enter a partnership with someone simply by virtue of the fact they are carrying on business with a common view to share profits or by permitting someone to hold themselves out as a business partner. If that is the case, there are a number of grounds upon which the individual partners or the "partnership" may be found liable for the debts and obligations of the partner or individual holding him or herself out as a representative of the 'partnership'.

2. Limited Partnerships. Under the *Limited Partnerships Act* in Ontario, one or more persons can act as general partners and one or more persons can act as limited partners. The limited partners are usually passive investors whose liability is typically limited to what they invested into the partnership, whereas the general partners attract general liability related to the operation of the business.

The General Partner-Limited Partner (GP-LP) structure is a common arrangement in investment funds and real estate ventures. In this setup:

- The General Partner (GP) manages the day-to-day operations and makes investment decisions. GPs have unlimited liability,

meaning they are responsible for the debts and obligations of the partnership.
- Limited Partners (LPs) contribute capital but do not participate in management. Their liability is limited to their investment amount. LPs typically include individual investors, institutional investors, or other entities.

A partnership agreement can then deal with the intricacies of the business, like how a partnership interest can be sold/cashed out etc.

This structure is favored in industries like private equity, venture capital, and real estate due to its flexibility and efficiency in pooling large sums of capital for investment. GPs bring expertise and management, while LPs provide the necessary funding without the risks and responsibilities of active management.

In the GP-LP structure, both the GP and the LP are often corporations themselves, or in investments circumstances, sometimes a family trust or other entity.

3. Limited Liability Partnerships. Limited liability partnerships (LLP) are essentially a cross between a general partnership and a limited partnership. We do not cover LLP's in this book since they are only available for limited purposes (including forming law firms). They are not generally available to the public.

Partnerships as Flow Through Entities for Tax Purposes

In a partnership, partners report their share of the partnership's distributed income on their personal tax returns. This income, whether it's a profit or loss, is combined with each partner's other earnings in that tax year and is taxed at their personal tax rate (or if the partner is a corporation, their corporate tax rate) based on the type of income earned. In short, the profits (and losses) of the business flow through to the individual partners.

JOINT VENTURES & FRANCHISES

Although they are not often relevant for founders in the start-up space, especially in the technology space, it is important to be aware of joint ventures and franchises.

Joint Ventures

A joint venture occurs when two or more businesses collaborate on a specific project or business activity. While sometimes it may be carried on by entering a joint venture agreement, in other instances, it may be achieved by having two companies form a new entity that has a specific purpose.

Take for example Sony and Ericsson. They entered the Sony-Ericsson joint venture in 2001, which stands as a compelling example of how joint ventures can be a powerful tool even in the tech space. At its core, this collaboration made perfect sense. Sony, renowned for its consumer electronics and entertainment, joined forces with Ericsson, a telecommunications giant renowned for its expertise in mobile networks.

While Sony and Ericsson independently continued to operate their own lines of business, the joint venture was driven by a shared vision of conquering the burgeoning mobile phone market. Sony's multimedia capabilities seamlessly blended with Ericsson's telecommunications infrastructure, paving the way for innovative mobile devices.

Joint ventures offer several benefits, such as accessing new markets, cost-sharing, and enhancing business capabilities.

However, like any relationship, clear communication and a solid agreement are vital. Even with well-drafted joint venture agreements, numerous issues can go wrong.

In one instance, Bombardier, a Canadian aerospace company, entered into a joint venture with Commercial Aircraft Corp. of China Ltd. (“COMAC”), a Chinese state-owned aerospace manufacturer. Their objective was to develop a regional jet aircraft that could rival Boeing and Airbus. Unfortunately, the partnership didn't go as planned. Bombardier sued COMAC, alleging that they had utilized Bombardier's technology to create a new jet that directly competed with the joint venture's intended project.

Often, in a joint venture, nailing down what rights each party has in any resulting technology or intellectual property (and sometimes even pre-existing technology) can be difficult. The Bombardier case emphasizes the importance of carefully drafting and enforcing intellectual property provisions in joint venture agreements. It also highlights the need for comprehensive dispute resolution mechanisms when joint ventures don't unfold as expected.

Franchises

A franchise is a type of business model where one business (the franchisor) allows an individual or another business (the franchisee) to operate under its brand. In return for using the franchisor's established brand, business model, and support, the franchisee pays a fee or “royalties” (i.e. a percentage of revenue).

Think of it like cloning a business. You're replicating a successful business model and brand, allowing others to operate their own versions of that business. It can be a powerful way to expand your business rapidly and (sometimes) with less risk, when compared to starting a similar business from scratch, without the established brand.

However, the relationship between a franchisor and franchisee is a delicate and sometimes adversarial one. It is not uncommon to hear of disgruntled franchisees on everything from one-sided franchise agreements, franchisors exercising too much control, little room for increasing margins and prices, competing franchise locations being opened too close for comfort, franchisors increasing prices on goods or ingredients they supply to franchisees and even the failure to adequately market the franchise.

A real-world example that comes to mind is the case of Dunkin' Donuts. In the early 2000s, a group of franchisees in Quebec sued the franchisor. The franchisees argued that Dunkin' Donuts did not uphold its promise to protect and boost its brand image in Quebec, which they believed led to the success of rival Tim Hortons. In 2012, the Quebec Superior Court ruled in favour of the franchisees, ordering Dunkin' Brands Canada Ltd to pay $16.4 million in damages.

Franchises can also require significant upfront investments from franchisees. I sometimes joke it is tantamount to buying a job, if you are going to be the person that operate the franchise.

On the other side of the table, as a franchisor, the relationship requires a proven and replicable business model, significant upfront work to create the franchise structure, and ongoing support for franchisees. Plus, you'll need to be comfortable with others representing the brand you worked so hard to establish.

While the law differs in each province, there are also very particular sets of legislation governing the franchise relationship, like the *Arthur Wishart Act* (Financial Disclosure) in Ontario. It sets out, among other things, disclosure requirements for franchisors. Having a lawyer review the franchise disclosure document and franchise agreement for you, is a must. In fact, you should not take the franchise disclosure documents and franchise agreement lightly, they can impose serious risks, including where franchisors require indemnifications and personal guarantees related to the franchise.

In the end, the franchise relationship is a dance between maintaining brand consistency for the franchisor and allowing for individual entrepreneurship. That said, if you want the full freedom that goes with being an entrepreneur, the creativity that goes with creating new products, adopting new services and marketing campaigns, buying a franchise likely isn't the path for you.

Now that we've gotten partnerships, joint ventures and franchises out of the way, let's turn to important points on negotiating founder and shareholder agreements when you start a new corporation.

CHAPTER 3: CO-FOUNDER AND SHAREHOLDER AGREEMENTS

Usually, the articles of incorporation and company by-laws are not sufficient to protect the interests and expectations of each founding shareholder in a start-up. Even before outside investors come on board, many start-ups enter a shareholder agreement to protect those interests and expectations.

It is important for founders to understand that shareholder agreements entered between two co-founders serves a different purpose than a shareholder agreement entered when private accredited or venture capital investors are involved. Smart founders have a defined relationship in place with co-founders, employees, contractors and option holders before they approach investors. Doing so will illustrate they are serious in protecting their (and the company's) interests, even if that agreement needs to be renegotiated, supplemented or amended to suit the demands of subsequent investors.

Without a shareholder agreement the control and operation of a start-up is fairly rudimentary. In most instances the majority rules. That means, the majority shareholder (holding voting shares) can appoint the directors of the company and in-turn control the management of the company with little input from the minority shareholders.

For example, if two individuals started a company with one owning 51% and the other 49%, without a shareholder agreement, the majority shareholder would be entitled to appoint the entire board of directors. For a minority co-founder who is investing significant time, skill, expertise or money, this is a concern. For this reason, some co-founder agreements include provisions in which all shareholders agree to vote both co-founders into office, at each annual general meeting of the shareholders, so long as each founder remains a shareholder.

In that case, it is sometimes minority shareholders who stand to benefit more from entering a shareholder agreement. However, the clarity that arises from entering the agreement can also serve to benefit a majority shareholder and the company itself.

Unfortunately, because most start-ups cannot afford to pay a lawyer to tailor their agreements for them, they either fail to enter a shareholder agreement, or they adopt a boilerplate agreement that has counterproductive terms and conditions, or terms the parties didn't understand the full meaning and impact of.

NEGOTIATING FOUNDER AGREEMENTS

While it is easy to think founder agreements are simply a matter of dividing up equity and capital investments, the reality is that founder agreements should deal with a lot more.

The rights distributed in a founder agreement can be far more complex and important than most founders realize. This section is intended to help you understand what issues you should be thinking about (and negotiating on) to form your founder agreement.

Once you read this section, consider using a form of non-binding founder term sheet for sketching out the general terms of your agreement. Doing so will make it easier for your lawyer (and hopefully less expensive for you) during the drafting process.

Without a summary of the core terms you've agreed to with your co-founder, usually a lawyer for one founder drafts a generic agreement and the parties spend days, weeks and even months trying to agree on amendments and understanding the terms.

Important Issues to Negotiate

Aside from the actual division of equity, in my opinion, the most important issues to discuss and try to document are:

- Control of the board of directors and who has a right to sit on the board or nominate board members;
- How founder shares are issued (i.e. on a vesting schedule or not);
- How shares can be issued to new shareholders;
- How founder loans can be incurred by the company and repaid;
- Whether any security interests (for example granting security to one founder over the company's assets, inventory, intellectual property etc.) will be granted to secure the founder's loans to the company;
- Who can incur and repay expenses on behalf of the company (and in what amounts);
- Who will have contract signing and spending authority;
- Whether the founders are working full-time, and what other business interests they have (or will be permitted to have in the future);
- Who will be entitled to compensation and when (whether in the form of employment income, consulting fees or dividends);
- The assignment of intellectual property rights;

- Who will have access to information about the company (including financial information, bank account access, accounting software access etc.). Some companies may consider other types of account access, for example, who will have access to software code repositories like GitHub, or payment processing accounts like Stripe, PayPal etc., email accounts, domain accounts, social media accounts, etc.;
- Whether there will be restrictions on founders competing with the company or soliciting contractors, staff or customers of the company in the context of their other businesses; and
- How the co-founder relationship can or will end. For example, will there be events that can lead to the forced sale of one party's shares (vesting terms, shotgun clauses or trigger events like death, disability, divorce, incarceration, bankruptcy, the resignation of a founder etc.). More on this below.

Of course, there are other issues founders can cover-off in their agreements. From the workings of employee option plans to drag and tag along rights in the event a third party wants to acquire the company, but let's get to those later.

A Fair Agreement

Clients often come to me and say, make the agreement fair. But what is fair in different circumstances varies, as do opinions on what constitutes 'fair'. How the above issues are addressed, and what constitutes 'fair' in a co-founder agreement may be impacted by factors like:

- Whether one or more of the co-founders is contributing a large cash investment or loans to the company;
- Whether one or more of the co-founders is bringing, or will be creating intellectual property (like software code, designs, trademarks/brands etc.);

- Whether one or more co-founder is only working part-time on the start-up;
- Whether one founder previously worked on developing the business or its product prior to the involvement of the second co-founder;
- Whether the relationship will result in a 50–50 split or a majority-minority shareholder position; and
- Whether there will be more than two co-founders.

THE 50–50 RELATIONSHIP

Often the hardest relationship to document is the 50–50 start-up, where both founders are to hold, initially, 50% of the shares and be one of two board members. The reason this can be the most difficult relationship to document is simple, it can lead to deadlock, where no single person is in control.

Sometimes, the fairest option is to require both founders to consent to all major decisions. However, the 50–50 relationship can lead to paralysis, where no decisions can be made, especially in the event of a founder dispute.

While there are provisions of a founder agreement you can include to address 50–50 deadlock, they often do not sound appealing to either founder. This is because they present the risk of losing what control each founder does have, to block or veto decisions on the board of directors.

That said, the main provisions to consider in addressing 50–50 deadlock, are:

- Vesting shares (if one founder's shares do not fully vest, it may result in a majority-minority shareholder relationship) potentially breaking the deadlock;

- The appointment of one of the two founders as a chairperson, with a deciding vote on all or select issues. For example, one founder could have a deciding vote to break ties on hiring or firing staff, taking on debt, signing a new contract, raising money, etc.
- The appointment of a third board member (even though ownership is still split 50–50) who has the ability to make tie breaking decisions; and
- A shotgun clause (which can be used to ensure the end of a co-founder relationship).

The Shotgun Clause

Each provision to break deadlock or founder disputes has its own risks, which you should discuss with your lawyer to ensure you understand. Whether you decide to implement the ability to break potential deadlock should be considered in your own circumstances, with your own lawyer.

The shotgun clause, in particular, should be carefully considered before being included in your agreement. A shotgun clause permits any shareholder to offer to purchase another shareholder's shares. If the offer to purchase is declined, the other shareholder is required to purchase the offeror's shares, on the same terms. It is an extreme remedy for owner disputes, which some lawyers refer to as the nuclear option, because it ensures a means to breakup two or more founders.

While it can ensure a breakup of the co-founder relationship, the main risk of a shotgun clause is the forced exit from a company you may want to remain with, or on terms you may not necessarily agree are fair. The shotgun clause can be abused, and in some circumstances, be regarded as unfair. For example:

- In early-stage start-ups where the company's fair market value is difficult to ascertain, or where only one of the founders has the technical ability to operate the business;
- One founder has fewer financial resources than the other, meaning they could never be a buyer in the shotgun scenario;
- If one founder is older or otherwise clearly has no desire to be a buyer. That is, they clearly do not want to continue to operate the company without their co-founder;
- If either founder has outstanding personal guarantees related to the company's debts, which they can't get out of even upon exiting the business;
- It may be difficult for one founder to determine if they should be a buyer if they don't have equal access to information, including updated financial information about the company, sales prospects, new customer relationships, etc.; and
- One founder may not have the support from necessary employees or customers, if the other founder were to leave.

More importantly, when combined with the assignment of a founder's IP, non-compete and non-solicit obligations, a founder could be forced to leave and not be permitted to start a competing operation or make a living in the same industry.

That said, a shotgun clause may make a lot of sense in a traditional business, that has fixed and hard assets on a balance sheet, on-going revenue and sales, and shareholders of comparable financial resources.

CONTROL OF THE BOARD AND MANAGEMENT OF THE COMPANY

The issue of control can be complex.

Without a co-founder or shareholder agreement, one or more voting shareholders who form a majority can control the company by voting in and out the company's board of directors.

This means they control the corporation and its management. Unless there is an agreement that says otherwise, those management rights include the ability to issue new shares (which might dilute existing founders), bring on new shareholders, enter contracts, control spending and bank account access, take on loans, hire and fire staff, appoint officers (President, CEO, Chief Technology Officer etc.) and many more.

While some founders are fine with a majority holder exercising complete control, some are not. A founder agreement can balance the control issue by specifying how decisions on important issues can be made, and in what scenarios the approval of more than a simple majority of the board is required to make a decision.

In terms of issues around control and management to negotiate with your co-founder, here is a list of some of the most important ones:

- Will each founder be entitled to sit on the board of directors, regardless of whether they hold a majority of the shares?;
- How are new board members approved or elected? Is it a simple majority vote of the shareholders, or will founders have the right to nominate and appoint a certain number of directors?;
- If there are only two founders, are you accepting that a 50–50 board may lead to deadlock, or do you want to have a means of breaking potential deadlock?;
- If you want a means to break potential deadlock, how do you want to do it? See some of the options above;

- Are there any issues or decisions the company makes that the founders want to have a veto on, or a different threshold (aside from a majority vote)? For example:
    - Issuing new shares, which will dilute the founders;
    - Selling all or a material company asset (like its main software product);
    - Taking on new loans or debts;
    - Allowing existing shareholders to sell or transfer their shares;
    - Expenses above a certain dollar amount;
    - Hiring new staff or contractors or paying founders a salary;
    - Paying dividends on shares;
    - Amending the company's articles of incorporation;
    - Dissolving the company or entering a merger;
    - Commencing litigation; or
    - Others, unique to your company's circumstances.

The Appointment of the Board

As mentioned, without a founder agreement or other form of agreement among shareholders, the board of the company is voted in by a majority of the voting shareholders, in accordance with the company's articles of incorporation and by-laws.

This means, if two directors are appointed when the company was formed, and there are only two shareholders with equal equity and voting rights, the addition or removal of any board member would require the consent of both shareholders.

However, if there is a division of equity that is anything other than 50–50, any founder or group of founders who can form a majority, can vote in and out the board. This can be problematic if you are a minority shareholder or a founder with an expectation that you will continually be allowed to remain on the board of the company with management and information rights.

The Right to Continually be Appointed to the Board

As a result, founders, even those in a minority situation, can negotiate as part of the founder agreement, for the right to have all shareholders vote to appoint them (or their nominee i.e. someone who will look out for their interests) to the board, irrespective of the fact that they do not, themselves, have enough shares to carry a vote.

While being a board member, or the right to appoint a board member, can be an important right to have, being a board member is a serious undertaking. It presents its own risks and liabilities and requires you to make sure you are acting in the best interest of the company, kept apprised of the company's finances, material contracts and have a good understanding of what the company is doing, among other obligations. As we explored earlier, individual liability, as a director, can be imposed on you for things like unpaid corporate taxes, unpaid employee wages, environmental damages and others.

For this reason, and others, some minority shareholders prefer not to sit on the board, but retain contractual rights that give them some of the powers they may have had as a board member. While that may be preferable, for various reasons, there are scenarios where doing so, even as a shareholder, can impose some of the same liabilities on you as if you were a director.

ISSUING NEW SHARES

One of the most important tasks the board of directors has is issuing additional shares.

While there are different routes you can go, at a minimum, you want to make sure that no additional shares can be issued without a duly passed board resolution. Some companies elect to go even further and require that the board must have the unanimous consent of all board members or the consent of all founders or shareholders, to issue new shares. This leaves even minority founders in a position to veto the issuance of new shares, which would have the impact of diluting their shareholdings.

The more common right founders often include is a right of first refusal. If the board agrees to issue additional shares, the right of first refusal gives each founder the ability to purchase whatever portion of the new share issuance required for them to maintain their then current equity percentage. For example, if you own 25% of the company, and the company is selling $100 worth of new shares, you can contribute $25 and maintain your 25% shareholding.

The issue here, for early-stage companies, is often young first-time founders are not flush with cash to pony up in the event major capital is being raised. So even with a right of first refusal on the issuance of new shares, they may not be in a financial position to do so. For those types of founders, they may want to hold on to a veto right. They could do this by requiring a unanimous decision to issue new shares, at least in the early stages, so they have a degree of control over new shareholders coming on board that they may not want involved in the company, or that may dilute their ownership in a way, or to an extent, they don't agree with.

Keep in mind, this right, can sit in the founder agreement until such time as investors (injecting real cash) come on-board, and the group of new shareholders (founders included) can agree on a new form of shareholder agreement removing a founder's veto rights and re-addressing how the issuance of shares will be governed.

DEALING WITH FOUNDER LOANS AND EXPENSES

Some founders like making it clear that while neither founder will be obligated to advance loans or cover company expenses, to the extent they do so, the company will document all the loans and expenses and repay them when the board determines there is sufficient capital to do so.

Likewise, it often makes sense to agree that no founder loan will be repaid in priority to any other founder. That is, founder loans are only repaid proportionally to the value of their loans at the time of the repayment. For example, if founder A lent $70,000 and founder B lent $30,000, when the company wants to repay $1,000 worth of loans, it has to repay $700 to founder A and $300 to founder B.

It is sometimes desirable to require unanimous consent from each founder to repay all or any portion of a founder's loan. This helps protect the company, as it means that neither founder can demand repayment in a manner that might cause the company to become insolvent. On the other hand, as a founder you are agreeing that you may not get your loan back until the company is well capitalized.

Although it is up to the founders to decide what they view as being fair and reasonable, in some cases, founders register security interests over the assets of the company (for example, IP, inventory and other assets) as collateral for their loans. This is rare in early-stage companies, as it means future investors or other co-founders may reject the notion that one founder has security over their investment while they do not. That said, it certainly may form part of the agreement, especially where one founder intends on becoming much more indebted than others.

It a fast-moving start-up, it's not uncommon for some or all of the founders to have incurred expenses to get things going, whether buying a domain name, paying a developer for some initial code, paying for AWS accounts, bank fees, incorporation fees, legal work, you name it. Often the company is not in a financial position to immediately repay expenses. In these situations, a founder agreement can specify that, if the company approves of the expense, it will add the expense amount to the applicable founder's loan account and record it as an amount owing to the founder.

INTELLECTUAL PROPERTY OWNERSHIP

Often prior to incorporating a company one or more of the founders has created intellectual property, whether software code, algorithms, designs, logos, or other forms of intellectual property.

In most cases, the founders agree that any intellectual property they each develop (or previously developed) in the context of the company's operations, or which is brought to the company for it to use, will be owned by and assigned to the company, or, at a minimum, will be licensed to the company for it to continue to use.

While there are exceptions, the general starting point is that the creator of the intellectual property (whether copyright, trademarks, or patentable works) owns it. This may not be the case if the works were developed under an employment relationship or under an agreement that expressly says otherwise.

Each founder should be careful to ensure that any intellectual property they developed, while under an employment relationship (even if they terminated that relationship before starting their new company) is not owned by their previous employer or other third-party.

It is a good idea to have your lawyer review any previous or current employment agreements or relationships you entered which may have an impact on the ownership of intellectual property you intend to bring to your new start-up.

Likewise, this makes (i) documenting the ownership of your works which you previously developed and are bringing to the company for it to own or use; along with (ii) negotiating the future assignment of your new works, an important component of the founder agreement.

Without documenting the assignment or licensing of a founder's intellectual property, there is a risk that should he or she depart the company, the company may be left with no legal right to continue to use the intellectual property.

While it may seem obvious to want to have each founder assign all intellectual property they create in the context of the company, for it to continue to use, there are individual circumstances that may lead to a founder not wanting to do so. Take for example the scenario where a founder develops a general algorithm, that may be applied in various industries or for various purposes. It may be that the founder only wants the start-up to have a right to use the algorithm for a specific purpose, but not to allow the company to actually own the algorithm outright. In those cases, looking at licensing agreements may make more sense.

Domain Names

Similar to intellectual property, intangible property like domain names are sometimes acquired by an individual founder, in their own name, prior to incorporating. To ensure the company can continue to use the domain names you may want to assign them, in the founder agreement, to the company.

For example, the founders could agree that upon executing the founder agreement, any founder who owns domain names the company will use, will transfer them to a domain registrar account operated in the name of the company. The transfer price could be at the price the founder originally paid to acquire the domain name, or some other agreed upon value.

You might think the domain name issue isn't an important one to address. However, often a company's website and social media accounts can form the primary means of driving business. If one founder were to leave the company and take the position that they own the domain names, it could have serious consequences for the company and its ongoing operations. The same applies to other accounts, such as GitHub accounts, social media accounts, access to email accounts etc.

NON-COMPETE

It is not uncommon for some founders to have an interest in multiple businesses. For example, founders who have a track record of building various app or software programs may want to continue to have the right to be a shareholder and/or director of other companies, even ones in a similar space.

That said, the company itself and future investors, should or will want some assurance that founders won't leave and start a competing business.

What is often up for negotiation between founders is the scope of the non-compete. It can take thoughtful drafting to narrow down what the company wants to legitimately protect. This can only be done in the context of what the business does (or intends to do) and what the individual founders want to ensure they can continue to do in the future, regardless of what happens with their new start-up.

That said, assuming you want to include a non-compete, the two main factors to negotiate are (i) how long the non-compete will last after you cease to be a shareholder; and (ii) what, specifically, it precludes you from doing.

Overly broad non-compete clauses (both in duration and what it precludes you from doing) risk being found to be unenforceable, as courts generally do not like seeing people contract out of their ability to make a living. For example, if you are a graphic designer, it wouldn't be a good idea to contract out of your right to provide graphic design services after you leave your start-up.

On the flip side, if you are a software developer, you may reasonably contract out of your right to work for another enterprise building an application or software that directly tries to compete with the same software your start-up was developing.

Founders and their lawyers should consider the specific scope of the non-compete in their own personal circumstances and the circumstances of the company.

Director Duties in the Conflict of Interest and Non-Compete Setting

Individual founders should also consider, and seek advice on their duties as directors of the company (assuming they are acting as a director). Even without a non-compete clause in the founder agreement, founders can have statutory restrictions on what they can and cannot do outside the context of the company.

For example, directors have a duty to avoid conflicts of interest, which, in some situations, may operate similar in nature to not having interests in competing companies, or an interest in transactions which are conflicting in interest with the company.

Directors may also have statutory and common law duties not to divert corporate opportunities they become aware of, which, in ordinary circumstances, the company may want to pursue.

So, even without a non-compete clause, a director may be in breach of their duties to the company if they were to learn of an opportunity that their company would want to pursue, but assign that opportunity to another business with which the director is involved in, or has an interest in. Directors in these circumstances may have to disclose the opportunity and refrain from voting or participating in the decision-making process on whether or how to pursue it.

NON-SOLICITATION

What is often far more important, and likely has a better chance at being enforceable by courts, are restrictions on founders being able to solicit the staff, contractors and customers of the start-up.

It is often agreeable between the founders that they won't leave the business and take employees, contractors and customers with them. Just like with a non-compete, this also provides good signals to future investors.

That said, there are scenarios where founders do not agree to non-solicitation clauses. For example, a founder may be using a specific software developer to provide services to the start-up and simultaneously be using the same person for one or more of their other businesses. Again, for that reason, the non-solicitation clause has to be considered in the individual circumstances of what your start-up does, and the personal circumstances of each founder.

CONFIDENTIALITY

For start-ups, protecting designs, trade secrets, software code, product research and development, customer lists and other forms of confidential information can be important for ensuring competitors don't get the upper hand.

The founders agreeing to keep non-public information about the business confidential until such time as it is reasonably necessary to advance the company's interests (or required by law) to disclose it, often makes sense and is generally not a contentious part of any founder agreement.

Founders should equally consider what other confidentiality obligations they have with third parties, and take steps to ensure they are not in breach of those obligations in the context of their new business. The most common scenario where this becomes a risk is where you have access to confidential information owned by a previous employer.

VESTING PROVISIONS

Particularly in start-ups where neither founder is making a large cash investment, it is common for one or more of them to be on a vesting schedule. That is, their shares are either dripped to them over a period of time, or the opposite, they acquire their shares up front, but the corporation or another founder has the right to repurchase all or a portion of those shares if they were to leave.

The actual mechanics of a vesting relationship vary quite significantly. Vesting provisions can be in your founder agreement or in a separate stock option agreement. Some lawyers also include them in the form of a restricted stock subscription agreement or 'RSA'.

Wherever they reside, the most important factors are:

- How long is the vesting schedule. It is common to see anything from 1–4 years;
- How frequently the shares vest (i.e. monthly, quarterly, yearly etc.);
- What constitutes a trigger event giving rise to the shares no longer vesting. For example, does the founder have to formally resign and leave, can he or she be fired from the company, etc.

RSA's and Reverse Vesting

Reverse vesting is the concept that a founder will acquire all of his or her shares upfront, but the company will have an option to buy them back in the event the shares do not fully vest, whether based on a timeline or milestones.

This protects against the scenario where one founder quits (especially where they were issued shares for nominal value) and the other founders continue to operate the company. In that situation the company will not want to find itself in the situation where one shareholder is doing no work, has left the company but enjoys the profits of the company as if he remained, for example, a 50% shareholder.

Reverse vesting of course can become more complex where a founder has actually contributed something of value to the corporation in exchange for their shares. For example, if co-founder 1 brings intellectual property, software code etc. to the company, and is assigned shares in consideration for transferring the right to the software code, it would likely impact the terms of any vesting agreement.

The same is true, of course, where one of the founders is actually investing substantial sums of cash into the business to acquire his or her shares.

How you manage the vesting of shares may be impacted by important tax considerations. You should always speak with a tax advisor before agreeing to vesting and reverse vesting provisions or the acquisition of any securities (stock, options, convertible debt etc.) for that matter.

MANDATORY SHARE SALES

Aside from a founder agreeing to have their shares vest (or reverse vest) to them over a period of time, there are events that may occur which the founders may want to agree, up front, will trigger a right or an obligation for them to sell their shares. While this may include the resignation or termination of a founder's involvement with the company, the most common events (often referred to as 'trigger events') are:

- Death;
- Disability;
- Divorce; and
- Bankruptcy.

The result of these events is that a remaining founder will not have the benefit of their co-founder continuing to be actively involved in the company, or worse, a third party may actually, by operation of law, take control of a founder's shares. For example:

- In the event of death, an estate may take ownership of the shares;
- In the event of disability, the co-founder may no longer be able to contribute to the company;
- In the event of divorce, as part of the family law proceedings, a spouse may obtain a court order for the transfer of shares as part of dividing up the net family property;
- In the event of their bankruptcy, a co-founder may be required to transfer their shares in your company to a creditor.

When founders, especially of an early-stage company, enter a business relationship with a co-founder, they likely do not want to be left in a scenario where their co-founders shares are transferred to a new shareholder, or no longer be able to benefit from the work of their co-founder. In these cases, it often makes sense for co-founders to agree that they will (if asked to do so) sell their shares back to the company, or to their co-founder, at fair market value.

Other trigger events to consider include:

- The resignation of a founder, even after their shares have fully vested;
- The termination of a founder's role with the company (whether as a director, officer, employee, contractor etc.); and
- The incarceration of, or one founder being convicted of a crime in relation to the business, like fraud.

How fair market value is determined is any entirely separate matter, but it is often whatever price the parties can agree to, and if it cannot be agreed upon, your founder agreement can require a valuation process, like the appointment of an independent chartered business valuator.

That said, valuing an early-stage company or any technology company for that matter is not an exact science and quite often one or more founders is not happy with whatever valuation is obtained.

Drag and Tag Along Rights

The next, and often less contentious issue leading to a mandatory sale of shares, often agreed to, are drag and tag along rights. In short, where a majority shareholder receives an offer to sell the whole company to a third party, they can compel the minority shareholders to sell their shares on the same terms, to the same third party.

On the flip side, tag along rights allow a minority shareholder to tag along in the event a majority of the company's shares are being sold. This ensures they can achieve an 'exit' at the same time if the majority shareholder is selling his or her shares.

THE FOUNDER RELATIONSHIP AS DISTINCT FROM THE INVESTOR RELATIONSHIP

The issues that arise between two founders can be quite different from the relationship formed between one founder and one or a group of investors. Investors are often just cutting a cheque, with no expectation that they be involved in operating the business. In those situations, especially for larger institutional investors, they often do not want to agree to things like:

- Non-compete or non-solicit provisions as they may have other investments, or want to make other investments in a similar space;
- The mandatory sale of their shares, unless it is in the context of drag or tag along rights when the entire company is being acquired; or
- The assignment of intellectual property since they are not contributing to the company's operations.

For that reason, it is sometimes preferable to have the founders and the company enter their own form of agreement, before outside capital is raised and additional investors are brought into the company. At a later stage, a separate form of unanimous shareholder agreement can be entered with any additional investors.

INFORMATION RIGHTS

Even if you are a founder, if you are a minority holder and not a board member, you don't have a statutory right to company information; like bank statements, contracts, internal company documents, etc. While minority shareholders often have the right to attend year-end shareholder meetings, and, if it hasn't been waived, the right to require the company to undergo a financial audit each year, aside from that, shareholders without contractual information rights can be left flying in the dark on many issues.

Founders may want to document a right to have viewing access to the company's bank accounts and credit facilities (credit cards, loans, lines of credit etc.) to know the company's financial position and how their equity holdings are doing. If they are directors, they should be staying on top of this information either way.

Some founder agreements will document information rights which get extended to a founder, even if or when they stop acting as a director. Meaning, they can be given the right to know what the board is doing, what contracts are being entered and approved, what resolutions are being signed, etc.

When you do early-stage financing rounds, you'll notice some investors demand these types of information rights.

DISPUTE RESOLUTION

The harsh reality is that courts and the litigation process are often slow and costly. If a dispute arises in the context of your co-founder relationship that is litigated, there often is no winner. Litigation can result in disruptions to the company's business and large expenses incurred by everyone involved.

One alternative to litigation is to have a private arbitrator hear and settle disputes. While arbitration is not always more cost effective (as you have to pay an arbitrator) many arbitration institutions have expedited arbitration rules, which are intended to shorten the dispute resolution process. This is done primarily by the arbitration rules limiting the parties in the amount of evidence and submissions they can make in connection with the dispute.

There are even some arbitration institutions who will, for a smaller fee, issue a decision without any in-person hearing or reasons for their decision.

OPPRESSION REMEDY

Another issue founder agreements can help overcome, or at least mitigate, are the statutory rights minority shareholders have arising under the 'Oppression Remedy'. In short, the oppression remedy is a catch-all remedy that courts (and arbitrators) can use to consider whether some action the corporation or other shareholders have taken is fair and reasonable, and not contrary to the 'reasonable expectations' of the minority shareholders. Founders are often surprised to learn how wide the discretion is that courts have to find remedies to rectify corporate actions that appear unfair to minority shareholders.

A great example is where one founder pays him or herself a salary or dividends (if they held a separate class of shares) to the exclusion of their co-founder (who might not hold a board seat, or who could be out voted). Depending on the circumstances, and even the size of the salary or dividend, it may be regarded as oppressive and unfair in some situations, giving rise to a court deciding it cannot be done. For that reason, the founder agreement is a perfect opportunity to really set what the reasonable expectations of both parties are on these types of issues.

CHAPTER 4: RAISING CAPITAL AND ISSUING SECURITIES

The first thing I realized working for start-ups is that access to capital is difficult. Banks typically won't lend to new companies or entrepreneurs unless they can satisfy themselves with some form of collateral. Banks typically want to lend to companies with existing cash flow (even take factored loans)[1], fixed assets and founders that can make personal guarantees of value (i.e. they own a house or other assets). For many early-stage founders, bank loans like this are either not available, not appealing (due to rates and collateral) or the amount the bank is willing to advance would only cover marginal costs or small working capital allotments.

FOUNDER LOANS

This leads to many businesses being self-financed, either with founder loans, or loans from friends and family. When doing so, some founders consider protecting their loans against trade creditors and other lenders by entering a form of loan agreement or promissory note, along with a general security agreement and registering that security interest against the assets of the company. As the company grows, this can help protect your capital in the event your start-up goes insolvent, with you being able to have first dibs (assuming you have an enforceable first ranking security interest) over the assets of the company.

Even for companies with no physical assets of value, registering a security interest can still be worthwhile if the business has intellectual property (like software code, patents, trademarks etc.) that you may want to own and continue to use in the event your company goes insolvent.

PROMISSORY NOTES AND GENERAL SECURITY AGREEMENTS

In a fast-moving start-up, it is common for founders to make loans, or incur expenses (which are later documented as loans to the company) and overlook formally entering promissory notes (or other forms of agreement documenting the debt obligation) and a 'general security agreement' or 'GSA'.

If entered, the promissory note outlines the specifics of the loan, for example, the total amount, the method and timeline of repayment, interest rate etc. and the implications of a failure to repay. Other forms of loan agreements, such as a revolving credit agreement or fixed rate/fixed term loan agreement can be entered, the latter often not being ideal for a founder that wants the flexibility as to when the company causes repayment.

A GSA, on the other hand, serves as a protective measure for the lender (in this case, the founder). If a situation arises where the company cannot repay the loan (i.e. it is insolvent), the GSA (if registered and perfected under the applicable legislation) can allow the founder (with some exceptions) to claim, seize and/or liquidate the company's assets in order to recoup the loan amount (or more likely, part of it).

Take for example one client of mine, an e-commerce store sitting on inventory, that was forced into insolvency by a creditor. Because the founder had properly registered a security interest (pursuant to the *Personal Property Security Act* in Ontario or "*PPSA*") over their inventory for loans made by the founder, despite the insolvency, the founder was left in a position where he had a legal right to the inventory, liquidated as repayment for his loans. The unsecured creditor (Facebook in this case), was left with cents on the dollar of the debt owing to them, after the inventory was liquidated.

However, the use of GSA's and *PPSA* security interests can also be abused. For example, I had a client see me years after they signed a loan agreement (which I did not advise on) where investors secured loans they made to a start-up. In hindsight, the loan seemed to have been made with the expectation the start-up would never be in a cash position to repay it on time.

Verbal statements were made to the founder, when the loan was made, encouraging them to come back to the lender when the company ran out of money. Instead, when funds ran low and the lender knew the debt could not be repaid, the lender made a demand for repayment, forced the company into insolvency, and moved to take the assets (including things like software code under development, trademarks, and other IP) to go start a new company.

In that situation, the lender effectively stripped the founder of their equity because they acquired the assets as payment for the loan (in connection with liquidation proceedings), and started a new entity without the original founder. In this example, it became clear the lender actually preferred to take the assets instead of repayment of the loan because they viewed the ability to use those assets (a new and yet to be released software program) inside a new company as more beneficial than the repayment of the loan. Their intent was to put a new CEO in place and move forward with a new company to market the software without the original founder.

You can imagine how painful that outcome would be for a founder who put all the blood, sweat and tears into creating their start-up. It would equally be painful for other minority shareholders of the company, and even employees who held stock options in the original company.

As you can see, it quickly becomes obvious why the terms of any loan with a co-founder or other lender are important, and why secured debt can have a significant impact on the company's trajectory. The lessons? (1) be very careful with taking on debt and giving up security interests in your company; (2) consider having your own GSA and PPSA registration (done by a lawyer) if you are lending to your own company; and (3) have a lawyer review the terms of debt financings and specifically seek advice on what will happen in the event of a default on the repayment of the debt.

To make things more complicated, there are various circumstances under both legislation and common law that may result in even your first ranking security interest being void, declared to have been improperly registered, or even bumped below other creditors, even though they did not have a prior registered security interest. Among other examples:

- In Ontario (and possibly other provinces) lawyers may be able to register a solicitor's lien on account of payments owing to them;
- Legislation may also permit the registration of a purchase money security interest (a "PMSI"). In short, a PMSI allows a lender to provide a loan to a debtor and register a security interest over a specific asset the money is used to buy. In that situation, even if you had a prior ranking security interest over all the assets of the debtor, the holder of the PMSI can take priority in the receipt of funds from liquidating the asset in question (or repossess that asset); and

- Courts may, in rare circumstances, also arrive at equitable and common law grounds for declaring a third party to have a greater right to an asset or cash, including for example as a result of constructive trusts or tracing remedies.

Again, seek legal advice from a lawyer anytime you are registering a security interest or PMSI, or when you are trying to enforce your rights in relation to a loan or GSA.

Keep in mind also that enforcing your security interest, especially in the event of bankruptcy and insolvency proceedings involving multiple creditors, can be slow and complicated. Courts will also issue a stay of proceedings against an insolvent company while creditors rights are sorted out. Often to enforce a security interest requires the appointment of a receiver or liquidator (sometimes appointed by a court) to carry out the orderly dissolution of the business. Nevertheless, registering your security interest can be an important step to take to protect your capital.

Subordinating Debt

Even with taking all the steps to protect your loans, if you later seek loans or convertible debt from more sophisticated lenders, like banks and private equity investors, they may require, as a condition of their loan, to take priority in the event the company defaults on its loans; a process referred to as 'subordination'. That is, you are subordinating your rights, in favour of another lender coming after you.

Whether you decide to subordinate your existing debts owing to you from the company requires careful consideration, as you would need to decide whether the benefits of an additional loan from the new lender or other third party outweigh the drawback of potentially losing your front-of-line position on being repaid your debt.

QUICK NOTES ON CORPORATE STRUCTURING

Some founders also think proactively about these situations (i.e. insolvency where a creditor has a claim to your material assets) and use corporate structuring techniques to play defence against such risk. For example, in software companies, founders may have the IP (software code, domain names, trademarks etc.) registered in Company “A”, which licenses those assets, to Company “B”, where loans and other debts are taken on to run the company. Company “B” would then pay ordinary course licensing fees to Company “A” without (subject to certain exceptions) exposing Company “A” to trade and other creditors of Company “B”.

Of course, smart lenders seek a security interest for both companies, making the above structure of little value in relation to lenders, but may still be effective against other trade and judgment creditors.

Even in the example above, there are all sorts of complications that arise and that you should ensure a lawyer advises you on, including:

- Whether there is a *bona fide* licensing agreement in place;
- Whether the two entities are truly separate entities, and that there are (and in the future will be) no grounds for arguing that the two companies are one in the same entity for the purpose of liability. For example, this can occur if the two companies are co-mingling assets, have common ownership to the extent there is no separate identity, among other things. A

lawyer can also advise you on the risks posed by the 'alter ego doctrine' a principle used by Canadian courts to determine if two legal entities are truly distinct, or whether courts can treat them as one in the same entity for the purpose of liability;

- Whether the structure will cause problems with potential investors, who may want assurances they are investing in the company that actually owns the underlying IP;
- That there are no negative tax implications from the structure; and
- That the structure is otherwise lawful and makes sense in your circumstances.

Complications can also arise if you are attempting to put the above structure in place after having already operated with a single operating company for a period of time. For example, if you had a secured or even unsecured creditor, who had security or an interest over your IP in the event of insolvency, you would likely need their approval to transfer the IP out of the operating company. Getting that approval would likely be difficult. Depending on what the operating company receives in exchange for the IP, there may be no incentive for the creditor to grant such consent.

More importantly, depending on the circumstances, it can also be illegal under legislation like the *Fraudulent Conveyances Act* (Ontario), as just one example, to transfer assets to a holdco or other entity where a creditor would be prejudiced by the transfer, or the intent of the transfer is to defeat or prejudice a creditor's claim. Again, seek legal advice not just on the structure, but on the implementation and operation of the corporate structure and the transfer of material assets, like IP, out of a business. Depending on the details of the transaction, shareholders may also need to consent to the transfer of material assets.

Lastly, a structure where you have an IP holdco can also give rise to complexities if there is ongoing development of the IP by your operating company. For example, where the operating company's staff and contractors are paid by the operating company to continue to develop the IP, transferring ownership rights from the operating company to the holdco triggers all the same complexities outlined above. You can quickly see that this is a very nuanced and complicated area of law, and you should seek legal and tax advice on your circumstances before attempting any such corporate structure as the legal risks, tax considerations and other factors can be grave.

GOVERNMENT OF CANADA LOANS & GRANTS

While there are worthwhile start-up loan programs in Canada, including the Canada Small Business Financing (CSBF) Loan, which is backed by the federal government but administered by the banks, most loan programs do not apply to technology companies for a number of reasons. For example, the CSBF loan is typically for financing the purchase of fixed assets such as real estate or making leasehold improvements.

Because the CSBF is government money (in part) but administered by the banks, the banks often require founders to provide personal guarantees to access the loan and subordinate the repayment any founder loans on the books. This is less than ideal and not appealing to many founders.

Other government lending programs and grants exist, but in my experience, they tend to be difficult to obtain and slow to dole out the cash.

When you incorporate a Canadian federal corporation, Corporations Canada sends you a link to a “Business Benefits Finder” intended to identify funding and grant opportunities for your business. However, for most start-ups, I find the tool not particularly useful, nor are there many programs out there for the average start-up.[2]

Business Development Bank of Canada (“BDC”) is another government backed lender for founders and start-ups. They will lend not only to help businesses get started or grow, but also finance acquisitions. However, just like CSBF loans, loans from BDC often require GSA’s and personal guarantees as well. They will also likely require that you subordinate any of your own debts owing to you from the company.

Founders in Canada should also be aware of the Scientific Research and Experimental Development (SR&ED) program. SR&ED is a federal tax incentive program, administered by the Canada Revenue Agency (CRA), which aims to encourage businesses to engage in scientific research and experimental development by providing tax credits or refunds for eligible research and development expenses.

At the time of drafting, if granted, Canadian-controlled private corporations or “CCPCs” can receive refundable tax credits of up to 35% on qualified expenditures, while other corporations, individuals, and trusts may be eligible for non-refundable tax credits at lower rates.

To claim SR&ED incentives, businesses are required to submit a comprehensive application demonstrating that their R&D activities meet the program's eligibility criteria, which include technological advancements, scientific uncertainty, and systematic investigation.

For confidentiality reasons, some founders are hesitant to share the application information with the government (and their agents).

The SR&ED program offers refundable tax credits, meaning that the company can receive a cash refund instead of a reduction in taxes payable. This cash infusion can be helpful for early-stage companies, allowing them to fund further R&D activities, hire skilled personnel, and invest in necessary resources for growth.

You can appreciate that loans and grants are hard to come by in the Canadian start-up ecosystem, especially if you don't want to be giving up personal guarantees. The access to capital problem has undoubtedly contributed to the trend towards "lean start-ups", raising money on the internet via crowdfunding and publicly financed incubator and accelerator programs. All of which are becoming an increasingly important component of Canada's start-up ecosystem.

CONVERTIBLE DEBT

Before we get into private equity investments, it is important to be aware of convertible debt. A convertible loan, also known as a convertible note, is a short-term debt instrument often used in the early stages of a start-up's life cycle. It is a loan from an investor that can convert into equity, usually preferred shares, during a subsequent funding round.

Subject to the loan being repaid (and sometimes the investor getting to elect to either have the loan repaid or an equity conversion), the conversion usually happens during the next investment round, at a discounted rate relative to the price per share in that round. The discount compensates the convertible loan holder for the increased risk they bore by investing earlier.

Convertible loans are employed in early-stage investments for a variety of reasons. They allow start-ups to avoid a direct valuation. This can be helpful given it is challenging to accurately value a start-up in its early stages due to a lack of operational history or steady cash flows. Instead, the convertible loan agreement defers the valuation until a later date when more information is available (i.e. in a subsequent equity financing).

Convertible loans are often faster and less costly to execute than equity financings. Traditional equity financing requires extensive negotiation and legal work around terms like valuation and control rights. In contrast, convertible loans bypass many of these complexities.

Despite their benefits, convertible loans also present challenges for founders. A significant issue is the potential for dilution of the founders' equity when the loan converts into shares. This dilution can be substantial if the company's valuation at the next round is lower than what the founders anticipated. The terms of a convertible loan can also create conflicts between founders and early investors. For example, if the conversion discount is high, or if the note includes a valuation cap (a maximum company valuation at which the loan can convert), this can lead to substantial dilution for existing shareholders (often founders, friends and family).

There is also the risk that if the company does not raise additional capital, or have sufficient cash flow, it could be stuck in a situation where it is obligated to repay the loan in cash but doesn't have the capital to do so. Even if it does have the capital, the repayment can be a significant drain on a young company's resources, which in some situations may not even have started earning revenue yet.

One benefit to founders, however, is that early investors with convertible loans do not have the same voting rights as those who own equity. This could mean that such investors have less say in the company’s decision-making, although they've taken on risk at an early stage.

While convertible loans can provide an efficient way for start-ups to raise initial capital, founders must be very careful of the potential pitfalls. It's crucial to engage in careful planning and negotiation when structuring convertible loans, keeping in mind the impact on the company's future capital structure and governance.

There are many potential pitfalls for founders using convertible notes. For example, assume the investor also wanted a first ranking security interest on their loan, if there was no conversion of the debt and the investor had a right to demand repayment, the company could be forced to hand over its assets (such as IP, inventory and the like) in return for repayment, a risk explored above.

In the next section we will focus on raising private growth stage investment capital from private accredited investors, private equity and venture capital firms. We will then explore rewards and equity-based crowdfunding, and the once trendy topic (at least in 2017) of initial coin offerings.

TWO MAIN REGULATORY BARS TO RAISING EQUITY CAPITAL

We’ve now explored important aspects of using debt and convertible debt for raising capital as a founder. Before we dive into discussing equity investments, it is important to understand the general securities law framework at play in Canada.

Many first-time entrepreneurs that come to me for advice are surprised at just how regulated equity financings are, even for small companies. While securities laws differ from province to province, in some respects, the two most important points of the framework in Canada are:

1. You can't sell securities to just anyone. There is a general ban on soliciting the sale of securities in your company to the public; and
2. The starting point for raising equity is having a prospectus or offering memorandum (in some circumstances). Both are detailed disclosure documents with surrounding requirements for seeking capital. These are typically expensive undertakings (in terms of legal fees and regulatory compliance). The classic "you need money [to spend on securities lawyers] to raise money" conundrum.

As Jeffery MacIntosh put it in a National Post article, raising money from public markets is expensive:

> *"Because of arcane securities laws whose full import is only understood by two or three Tibetan monks, this is expensive. Even Buy-Rite-Cut-and-Paste-Prospectuses [disclosure documents] will charge you about a hundred grand, and the bulge-bracket firms reportedly like to take an option on your first-born child. Understandably, the prospectus option is not the first choice of start-up firms looking to raise money."*

The result is that, unless an exemption to the prospectus requirement applies, you can't invest in the local bakery, or any other start-up or medium-sized business for that matter (i.e. ones not listed on exchanges).

The good news is that there are exemptions to the prospectus and offering memorandum requirements. While there are others, key exemptions in Ontario (at the time of writing) used by early-stage start-ups are:

- **The Private Issuer Exemption:** which permits (under certain circumstances and among other limited types of investors) close personal friends and family members to invest.
- **The Accredited Investor Exemption:** which permits individuals who, alone or together with a spouse, who own financial assets or have an income that meet a certain threshold, to invest. We won't go into detail on this exemption, but it allows high net worth ‘angel’ investors to purchase securities in your company. It is a sub-category of the private issuer exemption.
- **The Equity Crowdfunding Exemption:** Which allows businesses to list on a regulated crowdfunding portal and raise small amounts from a large group of people; and
- **The Self-Certified Investor Exemption:** A new and possibly temporary exemption, which is not applicable in provinces other than Ontario at the time of writing, and allows individuals who possess the necessary business knowledge, through qualifying education or work experience, to invest in start-ups without a prospectus or offering memorandum. Such investors would still need to sign a certification, complete a risk acknowledgement and meet other regulatory requirements. They are also limited to investing a maximum of $30,000 per year under the exemption.

While the above exemptions are available for issuing securities to certain individuals (and entities in some situations), you should always seek legal advice before issuing securities to ensure the exemption applies in your circumstances. Your lawyer can also help you conduct the necessary due diligence on your investors to ensure they qualify and assist with other statutory requirements. For example, you may be required to have investors sign statutory risk acknowledgement forms. You may also be required to ask certain questions, or be disclosed certain information, to ensure an investor meets certain definitions, like the accredited investor definition.

Below, we will explore two of the four exemptions mentioned above, the private issuer exemption (friends, family and close business associates) and the crowdfunding exemption. Although no securities are issued, we will also quickly cover rewards-based crowdfunding, a topic I have followed closely over the years.

PRIVATE ISSUER EXEMPTION

The Private Issuer Exemption is a key element of Canadian securities law. It enables private companies to issue securities without a prospectus. In Ontario, the exemption applies to companies with fewer than 50 shareholders, excluding employees. It provides a framework around the sale of securities to a specific group, including founders, employees, directors, officers, and the close personal friends and close business associates of the directors, officers and control persons of the company.

Friends and Family

You might be thinking, well I can just call someone my friend, and sell them some shares, right? Nope. There are still important regulations to follow under each exemption. For example, the definitions of ‘friend’ and ‘family’ member are laid out in the law, and in companion policies issued by regulators.

At the time of writing, 'family' under the exemption in Ontario includes close family members like a spouse, parent, grandparent, brother, sister, child or grandchild of a director, executive officer or control person of the company.

The 'friends' portion isn't simply anyone you're on good terms with. They must be individuals with whom you've had a relationship that's close enough to suggest a strong level of trust. The Ontario Securities Commission ‘Companion Policy’ to the law states:

> *“ ... a "close personal friend" of a director, executive officer, founder or control person of an issuer is an individual who knows the director, executive officer, founder or control person well enough and has known them for a sufficient period of time to be in a position to assess their capabilities and trustworthiness and to obtain information from them with respect to the investment.”*

There are similar rules when relying on the ‘close business associate’ portion of the exemption. The regulators want to ensure that same element of trust. The same companion policy says:

> *“ ... a "close business associate" is an individual who has had sufficient prior business dealings with a director, executive officer, founder or control person of the issuer to be in a position to assess their capabilities and trustworthiness and to obtain information from them with respect to the investment.”*

A recent acquaintance or someone you've met through a networking event, for instance, wouldn't likely qualify as a close personal friend or close business associate.

Companies relying on the ‘Friends and Family’ or ‘Close Business Associate’ exemption are also required to have the investor complete and sign a statutory form indicating who the friend or family is at the company, what their role at the company is and how long they have known them. The form also serves as a risk acknowledgement indicating that the investor could lose their entire investment.

Aside from completing the appropriate form, it's important to remember that the onus is on you, the company (or the person issuing the securities), to ensure the relationship meets the standards required by the exemption. Again, this is something you should seek legal advice on, to ensure you are not unlawfully selling securities (for which there can be grave consequences).

When selling shares under the private issuer exemption, the issuer is required to obtain information from the investor to determine whether the investor qualifies or not. For example, if the investor represents they are a close personal friend of a director, the details of that relationship must be obtained. It is not sufficient for the business to accept standard representations in a share subscription agreement or even just complete the relevant statutory exemption/risk acknowledgement form mentioned above. The business has to take reasonable steps to verify the representations made by the investor are true.

If you want to dig in the weeds on this point before you talk to your lawyer, you can see some of the sample statutory forms for Ontario at https://www.osc.ca/en/securities-law/instruments-rules-policies/4/45-106/unofficial-consolidation-form-45-106f12-risk-acknowledgement-form-family-friend-and-business.

Lastly, remember that while this exemption can be a cost-effective way to raise early-stage capital, it is not without its pitfalls. Raising funds from friends and family can be a sensitive undertaking, with personal relationships on the line. You should handle these situations with care and the guidance of a lawyer. Be clear about the risks involved and ensure that your friends and family are comfortable with the potential loss of their investment. Of course, the above does not cover all the elements of raising money under the exemption, as there are subscription and possibly other agreements, along with financing closing documents you will want prepared by a lawyer.

CROWDFUNDING & THE NEW ERA OF ENTREPRENEURIAL FINANCING

Rewards Based Crowdfunding

The 2008 financial crisis left small businesses with little means to raise capital, the wells of capital dried up. So, it wasn’t a coincidence that a year later, in 2009, Kickstarter was founded on the basis it could be part of the solution to the access to capital problem.

Envisioned as an innovative way for founders to bring their projects to market, Kickstarter aimed to bridge the gap between ambitious ideas and the financial support required for their fruition.

Kickstarter's unique approach allowed creators to present their products to the public, offering various rewards in return for pledges from backers. Over the years, the platform transformed countless product ideas into reality, proving instrumental in the success of numerous artistic, technological, and social ventures.

Rewards based crowdfunding flipped the normal product rollout for start-ups. That is, instead of spending thousands or hundreds of thousands of dollars designing, building and manufacturing a product to take to market, companies are able to take a concept, idea or prototype to market and find out if there was demand for it. In effect, crowdfunding allows a founder to create a market, and demand for a product, before formalizing it and committing to development.

Rewards based crowdfunding saw explosive growth from 2009 onwards. As of 2020, over 500,000 projects have been launched on Kickstarter to date, raising in excess of USD $5.4 billion. The platform boasts over 18 million total backers from around the world and nearly 64 million total pledges over the years, truly remarkable.

On Kickstarter, some projects are raising over $1.0 million (without giving up equity) from thousands of "funders" in less than 30 days. In fact, I have had multiple clients who came up with a product idea and before having to spend thousands of dollars on marketing, doing a large batch inventory order and taking a risk on a product that may not sell, they posted it on Kickstarter to realize there was massive demand for their products.

In effect, it allowed them to hit a threshold, pre-sell a product, rally a business around that product and put a plan in place to get the product made and delivered. Two great examples were:

- *Venque* (https://www.venque.ca) making stylish bags; and
- *North Aware* (https://northaware.com) making winter coats that raised over $3.5 million on Kickstarter.

One of the exciting projects of the day was a project by Double Fine which raised $3.3 million from over 87,000 people to develop a new computer game and again, gave up no equity in their company. The funders (or backers as they are sometimes called) received everything from t-shirts and copies of the video game, to limited edition games and signed memorabilia.

I have encouraged many clients I work with who have consumer facing products to consider crowdfunding, not only to raise money for the development of their business, but to get an understanding of how the market will accept their product before further capital is spent developing it.

Crowdfunding represents a significant disruption to the traditional models of funding businesses and will continue to grow as a means of raising capital.

Equity Crowdfunding

With the rise of Kickstarter, many started to ask, why can I pre-order a product I like, support the founders by buying their various rewards, like t-shirts, and not, at the same time, take a small amount of equity in exchange for a small investment.

With the rise of the Internet and the prospect of viral videos and viral product ideas, was there really that big of a risk to investors from contributing $100 to a team who could demonstrate a prototype?

Why should the 'crowd' be barred from investing small amounts of money in a product idea, while at the same time be permitted to take the risk that a founder isn't able to actually deliver on their products promised.

So, in April 2012, the US *JOBS Act,* (specifically Title III, the *Crowdfund Act*) was signed by President Obama. The *Crowdfund Act* significantly changed U.S. securities laws. It permitted, for the first time, online funding "portals" to operate in which "emerging growth companies" could list their business with the prospect of raising up to $1 million from up to 2000 investors online. Since then, the US equity crowdfunding framework has changed. However, at the time, I grew jealous. Why didn't Canada have something similar?

I saw a risk that there would be a move by Canadian founders to set-up US entities for the purpose of equity crowdfunding to the US market. With the age of the Internet, investment and business transcends international boundaries making it difficult for Canadian regulators to preclude Canadians from both setting up shop in the US and even investing in U.S. start-ups online.

Canada risked losing not only talented entrepreneurs, but also taxable revenue and job creating companies.

Realizing the amazing impact Kickstarter was having on funding great start-ups and new products, and the risk of losing Canadian founders to the US equity crowdfunding regime, in 2012 I wrote articles for the Toronto Star (Crowdfunding - Time for Canada to Jump Onboard)[3] and later the Globe and Mail ("*The Economic Potential of Crowdfunding is Underrated*")[4] on why Canada should be pursuing equity crowdfunding to spark innovation and help further finance Canadian founders. In the Toronto Star article I said:

> *"The provincial legislatures should be racing to the front of the line to address crowdfunding legislation. The intent of which will be to generate an entirely new wave of crowdfunded businesses and divert the brain drain to flow inter-provincially as opposed to internationally."*

In 2013, I became involved with the founding members of the National Crowdfunding Association (now the National Crowdfunding and FinTech Association or "NCFA"). I had seen, firsthand, the immense impact rewards based crowdfunding platforms like Kickstarter were having, even on Canadian founders and I (like many others) wanted to be involved in advancing that progress with a shift to permitting equity crowdfunding.

My involvement with the NCFA led to a meeting with the Ontario Securities Commission ("OSC") and ultimately the NCFA was successful in pushing for an equity crowdfunding regime in Saskatchewan first and later Ontario.

However, it was painful to watch the rollout from a securities law perspective. Clearly, the true power of equity crowdfunding would come from having the largest crowd possible to draw from. By having the individual provincial securities regulators create their own crowdfunding rules, it meant, initially, that founders could only raise money from the 'crowd' within their own province.

For example, in the Saskatchewan context, both the business and the investor had to be in Saskatchewan. With a small population of roughly 1,000,000 people, Saskatchewan clearly would not see a significant impact from crowdfunding, under their exemption, unless the framework was harmonized with other Canadian or international jurisdictions.

In context, the US (with much larger population and therefore larger potential crowd to raise money from) proceeded quickly, before Canada, with a national crowdfunding framework. So, when the first two provinces rolled out their own, I was heavily dissuaded, and lost interest in equity crowdfunding in Canada. In my view, the potential for equity crowdfunding in Canada was significantly curtailed. I was upset that Canadian securities regulators couldn't come together to agree on a national framework.

In fact, for a long time, even after the Ontario exemption was passed, there were no registered crowdfunding portals that Ontario companies could even use. I viewed the OSC's moves as having killed equity crowdfunding, at least in the short term.

A New National Crowdfunding Regime in Canada

The good news, however, is that as of September 2021 National Instrument 45-110, implemented by the Canadian Securities Administrators ("CSA") harmonized the Canadian equity crowdfunding rules. National Instrument 45-110, aims to streamline the process for businesses to raise capital through crowdfunding by providing exemptions from registration and prospectus requirements, subject to certain conditions. The key features of Canada's framework, as of September 2021 are:

- **Registration Exemption:** Early-stage companies and start-ups are exempted from the registration requirement, as long as they work with a registered funding portal and adhere to investment limits.
- **Prospectus Exemption:** Businesses meeting specific criteria are exempted from the prospectus requirement, enabling them to issue securities without a comprehensive prospectus. Instead, they must provide investors with a simplified offering document containing essential information about the business, management, and the offering. Google "Form 45-110F1 Offering Document" to see what is required in the disclosure.
- **Investment Limits:** The legislation sets investment limits. Non-accredited investors can invest up to $2,500 per investment and companies can raise up to $1.5 million within a 12-month period.
- **Funding Portals:** National Instrument 45-110 mandates that start-ups use registered funding portals to facilitate crowdfunding transactions. These portals ensure compliance with the regulatory framework, including investor eligibility verification, offering documents, and monitoring investment limits.

The new Canadian framework has much greater potential than the fractured provincial rules that came before it. Take for example, in December of 2021, PKA SoftTouch Corp raising over $1M from 662 investors with a minimum investment amount of $500.

In my view, equity crowdfunding presents a real opportunity, and if done right, can leave the company in a better position compared to taking on a sophisticated private equity or venture capital investor. There are two main potential benefits:

1. Founders have the opportunity to achieve a better valuation. In fact, they can set the valuation and the crowd will either accept or reject it. Whereas with more sophisticated investors they may drive a harder bargain in terms of the valuation, and ultimately how much equity you give up. Or worse, they may try to have you sign some form of exclusivity period, where you agree to negotiate with them alone, for some period, to avoid you shopping a deal.
2. Founders have the ability to protect against giving up a liquidation preference, control, management rights, or even a minority seat on the board. For example, there is a trend toward having the 'crowd' sign voting trust agreements. This means that while the crowd may still have the same economic benefits, in terms of share classes, dividends etc. as the founders, they effectively assign the right to vote those shares to a third party. This means that the founder can still exercise control over the company (and not dilute his or her ability to vote people onto the company's board). It also means they can avoid painful negotiations with private equity and venture capital investors around things like giving up preference shares, or various other minority shareholder rights, like those canvassed in the chapter on negotiating founder and shareholder agreements.

INITIAL COIN OFFERINGS

In 2017, while crypto currency prices soared, people started down this trendy new path of initial coin offerings or ICOs. I had numerous phone calls from people interested trying to raise money using an ICO. Many assumed that crypto tokens were not securities and therefore compliance with securities law would not apply. They assumed if they were not securities, and securities laws did not apply, they didn't need to rely on a prospectus exemption to offer the tokens or coins to the public.

Those were bad assumptions and they seem to arise from news headlines about whether Bitcoin itself was or was not a security under US law. Regardless of whether Bitcoin was to be determined to be a security or not, it does not follow that all crypto tokens or coins would also not be securities.

In fact, in some situations, regulators began to take the position that Bitcoin is, was or can be a security based on how it is custodied and stored when sold in connection with exchanges and other intermediaries. This was an issue that all Canadian crypto exchanges had to address when the regulators issued a guidance, three years later in 2020, to the effect that even if a token or coin was not a security, they could become securities if the exchange on which they were sold held the token on a user's behalf.

On January 16, 2020, the Canadian Securities Administrators ("CSA") issued Staff Notice 21-327 to provide further guidance on the factors to be considered when determining whether securities legislation applies to crypto exchanges. The CSA noted that exchanges that are merely providing users with a contractual right to an underlying crypto asset, like Bitcoin, rather than immediately delivering the crypto to the users (in their own self-custody wallets), are subject to securities laws, even if the underlying asset itself is not a security.

So, while it was tempting for me to take on files from prospective clients looking at ICOs in 2017, I resisted the temptation because in my view, depending on the nature of the offering, the token or coin was either clearly a security, or it fell into a grey area of the law and faced a real risk of subsequently being determined to be a security for various reasons. That being the case, complex securities laws would likely apply to the sale and offering of those tokens or coins including prospectus and disclosure requirements, or subsequently on the exchange and secondary market sale of those assets.

Among the flurry of interest in 2017, to the OSC's credit, they published a notice that stated:

> *"Every ICO/ITO is unique and must be assessed on its own characteristics. For example, if an individual purchases coins/tokens that allow him/her to play video games on a platform, it is possible that securities may not be involved. However, if an individual purchases coins/tokens whose value is tied to the future profits or success of a business, these will likely be considered securities.*
>
> *We have received numerous inquiries from fintech businesses and their legal counsel relating to ICOs/ITOs. With the offerings that we have reviewed to date, we have in many instances found that the coins/tokens in question constitute securities for the purposes of securities laws, including because they are investment contracts. In arriving at this conclusion, we have considered the relevant case law, which requires an assessment of the economic realities of a transaction and a purposive interpretation with the objective of investor protection in mind.*
>
> *In determining whether or not an investment contract exists, businesses should apply the following four-prong test. Namely, does the ICO/ITO involve:*

1. *An investment of money*
2. *In a common enterprise*
3. *With the expectation of profit*
4. *To come significantly from the efforts of others"*

To go one step further, and to illustrate how complicated this topic gets, regardless of whether I could give a prospective client an opinion on whether their particular offering was or was not a security, if they wanted to offer it in other jurisdictions, aside from just Ontario, they would have to consider the impact of the law in all other jurisdictions the offering was available.

The legal decision then, in 2017, as to whether to try to raise funds via an ICO was complicated to say the least. Some entrepreneurs took the risk nonetheless and tried (and sometimes failed) to structure their token in a way, and in hopes, that it would not be regarded as a security.

Take for example the Canadian based company Kik Interactive Inc. According to a Securities and Exchange Commission ("SEC") complaint filed against Kik in the United States, in early 2017 the Canadian mobile messaging start-up had depleted its venture funding and was months away from firing everyone and calling it quits. Instead, they turned to the hottest new way to raise money, an ICO, introducing their "Kin" token.

In the complaint, the SEC:

- Claimed that Kik offered and sold one trillion digital tokens called "Kin" and that they were required to register the offering as a security with the SEC;
- Found that over 10,000 investors worldwide, including many from the United States, purchased Kin for approximately $100 million. The lack of registration with the SEC meant investors

did not receive the necessary disclosures required by US securities laws; and
- The SEC sought a final judgment to permanently stop Kik from future violations, order disgorgement of ill-gotten gains with interest, and impose civil penalties.

At the time of the complaint, the Kin tokens were trading at about half the value that public buyers paid. Today, however, at the time of writing, Kin was trading at $0.00002183 (yes that's 4 zeros!).

The SEC's argument was rooted in the Howey Test—a legal test based on US case law that defines a transaction as a security if there's an investment of money in a common enterprise with a reasonable expectation of profits derived from the efforts of others. A test not too dissimilar to the test in Canada for determining if something is a security.

Although the SEC did not get all the relief sought, they were largely successful in their complaint. The court granted a judgment finding that undisputed facts established that Kik's sales of "Kin" tokens were sales of investment contracts, and therefore of securities, and that Kik violated US federal securities laws when it conducted an unregistered offering of securities that did not qualify for any exemption from registration requirements.

The judgment signified the importance of compliance with securities laws and made it known to others that ICO's like Kik's were unlawful, and would constitute unregistered securities offerings.

What was truly bizarre about Kik's case was that, in citing weak guidance from regulators, Kik banned Canadians from participating in the ICO. According to reports, in a blog post Kik's CEO, Ted

Livingston, said Kik reached out to the OSC, but did not receive a clear answer as to whether the token was as security. To avoid scrutiny from Canadian regulators, Kik decided to exclude Canadians from the ICO, but proceeded in the US and other countries around the world.

Think about that. Despite fearing a ruling from the OSC that the token was a security, and despite the fact that the test for determining if the token was a security is at least similar in the US and Canada, Kik took the risk of offering the Kin token to thousands of US 'investors' but not Canadian. To me, and obviously to the SEC, this served as a tacit admission that Kik knew they had exposure to a determination that the token was as security.

Given the company's public blog post (that I bet a US lawyer never reviewed) you can see how easy of a target Kik was to the SEC. In their own blog post they admitted that it was, at best, a grey zone as to whether their offering was a security in Canada, but proceeded to sell the token to people in the US and around the world. In my view, they were lucky to get away with the fine they paid. In any event, the SEC case, decided on summary judgment, gave the SEC a relatively quick win, sending a message to the world that a Kik style offering to US 'investors' wouldn't be ignored. That being the case, Kik-style ICOs died.

If you want to see how damning the complaint from the SEC was, you can read it at https://www.sec.gov/files/litigation/complaints/2019/comp-pr2019-87.pdf. One of my favourite parts is paragraph 97 where the SEC recounts evidence that Kik had a US consultant telling them, in no uncertain terms, that the Kin token "risked becoming a security in the eyes of the SEC very quickly". Perhaps the consultant shouldn't have been ignored.

VENTURE CAPITAL AND PRIVATE EQUITY

After watching an episode or two of the Dragon's Den or Sharks Tank founders might be tempted to think that negotiating a deal to raise equity capital from investors is simply a matter of valuing shares and dividing up equity. It's not.

The handshake deals made on TV are not final. After the show, 'Sharks' have their team do lengthy due diligence on each company, after which a term sheet may (or may not) be presented.

The due diligence may involve (to name only a few items) investigating the founder's background, financial and sales audits, a review of key customers (and whether they are still customers), corporate debts, liability risks, employee option plans, other securities outstanding and even due diligence on the other shareholders involved in the business. Kevin O'Leary points out that sometimes founders overestimate their company's abilities under the excitement of the show, leading to discrepancies during due diligence.

Even with extensive due diligence, investors will likely ask for representations and warranties, in the investment contract, that all the information disclosed, such as financial statements, sales history etc. are accurate. There may also be a negotiation on things like the founder's salary, before you get a term sheet, or investment contract.

It is not surprising that a study of deals from the first 14 seasons of Shark Tank revealed that while 60.13% of companies made a deal on air, only about 48% of those deals actually closed.

Aside from investors not proceeding, in some cases, the founders themselves may get legal advice on the terms proposed by the 'Shark' and choose not to move forward. In this section we look at a list of some of the issues that founders need to address, and issues that need to be negotiated before a deal is 'inked'.

Private equity and venture investors should be regarded as more shrewd and seasoned investors, particularly in relation to any equity crowdfunding or friends and family round you close. In equity crowdfunding and friends and family rounds, by in large, you set the terms of the deal and investors decide if they will play ball or not. That is, in equity crowdfunding offerings, there isn't an opportunity for the crowd to negotiate, nor would such negotiations with hundreds of people be practical. Friends and family rounds may be subject to some negotiation, but likely not to the same extent as a private equity or venture investment, where the investors typically set the deal framework in a term sheet.

The Process

The typical process for onboarding venture and private equity investors starts with entering a non-disclosure agreement. This puts your company in a better position to disclose certain confidential information about your tech, your finances, trade secrets etc., as part of a due diligence process. After conducting their due diligence, the investors will decide whether they want to proceed with an investment and start negotiating on the deal structure. To do so, the investor typically presents the company with a term sheet, setting out the high-level terms on issues like:

- The type of security (for example, convertible debt vs equity);
- The class of shares and their corresponding liquidation preferences. Liquidation preferences determine the payout order to investors (i.e. return of their capital) in the event of a company's liquidation or insolvency;
- Voting and dividend rights;
- The valuation (price per share);
- Anti-dilution protections, such as rights of first refusal on new share issuances;

- Information rights, for example, some firms negotiate for the right to see company documents as if they were a board member, even if they have no board nominee;
- The use of the proceeds from the investment; and
- Some investors will want an employment agreement with the founders to make sure their salary expectations are set, and maybe have the founder's shares tied to a vesting schedule. They may also want non-compete and non-solicit obligations in the employment agreements, among other provisions.

Professional investors will be pointed in negotiating their term sheet, hitting all the pain points for founders around ownership (percentage of equity), control (board seats etc.) and minority shareholder rights.

While some of the issues you negotiate with a private equity investor will replicate the issues you cover off in a founder agreement (as we discussed in previous chapters) the considerations are fresh in the private equity and venture capital context.

Negotiating Ownership and Control in Venture Capital and Private Equity Deals

The classic struggle between founders and investors is over ownership and control.

Often those two concepts are misconstrued by founders. It is easy to assume that your level of equity ownership of a corporation dictates your level of control of that corporation. While that can be true, experience venture and private equity investors often try to extend their control of the company despite being minority shareholders. It is for that reason that understanding the dynamics between these two concepts is crucial when negotiating investment deals.

- **Ownership:** Ownership refers to the percentage of a company held by its various stakeholders, including founders, employees, and investors. In an investment transaction, investors acquire a portion of the company's ownership through equity, which dilutes the ownership of existing stakeholders. It's essential for founders to understand and manage dilution (and anticipate how future share issuances will impact ownership and control) while raising capital.
- **Control:** Control relates to the decision-making authority within a company. VC and private equity investments often include control provisions such as board seats, protective provisions (veto rights on specific decisions), and other governance mechanisms. Control provisions can impact a founder's ability to make independent decisions and may sometimes result in conflicts between founders and investors.

The perfect illustration is Mark Zuckerberg's ownership and control of Meta. At the time of writing, Zuckerberg owned just 13 percent of Meta's stock, but controls 61.1 percent of the shareholder vote. This is achieved, in Zuckerberg's situation, because Meta has two separate classes of voting shares. Class A shares grant one vote per share and Class B shares hold 10 votes per share. Zuckerberg owns 99.8 percent of the Class B stock available, allowing him to outvote the Class A shareholders in many instances.

What Zuckerberg achieved with a class of shares carrying additional voting rights, private investors may seek to achieve using other mechanisms. For example, it is not uncommon to see minority shareholders, who are making a large investment in a company, seek:

- Board seats, where they have oversight over their investment and may seek to influence other board members, or even seek to have a deciding vote in the event of a tie;
- Various types of anti-dilution protection;
- Veto rights on decisions like:
    - Raising more money and issuing new shares (or other securities like employee stock options);
    - Paying dividends;
    - Management salaries;
    - Hiring and firing;
    - Spending on certain assets and capital expenditures;
    - Selling the company;
    - Buying shares back from other shareholders;
    - Entering mergers or large deals;
    - Changing the nature of the business; and
    - Commencing or settling lawsuits.

Investors like Mark Cuban may even go further and require that his team take over aspects like accounting and website design.

Consider the two extremes, in terms of investors seeking control. On one end of the spectrum you have passive investors who do not partake in management and have no appointee on the board of directors. On the other, you've got an investor with a right to appoint one or more board members, rights to approve budgets and spending or even appoint management (CEO's etc.). As the company requires additional cash, consider that VC and private equity investors may seek additional board seats, further impacting the element of control.

Some investors will be content to be passive, step back and let their money ride, trusting the founders to move the needle on the investment and growing the company. Others will require significant control, or plan for contingencies to take control in the event the company is not performing. The role of the entrepreneur is often to negotiate for the former; to maintain control. Seasoned investors often want the latter, some element of control, beyond what their 1 vote per share would carry when it comes time to elect the board.

You can see how dramatically the control rights in an investment transaction or shareholder agreement can impact the outcome of the company, how it is managed and decisions that get made on its growth trajectory.

Some founders turn to entering voting trust agreements with their friends and family, or other passive or early-stage investors, to lock up the right to vote their shares at shareholder meetings, further extending their voting control of the company. This can be helpful in later rounds of financing where, without the votes being assigned, you would lose the ability to control 50% +1 of the vote.

When engaging with professional investors, many first-time founders do not appreciate control as an issue, until they engage a lawyer (sometimes after a term sheet is signed) and the lawyer explains the impact of the control mechanisms in their particular circumstances.

First time founders are often excited to get a cheque, announce their company raised money, and get to work. They want the lawyer to just get the deal done fast, and not nit-pick a term sheet or shareholder agreement, line for line. Those types of clients can be hard for lawyers to advise. Undoubtably, the lawyer will be in the background advising them on all the nuances to the deal, and how various provisions may impact their control of the company either when the deal closes, or sometimes, down the road.

Those same clients, who may not heed their lawyer's advice, will be surprised when the investor's board appointee calls a meeting wanting to discuss the burn rate and the founder's compensation. It is all fun and games when the cash is fresh and no tough decisions have to be made. However, when cash is tight, the burn rate is high and investors are worried about their investment, you should assume VC and private equity investors will shrewdly protect their investment and exercise the rights, over control, to the maximum extent possible.

That may mean influencing the termination of employees or founders, selling divisions of the business etc. Or worse, it could mean that if the same VC or private equity firm as debts outstanding, that they exercise rights to liquidate company assets to repay their debts, and take further control of the company or its main assets (software code, trademarks etc.)

Striking the Right Balance

The key to successful investment negotiations is knowing the ownership vs control issue exists and being proactive with investors about your expectations on both. For some founders, giving up any bit of control may be a deal breaker. Others may be so motivated to get a cheque that ceding a level of control to investors is worthwhile; to keep the company alive or accelerate growth.

While investors will naturally seek a level of control to safeguard their investments, in my view founders should ensure they maintain sufficient ownership and control to guide the company's vision and make critical decisions. This can require careful planning (including in a shareholder agreement) with foresight around future share issuances and rounds of investment.

There are many moving parts and various mechanisms that impact control. Scenarios may exist in the company's trajectory that materially change the control issue. Take for example a situation where a co-founder exits a company and resigns from the board. Originally, both co-founders might have had the combined voting power to pass board resolutions (with 2 of 3 board members), with a private equity firm having a right to appoint a third board member. However, this dynamic changes when the board is left with only the investor's nominee and the remaining founder. All of a sudden the company faces a 2 of 2 voting situation, where both directors must agree to pass any resolution. In such cases, the control previously held by the co-founders is disrupted, altering the decision-making process substantially.

By understanding the implications of various control mechanisms, founders can strike a balance that aligns their interests with those of investors, while maintaining the flexibility and autonomy needed to grow the business successfully.

Positioning Your Company for Investment

When an investor is deciding to cut a cheque, they will likely undertake legal, financial and business due diligence on you. As part of the financial due diligence, investors will ask for copies of your financial statements, tax returns, audits, credit agreements/lines of credit and other records. In the context of SaaS and e-Commerce companies, they may even ask to see the backend of your online store (showing sales records etc.) or payment processor accounts like Stripe, PayPal etc. to verify revenue and sales figures.

As part of the legal due diligence, whether you are raising money with friends and family, accredited investors, an equity crowdfunding campaign, or institutional investors, you will need to make sure your company has a clean corporate minute book.

As we explored previously, a minute book is a vital record for corporations, holding key documents like the articles and certificate of incorporation, by-laws, meeting minutes, resolutions, share certificates, shareholder registers and records of directors, officers, and shareholders. It's legally required for compliance and governance, documenting corporate decisions and actions. The minute book is essential during audits, legal disputes and due diligence (including when investors are looking to invest, or when the company is being sold).

Investors will want to see the minute book to confirm things like how many shares and other securities are outstanding, who owns them, how the company operates (for example how the by-laws set out calling shareholder and director meetings, whether a chairperson has a deciding vote in the event of a tie, etc.). They may also want to see past board and shareholder resolutions to understand the corporate history, and even look at what past investors and founders paid to acquire their shares.

To make a good first impression with investors and potential acquirers, having your minute book and a due diligence package ready to be shared is essential. It is not uncommon for early-stage companies to overlook their minute book, which requires lawyers to prepare rectification resolutions and update the minute book before investors are on-boarded.

Aside from a well-kept minute book, other legal due diligence items you should be prepared for include things like:

- The company’s capital structure, including a list of holders of any other form of security such as options, warrants or convertible debt, and any agreements affecting the shares of the corporation.
- IP records and registrations, for example, the status of trademark and patent applications and registrations.
- IP licences (either held or granted by the company).

- A list of key employees and the terms of their employment agreements (for example whether they have non-compete or non-solicit obligations).
- Any settled, outstanding or prospective litigation or disputes.
- A list of key suppliers, retailers, resellers or distributors and the terms of their agreements.
- Other material contracts that impact the business (service agreements, contractor agreements, leases, real estate etc.).
- Loan and financing agreements.
- *PPSA* registrations (a topic covered above).
- Information about any parent or subsidiary companies.
- Corporate profile reports and status certificates, showing the company is in good standing.

Keep in mind the above information is not exhaustive, some investors will be more detailed in what they ask for, and others may overlook these types of requests. Some investors may even rely on a lead investor to have done due diligence, resulting in others piggy backing on and assuming the lead investor's due diligence was satisfactory (a mistake many investors in the now defunct crypto exchange FTX made).

Aside from due diligence on the company, investors may undertake due diligence on you as well, as a founder. For example, they may conduct criminal background checks, talk to other investors, talk to your colleagues and other people.

Many founders often view legal due diligence as a routine step following the signing of a term sheet, underestimating its significance. In reality, legal due diligence can profoundly influence a financing transaction. This process impacts key aspects such as the company's valuation, the timing of the transaction's completion, and sometimes, the likelihood of the deal's closure itself.

So, prepare your company for potential investments by anticipating that investors will conduct thorough due diligence, inquiring on the above topics, information and documents. Possessing a comprehensive and organized due diligence package beforehand can streamline the process and facilitate discussions about the business and legal terms of your deal, impressing your lawyer in the process.

Due Diligence on Investors

Just like everything else in life, there are good and bad investors. There are ones that pester founders week after week, acting as a hindrance on your operations. Or worse, ones that are a stain on the company's reputation.

There are others who you may not hear from in years, that you contact from time to time with company updates and maybe a dividend payment. In my view, the perfect investor is one that is somewhere in the middle, but eager to help the company grow when called upon. That may mean they make important introductions, help with recruiting talent or get you a meeting with potential clients.

Strategic investors may act as partners too, for example, a professional athlete like Mike Camilleri (a former NHL hockey player my brother played with) investing in the early days of Biosteel. Camilleri became a major reason behind Biosteel's success, leading other NHL'ers to use and endorse the drink.

Another example of a strategic investor is Tim Ferris, who is rumoured to have done deals where he doesn't invest any capital, but simply takes equity for both endorsing a product and acting as an advisor.

To protect against having a ‘bad’ investor, it’s ok to do some of your own due diligence on accredited or private investors cutting you a cheque. I have seen horrible situations where, for example, a company closed an investment with someone who it later became clear was using ‘ill-gotten gains’ to make the investment. That can later impact the company in many ways, the least of which is a lawsuit tracing the proceeds of the investment, but also making it harder to raise subsequent rounds of financing, or worse, harder to sell the company because of the smell left from the bad actor. If you were an investor doing due diligence and the cap-table had the name of someone accused of fraud in national newspapers, you might pass on the investment.

At a minimum, do some Google and case law research on the investor, but also consider having a lawyer or professional advisor do more extensive due diligence on firms cutting you a cheque. You may even ask VC and private equity investors to put you in touch with the CEOs of other companies they have invested in. This could give you a sense of what they are like to deal with post-closing.

STOCK OPTION PLANS

Employee stock options (ESOs) are a popular form of compensation among start-ups, particularly in the technology sector. Options grant employees the right, but not the obligation, to purchase company shares at a predetermined price, often vested over a period of 3-4 years. This setup aligns the interests of the employees with those of the company, fostering a shared commitment to the organization's growth and success.

ESOs serve as a valuable tool for attracting and retaining top talent. They offer employees a tangible stake in the company, incentivizing long-term commitment. For employers, ESOs can be a cost-effective way to compensate employees, especially when cash flow might be limited. This is particularly relevant in the early stages of a technology company's lifecycle, where rapid growth and scalability are key objectives.

Mutual Benefits for Employers and Employees

From an employer's perspective, ESOs can be instrumental in building a motivated and dedicated workforce. They also help in maintaining a competitive edge in the job market. For employees, these options represent a potential for significant financial reward, should the company's value increase. This dual benefit creates a synergy between employer and employee goals, fostering a culture of ownership and collaboration.

Legal Framework

In Ontario and across Canada, ESOs are subject to legal and regulatory frameworks. Corporate, securities and tax laws are the main areas to consider.

Aside from the main areas of governing law, careful consideration should be given to what class or type of shares are granted pursuant to the plan. Often employees are granted a separate class of shares under the plan which carry different voting and dividend rights. The share class may also have a lower preference on the return of capital in the event of insolvency.

If employees were granted a class of voting shares, for example, the same class of common shares as the founders, it could have a material impact on control and governance of the company. For example, if two founders held 50% of the company, the first employee who exercises options would have the ability to break a tie vote at the shareholder level. For a more detailed discussion on control, see the section above on founder agreements.

For many employees, the overall deal can be difficult to understand. You will face questions about what percentage of the overall equity the employee is being granted. Questions like that can be tricky to respond to simply because the number of options they receive will be fixed, but the number of shares outstanding in the company may vary over the term of the employment relationship. This means that the percentage of equity held may fluctuate. I typically try to have clients avoid discussing percentages for that reason, and focus on the number of shares subject to the option and the then current number of shares outstanding.

Careful consideration related to the disclosure of the overall deal to employees should be undertaken as well. While each employee should have their own lawyer review the terms of the employee stock option plan, option grant agreement, employment agreement, etc., seek your lawyer's advice on disclosing a summary of the plan, agreements and issues like (among others):

- The exercise price to acquire shares under the option agreement.
- The vesting period.
- Trigger events that stop the vesting period, including in relation to the cessation of the employee's employment.
- The options and shares not being transferable.
- The company not being a public company and there being no public market to sell the employee's shares upon exercising the option.
- It may be difficult for the employee to assess whether to exercise any stock options before they expire and what the fair market value of the company's shares are at the time the employee decides to exercise.

- Whether there are provisions that can force the employee to sell their shares back to the company, or to a third-party, for example, if the company is being acquired.
- There being no guarantee that the employee will see a return on their investment in purchasing shares in the company and the employee may lose all of their investment.
- Additional employee option grants, and the issuance of any additional shares in the company, will have the impact of diluting the employee's options (or any shares the employee purchases).
- There may be significant taxes the employee will be required to pay in connection with the options and/or the sale of shares once the option is exercised.

Tax Implications of Employee Stock Options

There can be negative tax implications for Canadian companies and the employee stock option plan participants, often arising from three main considerations (although there are many other considerations your accountant and lawyer can advise on): (i) whether the company is (and remains) a Canadian controlled private corporation ("CCPC"), a status defined by tax laws; (ii) whether options were issued at fair market value to the participants; and (iii) whether the participant is a contractor or employee.

CCPC Status

At the time of writing, being a CCPC can significantly impact the taxation of stock options. For Canadian employees of a CCPC, a key benefit is the deferred taxation on the employment benefit associated with the grant or exercise of stock options. Instead of being taxable at the time of exercise, as may be the case with public companies or non-CCPCs, the taxable benefit for employees of a CCPC may be able to be deferred until the options are exercised and the shares are actually sold. This deferral aligns the tax liability with the realization of actual economic gain (i.e. you actually receive cash for the sale of your shares), offering a liquidity advantage to employees.

However, this favorable treatment may be subject to specific conditions, underscoring the importance of seeking legal and tax advice in your specific circumstances.

Fair Market Value of the Options

Issuing options for an exercise price below fair market value can carry tax implications as well. For example, when employees are issued shares at a price below the fair market value, the discount they receive may be considered a taxable employment benefit. The tax on the benefit may also be payable at the time of exercise, rather than the time in which the shares are sold. More importantly, the benefit may be taxed as employment income, not as a capital gain. Consequently, the benefit is taxed at the employee's marginal tax rate, which is typically higher than the capital gains tax rate.

Contractors vs. Employees

Perhaps the most important consideration is whether the recipient of the option is an employee or not. At the time of writing, the tax implications for contractors receiving stock options can be notably less favorable compared to employees. Typically, contractors may face immediate tax liability upon receiving the options, rather than deferring the tax until the options are exercised or the underlying shares are sold, as can be the case for certain employees.

This immediate taxation occurs because the benefit from the stock option grant is considered income for a contractor, taxed in the year the options are granted. This immediate tax burden can create cash flow issues for the contractor, as they incur a tax liability without a corresponding immediate cash gain. That is, in a private company, the contractor receives an option to purchase shares, and once the shares are purchased, they are illiquid, not easily sold. So, the contractor could be left footing the tax bill, even though all they have is illiquid options or shares.

Employees, however, under certain conditions, may be able to realize the tax liability in tandem with either the exercise of the option, or the sale of their shares (rather than the date upon which the options are granted).

Additionally, contractors may not benefit from certain other tax deferrals or reductions available to employees. These factors make stock options a potentially less attractive form of compensation for contractors and require careful tax and legal advice if pursued.

Personally, I disagree with the tax policy that leads to granting options to contractors less favorable, and in most cases, not practical. In my view, options granted to Canadian contractors of a CCPC should only be taxable when the contractor actually exercises their options and subsequently sells their shares. This would make the operation of early-stage start-ups (who sometimes lack the budget to hire full-time staff) much easier.

As I am sure you can appreciate from the above sections (only covered in a very short form), the taxation of stock options (and their subsequent exercise and sale of shares) is complex and outcomes can vary dramatically based on various factors such as the type of option, the exercise price, the participant's status with the company and the timing of the sale of shares.

There can be other serious tax considerations that tax advisors can advise you on at the time your employee stock option plan is created, and when you are considering the award of options to participants. Again, seek legal and tax advice in connection with the creation of a stock option plan and the granting of any options under the plan.

End Notes

[1] Factoring is a transaction in which a business sells its accounts receivable to a third party at a discount.

[2] https://innovation.ised-isde.canada.ca/innovation/s/?language=en_CA.

[3] https://www.thestar.com/business/small_business/money/2012/05/15/.
crowdfunding_time_for_canada_to_jump_onboard.html.

[4] https://www.theglobeandmail.com/report-on-business/small-business/startups/economic-potential-of-crowdfunding-is-underrated/article10397500/.

CHAPTER 5: THE USE OF HOLDING COMPANIES

In the section above (*Ensure You Really Are a Separate Legal Entity*), we explored the risks related to ensuring that your corporation is actually a separate legal entity from you, as the shareholder. Those same risks apply whether you hold ownership of your company individually, or via another 'holding company' or 'holdco'. In that section, we covered the 'alter ego' doctrine, as one of the grounds for finding that either you personally, or another corporation you control, could be liable for the debts, duties and obligations of your operating company.

In a separate section (*Quick Notes on Corporate Structuring*), we explored that some founders use intellectual property holding companies, where IP is held by one company and licensed to one or more operating companies.

There are endless types of corporate structures, and various reasons for why those structures are put together, IP holding companies being one of them. Based on other objectives, there are other types of holdco structures that may be put in place. The structure that is right for you may depend on whether you are optimizing for tax planning, the sale of your business, attracting investment from third parties, estate planning (passing your business to another generation) or even asset protection.

For example, one use may be for business owners to regard a holdco as a private pension plan. The owners can accumulate funds in a holding company during high earning years, and then withdraw these funds when they are required, often when they are taxed in lower brackets.

Aside from using separate entities for holding intellectual property, holding companies (whether they hold cash, investments or shares of subsidiary companies, can, if done properly reduce risk, minimize or defer tax (in some situations) and be an effective estate and asset protection planning tool.

However, there is no one-size fits all solution. If you plan to use a holding company, or a particular corporate structure, speak with an accountant and lawyer first to understand the pros, cons and risks in your circumstances. Choosing a structure and even implementing a structure incorrectly, can not only be counter-productive, but it can also end up achieving the opposite of what you intended; resulting in increased tax and exposed assets.

More complex corporate structures also include the use of family trusts. At the time of writing, family trusts are primarily used in an attempt to allow family members to take advantage of the lifetime capital gains exemption in the event your company is sold. However, that may not be the case at the time you read this.

That said, it is not uncommon, from a liability perspective, for professional advisors to want your operating company, once (or even before) it has sufficient operating capital and cash reserves, to distribute the cash to a holdco.

In Canada, in certain circumstances and for qualifying companies that are “Canadian Controlled Private Corporations”, the distributions of profits up to a holdco may be able to be done on a tax deferred basis. The holdco can then either pay you a dividend when you personally need the cash (which you would be taxed on), or use cash accumulating inside the holdco to reinvest in other businesses, public markets, real estate or other ventures. Again, make sure you obtain tax and legal advice to confirm what the implications are in your circumstances.

If one or more of your operating companies requires part of the cash distributed to the holdco, at a later date, subject to tax rules, you can always look at lending the cash back to the operating company. Ideally, this would be done with a registered security interest over the assets of the business (see the chapter above on "Founder Loans and Understanding Promissory Notes and General Security Agreements").

Such loans should also be done formally in an agreement, in compliance with applicable law, any shareholder and other agreements in place. Keep in mind that there can be tax rules (and negative tax consequences) around such loans, and their repayment. Before making any such loans, they should be coordinated with your accountant and lawyer. For example, there is a risk that loans from a holdco back to an operating company could be characterized as a shareholder benefit or a deemed dividend, which could have tax implications. Again, get specific advice on this from a lawyer and accountant based on your circumstances.

From a liability perspective, there is a saying among lawyers that "*litigation is the search for the solvent defendant*". Defendants with money and assets (or a good insurance policy) are more appealing litigation targets. I have said elsewhere that nothing attracts litigation more than a business with financial success. For some, their planning involves moving excess cash, that is not required for the operation and growth of the business, to a holdco or another entity that can be used for investment and other purposes, instead of using or investing that cash directly from within the operating company.

Of course, this decision is one that gets made by a board of directors, so if you are not the sole director, it is a decision by the board as to whether there is excess cash, and if so, whether it will be paid out to the shareholders.

While many growth companies won't pay a dividend, because they reinvest cash back into their own business to accelerate growth, businesses that accrue excess cash on the balance sheet leave that cash exposed to lawsuits, judgments and claims against the business. For this reason (and obviously to reward shareholders for their investment) dividends may be paid out on a regular basis.

However, under Ontario law, and other provinces, you cannot transfer assets out of an operating company, or even pay dividends, where (i) the company is insolvent (and possibly even when the company is in the 'air of insolvency' (i.e. close to being insolvent); or (ii) where the payment or distribution was made with the intent to defeat or hinder a creditor who is owed money or assets. In that respect, section 2 of the *Fraudulent Conveyances Act* (Ontario) says:

> *"Every conveyance of real property or personal property and every bond, suit, judgment and execution heretofore or hereafter made with intent to defeat, hinder, delay or defraud creditors or others of their just and lawful actions, suits, debts, accounts, damages, penalties or forfeitures are void as against such persons and their assigns."*

This means that if part of your planning, in having a holdco, is to have a place to invest cash (possibly) outside the reach of judgment creditors, dividends should only be paid where there is no 'intent' (or even the risk of a perceived intent) to defeat a creditor. For some, this means their operating company profits are paid to shareholders on a regular basis, following a duly passed board resolution, as and when excess cash is available. This can avoid the risk of your operating company panicking and transferring lump sum amounts, potentially violating the *Fraudulent Conveyances Act*, at a time when there may be a claim or threat of a claim against the company.

With that in mind, before you undertake any corporate structuring work, or the distribution of assets or dividends out of the company, make sure your lawyer advises you on how the F*raudulent Conveyances Act* (and similar legislation in other provinces), may impact your structure, the ongoing operation of your company and the distribution of profits.

Your lawyer and tax advisor may advise you, in your circumstances, that it would be a good idea to regularly distribute excess cash, in regular intervals, to try to avoid the problem of claims or potential claims arising before the payment of dividends or excess cash is made. As mentioned, in those situations, the payment of dividends could be unlawful. Similarly, there is a risk that if done improperly, creditors could seek to unwind any payments your operating company makes to your holdco, or worse, seek an order from a court that the holdco is, in effect, one in-the-same entity as your operating company for the purpose of liability.

I know I have been relentless on the point to get legal advice in this area, before you undertake any form of structuring, but I will reiterate it again. Why? There are very important rules and case law to follow, as guidance, for how to properly operate both your holdco and the related operating company in various situations, to assure (i) they are not making distributions that could be unwound, (ii) they are not commingling assets (a risk under the alter ego doctrine) or (iii) otherwise taking risk of being found, by a court, to be one in the same entity for the purpose of liability. Very careful legal advice should be sought to ensure you are setting up and operating your holdco entirely separately and that it is legally distinct from the operating company.

You should equally obtain tax advice as the use of holdcos can also have negative tax consequences and complicate a share sale transaction if you intend on selling your operating company one day.

CHAPTER 6: SECURING INTELLECTUAL PROPERTY RIGHTS

Intellectual property (IP) emerges as the cornerstone of a tech start-up's value and competitive edge. Without the ability to protect your IP, many tech companies would be worthless. As a founder, properly navigating copyright, patents, and trademarks can make or break your business.

Copyright shields the originality of your code and content, patents defend the novelty of your inventions, while trademarks are the banners under which your brand's trust and recognition are secured.

As we delve into the intricacies of each, you'll unveil just how important IP protections are in the context of your own business. If protected properly, you can use various forms of IP protection to build a moat around your business and your brand.

For start-ups, one of the most important steps to take in the early stages of the business is to ensure that the ownership of IP is securely established. IP ownership issues common for start-ups include:

- Ensuring that the founders, and not their previous employer or university own the IP;

- If owned by the founders (prior to starting the company), transferring or assigning their IP to the company; or
- Coming to some form of licensing agreement in which the IP is licensed from the founder to the start-up;
- Ensuring future work to develop IP created by founders, employees and contractors becomes the company's property; and
- Ensuring founders, employees and contractors cannot use the start-up's IP to compete with you (i.e. confidentiality, non-solicit and non-compete agreements, where the law permits them).

Where start-ups fail to consider these points, they often face a co-founder dispute, or worse, a dispute with a previous employer or third party who claims ownership of (and even the profits from) the IP your company relies on.

COPYRIGHT, COMPUTER CODE & TECH START-UPS

Copyright law in Canada protects "*original*" works of authorship, including literary, artistic, dramatic, and musical works. While various tech and e-commerce start-ups will be impacted by the *Copyright Act* differently in Canada, for the purpose of this book, we will be primarily focusing on the application of copyright to computer code.

That said, copyright is important in all different facets of a business, everything from your social media images and videos, product images and designs to art or music you may be selling.

The Canadian *Copyright Act* has a round-about way of nailing down protections for computer source code. If you are a software start-up, it is important to at least once, read the text of the legislation that forms the foundation of your business; section 3 of the C*opyright Act.* It states (I removed certain irrelevant subsections for software start-ups):

> *3 (1) For the purposes of this Act, copyright, in relation to a work, means the sole right to produce or reproduce the work or any substantial part thereof in any material form whatever, to perform the work or any substantial part thereof in public or, if the work is unpublished, to publish the work or any substantial part thereof, and includes the sole right*
>
> *(a) to produce, reproduce, perform or publish any translation of the work,*
>
> *(b) […],*
>
> *(c) […],*
>
> *(d) in the case of a literary, dramatic or musical work, to make any sound recording, cinematograph film or other contrivance by means of which the work may be mechanically reproduced or performed,*
>
> *(e) […],*
>
> *(f) in the case of any literary, dramatic, musical or artistic work, to communicate the work to the public by telecommunication,*
>
> *(g) […],*
>
> *(h) in the case of a computer program that can be reproduced in the ordinary course of its use, other than by a reproduction during its execution in conjunction with a machine, device or computer, to rent out the computer program,*

(i) […], and

(j) in the case of a work that is in the form of a tangible object, to sell or otherwise transfer ownership of the tangible object, as long as that ownership has never previously been transferred in or outside Canada with the authorization of the copyright owner, and to authorize any such acts.

Literary work is then defined as:

literary work includes tables, computer programs, and compilations of literary works;

A “computer programs” is defined as:

computer program means a set of instructions or statements, expressed, fixed, embodied or stored in any manner, that is to be used directly or indirectly in a computer in order to bring about a specific result;

Computer programs, as a form of literary work, are therefore protected under the *Copyright Act*. So long as the work is “original”, and otherwise capable of copyright protection, creators can automatically obtain copyright upon creating the work, without a requirement that the copyright be registered.

While copyright holders can register their interest in the work, registration is not required to be afforded copyright protection. Registration will however help establish that you were the first author and creator of the work in the event of a dispute. A certificate of registration can be used in court as *prima facie* evidence of ownership (which could still be challenged in various circumstances).

At the time of writing, copyright protection under the Canadian legislation lasts for the remainder of the calendar year in which the author dies, and a period of 70 years following the end of that calendar year (see section 6 of the Canadian *Copyright Act*). Different rules apply in different circumstances, including for example, where the author is anonymous or pseudonymous.

That said, there are lots of qualifications or conditions for the subsistence of copyright in the legislation, which we won't delve into for the purpose of this book. If you are building computer software (or other original works to which you believe copyright applies) you should consider obtaining a legal opinion from your lawyer to confirm that you do in fact have copyright protection (and if so, where).

Copyright protection can get complicated, for example where multiple people (founders, employees, contractors etc.) are all working on the software, and they all may have different contractual terms related to the assignment of the IP rights underlying their contributions. Perhaps some of the development relied on open-source software, or licences obtained from GitHub or other repositories. If so, there may be impacts on the overall protections afforded to the complete version of the software.

To make matters more complicated, while copyright may apply in Canada, the nature of your company may require you to consider international copyright implications for your software or product, including the implications or application of various international treaties, like the:

- **Berne Convention for the Protection of Literary and Artistic Works:** Canada is a signatory to the Berne Convention, which sets the minimum standards for copyright protection worldwide (in signatory states). It has a framework to protect works created in one member country in other member countries.

- **WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS):** The TRIPS Agreement, part of the World Trade Organization (WTO), requires member countries, including Canada, to provide strong protection for intellectual property rights, including copyright. It sets out standards for enforcement and dispute resolution.
- **WIPO Copyright Treaty (WCT):** The WCT is administered by the World Intellectual Property Organization (WIPO) and deals with digital copyright issues. Canada is a party to this treaty, which addresses the challenges posed by the digital environment and the protection of works in digital formats. Canada passed the *Copyright Modernization Act* to implement treaty provisions in domestic legislation. Key changes that were implemented include (among others): (i) the mash-up exemption, discussed below; and (ii) provisions on technological protection measures (TPMs), which make it unlawful to break digital locks, to better facilitate digital rights management.
- **WIPO Performances and Phonograms Treaty (WPPT):** The WPPT is administered by WIPO and focuses on the rights of performers and producers of phonograms in the digital environment. Canada is a party to this treaty, which complements copyright protection.

In my view the most important concept to understand in copyright law, as it applies to computer programs and apps, is that while copyright can (not in all instances) stop others from making copies of your programs or applications, they could still create and protect their own programs and applications that do the same thing (i.e. have the same functionality) as yours, through different underlying source code.

If you want to protect a particular feature or functionality related to your software, you will need to consider whether the functionality is something capable of patent protection. Otherwise, in terms of intellectual property, you can also consider the importance of your brand in relation to the software code and register trademarks in connection with the application; maybe your brand wins, like Facebook over MySpace.

This leads to the important topic of what constitutes copyright infringement in the software context. If you haven't watched it, go watch Tetris on Apple TV, which has the incredible story of the foundations of the Tetris computer game software code and the complex negotiations for Nintendo to acquire the rights to the game. It will give you a new appreciation for the important of copyright laws.

In the Canadian (Ontario) context, one of the most important rulings (in my opinion) was the 2002 Ontario Court of Appeal cased called *Delrina Corp. v Triolet Systems Inc.* The case dealt with a number of copyright issues in the context of software applications and source code. The plaintiff Delrina Corp. hired a developer (Brian Duncombe) to improve an application called Sysview. After leaving Delrina Corp., Duncombe began working for the defendant, Triolet Systems Inc., to design an application functionally similar to Sysview, which would compete directly with it.

Delrina Corp. brought an action for copyright infringement against Duncombe and Triolet Systems Inc., alleging that Duncombe copied Sysview. An expert retained by the defendant said that while the two software programs were functionally similar, there were no substantial parts of the program that were copied. This was evidence the trial judge, and in turn, Court of Appeal accepted.

The Court of Appeal ruled that:

> *The proper analysis, which [the trial judge] applied, was to determine whether Sysview as a whole was entitled to copyright and then to determine whether the quality and the quantity of part reproduced by [Duncombe] was a substantial part of the whole. The trial judge properly considered whether the elements of Assess alleged to be similar to Sysview were entitled to copyright protection. In this case, the trial judge found that all of the alleged similarities, including similarities in the arrangements of elements, were dictated by functional considerations or otherwise not protectable by copyright. It is a fundamental feature of copyright law that copyright protects only original expression. It does not protect the idea underlying the expression, and it has been recognized that the non-protection of ideas embraces the view that there is no copyright in any arrangement, system, scheme or method for doing a particular thing or process.*

The Court of Appeal found that because there were no "*substantial*" portions of the original software code subsisting in Triolet's new software, there was no unlawful copyright infringement. The Court clarified that:

- The law of copyright goes beyond copying from something that is physically before the person who made the copy. It includes copying from memory, even subconscious memory;
- However, functional similarities between two computer programs is not necessarily evidence of copying or copyright infringement;
- Some similarities between two programs resulting from a developer's style and experience does not mean one program was a copy of the other giving rise to unlawful infringement;
- The key test is whether someone copied a "*substantial*" part of the software code. To determine whether a substantial part of

your code has been copied, the court said, "*Whether a part is substantial must be decided by its quality rather than its quantity*" and the analysis starts by looking at the work as a whole and not small individual parts of the work.

Perhaps the most obvious outcome of the case is that making this determination, as a judge (without software code training) doesn't lead to an obvious outcome in all cases. Determining whether two apps are functionally similar may not be all that difficult. But doing a line for line comparison of the code is; hence why having an expert witness was so important in the *Delrina* case.

Aside from that, the key take-aways from *Delrina* are:

- To ensure that you try, by contract, to restrict your employees, contractors and co-founders (or shareholders) from competing with you (in terms of the app's functionality) for some period of time, to the extent the law permits it (a tricky subject in and of itself); and
- Restrict, by contract, your employees, contractors and co-founders (or shareholders) from taking confidential information, like source code, and using it for some alternative purpose; and
- Considering, at an early stage, if the functionality of what you build is capable of patent protection.

Exceptions to Copyright

We covered the fact that copyright can subsist automatically in your work, subject to certain qualifications. To make matters more complicated, even if you have copyright protection under the *Copyright Act* in Canada, others can still rely on exceptions to copy your works for various purposes.

Section 29 of the *Copyright Act* covers a list of the exceptions under the umbrella of 'Fair Dealing'. The fair dealing exception allows for use of copyright-protected works for the purposes of:

- Private Study
- Research
- Review
- Criticism
- News Reporting
- Education
- Parody
- Satire

Mash-Ups and Memes

More recently, section 29.21 was added to the *Copyright Act* to add an exemption which some refer to as the 'mash-up' or 'meme' exemption. Section 29.21 outlines that it's not an infringement of copyright for an individual to use an existing work in the creation of a new work under certain conditions, including:

- The new creation is non-commercial;
- The source of the original work is cited;
- There are reasonable grounds to believe the underlying work does not infringe copyright; and
- The new work does not have a substantial adverse effect on the market of the original work.

Whether one of the above exceptions to copyright applies can be a complicated matter to determine. Courts have grappled with determining whether copyright exist, and if so, whether an exemption applies in various circumstances for years and in various fact patterns. That determination isn't so obvious all the time. It is a determination that turns on the facts of each individual case.

Copyright Case Examples

One case that I thought was more obvious, but went to trial, nonetheless, was *Trader v. CarGurus*. CarGurus, a digital car marketplace, used web-scraping to collect car listing data from various sites, displaying them on its platform. Some listings contained photos owned by Trader Corporation, which operates autotrader.ca. Upon discovery, Trader demanded the removal of their photos from CarGurus' site, and later sued CarGurus for copyright infringement concerning thousands of car photos.

The court examined if the photos were protected by copyright and owned by Trader, whether CarGurus infringed on this copyright, and if CarGurus could claim the "*fair dealing*" defense under the Canadian *Copyright Act*. Additionally, it assessed if CarGurus could be exempt from statutory damages as an "*information location tool*" provider under the *Act*.

The court confirmed the copyright protection of the photos, dismissing CarGurus' argument regarding the storage of photos. It found CarGurus had infringed on Trader's copyright as the photos were made available to the public.

CarGurus’ fair dealing defense was rejected, as the purpose behind displaying the photos was commercial, not for research, private study or some other exempt purpose.

Initially, Trader sought statutory damages of $500 for each photo, totalling around $72.5 million, plus punitive damages of $1 million. However, the court awarded Trader statutory damages of $305,604 against CarGurus for copyright infringement.

The case highlights the significance of adhering to copyright laws for online businesses, especially when aggregating or displaying third-party content using web-scraping technology. The damages awarded underscore the financial consequences of copyright infringement.

Copyright and Considerations for Employees and Contractors

While in many situations, where an employee is formally hired (i.e. paid as an employee with a T4 and statutory deductions made for CPP, EI, income taxes etc.) there is a presumption, absent an agreement to the contrary, that the works they create in the context of their employment are being assigned to an owned by the employer.

That same presumption may not apply to founders (for example if they are not being paid a salary) and does not apply to independent contractors. So, whether you are hiring an employee, engaging a contractor or otherwise, you should always have an agreement that clearly addresses the assignment of intellectual property.

In many situations, standard form language governing the assignment of IP created by employees who are software developers or software contractors works just fine. However, in my practice I have come across numerous situations where standard form IP assignment clauses simply don’t work.

The essence of a standard form assignment clauses, in both employment and contractor agreements, is that the employee or contractor assigns all of the intellectual property that they create in the course of their employment, or in the case of the contractor, in the scope of their engagement, to the company.

One example of where that could get complicated is if you engaged a contractor to build some form of app or widget that they have previously built for others (i.e. on a white label basis), and all they are doing for you is tweaking the baseline code, maybe amending some of the functionality, but rebranding the app or portal.

In those situations, assigning the IP may not be feasible, but granting a perpetual and irrevocable commercial license to the code and deliverables may be.

As another example, consider the situation where you engage a contractor to implement or fine tune some form of open-source software (or mash together various open-source or licensed code bases). I have seen at least one situation where a contractor was using open-source software for implementing the bulk of a project's code (baseline code for a SaaS platform), and the client wasn't aware of that fact.

So, the client thought they paid for the development of unique and proprietary code base (capable of copyright protections), and contrary to their agreement with the contractor (which was boilerplate and said all IP was being assigned) the client came to learn that no such assignment was possible, because the contractor was using open-source software for the bulk of their SaaS platform implementation.

Open-Source Projects

That leads to the discussion of open-source software issues more generally. It is not uncommon for many tech companies to rely, at least in part, on some component of open-source code via open-source repositories, often on GitHub, but also other places.

Caution needs to be had with respect to the terms of open-source licenses you plan to rely on. Just because a code repository is open source doesn't mean you can use it at will. Open-source code repositories often have open-source licensing terms associated with them and it is crucial that you comply with those terms.

The classic example is developers relying on open-source code repositories missing the fact that the code was only open-source for 'non-commercial' purposes. So, if you use that code, or a developer brings that code to your company for you to use for commercial purposes, you could very well be in breach of the license terms (and possibly, therefore, in breach of copyright).

An illustration of this, and to realize how complex this topic can get, is to consider Meta's Llama 2 "Open-Source" licensing terms to permit the use of their large language model. At the time of writing, the Meta license forbids the use of Llama 2 to train other language models, and it requires a special license from Meta if the model is used in an app or service with more than 700 million monthly users.

While that number is large, and appears intended to stop competitors like Apple and Google from using it, the point remains, that (ii) if you hit that threshold, you have a problem under the license; and (ii) "open-source" projects that publish code openly online can still have intricate terms that attach to their use that can be tricky to comply with, or can put you unwittingly in breach of the terms if you (and your employees and contractors) don't consider them carefully.

Moral Rights

Section 14.1 of the *Copyright Act* says:

The author of a work has, subject to section 28.2, the right to the integrity of the work and, in connection with an act mentioned in section 3, the right, where reasonable in the circumstances, to be associated with the work as its author by name or under a pseudonym and the right to remain anonymous.

While moral rights cannot be sold or transferred to anyone else, many employment and contractor agreements call for software developers (and other creators) to waive any moral rights they have in the works they create.

The right to the integrity of the work can safeguard a creator against modifications to, or distortions of, their work that could be prejudicial to their reputation. For software developers, this right is pertinent when others attempt to modify or adapt their code in a manner that could potentially harm their reputation or distort the original intent of the software.

However, most software companies do not want (and do not permit) individual developers to hold such rights (and ask that they be waived), for fear that it may impact the company's ability to adapt or modify future versions of the software in their sole discretion.

In some cases, you will see negotiations on moral rights by developers (when they are asked to waive such rights), to at least permit them to continue to be identified as a create of the software in question.

SHOULD YOU TRADEMARK IT?

Trademarks play a pivotal role and can impact the long-term success of a start-up. Trademarks not only protect a company's brand identity but also assure consumers of the origin and quality of products.

A trademark is a word (or words), a design, or a combination of both, used to identify your goods or services. Your trademark is your identity in the marketplace. Trademarks help your customers distinguish your products and services from others. For successful brands, a registered trademark becomes a valuable asset worth protecting.

In Canada, you can protect your trademark (across Canada) by registering it with the Canadian Intellectual Property Office ("CIPO") and taking enforcement actions against infringers. However, for most software businesses, and many others (since you will likely sell globally), you will want to protect your trademarks globally and not just in Canada.

Justice Binnie of the Supreme Court of Canada said it best, when describing trademarks. He said:

> *“Their traditional role was to create a link in the prospective buyer’s mind between the product and the producer. The power of attraction of trade-marks and other “famous brand names” is now recognized as among the most valuable of business assets. However, whatever their commercial evolution, the legal purpose of trade-marks continues […] to be their use by the owner “to distinguish wares or services manufactured, sold, leased, hired or performed by him from those manufactured, sold, leased, hired or performed by others”. It is a guarantee of origin and inferentially, an assurance to the consumer that the quality will be what he or she has come to associate with a particular trade-mark.” Mattel, Inc. v. 3894207 Canada Inc.*

To be afforded the best level of protection a trademark needs to be registered in the jurisdictions you want to protect its use. However, registration is made under a specific category of goods and services, meaning the protection afforded by registering is to be able to use the trademark, to the exclusion of others, in your particular categories of registration. Great care and legal advice should be sought from a trademark lawyer on what categories of goods and services you will seek protection under, and in what jurisdictions.

Even if you successfully register a trademark, others can still challenge the registration on the grounds that there are pre-existing common law rights that trump the registration. These challenges could include, for example, arguments as to:

1. **Prior Use:** Demonstrating that the trademark was used in commerce before the registration date by another party.
2. **Distinctiveness:** Arguing that the registered trademark has become generic or is not distinctive.
3. **Confusion:** Showing that there is a likelihood of confusion with a pre-existing common law trademark.
4. **Bad Faith:** Proving that the registered trademark was obtained in bad faith, without intention to use.
5. **Non-Use:** A trademark can be expunged if it has not been used for a specific period, typically three years in Canada.

The strength of a common law claim may weaken over time, especially if the registered trademark has been used extensively and has become well-known. It is also important to challenge a registered trademark as soon as possible to avoid issues of acquiescence or delay, which can undermine a common law claim.

The Barbie Case

One example of a trademark being challenged (albeit unsuccessfully) is the case of *Mattel, Inc. v. 3894207 Canada Inc.* (also known as "Barbie's case") which went all the way to the Supreme Court of Canada.

In Barbie's case, Mattel, Inc., the makers of Barbie dolls, opposed the registration of the trademark "Barbie's" by a restaurant business. Mattel argued that the "Barbie's" mark was not distinctive because the public could be confused into thinking that the restaurant was associated with Mattel's Barbie dolls.

The Federal Court of Appeal in 2006 upheld a decision that there was no likelihood of confusion and that the restaurant's mark was distinctive of its services. The court noted that the owner of the "Barbie's" restaurant had established a distinct commercial impression separate from Mattel's dolls, thus upholding the validity of the "Barbie's" trademark registration under the *Trademarks Act*.

The case was appealed to the Supreme Court of Canada, with a final judgement issued in 2006. The Supreme Court upheld the decisions of the lower courts, concluding that there was no likelihood of confusion between the restaurant services offered under the "Barbie's" mark and Mattel's Barbie dolls.

The Supreme Court applied the test, from section 6(5) of the *Trademarks Act*, to the facts of the case, to determine whether the trademark would lead to confusion. In doing so, the Court emphasized the importance of the surrounding circumstances, facts and context of each case.

The relevant test, which was the subject of analysis in the case was:

"…(5) In determining whether trademarks or trade names are confusing, the court or the Registrar, as the case may be, shall have regard to all the surrounding circumstances including
(a) the inherent distinctiveness of the trademarks or trade names and the extent to which they have become known;
(b) the length of time the trademarks or trade names have been in use;
(c) the nature of the goods, services or business;
(d) the nature of the trade; and
(e) the degree of resemblance between the trademarks or trade names, including in appearance or sound or in the ideas suggested by them…"

The Court emphasized that no single factor from the above test is dominant and that the test is not purely mechanical; rather, an assessment must be made on the basis of the facts of each individual case. The decision ultimately rests on whether, as a matter of first impression in the mind of a casual consumer somewhat in a hurry, the trademarks are likely to be confused. To that, they answered "no".

Trademarks - A Complicated Space to Navigate

Trademarks can be a complicated avenue to navigate, especially for online and global companies. Just because your trademark is capable of registration in Canada, does not mean it will be capable of registration in other jurisdictions.

There are instances where a brand starts-up in Canada, gets traction and turns to foreign markets only to realize their mark is already in use in those foreign jurisdictions, and worse, possibly used in the same category of goods and services. This can create major problems, either having to negotiate rights to use the trademark, narrow the category of use or registration, or rebrand your operations overseas.

Other trademark complications can arise from your business pivoting or expanding to sell other categories of goods and services which are not covered by the trademark you initially registered, or contemplated at the time your business was founded.

The 1970's litigation saga between Apple Corps and Apple Computer, which we reviewed previously, shows how an evolving business model and market expansions can entangle companies in trademark disputes. At the heart of the dispute was a seemingly simple matter; the use of the iconic apple logo and name. However, beneath this seemingly straightforward issue lay a complex web of business ambitions and legal agreements.

Apple Corps, founded by The Beatles in 1968, was originally established as a multimedia corporation focusing on music, film, and other creative endeavours. They held rights to a trademarked apple logo, which symbolized their musical empire. In contrast, Apple Computer, established almost a decade later in 1976, initially confined its operations to the world of personal computers. To avoid any potential trademark conflict, the two Apples entered into a prior agreement that limited Apple Computer's scope of business strictly to the realm of computers.

As Apple Computer grew, so did its aspirations. The company's expansion into areas beyond computing, including music-related software and digital music distribution, brought them into closer competition with the main business of Apple Corps. This shift in focus was the catalyst for a trademark dispute. Apple Corps contended that Apple Computer's expansion violated their agreement and constituted trademark infringement. What began as a tech company's innovative journey spiralled into a complex legal battle, illustrating how an evolving business model, and entering new markets, can lead to entanglement in trademark disputes.

Why Protect your Trademark?

A fairly easy and clear trademark case, *Harley-Davidson Motor Company Group, LLC v. Manoukian* shows how registering your trademark can help you stop an infringer.

In Harley-Davidson's case, they were the registered owner of their classic emblem trademark. The defendant, Mr. Manoukian was found to have been selling products bearing the trademark or a mark confusingly similar and was ordered by the Federal Court of Canada to pay damages of more than $115,000 to Harley-Davidson.

However, in the eyes of a founder building a growth start-up, the single most important reason to register a trademark, as soon as possible, is to make your company 'salable'. If you want to sell your business, a buyer will want assurances that the company they acquire has secured the rights to continue to use their name (and brand names) in the markets in which they operate. They may also want evidence you are taking appropriate steps to defend your trademark, and prosecuting those who may be infringing it.

Pretend for a moment that you were going to acquire Coke, the beverage company. If someone told you that there was a real risk the Coke trademark could be invalidated, or that it was not secured in one or more jurisdictions where you operated, would it impact the amount you would be willing to pay for the company? You bet it would. What is the value of the Coke recipe and product, without the Coke brand and trademark?

Well, Coke and its accountants believe, as of 2023, that the Company's trademarks with 'indefinite lives' are worth over $14

Billion. That is according to Coke's financial statements. Another $18 Billion is attributed to goodwill.

On a smaller scale, the same logic applies to any software, e-commerce or other brand you build up in the market. If you have past customers, especially ones who like your products or services, there is goodwill and value in them being able to come back and buy more products or services based on the experience they had. Trademarks encapsulate part of that value.

This concept can be applied equally to investors when you are looking to raise money. Smart investors will not cut a cheque without doing some level of due diligence, which often includes due diligence on your portfolio of trademark registrations. From the investor's standpoint, they do not want to cut a cheque, only to later find out the company did not have the rights to continue to use the brand they were investing in.

In fact, one of the first things potential purchasers of your business (and investors) will do, is give you a due diligence checklist of questions and ask for information related to your trademarks.

The Risk of Not Registering your Trademark

Sometimes, it helps to think of things in reverse. What if you failed to register your trademark? Failing to register may expose your start-up to:

- A greater possibility that someone else demands that you change your branding or stop using a particular name or logo;
- Costs thrown away on marketing and branding you have done to date, and the risk of losing customers you have earned;
- A chance investors do not invest because you do not own your trademark (and the registration process can take a while);

- If you were found to be infringing someone else's trademark, damages, including the possibility of an accounting of profits you made in connection with the infringement.

When should I Register my Trademark?

In short, it is never too soon to take measures to protect your trademark (subject to registration requirements). In many jurisdictions you are required to show that you are using a trademark commercially to proceed with an application. However, consult with your trademark lawyer on whether you can file an "Intent-to-Use" or "Propose to Use" trademark application in the applicable jurisdiction, if you have not yet started using the mark.

"*Intent-to-Use*" or "*Propose-to-Use*" applications may be able to be filed when you have a *bona fide* intention to use the trademark in commerce, but have not yet begun to do so. It may allow you to reserve certain rights to a trademark until you are ready to use it commercially.

Trademark registrations can take a long time (sometimes an exceptionally long time) in Canada to complete; often as much as 12-18 months. This is because the Canadian Intellectual Property office has to appoint an examiner to review your application, consider existing registrations and publish notices to the public who may wish to contest your registration. So again, the sooner the better.

The Mark Cuban Trademark Story

Mark Cuban loves reminding people on X/Twitter and on podcasts that he owns the trademark for the "*City of Champions*". Cuban, a well-known entrepreneur and owner of the Dallas Mavericks, thoughtfully navigated (or became a trademark troll, depending on your perspective) the trademark waters by acquiring the rights to the phrase "*City of Champions*" for a sum of $38,000 to $40,000, as reported by different outlets.

This phrase, coined by another individual, was bought by Cuban with a simple idea: to license the trademark to cities celebrating significant sports victories. The acquisition was officialised through an assignment agreement transferring the trademark to Mark Cuban, according to United States Patent and Trademark Office records.

Cuban's strategic move was spotlighted when, in 2020, following victories by the Los Angeles Dodgers and Lakers, LeBron James expressed a desire to celebrate the city's triumphs under the banner "*City of Champions*". Cuban promptly reminded the public, via X/ Twitter, of his ownership of the trademark, a move that underscored the potential licensing opportunities for the phrase's use on merchandise.

This scenario paints a picture of how trademark rights can be leveraged for financial gain, even in areas tangential to one's primary business operations. It also serves as a cautionary tale to budding entrepreneurs and established business entities alike on the imperative of thorough trademark research, registration, and strategic foresight in the growth of your business, brands and alternative avenues of income.

PATENTS AND YOUR INVENTIONS

A patent is a legal instrument granted by the government that gives an inventor exclusive rights to use, make, sell, and license their invention for a limited period (at the time of writing, 20 years in Canada). Patent protection is intended to encourage innovation by allowing inventors to realize the benefits of their creations.

Computer code by itself is not patentable in Canada. However, a computer program may be patentable if it offers a new and inventive solution to a problem by modifying how the computer or device works. For example, Amazon registered a patent in Canada for the 1-Click Checkout (patent no. CA 2263781), which allows online shoppers to skip the whole shopping cart process.

The patent name is more technical, described as a "Method and System for Placing a Purchase Order Via a Communications Network". Although the patent application was filed in 1998, the patent was not actually issued until 2016! That meant that the 20-year period for the patent expired in 2018.

In the context of start-ups, patents can be crucial for protecting novel and useful inventions, processes, and designs. These protections are particularly vital in competitive industries where a unique invention can be a significant differentiator and a key to business success. Patents not only safeguard an invention from unauthorized use but can make a company more appealing to investors.

The *Patent Act*, RSC 1985, c P-4 in Canada defines and invention to mean:

invention means any new and useful art, process, machine, manufacture or composition of matter, or any new and useful improvement in any art, process, machine, manufacture or composition of matter;

Section 28.3 of the *Patent Act* then says:

28.3 The subject-matter defined by a claim in an application for a patent in Canada must be subject-matter that would not have been *obvious on the claim date to a person skilled in the art or science to which it pertains*

While there are other factors, when combined, these sections are taken to create a framework for determining whether something is capable of patent protection. In summary, the requirements are:

- **Novelty**: The invention must be new.
- **Utility**: The invention must be useful and functional, demonstrating a practical application.
- **Inventiveness**: It must exhibit an inventive step that is not obvious to a person skilled in the relevant field.

In addition, the invention must be a product or process that fits within the categories of patentable subject matter as defined by Canadian patent law.

As there can be implications on your ability to register a patent if the idea or design has been previously disclosed, or made public, you should speak with a patent agent right away if you intend to seek a patent before you make any disclosure of the idea, designs, or functionality.

A patent agent can give you an idea as to the likelihood of success in registering the patent, registration costs and help you consider the various jurisdictions you may wish to register the patent. That is, patents are territorial and must be filed in each jurisdiction where protection is sought.

The patent registration process is not for the faint of heart, especially if you are attempting registration in multiple jurisdictions, which can make the patent process lengthy, intricate, and often expensive. Founders must carefully weigh the potential benefits against the drawbacks before deciding to pursue a patent.

Here is a quick snapshot of the benefits and drawbacks of patents:

Benefits of Patenting

- **Exclusive Rights:** A patent grants the inventor a temporary monopoly, allowing them to exclude competitors from using, manufacturing, or selling the patented invention. This exclusivity can provide a competitive advantage in the marketplace, helping to secure market share and generate revenue.
- **Licensing Opportunities:** Patent owners can license their invention to others, granting them the right to use the invention in exchange for royalties or other forms of compensation. Licensing can be an additional source of revenue and a means of leveraging the value of the patented invention.
- **Attracting Investment:** Patents can be valuable assets that demonstrate the innovation and potential of a business to investors.

Drawbacks of Patenting

- **Cost**: Obtaining (and defending) a patent can be expensive, with costs including filing fees, legal fees, and maintenance fees. Depending on the complexity of the invention and the number of jurisdictions in which protection is sought, the total cost of obtaining and maintaining a patent can be substantial. Even if a patent is awarded, there can also be substantial legal fees associated with defending the patent from others and enforcing your rights.
- **Disclosure Requirements:** To obtain a patent, inventors must publicly disclose the details of their invention. This disclosure

can enable competitors to develop similar products or technologies that work around the patent, potentially eroding the inventor's competitive advantage.

- **Limited Geographic Protection:** Patents are granted on a jurisdiction-by-jurisdiction basis, meaning that protection is limited to the country or region where the patent is granted. Obtaining patent protection in multiple jurisdictions can be costly and time-consuming, and may still leave the invention unprotected in some markets.

Design Patents

In the US, there are separate types of patents you can register, utility patents and design patents. In Canada, we do not have ‘design patents’ per se. Instead, we have the *Industrial Design Act*, which allows you to register designs or ‘industrial designs’, defined as:

> ***design*** *or* ***industrial design*** *means features of shape, configuration, pattern or ornament and any combination of those features that, in a finished article, appeal to and are judged solely by the eye;*

These protect the ornamental design of a functional item, which can be crucial for a business whose product's aesthetic is a key market differentiator.

Apple for example, in National Application/Registration: 203244, has registered industrial designs for their popular AirPods, including the design of the case.

Registering an industrial design in Canada under the *Industrial Design Act* provides several key protections:

- **Exclusive Rights:** The registration grants the owner exclusive rights to the design. This means the owner has the sole right to make, use, and sell any article embodying the registered design.
- **Control Over Reproduction:** The owner can prevent others from making, importing, renting, or selling any article bearing a design that is a copy, or substantially a copy, of the registered design.
- **Infringement Actions:** The owner has the legal right to initiate infringement proceedings against anyone who uses the design without permission. This includes the right to seek damages or an injunction.
- **Commercial Advantage:** A registered design can enhance the commercial value of a product, as it provides a form of branding and can make the product more appealing to customers.
- **Duration of Protection:** The protection for a registered industrial design in Canada lasts up to 15 years from the date of registration.

To register an industrial design in Canada, specific requirements must be met, including, for example:

- **Originality:** Section 2 defines an industrial design as "the features of shape, configuration, pattern or ornament and any combination of those features that, in a finished article, appeal to and are judged solely by the eye." This implies the requirement for originality.
- **Visual Appeal:** This is inherent in the definition in Section 2, focusing on features that appeal to the eye.
- **Association with an Article:** Section 2 also specifies that the design must be applied to a "finished article," establishing the association with a physical object.

- **Novelty:** Section 8(1) mentions that an application must be filed within one year after the design was first published anywhere in the world. This establishes the novelty requirement and the grace period for public disclosure.
- **Not Solely Dictated by Function:** Although not explicitly stated, the focus on features judged solely by the eye in Section 2 suggests that the design must have aspects not dictated solely by function.
- **Visibility in Normal Use:** The requirement for visibility in normal use is implicit in the definition of an industrial design in Section 2, as it must be a feature of a finished article that appeals to the eye.
- **Proper Representation and Description:** Section 6 of the *Act* requires that an application for registration of a design include drawings or photographs of the design and a description of the design.

After filing, a CIPO examiner reviews the application and conducts searches for similar designs to identify any objections. Typically, securing an industrial design registration takes 12 to 18 months from filing to registration, and it may extend beyond this period. For example, Apple's AirPods design was submitted for registration on May 3, 2021 and registered on January 16, 2023.

Patent Trolls

Known as patent trolls, non-practicing entities (NPEs), or patent assertion entities (PAEs), these are individuals or companies that obtain patents solely to demand licensing fees or legal settlements from businesses claimed to infringe their patents. Patent trolls don't engage in creating, manufacturing, or selling any goods or services related to their patents. Instead, their income is derived from using the intellectual property they possess or manage, employing confrontational legal strategies to do so.

Patent trolls build patent portfolios, often acquiring patents of questionable quality or broad scope. These patents can be purchased from inventors, defunct companies, or other patent holders looking to monetize their intellectual property. Armed with these patents, trolls target businesses with infringement claims, demanding licensing fees or threatening costly litigation.

Defending against a patent infringement lawsuit can be very expensive. Patent trolls exploit this by proposing settlements for amounts lower than the cost of litigation. As a result, many businesses, even those confident they have not infringed, choose to settle to avoid the high costs and uncertainty of a long legal battle.

Why Founders Should Be Concerned

Patent trolls pose a threat to founders for several reasons:

- **Financial Burden:** The cost of defending against a patent infringement claim can be overwhelming for start-ups, diverting money and people away from innovation and growth.
- **Stifling Innovation:** The aggressive tactics employed by patent trolls can deter founders from developing new products and technologies, fearing the potential for costly infringement claims.
- **Loss of Market Advantage:** A successful infringement claim by a patent troll can undermine a company's market advantage, forcing them to abandon a key product or technology or pay substantial licensing fees.
- **Reputation Damage:** Being targeted by a patent troll can tarnish a company's reputation, eroding customer trust and making it difficult to attract investors and partners.

To mitigate the risks posed by patent trolls, founders should take proactive steps. These may include conducting thorough patent searches before developing and launching new products, registering your own patents and seeking legal advice from experienced patent lawyers.

While patent trolls get a bad name, the flip side of the equation is that they spent resources to develop or acquire patents, those patents afford legitimate protections, the law gave them a monopoly, for a limited period of time to exploit the innovation and if someone was truly in breach of the patent rights, it is just and moral for them to pay up. There is a difficult to decipher (and vague) line between companies who 'troll' as a business model, with no real intent to develop and sell an underlying product and those that are bona fide in their intentions, to patent an invention, pursue it and block others from capitalizing on their registered invention.

TRADE-SECRETS, KNOW-HOW AND THE IMPORTANCE OF CONFIDENTIALITY AGREEMENTS

Having done a deep dive on the importance of copyright, trademarks and patents to your business, we can't move on without casting a spotlight on a less heralded, yet potent tool in your IP armoury - the confidentiality agreement.

Confidentiality agreements can help keep your invaluable IP secure in interactions that precede or circumvent formal IP registration. Whether you're in dialogues with potential investors, collaborators, or even early-stage employees, a well-forged confidentiality agreement can ensure that your IP and know-how remain shielded from misuse or unwarranted exposure.

Confidentiality agreements operate in the shadows, yet their role is paramount in maintaining the integrity and control over your intellectual property and know-how. There is a synergy between confidentiality agreements and registered IP, each complementing the other when used properly, ensuring that your start-up's innovation remains shielded in the competitive landscape.

You may also have confidential information that isn't capable of IP protections (i.e. not protected by copyright and can't be registered as a trademark or patent) or, for whatever reason, you don't want to register it. For example, you may have source code or algorithms that are protected by copyright that you don't want to register, because registering it would imply that the public can go and look at the registration and see the code. Maybe that leads to people scrutinizing your algorithms. Or maybe the code changes so fast and so frequently, registration wouldn't have that much meaning in the first place.

You may also have 'trade secrets' or 'know-how'; information about how to do something, that if it was known to others, or widely distributed, it could impact your competitive advantage, especially if you were not able to register any IP that protects your exploitation of the information.

IP registrations for copyright, trademarks and even patents may not save the day and protect the essence of what it is you want to protect. In these situations, a confidentiality agreement can fill and important gap and are often used (and sometimes abused) to protect start-ups and companies at all different stages.

One great example is Coke's recipe for their famous beverage. It has notoriously been protected and only available to a limited number of company executives, each bound by meticulous confidentiality agreements.

And while having a confidentiality agreement in place is important, so too is taking practical steps to protect against disclosure. As just an example, I became aware of one company in my practice that had a document they viewed as so valuable to their business that they only allowed people to see it in a special room and after viewing, it was put back in a safe for future use. No copies were allowed, and everyone was required to sign an NDA before walking into the room.

In Canada, common law court precedents have numerous examples of litigants enforcing confidentiality agreements, which are common not just in the employment setting, but in shareholder and founder agreements as well. Often, smart investors will not cut a cheque without assurances that the founders, employees and consultants to the business are bound by some form of confidentiality obligation to protect the company's trade secrets and know-how.

INTELLECTUAL PROPERTY RIGHTS AND THE RISE OF AI

Artificial Intelligence (AI) has rapidly emerged as a transformative technology, revolutionizing various industries and raising new legal and ethical questions. As AI systems become more prevalent, understanding intellectual property rights associated with AI innovations is crucial for businesses and entrepreneurs.

AI-Generated Creations

AI systems can generate a wide range of creative outputs, including music, visual art, literature, and inventions. These creations pose unique challenges to traditional IP frameworks, which are based on human authorship and inventiveness. At the time of writing, in most jurisdictions, copyright, patent and trademark law are somewhat unclear in relation to AI as an author or inventor.

As AI continues to advance, the legal landscape surrounding IP rights and AI is expected to evolve. Policymakers and stakeholders are actively debating the need for new legal frameworks to address the challenges posed by AI-generated creations. Founders should stay informed of these developments and engage with industry associations, legal advisors, and policymakers to shape the future of IP law in the context of AI.

At the time of writing there are outstanding cases proceeding through the US and other judicial systems related to using data within AI models to produce new content and whether doing so (i) may breach the rights of copyright and trademark holders; and (ii) whether (or when) the resulting work, produced by AI, is capable or copyright and trademark protection. Likewise, there remains a question as to whether a patent can be registered in respect of an invention made by using AI. While that point may have been settled in the United States[1], it does not appear to be settled in other jurisdictions.

The rise of AI has significant implications for IP rights, presenting both challenges and opportunities for businesses and entrepreneurs. As the legal landscape continues to evolve, understanding the complex interplay between IP law and AI will be crucial for many businesses.

End Notes

[1] See “US Supreme Court rejects computer scientist's lawsuit over AI-generated inventions” Reuters, Blake Brittain https://

www.reuters.com/legal/us-supreme-court-rejects-computer-scientists-lawsuit-over-ai-generated-2023-04-24/. Accessed on January 2, 2024.

CHAPTER 7: EMPLOYEES AND CONTRACTORS

As businesses expand, entrepreneurs need to decide between hiring independent contractors or employees. Both choices have pros and cons, as well as risks and responsibilities. This section helps explain the differences between these work arrangements and the possible outcomes of incorrect classification.

Independent contractors are self-employed individuals who provide services to clients through their own businesses. They work on specific tasks or projects and are not part of the client's business. On the other hand, employees provide services to an employer as part of the employer's business and are subject to the employer's control and policies.

MISCLASSIFICATION RISKS

Hiring independent contractors can save money and reduce paperwork, since there are fewer legal responsibilities (like payroll taxes, CPP, EI and other withholdings) compared to employees. However, if a worker is wrongly classified as an independent contractor, when they ought to have been classified as an employee, employers can face serious consequences. One set of consequences arise as a result of tax laws, and the other due to employment laws.

Potential Liabilities

If a worker is misclassified as an independent contractor, employers may be exposed to various liabilities, including (among others):

1. Penalties for non-payment of wages and taxes that comply with applicable minimum standards legislation and tax laws (meaning you could be ordered to pay back-taxes);
2. Compensation for losses suffered by workers due to minimum standard violations (for example if minimum wage laws were not met or termination pay not given);
3. Orders to change employment practices to comply with minimum standards; and
4. Fines for minimum standard violations.

Additionally, employers may face financial consequences for misclassification in relation to payroll deductions, such as unpaid employer and employee CPP and EI contributions, penalties for non-deduction or non-remittance, and fines.

In some cases, where the company is not in compliance, directors can also be personally liable for things like unpaid wages, penalties and taxes.

Minimum Standards Legislation and Workers' Compensation

Misclassified workers may be entitled to additional payments upon termination under minimum standards legislation. Employers may also be required to participate in workers' compensation regimes for misclassified workers, leading to potential liabilities, such as payment of retroactive contributions, costs associated with worker injuries, and fines.

DISTINGUISHING BETWEEN INDEPENDENT CONTRACTORS AND EMPLOYEES

Determining the status of a worker can be challenging, as they may not fit neatly into either category. Courts and administrative tribunals apply various tests to determine whether a worker is an independent contractor or employee. Factors to consider include (among others):

1. The level of control the employer has over the worker's activities.
2. Whether the worker provides their own equipment.
3. Whether the worker hires their own staff.
4. Whether the worker has other clients he or she does work for (indicating they are operating a *bona fide* business).
5. The degree of financial risk taken by the worker.
6. The degree of responsibility for investment and management held by the worker.
7. The worker's opportunity for profit.

Given the potential risks and that the facts and circumstances change from worker to worker, it is always a good idea to have a lawyer advise you on properly classifying workers. It is also worth considering categorizing a worker as an employee if there is a risk the individual may be improperly categorized. I have seen some companies engage *bona fide* contractors in the short term and, where appropriate transition them to an employment relationship if the person is going to stay beyond some fixed term project.

In a world where you may want to hire workers across not only Canada, but around the world, additional complications may arise under the laws of the jurisdiction where the worker is based. For example, if you are a tech company in Ontario, and you want to hire someone in BC, the laws of BC will likely govern the employment relationship, so you will want a BC lawyer advising you on the application of BC law and the employment agreement. The same may be true if you want to hire, or even engage a contractor in a jurisdiction outside of Canada.

To make matters more complicated, where you hire an employee in another province, you would need to consider whether that triggers a requirement that your business be registered in that jurisdiction (a process called extra-provincial registration), to be permitted to carry on business there. This may be regardless of whether the employee is in an office or working from home. If such registrations are required, it will have tax implications, and you may be required to file tax returns in that jurisdiction if your business is extra-provincially registered there.

As you can see, the legal issues add up which often make engaging a worker as a contractor, at least initially, appealing while facing the real risk of misclassification.

As a result, in Canada, to mitigate the tax risks that go with improper classification, businesses can request a ruling from the Canada Revenue Agency (CRA) to determine the nature of a working relationship for the purposes of paying CPP and EI premiums, to determine is someone should be classified as a contractor or employee. It is essential to seek specific legal advice before submitting any request. To my knowledge, there is no similar process in which you can request the Ministry of Labour, in Ontario, or other provinces, to rule on the classification of an employee.

TERMINATING EMPLOYEES

Employment law can change (and has changed) quite dramatically over time, especially in Ontario. It is a good idea to have a lawyer draft your employment agreement and keep it updated over the course of the employment relationship. Doing so can potentially save you from the risk of significant employee claims that accrue the longer an employee works for your business.

Statutory Entitlements

Although it's not an item you would see on a balance sheet, the amounts you owe an employee on termination are, in effect, a contingent liability. That is, if you decide to terminate an employee, especially without cause, you will owe them minimum amounts by statute, including notice, or termination pay in-lieu of notice, severance (if required by applicable legislation), unpaid vacation pay, the continuation of benefit plans at possibly other amounts.

Those amounts grow the longer an employee stays with your business. Lawyers refer to these amounts and benefits as 'statutory entitlements'. They are amounts an employee is entitled to by statute, in Ontario for example, the *Employment Standards Act* ("*ESA*").

You can read the Ontario Government's guide to the termination of employment called "*Your Guide to the Employment Standards Act*" at the link in the footnote.[1] In fact, if you are an Ontario employer, I encourage you to read the guide at least once to understand the statutory framework for hiring staff and employee rights related to the termination of their employment. Partway down the page, you will see the notice period chart showing the number of weeks of notice (or pay in lieu of notice) an employee is owed for each year of service.

Keeping in mind that different provinces have different regimes, in Ontario severance is a payment in addition to the notice period referenced above. At the time of writing, severance is only payable under Ontario's employment standards legislation, when:

1. The employer has a payroll in Ontario of at least $2.5 million; and
2. The employee has worked for the employer for five or more years.

If those two conditions are met, the employee is owed severance in addition to their other statutory entitlements. Severance pay in Ontario is calculated based on an employee's length of service. The formula (referenced at section 64 and 65 of the Ontario *ESA*, at the time of writing) is as follows:

- Severance pay equals the employee's regular wages for a regular work week multiplied by the sum of:
- The number of completed years of employment; and
- The number of completed months of employment divided by 12, for a year that is not completed.

For employees that work entire careers with an employer, statutory entitlements like notice pay, severance, the continuation of benefit plans etc. can add up. These benefits should be kept in mind by founders making sure that cash is available to pay these entitlements, whether you are a lean and small shop with only a few employees, or a large entity with hundreds of staff.

Common Law Entitlements

Separate from statutory entitlements on the termination of employment, an employee may also have common law claims or entitlements. They are amounts or benefits that courts view as fair and reasonable above and beyond the statutory minimum entitlements, based on the individual circumstances of the particular employee.

While the factors may be different in different provinces, Ontario Courts award additional amounts (i.e. common law entitlements) to employees based on factors like (there are others):

- **Character of the Employment:** The nature of the job, including the position and responsibilities.
- **Length of Service:** The duration of the employee's service with the employer.
- **Age of the Employee:** The age of the employee at the time of termination.
- **Availability of Similar Employment:** The likelihood of the employee finding a similar job, considering their skills, qualifications, and the job market.

This is all without considering possible claims by an employee for wrongful termination based on other statutes or other common law theories of law, like human rights, privacy legislation and common law torts like harassment, among others.

For many employers in Ontario, the main purpose of an employment agreement is to try (to the extent permitted by law) to have the employee accept they will only receive the minimum statutory entitlements upon the termination of their employment. Doing so is, in effect, an attempt to preclude having to pay the employee additional common law entitlements.

This, of course, may be different for higher-end employees, earning larger salaries and that have more negotiating leverage. In those situations, an employment agreement may lay out additional pay or benefits an employee would be entitled to, above and beyond the minimum statutory entitlements.

In contrast, contractor agreements (assuming the person has been correctly classified as a contractor) can often state that the agreement will terminate either on a short notice period (or even no advanced notice).

The Risk of Outdated and Unenforceable Employment Agreements

It is not uncommon for outdated employment agreements, or agreements that do not comply with applicable legislation (like the *ESA* in Ontario) to be invalidated by courts. The main risk of having an unenforceable employment agreement is the ability for an employee to then claim both their statutory and common law entitlements, which in some situations and based on various factors, can be significant.

Take for example the case of *Rodgers v. CEVA* in Ontario, where my father David Wires represented Bruce Rodgers who was awarded 14 months of additional pay upon termination following only three years of employment.

Although this case had a unique set of facts, involving (i) an inducement by the employer to pull the employee away from secure employment; and (ii) the employee being required to buy shares in the employer (as a condition of employment) the judge held, as part of the reasoning for a longer than normal notice period:

> *"I find that the required investment in CEVA Investments was intended to create the impression in the mind of the plaintiff that by accepting employment with the defendant he would have a degree of job security beyond what would normally be anticipated."*

So, in that case, although Mr. Rogers would have only been entitled to a relatively nominal amount (3 weeks of pay plus benefits and other statutory entitlements under the *ESA*) having worked only for three years, he got over 1 year of additional notice pay.

The case highlights just how dramatic the contingent liability, which your business accrues to the date of termination, can be. While it may not be that grave for Fortune 500 companies, small businesses can be dramatically impacted if they were to have to pay an employee an additional 14 months of pay, after only 3 years of service.

Many employers in Ontario do not understand the interplay between statutory and common law entitlements on termination, let alone that they can take important steps in an employment agreement to contract out of an employee's ability to make certain common law claims.

Founders often learn the hard way on how employment law works, when they go to fire their first employee. It is usually at that time, they see the value in having a lawyer draft their employment agreements to try to ensure staff contract into the minimum entitlements under the applicable provincial legislation.

In Ontario, if an employee has a binding and enforceable employment agreement, which contracts the employee into the statutory minimums, in terms of notice pay and severance, employers can have great success at containing the contingent liability owing to terminated employees. On the flip side, as your company grows, and as you hire more and more employees, who accrue years of service, your business accrues a larger and larger contingent liability.

More recently, in Ontario, there have been a slew of court decisions leading to the finding that various employment agreements were found to be non-binding and unenforceable, in some situations for reasons that I personally find troubling (as someone who represents start-ups).

Take for example the case of *Waksdale v. Swegon North America Inc*. In this case, the Ontario Court of Appeal addressed an employment agreement with two separate termination provisions; one for "*just cause*" (i.e. terminating an employee for something particularly egregious) and another for "*without cause*" termination.

While the employer was relying on the “*without cause*” termination clause, which gave the employee the minimum statutory entitlements, the Court found that because the “*just cause*” section of the termination clause did not specifically state that it was still subject to the employee receiving their statutory entitlements under the *ESA*, the entire termination clause was found to be unenforceable.

This was despite the fact that the employer was not relying on the “*just cause*” termination provision, and instead was terminating the employee without cause and paying the employee pay in accordance with their statutory entitlements.

Consequently, the illegality of the "*just cause*" provision rendered the entire termination provision, including the "without cause" provision, null and void, and unenforceable. This meant that the employee was entitled to claim both statutory and common law entitlements.

There are similar cases, where termination provisions in an employment agreement are found to be unenforceable for various reasons, and in turn, an employee is entitled to claim common law notice periods far in excess of their statutory entitlements.

In another case from 2024, D*ufault v. The Corporation of the Township of Ignace* a judge found the termination provisions of an employment agreement unenforceable, and therefore permitted the employee to claim common law entitlements, for two main reasons:

1. Just like in *Waksdale* the "*with cause*" provision was too broadly defined (and, therefore, violated the minimum threshold set by the *ESA* to terminate an employee without pay). As a result, the termination provisions in the contract were invalid and common law entitlements applied; and
2. Going one step further than *Waksdale*, the judge found that the section of the employment agreement that stated, "The Township may at its sole discretion and without cause, terminate this Agreement and the Employee's employment thereunder at any time upon…" violated the *ESA* because the use of the words "its sole discretion" and "at any time" were contrary to certain sections of the *ESA*.

Why, you ask, does that wording violate the *ESA*? The judge found that because there are situations where the *ESA* prohibits an employer from terminating an employee outright, the language used attempted to override those provisions.

For example, section 53 of the *ESA* prohibits an employer from terminating an employee on the conclusion of an employee's leave, and section 74 prohibits an employer from terminating an employee for inquiring about or exercising any right under the *ESA* (for example, asking about entitlements to overtime pay).

To be clear, the judge invalidated the entire employment agreement despite neither section 53 nor 74 of the *ESA* being breached in the case. The decision was simply that the employment agreement wording appeared to try to preclude the employee from enforcing section 53 and 74 if she wanted to, and therefor the court found it fit to invalidate the termination clause.

So, regardless of whether the employee was paid all of her entitlements under the ESA or not, simply based on the wording of the agreement, the entire termination provision was found to be unenforceable, and therefore permitted the employee to claim common law entitlements.

With the *Rogers vs CEVA* case in mind (where an employer had to pay another 14 months of the employee's salary), along with the risk of your employment contract being unenforceable (resulting in common law claims for damages against your business), I am sure you can appreciate why having an employment lawyer draft a well-constructed employment agreement can be crucial. A well drafted employment agreement is the principal way to mitigate claims from employees on the termination of their employment.

While it may be immaterial for a large company or government, getting stuck having to pay long common law notice periods to an employee can really sting a start-up or small business.

Employment agreements should also be revisited frequently, as they can become out of date, leading to a greater risk of unenforceability for two main reasons. First, the employment agreement may no longer accurately reflect the employee's role, salary, seniority and other items. Second, employment agreements may become outdated as common law judicial decisions evolve (like in *Waksdale* and *Dufault*).

Some lawyers conclude that the *Waksdale* decision alone may have invalidated thousands of employment agreements that had similar 'for cause' termination provisions. Employment lawyers can help you update your existing outdated agreements, but in doing so, the employee would have to be given additional consideration in order to accept the new terms; a complicated topic in itself and which you should speak to a lawyer about when the time comes.

RESTRICTIVE COVENANTS

Non-compete and non-solicit clauses (often referred to as restrictive covenants) are another area to tread very carefully. For many types of employees, non-compete clauses are not enforceable (as at the time of writing) in Ontario. So, considering restrictive covenants, including non-solicit obligations, should be done in the context of the governing law at the time you enter the relationship. If a non-compete or non-solicit clause is going to be included, you should seek legal advice on the wording of the clause as courts are reluctant to enforce them, and they will only be enforced if they are reasonable in the circumstances, considering various factors like the nature of the employee's role, scope/area to which the clause applies and duration for which the restrictions will apply.

CONTRACTOR AGREEMENTS

Contractor agreements differ quite significantly from an employment agreement, especially on the issues like, the assignment of intellectual property (covered above), taxes (including sales taxes), liability, and restrictive covenants. Even in the software space, where I primarily practice, contractor or services agreements can differ significantly based on the facts and circumstances of the client and the contractor or service provider in question. There is also far greater control over mitigating claims in the event you decide to terminate the agreement.

DEPENDENT CONTRACTORS

Courts have recognized a middle category called "dependent contractors." These workers are not employees but are economically dependent on a main company for work. Dependent contractors may be entitled to certain benefits, such as reasonable notice of termination, just like employees. In this situation, even if a court found someone was properly classified, you may still face common law claims, similar in nature to those of employees.

So, properly determining a worker's status as an independent contractor or employee is crucial for founders to avoid potential risks and liabilities. By understanding the distinctions between these working relationships, entrepreneurs can make informed decisions, with their lawyers, that support their business's growth and success while mitigating claims from employees and contractors.

ISSUES TO WATCH OUT FOR WHEN HIRING

As a final note of caution when starting the hiring process, here are some quick items to consider:

- Have a written employment agreement prepared by a lawyer and updated regularly for each employee.
- Consider if the candidate signed a restrictive covenant with a previous employer. If they have, will it impact what the candidate can do for your business?
- Have you made sure that your job description is accurate and not misleading?
- Have you made sure that the candidate can lawfully work in the jurisdiction you operate?
- Don’t make promises or statements regarding long term job security.
- If you are recruiting someone away from secure employment, it is a good idea to speak with a lawyer about the potential implications. In some situations, terminating such employees can increase notice pay obligations. Courts can, in some cases, consider the period of employment the candidate served with the previous employer.

End Notes

[1] Ontario Ministry of Labour, “Your Guide to the Employment Standards Act” https://www.ontario.ca/document/your-guide-employment-standards-act-0/termination-employment, accessed May 29, 2024.

CHAPTER 8: INTERNET BASED BUSINESSES

Many businesses in Canada have an e-commerce or online component to them. Whether it is a simple website describing a traditional 'offline' business, or a complex software as a service or e-commerce store. The legal considerations for each type of business vary significantly. In this chapter, we address a core group of legal issues that most web-based businesses will face.

The first issue all web businesses face is, what laws govern you? One of the greatest difficulties in advising my Canadian SaaS and e-commerce clients is that due to the international nature of their business (users and customers in other countries), there is potential liability, governing laws and legal requirements to be met under foreign laws.

That is, if you have users or customers in places outside Canada, those places will have their own set of laws intent on protecting people in those jurisdictions. From consumer protection and tax laws to privacy laws, the application of foreign laws to your business can be significant.

In Canada, businesses frequently overlook the impact of U.S. laws on their operations, especially when selling products or services to U.S. customers. Small web start-ups often find the cost of legal advice in every intended customer jurisdiction prohibitive. However, if a web company plans to engage in sales or establish a presence in a foreign jurisdiction—through employees, consultants, offices, warehouses, marketing, or user base—it is crucial to seek legal and tax advice about obligations in those areas.

Tax Considerations for Online Businesses

While tax falls outside the scope of this book, founders should be aware of the economic nexus test, that may result in taxes (or at least tax returns) having to be filed in other jurisdictions. In short, the closer of an economic nexus you have to a jurisdiction, the better the chance your business will have to declare income from that jurisdiction for tax purposes and pay taxes in that jurisdiction. This may be the case even if you have no entity incorporated in that jurisdiction. Factors that various jurisdictions apply, to consider the economic nexus, include (among others):

- Physical office space or warehouses where inventory is shipped from;
- Employees or representatives in, or frequently attending in the jurisdiction;
- Marketing efforts in the jurisdiction;
- Sales figures in the jurisdiction.

In various jurisdictions there may also be sales tax or VAT requirements you have to meet in order to be able to sell products into that jurisdiction. For example, several U.S. states require companies outside of the U.S. to collect and pay sales tax for sales made into their state. In fact, after the *South Dakota v. Wayfair, Inc.* Supreme Court decision in 2018, many states adopted parts of the economic nexus test into their laws. These laws stipulate that if a business, regardless of its location, meets specific sales thresholds in a state (among other factors), it must collect and remit sales tax in that state.

The thresholds vary by state but generally involve a certain amount of revenue or a specific number of transactions. For companies outside the U.S., including in Canada, this means they must be aware of each state's laws where they have customers. They might need to register for a sales tax permit and comply with the state's tax collection and remittance requirements if they meet the criteria for economic nexus in that state.

Consider also, the reverse. That is, Canada’s requirements for foreign sellers, operating outside of Canada, but shipping goods from a Canadian based fulfilment centre. As of 2020, there are new rules around the collection and remittance of GST/HST.[1] The government of Canada FAQ website on the topic says:

> *What businesses would be affected by the measure relating to goods supplied through fulfillment warehouses in Canada?*
>
> *Under the proposed measure, distribution platform operators would be required to register under the normal GST/HST rules and to collect and remit the GST/HST in respect of sales of goods that are located in fulfillment warehouses in Canada (or shipped from a place in Canada to a purchaser in Canada), when those sales are made by non-registered vendors through distribution platforms.*
>
> *Non-resident vendors would be required to register under the normal GST/HST rules and to collect and remit the GST/HST in respect of sales of goods that are located in fulfillment warehouses in Canada (or shipped from a place in Canada to a purchaser in Canada), when those sales are made by the non-resident vendors on their own (i.e., they are not made through a distribution platform).*
>
> *Fulfillment businesses in Canada would be required to notify the CRA that they are carrying on a fulfillment business and to*

maintain records regarding their non-resident clients and the goods they store on behalf of their non-resident clients.

FORUM SELECTION CLAUSES

For many online businesses, the legal objective is, to the extent possible, bring customers and users into the ambit of your home jurisdiction's laws. This is often done in your website terms of use or similar contract you enter with customers or users. In those terms, it is typical to include a forum selection clause requiring disputes to be resolved in your home jurisdiction, under your home jurisdiction's laws.

While a forum selection clause can give jurisdiction to Canadian courts (or arbitrators) to resolve disputes arising from your online business, including with foreign users, some jurisdictions may disregard those terms and permit lawsuits to proceed against your business outside of Canada. This can result in you having to defend claims against your business outside of Canada, even if you included a provision in your terms of use requiring disputes to be settled here. Typical situations where that may be the case include under consumer protection and privacy laws of foreign countries.

The jurisdiction issue is highlighted in a Canadian case involving Facebook; *Douez v. Facebook, Inc.* In that case, Douez commenced an action and sought certification of a class action against Facebook. Douez alleged Facebook used her name and portrait (and the names and portraits of other class members) in an advertisement on facebook.com without her consent, contrary to the British Columbia *Privacy Act*.

Facebook argued that it obtained either the express or implied consent of its users through its terms of use, disclosure on its website, and through a user's actions such as their privacy settings.

The preliminary issue, however, was Facebook's position that a Canadian court should decline jurisdiction on the basis that California was the designated choice of jurisdiction and applicable law in Facebook's terms of use.

The Court of Appeal for British Columbia held that Facebook's forum selection clause should be enforced and granted a stay of proceedings (a win for Facebook). This would have forced the Canadian plaintiffs to have to take their lawsuit to California.

However, on appeal to the Canadian Supreme Court, Douez was successful and the SCC ignored the forum selection clause (a loss for Facebook), holding that for public policy reasons (to be able to enforce BC privacy laws and to account for the unequal bargaining power of Facebook's users) the forum selection clause in the terms of use was not enforceable. This meant that the claim could proceed in BC against Facebook, even though Facebook's terms of use required proceedings to be commenced in California.

When you consider the reverse scenario, for a Canadian business, you realize that you can face the risk of ending up in a US, or other foreign courts to defend your business, even with a well drafted forum selection clause.

In this situation, founders are tempted to think that claims proceeding against their business, outside of Canada, where they may have no assets, is irrelevant. After all, who cares if someone obtains a judgement against your business in, say, Florida, if you don't have operations there, bank accounts there etc., right? Wrong.

I remember the first time I realized how easy the process was for foreign judgments (and arbitration awards) to be enforced in Canada, especially from countries like the United States; where there is a general regard for their judicial system and a general inclination towards reciprocity (we will enforce your judgements if you enforce ours).

This means that if your business is sued outside of Canada, to stage off the risk of foreign judgments being enforced against you in Canada, you will likely end up having to defend claims in overseas courts where your users or customers commence the claim.

So, doing everything possible to have customers and users agree to terms that select a governing law of your choice is a must for online business, or in fact, any business with international operations. However, it is important for founders to understand the limitation of forum selection clauses, and to seek the advice of lawyers in the foreign jurisdictions where you do business, on ways to (i) comply with their laws; and (ii) mitigate the impact of potential claims by your customers and users in those jurisdictions.

Leaving behind the issue of what laws apply to your business around the world, the next consideration is what laws apply to you in Canada. While the list below is certainly not exhaustive, here are some of the considerations for e-commerce, SaaS and online businesses.

PRODUCT LIABILITY

The *Canada Consumer Product Safety Ac*t (“*CCPSA*”) and other provincial consumer protection[2] and product safety legislation, impose duties on manufacturers, importers and sellers of consumer products to report product defects and incidents that have or may cause serious injury. There are also statutory provisions restricting the sale of dangerous products.

Regardless of whether you actually made the product, liability can attach to the sellers of products in Canada, whether online or via physical retail channels. In my own practice, I see lots of e-commerce companies selling products sourced on sites like Alibaba, manufactured in other jurisdictions that may not have the same safety, quality control and other standards as in Canada. Sellers providing these products to customers in Canada may not realize the scope of the potential liability they take, in offering the products to Canadians, even though they did not manufacture them.

If a Canadian consumer suffers damages, they will turn first to the retailers and try to hold the retailers primarily responsible if they cannot locate (or serve claims on) the overseas manufactures to commence claims against them. They will also prefer to bring the claims against the Canadian retailer, because starting lawsuits against a foreign manufacturer, in a foreign court, would be an uphill battle.

Even with limitation of liability provisions in your website terms and conditions, there may still be scenarios where liability arises which you cannot contract out of. This is especially true where 1) the claims are based on product liability legislation like the *CCPSA*, or 2) the claims are commenced by third parties (i.e. people who have not consented to your terms) who were using the product or service and you did not have a direct contractual relationship with them.

CONSUMER PROTECTION LEGISLATION

In 2001, federal, provincial and territorial governments approved a new approach to harmonize e-commerce consumer protection laws. The *Internet Sales Contract Harmonization Template*[3] legislation covers, among other things, contract formation, cancellation rights, credit card chargebacks and information provisions. Most provinces and territories have adopted the template legislatively, although in some provinces, with amendments.

In Ontario, the *Consumer Protection Act* ("CPA") adopted most of the Internet Sales Contract Harmonization Template into law. The CPA applies to all "*consumer transactions*" if the consumer or the person engaging in the transaction with the consumer is located in Ontario when the transaction takes place. A consumer is defined under the CPA as an individual acting for personal, family or household purposes and does not include a person who is acting for business purposes. A "consumer transaction" is any act or instance of conducting business or other dealings with a consumer.

If your business does not sell directly to consumers and there is no "consumer transaction", the legislation likely does not apply to your business. If it does apply to your business, the CPA also has provisions dealing specifically with "internet agreements", which are defined as, "*a consumer agreement formed by text-based Internet communications*".

If, at least at the time of writing, the total potential payment obligation of a consumer agreeing to your website terms and conditions is $50.00 or more, the CPA requires[4] among other things, that you disclose a list of prescribed information before the consumer enters the agreement.

Other key requirements from the CPA that founders should be aware of include:

- That you provide the consumer, "with an express opportunity to accept or decline the agreement and to correct errors immediately before entering into it." This means that just having your terms posted on your site may not be sufficient. You may need the customer to take a positive act towards accepting your terms.

- The CPA does not permit a consumer to settle disputes by way of arbitration unless they consent to arbitration after a dispute with you arises. That is, consumers will always retain the right to commence a court action even if there is an arbitration clause in your terms and conditions.
- The CPA does not permit a consumer to waive their right to participate in a class action lawsuit (at least at the time of the transaction).

Particular Laws Governing Your Industry

If you are selling products or services on your website, there may also be particular laws that apply to you. For example, product labeling, health, import/export laws and others. Based on the nature of the products you are selling, you should speak with a lawyer about whether there are particular laws that govern your business.

PRIVACY ISSUES

A website targeting Canadian users will need to ensure they comply with the *Personal Information Protection and Electronic Documents Act* ("*PIPEDA*") and its Privacy Principles. The Privacy Principals are published by the government as a summary of the core provisions of *PIPEDA* and are useful for businesses to know and understand, but don't fully capture all the relevant provisions and obligations imposed by *PIPEDA* itself.

Nevertheless, the 10 Privacy Principals are:

1. **Accountability**: Organizations are responsible for personal information under their control. They must appoint someone to be accountable for compliance.

2. **Identifying Purposes:** The purposes for which personal information is collected must be identified by the organization before or at the time of collection.
3. **Consent**: Organizations are generally required to obtain consent for the collection, use and disclosure of personal information.
4. **Limiting Collection:** The collection of personal information must be limited to that which is necessary for the purposes identified by the organization. Information must be collected by fair and lawful means.
5. **Limiting Use, Disclosure, and Retention:** Personal information must not be used or disclosed for purposes other than those for which it was collected, except with the consent of the individual or as required by law. Information should be retained only as long as necessary for the fulfillment of those purposes.
6. **Accuracy:** Personal information must be as accurate, complete, and up to date as is necessary for the purposes for which it is to be used, especially when it is disclosed to third parties.
7. **Safeguards:** Personal information must be protected by security safeguards appropriate to the sensitivity of the information.
8. **Openness:** Organizations must make information about their policies and practices relating to the management of personal information readily available to individuals.
9. **Individual Access:** Upon request, an individual must be informed of the existence, use, and disclosure of their personal information and be given access to that information. An individual is able to challenge the accuracy and completeness of the information and have it amended as appropriate.
10. **Challenging Compliance:** An individual shall be able to address a challenge concerning compliance with the above

principles to the designated person or persons accountable for the organization’s compliance.

PIPEDA governs not just personal information like names, age, gender etc., but also personally identifiable information. This is a result of *PIPEDA* defining “personal information” broadly as “information about an identifiable individual”. Personally identifiable information may include things like:

- Email Address
- Social Security Number/National Identification Number
- Passport Number
- Driver's License Number
- Credit Card Numbers
- Date of Birth
- Telephone Number
- Personal Photographs
- Biometric Data (Fingerprints, Retina Scans)
- Medical Records
- Bank Account Numbers
- Employee Identification Number
- Vehicle Registration Plate Number
- Insurance Policy Number
- Physical Characteristics (Height, Weight, Eye Color)
- Internet Protocol (IP) Address
- Geolocation Data

One of the main results of *PIPEDA* is that it necessitates businesses have privacy policies that set out, among other things, what personal information (including personally identifiable information) is collected, how it is used or disclosed in the course of commercial activities.

In the context of a SaaS or e-Commerce business, businesses will need to ensure they have a privacy policy that, among other things:

- Identifies what personal information the website collects, and only collect such personal information as is necessary for the purpose in which it is collected;
- Ensures users are consenting to the collection of the information;
- Ensures personal information is only kept for as long as necessary for the fulfillment of those purposes;
- Identifies who is collecting the information;
- Identifies the purpose for which it was collected;
- Has a process for an individual to request information about the existence, use and disclosure of his or her personal information, and given access to it; and
- Provide contact information for someone to contact regarding the privacy policy and compliance.

It has been my practice to be very detailed and forthcoming in privacy policies for clients, listing, in detail, all the various places where personal information may land as a result of using a client's website, SaaS platform or ordering goods from an online store. This includes for example (there may be many others depending on the circumstances):

- What payment processors are used when card information is entered (Stripe, PayPal etc.);
- Data hosting providers, for example AWS or Azure, where user personal information may land;
- Platform providers, like Shopify, who may log personal information;
- Email hosting providers, for example if your company offers email support services;

- Document or other hosting providers, if a user’s personal information will land in places like Google Docs, Zapier or other places etc.

In a client’s privacy policy, it is sometimes my practice to also link to third-party privacy policies of the services the client uses. For example, we may disclose that a user’s data may land on AWS servers and then link to the AWS privacy policy for the user to read, if they wish.

Provincial and International Privacy Law Considerations

There are also provincial statues in various provinces that govern similar topics to *PIPEDA*, including just as an example, Alberta’s *Personal Information Protection Act*, British Columbia’s *Personal Information Protection Act* and Quebec’s *Act Respecting the Protection of Personal Information in the Private Sector*.

In fact, at the time of writing there was a significant development in Quebec's privacy landscape underway with Bill 64, which proposes major reforms aligning the Province's privacy regime more closely with the European Union’s *General Data Protection Regulation* (“*GDPR*”). The Bill enhances personal information protection, introduces new business obligations, and increases penalties for non-compliance, signalling a shift towards stricter privacy governance.

Depending on the nature of your business, there may be other privacy laws that apply, like the *Personal Health Information Protection Act*, in Ontario, for businesses dealing with health information.

Canadian federal privacy law, at the time of writing, is also expected to undergo a significant overhaul. Bill C-27, known as the

Digital Charter Implementation Act, aims to modernize the framework for the protection of personal information in the private sector. This bill, if passed, will introduce three main statutes:

1. The *Consumer Privacy Protection Act* (*CPPA*) which will replace Part 1 of *PIPEDA*. The *CPPA* is intended to enhance the Privacy Commissioner of Canada's order-making powers and introduces significant fines for non-compliance, including administrative penalties up to $10 million CAD or 3% of global revenue, and in cases of serious contravention, fines up to $25 million CAD or 5% of global revenue.
2. The *Personal Information and Data Protection Tribunal Act*, which establishes an administrative tribunal to review certain decisions made by the Privacy Commissioner of Canada.
3. The *Artificial Intelligence and Data Act*, a new addition, that regulates international and interprovincial trade and commerce in artificial intelligence systems by establishing common requirements (including privacy requirements) for the design, development, and use of AI systems.

All businesses that have any form of personal information or personally identifiable information, should keep updated on the ever-evolving nature of privacy law, both in Canada, provincially and around the world.

If you have users or customers in other parts of the world, you will have to consider the application of foreign privacy laws, like the GDPR in the EU and US law, including state laws like the C*alifornia Consumer Privacy Act* (“*CCPA*”). The *GDPR* and *CCPA* get more attention than other jurisdictions and other privacy laws because of their broad impact, the number of people living in those jurisdictions, and in some cases, more stringent requirements.

For example, the *GDPR* applies to all companies processing the personal data of individuals residing in the EU, regardless of the location of the company collecting or processing the data. This global reach impacts many start-ups, especially those with online services. The same applies under Quebec's Bill 64 and the *CCPA*, that is, they are both intended to protect Quebec and California residents regardless of where the company collecting personal information is based.

Foreign laws can also impose regimes for transferring data across borders for use and processing. For example, the *GDPR* requires data transfers to countries outside the European Economic Area to ensure an adequate level of data protection. To comply, businesses must implement mechanisms such as the EU Standard Contractual Clauses, Binding Corporate Rules, or participate in the Privacy Shield framework.

- The EU Standard Contractual Clauses are legal tools approved by the European Commission to facilitate the safe and compliant transfer of personal data from within the EU to countries outside the EU or European Economic Area. They are pre-set contractual terms designed to ensure that data transferred internationally is protected and treated in accordance with the EU's data protection standards. By incorporating Standard Contractual Clauses into their contracts, organizations can demonstrate compliance with *GDPR's* requirements for cross-border data transfers, thereby ensuring the maintenance of data privacy and security standards across borders.
- The EU's Binding Corporate Rules are internal rules adopted by multinational companies. They allow personal data to be transferred internationally within the same corporate group to countries that don't provide an adequate level of data protection.

- The EU Privacy Shield framework was a mechanism designed to facilitate transatlantic data flows (EU to US) while ensuring compliance with the EU's standards for data protection.

DATA-DRIVEN BUSINESS MODELS (AGGREGATE DATA)

Big data is playing an increasingly important role, from feeding artificial intelligence systems to targeting advertising and influencing elections. Big data, including personal information datasets, offer unique insights that are sought after. The collection, analysis, and aggregation of personal data have become big business. Companies use the data to enhance products and services, improve customer experiences, and target marketing efforts.

Aggregate data clauses now appear in privacy policies and various agreements, including enterprise SaaS agreements. These clauses look to permit the use of anonymized and non-personally identifiable data for commercial purposes. They are sometimes seen as less risky since they do not involve sharing actual personal data.

However, some business models involve licensing the raw data itself (i.e. the actual personal information data rather than aggregate data reports that do not contain personal information). This presents significant privacy law risks, even if the raw data is anonymized and names are removed or pseudonymized. In such cases, careful compliance with global privacy regulations is paramount, particularly for businesses that integrate personal information into their core business model. The use of personal data in various forms, whether for direct selling, licensing, or targeted advertising, requires careful legal navigation.

I often advise clients on the use of aggregate data, both personal and non-personal. While understanding the law is important in this area, the proper technical expertise, to effectively anonymize personal data for aggregation and commercial use while ensuring it remains non-identifiable is perhaps more important.

Although it may seem like a trivial risk, the re-identification of anonymized data is a significant concern in privacy law, and there are several documented methods and cases where this has occurred. One method is 'linkage attacks', where anonymized datasets are cross-referenced with publicly available records to identify a specific person.

A startling finding from a 2019 study revealed that 99.98% of Americans could be correctly re-identified in any dataset using just 15 demographic attributes.[5] That study (link in the endnotes) is a worthwhile read for any company in the aggregate and anonymized data business. If you aggregate, anonymize and sell access to data, it is important to make sure you understand the risk of re-identification, and in turn, the risk of being offside with privacy laws.

Companies must continuously evaluate their data anonymization techniques against emerging technologies and methodologies that could potentially de-anonymize data in the future.

When licensing aggregate or anonymized data, legal agreements with third parties are crucial. These agreements offer an opportunity to safeguard your business with clauses for limiting liability, indemnities (from the data recipient), and placing obligations on data recipients to protect and restrict data use to specified and lawful purposes.

ANTI-SPAM LAWS

If you are collecting email addresses and sending email campaigns to users, Canada's anti-spam legislation, which came into effect July 1, 2014, applies. You will need to ensure that you have consent to send “commercial electronic messages” (i.e. emails, text messages etc.). While CASL has provisions that allows for implied consent from a recipient, in certain circumstances, express consent from the recipient (for example having a user click a box agreeing to subscribe to emails) is best. Among other requirements, CASL requires commercial electronic messages you send to be in a form that:

- Identifies the person/business who sent the message and the person on whose behalf it is sent (if different);
- Provides information enabling the recipient to readily contact the sender, including an address and email address; and
- Provide an unsubscribe mechanism complying with legislative standards.

CASL should not be taken lightly. Violators can be liable for significant monetary penalties. The Canadian Radio-television and Telecommunications Commission (CRTC) has actively enforced CASL since its inception. A notable case involved a $75,000 penalty imposed on an individual for conducting high-volume spam campaigns. Between December 2015 and May 2018, the individual was found to have sent thousands of unsolicited commercial electronic messages without consent from the recipients.

WEBSITE TERMS AND CONDITIONS

While terms and conditions of use for any website are important, they are particularly important for SaaS and e-commerce businesses selling products, software or services to users in Canada, and around the world. The importance of robust website terms and conditions cannot be overstated. Your terms of use not only form a contract between your business and your users but also serve as a means for protecting your intellectual property, limiting liability, and guiding user behavior. This section delves into some of the considerations for crafting effective terms and conditions for your online business.

However, don't forget the important notes discussed above on forum selection clauses, and the risk of your terms being found unenforceable in various jurisdictions around the world. It is important to seek legal advice on your terms in the jurisdictions in which you have users and customers.

The law regarding the enforceability of website terms and conditions is constantly changing in Canada, and worldwide. There are ongoing lawsuits where customers and users attack the enforceability of the terms of use of various websites, with new court rulings forming new precedents on enforceability. Just like with forum selection clauses, if you have users or sell to customers in other countries, you will have to consider how the laws of those other countries impact your business.

Even today there is uncertainty in Ontario about the acceptable method for having your users or customers agree to be bound by your website terms and conditions. Below we explore the use of both click-wrap and browser-wrap agreements. Regardless of the method used to enter a contract, proving that a contract exists requires at least seven main elements, a few of which are discussed in more detail below. There must be:

- An offer;
- Acceptance of the offer;
- An intention to form a legally binding contract;
- Consideration (i.e. a benefit to both parties);

- Legality (a contract for an illegal purpose is likely not enforceable);
- Capacity to enter legal relationships (i.e. be the age of majority and of sound mind); and
- A meeting of the minds (i.e. both parties have a mutual understanding and agreement on the essential terms and conditions of the contract).

Click-Wrap Agreements

One of the most common ways to contract online is with a "click-wrap agreement". A click-wrap agreement is formed where a user indicates their consent to a contract by clicking on an "I Agree" (or similar) button or checkbox. With some exceptions (and assuming particular provisions are not unconscionable or otherwise invalid) click-wrap agreements, as a method of entering a contract, have been found to be enforceable in Canada by courts in Ontario and British Columbia.[6]

Browse-Wrap Agreements

Another method used for forming (or attempting to form I should say) an online contract is the browse-wrap agreement. In a browse-wrap agreement, the terms and conditions of use are posted on the website, typically as a hyperlink in the header or footer of the screen. Unlike a click-wrap agreement, where the user must expressly consent to the terms and conditions by clicking to accept, a browse-wrap agreement does not require express consent. Rather, a website user purportedly gives his or her consent to be bound by simply "*browsing*" the website, using the software as a service online or downloading it.

Under the *Consumer Protection Act* ("CPA") in Ontario (with similar legislation in other provinces), at the time of writing, if the total potential payment obligation of a consumer is $50.00 or more, you are required to provide the consumer, "with an express opportunity to accept or decline the agreement…"[7] This may result in browse-wrap agreements being unenforceable for consumer transactions.

Outside the context of the CPA, Ontario courts have left a bit of a grey area around whether, or when, a browse-wrap agreement will be enforceable. What is clear is the enforceability of browse-wrap agreements will depend on the specific facts and circumstances of each case (and each website).

In Ontario, the case of *Kanitz v. Rogers Cable Inc.* ("*Kanitz*") indirectly dealt with browse-wrap agreements. In that case, the plaintiffs signed an agreement with Rogers Cable which stated that Rogers could amend the agreement at any time, and that any amendments would be posted on Rogers' website. Rogers did in fact amend the agreement and posted the amended terms and conditions online.

The court held that posting the amended agreement was acceptable and the terms of that agreement were binding on the Rogers customers who originally signed the agreement in stores. By continuing to use the website and service after the amendments were posted, Rogers customers were, "deemed to have accepted the amendments." Consequently an online agreement, similar to a browse-wrap agreement, was ruled to be binding.

However, there is an important proviso. In *Kanitz*, the court never dealt with or commented on whether the agreement would still be binding if the original Rogers contract was not signed and there were merely online terms and conditions posted on the website. That is, the online amendment in *Kanitz* was an amendment to an agreement, which the plaintiffs had physically signed.

So while this case marked an important step in the recognition of browse-wrap agreements, its application may be limited by the fact that the agreement in question was tied to an existing, signed contract. In my view, there remains some uncertainty as to when and in what circumstances browser-wrap agreements will be found to be unenforceable in Canada (province-by-province).

In British Columbia, the Supreme Court made the following remarks about browse-wrap agreements in *Century 21 Canada Limited Partnership v. Rogers Communications Inc.*:

> *[107] As noted in the authorities referred to above, the law of contract requires that the offer and its terms be brought to the attention of the user, be available for review and be in some manner accepted by the user. Such an analysis turns on the prominence the site gives to the proposed Terms of Use and the notice that the user has respecting what they are agreeing to once they have accepted the offer. To establish a binding contract consideration will also be given to whether the user is an individual consumer or a commercial entity and in addition a one-time user or a frequent user of the site.*
>
> *[108] Browse wrap agreements have the advantage of being readily available for perusal by the user. Their enforcement requires a clear opportunity for the user to read them which, given the nature of computer[s] and the Internet, is likely to be a better opportunity than that available to the user of a product with a standard form contract presented at the time of purchase. A properly enforceable browse wrap agreement will give the user the opportunity to read it before deeming the consumer's use of the website as acceptance of the Terms of Use.*

What is clear, is that to have any prospect of being binding, a browser-wrap agreement (at a minimum) must be prominently placed on each page of your website.

In my view, given the risks posed by consumer protection laws (potentially making browse-wrap agreements unenforceable) the risk of judicial determinations finding your terms were not presented in a way to make them enforceable, and the fact that judicial rulings will continue to evolve (in various jurisdictions) on enforceability, there should be a strong preference towards click-wrap agreements to implement terms and conditions on a business website.

That said, some businesses choose to weigh the risk of enforceability against the nature of their website and business. For example, if you are merely publishing uncontentious content as part of a free blog, maybe you are less worried about the risk of enforceability when weighed against a SaaS platform that stores end-user data and personal information.

You should seek legal advice for your own circumstances on the acceptance text and process for how your terms are fully implemented on your website. As part of the work I do with clients, I not only draft their terms, but sometimes advise on implementing the terms and reviewing the client website once the terms have been implemented.

When Should Users Accept the Terms?

There is a risk that your terms may not be binding as a result of a user having to agree to them (or be informed of the terms) after a transaction is complete, or after a user has signed up for an account and received the consideration (or benefit) for which they visited your site. That is, if they received the benefit from your site, they may receive no fresh or new ‘consideration’ for later agreeing to your terms of use. So careful thought should be given to not only how, but when your terms are presented to users to give the terms the best chance at being enforceable.

Other things many web-based businesses consider or do, when implementing their terms include:

- Forcing users to scroll through the terms before clicking to accept them. This is a technique that GoDaddy has used. In my view, it puts them in a better position to avoid arguments that a user didn’t have access to the terms, or that the terms were not adequately presented at the time of acceptance.
- Forcing the user to click the acceptance box (rather than having it pre-selected) will likely increase the prospect of enforceability and help indicate that the user actually accepted the terms.
- While there are others, which we do not cover in full in this book, one of the grounds for a court to find that your terms and conditions are unenforceable is where particularly “onerous” terms are not sufficiently brought to the user’s attention for acceptance. It is for this reason the terms dealing with limiting a website operator’s liability are often CAPITALIZED and/or in bold font. In some online contracts and website terms, businesses also require users to place their initials in a text box beside onerous terms.

If you do not require users to provide their name to be associated with an account, consider what impact it may have on the ability to enforce your terms. How do you know who clicked to accept your terms? Depending on the circumstances, consider (with your lawyer) whether your terms should specify that accounts are non-transferrable. If they are transferrable (or your terms were silent on that point), you risk users who accepted your terms in a click-wrap, later transferring their account or sharing a password with someone who never clicked to accept your terms.

If those users have access to your website or service, do you have a contract with them? This situation may present issues with enforcing your terms against such users. Having terms that prohibit the transfer of accounts and sharing passwords can at least put you in a position to argue that the original user breached your terms if they did share the password or transfer the account.

Consideration

In order for your terms to be binding, some form of consideration must pass between you and the user. In some instances, access to your website can constitute valid consideration granted to a user. Consider the British Columbia Supreme Court case of *Century 21 Canada Limited Partnership v. Rogers Communications Inc.* where the court found that access to the site alone was consideration granted to the site users:

> *[122] The defendants also argue that in offering access to their Website, Century 21 is not giving any promise of benefit and undertakes no burden and as a result there is no consideration. I do not find this in fact to be the case.*
>
> *[123] Clearly the databases created by developers of websites have value. Information has value. The evidence in this case is that Zoocasa has spent over $6 million on its Website. Century 21 has expended over $6,345,849.59 from 2006 to December 31, 2009. Zoocasa's actions in accessing the Century 21 Website and copying photographs, property descriptions and other information affirms that there is value. Presumably if the information was without value Zoocasa would not seek it or use it. In my opinion there is*

consideration for the contract as Zoocasa obtained the benefit of the information displayed on the Website.

Discussing the consideration issue with your lawyer is important when drafting your terms. What is it that users or customers get in exchange for agreeing to your terms? If there is no consideration given in exchange for agreeing to your terms, you risk the terms being unenforceable.

Capacity

Ensuring an end-user or customer of your website actually has the legal capacity to enter an agreement can be difficult. There are two main concerns for ensuring a user has the capacity to enter an agreement:

- Are they of the legal age necessary for forming a contract (that age may vary by jurisdiction); and
- Is the user of sound mind?

When contracting online, it can be difficult to verify this information. How do you know if a user is actually a certain age? If users are not the age of majority, they may be able to elect to cancel the contract even after they have expressly agreed to your terms. If a user is not of sound mind, it could result in the terms being unenforceable against them, with a court finding that no binding contract was entered.

Different sites have taken different measures to try to verify age. Some require users to click a box to indicate they are of a certain age, others may require that the user put their birth date in a data entry box etc. In my view, there is no good way for verifying age. That said, if your site markets towards people under the age of majority, you should be particularly careful and speak with your lawyer about the impacts of the site being used by and marketed towards people under the age of majority.

At the time of writing, there are two major lawsuits outstanding against the major social media companies in relation to children, and the addictive nature of their products to teenagers.

One claim was commenced by 35 state Attorney Generals in the US alleging that Meta purposefully employs features on its social media platforms that addict children, which is harmful to their mental health. The states claim that platforms like Facebook and Instagram use tactics such as infinite scrolling and content alerts to prolong youth exposure to the sites. The lawsuit seeks an injunction to halt Meta's use of these tactics and monetary relief for the damage caused to a generation of children. Because the states are not the users themselves, Meta trying to hide behind their terms of use will likely be futile for them.

In another claim, brought by parents of minors against Meta, TikTok and other social media companies, they claim that the design of social media platforms has contributed to a youth mental health crisis, sexual exploitation, and compulsive use, leading to negative mental and physical outcomes for children. Specific issues highlighted include endless content feeds, lack of screen time limitations, addictive features, algorithmic prioritization, filters that alter appearances, barriers to deleting accounts, and insufficient age-verification and parental controls. Again, efforts by the defendants to rely on their terms of use, given the claims are by minors, may very well be futile as well.

While this book does not canvass all of the different ways in which online terms and conditions can be found to be unenforceable, the above is intended to help you think through some of the more prominent issues for creating enforceable terms of use, and highlight the risks of your terms being unenforceable; especially provisions intent on reducing your liability exposure, or governing how disputes are settled.

Potential Liability Issues

While website terms and conditions can help reduce your exposure to a lawsuit, they do not guarantee that you will not be sued. Even companies with well drafted terms and conditions face liability for their site's contents, products and services. A key function of your terms and conditions is to try to reduce your exposure to a lawsuit, attempt to limit your liability in the event of a lawsuit and set the ground rules for how disputes with users will be resolved.

However, even limitation of liability clauses or disclaimer clauses can be struck by a court and found non-binding. Take for example the online trading case where a Canadian court refused to enforce disclaimer and limitation of liability clauses because of their obvious one-sidedness. In *Robet v. Versus Brokerage Services Inc.*, the Ontario Superior Court set aside a disclaimer that virtually eliminated liability for inaccuracy in the performance of an Internet stock trading service.

The Court found the effect of the clause as giving the defendant a "*licence to be reckless*", and held:

> *To suggest that there could have been a meeting of the minds between customer and broker, such that it could be said that the customer understood that he was exonerating the broker from acts of incredibly gross negligence on the part of its employees who were specifically charged with the sensitive task of entering the accounting information into the computer, however, defies logic, common sense or probability. In my view, no one would knowingly*

or willingly make a contract with a party who reserved the right to be grossly negligent.[8]

Accordingly, even with a limitation of liability provision in your terms, there are still scenarios where you and/or your employees, directors, contractors etc. may be found liable for acts and omissions, including in relation to the functionality of your site or the goods or services sold.

This is especially the case in the event of gross negligence, but may apply in other circumstances based on the facts of the particular case and language used in the limitation of liability clause in question.

While different websites and businesses have the potential to attract different types of liability, common areas where websites may face legal issues include (just as a small example):

- The sale of unsafe products or services or products or services which cause liability under consumer and product safety legislation. Such liability can arise even when you are not the manufacturer. This is particularly a concern where someone who did not agree to your terms and conditions is using the product or service.
- Inadequate provision for protecting user personal information. For example there have been cases where user data was either improperly given to a third party, lost or stolen. Limitation of liability clauses may not protect against such claims.
- Principal terms of a contract (such as a product description or price) were posted in a misleading or deceptive manner under consumer protection legislation.
- The website contains an unknown virus or malware which impacts a user or customer's own device.

- Transmission problems or server outages cause damages to your customers or users who rely on your site for business purposes (i.e. they lose access to their data and cannot conduct business or lose the ability to carry on business).
- Content on the site could contain material that is illegal, infringing on someone else's copyright or intellectual property rights or is defamatory.

Amending and Updating your Terms

While it has been common practice to state in your terms that you can amend them by posting the amendments on your site, or providing an email to a user, caution should be had with all updates, and you should seek advice from a lawyer at the time of the update. Your lawyer can help you consider the best way to make the updates enforceable based on the state of the law at the time of the update.

Take for example the 2022 case in the US of *Sifuentes v. Dropbox* where an updated version of the Dropbox terms and conditions were found to be unenforceable. While the case may be appealed, the court held that modifications to Dropbox's terms and conditions, which included a mandatory arbitration clause, did not bind the plaintiff. A main factor in finding the amended terms unenforceable was there being no evidence that the plaintiff had actually seen or read an email notifying them of an updated version of the Dropbox terms (which had the arbitration clause). As some commentators note, this case could have a dramatic impact. Professor Eric Goldman notes:

> *It apparently requires clickthroughs to form TOS [terms of service] amendments, regardless of what the TOS specifies as the amendment process. Given how rarely TOS amendments use clickthroughs, this opinion could anticipate the widespread failure of TOS amendments if it's the final word on the topic.[9]*

Copyright Considerations

As a website operator, under Canadian law you have certain obligations when it comes to copyright. First and foremost, you must ensure that you, your staff and agents do not post content to the website or your online service that infringes the intellectual property rights of any third parties.

Where you are operating a website or portal that permits third parties to post content, while your terms of use should attempt to limit liability (to the extent possible by law), the law imposes certain obligations on you. In the Canadian context, website operators can, in some situations be liable for the infringing content on their site, especially if, after receiving notice of the infringement, they do nothing to remove the content. You should work closely with a lawyer if you come to learn that your site hosts content that is alleged to infringe intellectual property (or other) rights.

Keep in mind that in the US and other jurisdictions, other laws, rules and regulations will apply that you may have to consider, especially if you have users, or the person who owns the copyright in question is based there.

US Considerations

Under the D*igital Millennium Copyright Act* ("*DMCA*") in the US, web companies hosting user-generated content are offered "safe harbor" protections. These protections shield them from liability for copyright infringement committed by users, provided specific conditions are met. For example, some of the requirements to be afforded the '*safe harbor*' protections include:

- **Notice-and-Takedown System:** Implement a system for copyright owners to notify the website of infringing content. Upon receiving a valid notice, the company must promptly remove or disable access to the alleged infringing material.
- **Designated Agent:** Designate an agent to receive these infringement notices. This agent's contact information must be registered with the U.S. Copyright Office and conspicuously posted on the website.
- **No Actual Knowledge:** The company should not have actual knowledge of the infringing activity or awareness of facts or circumstances from which infringing activity is apparent. Under the *DMCA*, an online service provider can lose its safe harbor protection if it is aware of facts or circumstances that would make infringement plainly apparent to a reasonable person (i.e., "*red flags*"). This concept is distinct from actual knowledge of specific acts of infringement. The distinction between actual and red flag knowledge is crucial and often litigated.
- **No Financial Benefit:** The company must not receive a direct financial benefit from the infringing activity, in situations where it has the ability to control such activity.
- **Policy for Repeat Infringers:** Adopt and reasonably implement a policy that provides for the termination of repeat infringers.

So, if you host a site with US users that post user generated content, you should seek advice from a US lawyer on the application of the *DMCA*. *DMCA* matters can be complex, and making determinations as to whether there has been an infringement and if so, whether there could be permitted use under, for example, the 'Fair Use' doctrine leads to complexities a US lawyer should advise on.

Separate from the *DMCA*, Canadian website operators should be aware of Section 230 of the United States *Communications Decency Act* in the US. Section 230 is a critical piece of legislation for technology companies in the US. In many instances, it allows companies to host and moderate user-generated content without being legally responsible for what users post. Some view section 230 as a crucial component of the modern internet. If companies were liable for content on their site posted by users, many would not take the risk of operating social media platforms like X, Reddit, Facebook etc.

Diverting liability away from the website operator, section 230 promotes plaintiffs who object to certain content (like defamatory content) to bring their claims against the person who posted it, rather than the platform itself. This can lead to other issues, like lawsuits against the platforms to disclose information about the person who posted the content, such as their IP address and user account details.

Section 230 has also been the subject of debate lately. Critics argue that it allows platforms to inadequately address harmful content. Calls for reform or reinterpretation of section 230 have emerged, focusing on how tech companies moderate content and the extent of their legal immunity. Many want reforms to make it easier to hold big tech companies liable for content on their platforms.

In a preliminary decision of a major US case in 2023 called Re: Social Media Adolescent Addiction/Personal Injury Products Liability Litigation, a court took a step towards highlighting the limits of section 230. In that case, a US district court judge ruled that discovery can proceed in a lawsuit against Meta, Google, TicTok and others, with the judge finding that section 230 did not necessarily bar the plaintiffs' claims related to the negative impacts of social media on children and teenagers.

In short, the judge’s preliminary decision was that there doesn’t appear to be section 230 protections for features of the social media platform, like end-less scrolling, lack of screen time limitations, etc., even if the defendants are protected from liability related to the actual content posted by users.

The ruling leaves the window open to find the defendant social media companies liable for negligence in the way they offer the above features on their platforms. While the ruling may be appealed, it will likely impact how these companies operate going forward.

Insurance

I tell clients that there is the trifecta for protecting against liability from end-users of your website, app or platform. We covered two already - incorporating and having website terms of use or other contracts that limit liability to the extent possible by law.

However, as we explored above, there is no 100% shield from all forms of liability. There are certain types of claims that courts will not permit you to contract out of liability for, there are statutory claims, like breaches of privacy rights, there are claims for gross negligence, and others.

So, the third part of the trifecta is good old-fashioned insurance. While the types and amounts of coverage will vary based on the nature of your business, all companies should consider what policies are right for them. As of late, there are policies and types of coverage that are marketed towards online businesses, including, just as one example, cyber liability policies.

Keep in mind that the wording of the actual policy matters, and despite any marketing materials and coverages summaries provided to you, it is a good idea to get a legal opinion on what the policies you are looking at actually cover and how that coverage relates to your specific business. I have been shocked more than once after clients have purchased a policy, brought it to me for review, only to realize that the thing they thought they were insuring against was actually excluded from the policy.

So, work with a reputable insurance broker, reputable insurer and have a lawyer advise you on the scope of your insurance coverage based on the wording of the policy. For online businesses, there may be various types of policies to consider, but some that come to mind include:

- General liability and umbrella excess liability insurance;
- Cyber liability and cyber errors and omissions insurance;
- Management and professional liability insurance;
- Directors and officers' liability insurance; and
- Other policies covering particular types of liability arising from the nature of your business, for example, if you are selling physical products, product liability insurance.

End Notes

[1] Government of Canada, FAQ - Application of the GST/HST in relation to electronic commerce supplies https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/faq-relation-electronic-commerce-supplies.html#, accessed on January 4, 2024.

[2] For example, see the Ontario *Consumer Protection Act*, 2002.

[3] Accessible online at https://www.ic.gc.ca/eic/site/cmc-cmc.nsf/vwapj/Sales_Template.pdf/$file/Sales_Template.pdf.

[4] *Consumer Protection Act*, 2002, O. Reg. 17/05: GENERAL, s. 31, 32 and 33.

[5] Luc Rocher, Julien M. Hendrickx & Yves-Alexandre de Montjoye. Estimating the success of re-identifications in incomplete datasets using generative models. Accessed online January 8, 2024 https://www.nature.com/articles/s41467-019-10933-3.

[6] C*entury 21 Canada Limited Partnership v. Rogers Communications Inc*., 2011 BCSC 1196 (CanLII) citing *Rudder v. Microsoft Corp.* 1999 CanLII 14923 (ON SC), (1999), 106 O.T.C. 381, 2 C.P.R. (4th) 474 (Ont. S.C.J.), Winkler J.

[7] *Consumer Protection Act,* 2002, s. 38(2).

[8] *Robet v. Versus Brokerage Services Inc.*, 2001 CanLII 28366 (ON SC), para 62.

[9] Goldman, Eric. Dropbox's TOS Amendment Fails (And If This Opinion Stands, Yours Will Too)–Sifuentes v. Dropbox. https://blog.ericgoldman.org/archives/2022/07/dropboxs-tos-amendment-fails-and-if-this-opinion-stands-yours-will-too-sifuentes-v-dropbox.htm, accessed January 4, 2024.

CHAPTER 9: SELLING YOUR BUSINESS AND THE “EXIT”

As an entrepreneur, it's important to have a vision for the future of your business. While some founders may dream of building a legacy and passing their company down to future generations, others may have their sights set on building a business that can be sold. In this section, we'll explore the concept of 'The Exit' and discuss strategies for building a business with the goal of selling it.

ASSET VS SHARE SALES

There are two ways to sell a business in Canada, you can sell the underlying assets of the business, or you can sell the shares of the corporation (which owns the assets).

Usually, it is preferable for the seller to sell their shares as opposed to the assets of the business since the gain from selling shares can be treated as a capital gain for tax purposes. Perhaps more importantly, subject to the terms of the purchase agreement, the buyer usually assumes all liabilities associated with the company.

Buyers often prefer asset purchases as they can claim depreciation on the purchased assets, and avoid inheriting the seller's potential, unknown or hidden liabilities. For example, a buyer could buy the company and find out a month later it was in the process of being sued. While there are ways to mitigate that risk in a share purchase agreement, the risk remains.

Knowing that you may be forced to sell the business in an asset sale, you should think early and often about making sure the business holds those assets in a way a buyer would want to receive them. One of the main considerations is whether the contracts you have with various third parties are assignable.

Take for example a situation where you operated a software company, and you entered licencing agreements with all your customers. Maybe you have one major customer that implements your software and you provide them with software and implementation services on a monthly or annual basis. In some cases, clever customers will negotiate to ensure that you cannot assign their contract to a new owner without their consent. Customers may try to force this on you to protect against their competitors or other undesirable third parties buying your business and, without your customer's consent, your customer may be forced to do business with the entity you sell to.

While it may seem immaterial at the time, and you want to close the sale, the assignability of your customer contracts may make the sale of your business easier.

Tax Matters

To better understand the main tax issue on selling a business, when you sell the shares and are a Canadian Controlled Private Corporation ("CCPC"), a concept we looked at earlier in the book, as a Canadian, you may be eligible to take advantage of the Lifetime Capital Gains Exemption ("LCGE").

The LCGE is a tax benefit that allows certain individuals to claim an exemption on the capital gains realized from the sale of shares of a qualified small business corporation, up to a certain amount. The LCGE amount is adjusted annually. As of 2023, the limit is $971,190.

This means that when a Canadian founder (or other qualified shareholder) sells shares of a qualified business corporation, they can claim the LCGE to reduce the amount of capital gains tax they would otherwise have to pay. This can result in tax savings for the individual and can make it more attractive for Canadians to invest in small businesses.

However, to qualify for the LCGE, aside from being a CCPC the company must meet certain criteria, including, for example, criteria related to (i) the duration of time the founder or applicable shareholder held the shares; (ii) the use of the company's assets; and (iii) the carrying on of an active business in Canada. So, speak with your tax advisor well in advance of trying to sell your business if you want to try to rely on the LCGE. They can advise you on whether you qualify, and if so, how to ensure you continue to qualify at the time of the sale.

On the flip side, when a business opts to sell its assets rather than its shares, the decision carries distinct tax implications. Understanding these consequences is essential for making informed decisions on the sale of your business, the purchase price and ultimately the end-calculation (in terms of what lands in your pocket, after taxes). Here is a rough outline of some of the tax issues and consequences you should speak with your tax advisors about (they can advise you on others that may apply in your circumstances):

- **Immediate Taxable Gains:** Selling assets often results in immediate taxable income for the business based on the value of the assets. Different asset classes (e.g., real estate, equipment, intellectual property) may be subject to varying rates of tax.
- **GST/HST Implications:** The sale of business assets is generally subject to Goods and Services Tax/Harmonized Sales Tax (GST/HST) in Canada. This tax must be collected and remitted by the seller, impacting the net proceeds from the sale. That said, depending on the various factors, there can be sales tax exemptions that apply to certain assets. The jurisdiction of the parties can also play a factor. Be careful here on seeking specific tax advice on how GST/HST applies in your circumstances.
- **Allocation of Sale Price:** Tax consequences vary based on how the sale price is allocated among different assets. The allocation can impact the tax burden, as different asset types are taxed differently.
- **Loss of Tax Attributes:** Asset sales may result in the loss of certain tax attributes like non-capital losses or tax credits, which could otherwise be carried forward or back to offset taxes in other years.
- **Potential Double Taxation:** Following an asset sale, the corporation may face double taxation if it distributes the after-tax proceeds to shareholders as dividends, which are taxed again in the hands of the recipients.

Given the complexities that go with tax matters related to both the sale of shares and assets, it is always good to involve a tax advisor in the sale process at an early stage. This is because the structure of the deal may impact the offer you are willing to accept from a buyer. In some situations, owners negotiate to increase the purchase price in the event of an asset sale, to account for the increase in taxes they will pay if they miss the LCGE.

THE LETTER OF INTENT

Leaving tax aside, business sale transactions typically turn to the negotiation of a letter of intent, or in many cases, entering a non-disclosure agreement ("NDA") first.

The letter of intent is supposed to be just that, an outline of the buyer's intent and framework for the deal (asset vs. share sale, intended price, etc.). It covers core issues, like:

- The purchase price;
- Whether there will be an earn out for the vendor;
- Whether individuals behind a buyer corporation will provide personal guarantees in relation to the purchase price (where the full payment isn't being made in cash on closing);
- The payment terms (for example, is part being paid upfront with the balance to be financed by the vendor?);
- The scope and duration of any non-compete and non-solicit clauses;
- What happens with employees etc.

However, the LOI is not supposed to be the actual agreement of purchase and sale, cover every issue that needs to be agreed upon or obligate either party to proceed with the transaction.

The LOI serves as a basis upon which the buyer conducts their due diligence, to confirm what the seller has said about the business is true, and to investigate the health of the business.

I prefer having an NDA signed first as this allows a basic level of due diligence to be done by the buyer, see the financial statements and other information, so they can prepare an LOI that makes sense in the context of the business they are buying. It also allows the parties to openly discuss the intended purchase price and to agree (subject to due diligence) on a number before they get into a deeper due diligence process and a discussion on the terms of the LOI. It also allows the seller to disclose non-public information about the business and respond to due diligence requests, before the buyer has to settle on a proposed deal structure.

I see situations where business brokers are involved in helping list a business for sale. Brokers sometimes give template NDA's and LOI's, off the shelf, to a client for them to lightly amend and sign. This can lead to problems, including where there are provisions that read more like an actual agreement of purchase and sale, rather than indicating the document constitutes a non-binding intent.

I have seen all sorts of unfriendly, ambiguous, and harmful clauses that sneak their way into and LOI and that later lead to disputes or tougher negotiations on the purchase agreement when lawyers get involved. Likewise, sometimes sellers agree to the outline of a transaction without fully understanding the consequences of everything in the LOI, from tax issues and financing conditions to earn outs and post-closing adjustments.

Broker's often dislike lawyers getting involved early (or in some cases, at all) in the sale process. They do not want the lawyer to kill the deal with protracted negotiations on an LOI, and then subsequently the purchase agreement. They want a quick sale to collect a commission and move on. The problem is, they take no risk and do not bear the consequences of not having understood the terms of the LOI or purchase agreement.

In my view, it is better to involve your lawyer at an early stage so they can explain the full consequences of the draft LOI to you, and help you negotiate changes upfront. It is way easier to face the tough issues in the LOI head on, from the get-go, rather than try to negotiate later for something contrary to the LOI. No buyer wants to be led down a path towards an agreement only to find out you want to change a core term of the deal.

While LOI's are typically non-binding, they do often have binding provisions, including on the issues of:

- Confidentiality (especially if an NDA was not previously signed);
- Exclusivity, where the buyer tries to lock up the seller from discussing the deal with other potential buyers for some period;
- Dispute resolution and governing law.

The dispute resolution and governing law provisions should not be taken lightly. If the agreement of purchase and sale is going to be governed by the laws of your home province (which you will likely want), you will likely want to try to negotiate to ensure that is the case for the LOI as well.

We explored the consequences of governing law clauses in other sections of this book. In short, you will need a lawyer acting for you that can practice law and give advice under the governing law. If a buyer shows up and says the laws of Texas govern, that complicates the deal right out of the gate for you. If you can keep your local jurisdiction as the governing law, it may save you from having to engage a foreign lawyer.

More importantly, if you had to go to another jurisdiction to resolve a dispute, as a Canadian entity you may have an uphill battle. Litigation is difficult and complex enough. Making it an international dispute, having to show up in a courtroom in, say, Texas (where they elect their judges) might not lead to the best outcome.

Founders selling their business should also consider careful legal advice around NDA's (or the confidentiality provisions of their LOI) as confidentiality provisions can have nuanced applications in the context of each business.

There have also been cases where buyers lock up a seller in an LOI, gain valuable insight into a business, terminate the LOI, and later use the information to compete or solicit your staff or contractors. Your lawyer can advise you on those types of risks based on the wording of the LOI (or NDA) and contextual factors, like where the buyer is located and what line of business they are in. Your lawyer may also be able to do some due diligence on the buyers themselves.

Due diligence

Once you've got an LOI signed, there is typically a period of time in which the buyer can perform further due diligence. As part of this process, you should expect an extensive list of questions. Depending on the nature of the deal, the main topics a buyer will want to cover include (there can be many others and the list is by no means exhaustive):

- Basic corporate documents.
- Shareholder information: cap table etc.
- Financial information: financial statements, audits, tax returns etc.
- Corporate finance: loans and debts outstanding, security interests granted to creditors etc.
- Taxation and government compliance.
- Operations: lists of suppliers, contracts, material customers, inventory, product warranties, customer relations etc.

- Sales and marketing: for example, in the e-commerce space, evidence of conversion rates, user acquisition costs etc., are a big topic.
- Employee matters: benefit plans, pension plans, commission agreements, employment contract reviews etc. This can be a big topic, because as we explored above, the termination of employees can be seen as a big contingent liability. If the business is acquired, and staff are laid off, they may have significant entitlements, including termination pay.
- Tangible and real property holdings.
- Intellectual Property: do you have registered trademarks, copyrighted works, patents etc?
- Litigation and audits: has the company been sued or does the company have outstanding claims? Are there government audits or investigations outstanding?
- Insurance: are there policies outstanding, if so, what happens to them on the sale of the company etc?
- Consents and approvals: are there government or third-party consents required to sell the business, for example with landlords, franchisors, and others?

Smart sellers have a tidy due diligence package in place anticipating questions on the above topics (among others). Not being able to answer basic questions about the business always leaves a buyer with a bad taste.

If you present the company poorly as part of the due diligence process, you may also see buyers that only want to buy your assets. This is because they will have greater concerns about hidden liabilities that even the best due diligence could not uncover.

Likewise, sellers who do not have clean contracts with employees, contractors, suppliers, customers, end-users etc., present poorly. Smart buyers assess all forms of risk. For example, if you do not have clean terms of use for your online software start-up, that limit your liability, your buyer may factor the corresponding risk exposure into their purchase price and deal structure. The buyer may have concerns about buying your business and facing future claims from end-users.

The same is the case for employment matters. If you have well drafted employment agreements that contain what employees are owed on termination, your buyers will assess that contingent liability in better light. If they buy a business, find out they don't need all the staff and want to cut costs, they will not want to face larger than necessary common law notice and severance payouts.

If you know you want to sell your business at some stage, knowing the due diligence process now, before you start your business, or at least well before you intend to sell it will help you ensure you can proactively take steps to present well to prospective buyers. You can make sure your minute book is in order, you have clean contracts with employees, contractors, suppliers and customers. You can register your IP, protect your business names and take all sorts of other steps which we have covered in this book. Doing so will greatly increase your marketability when the time comes that you want to exit the business.

THE PURCHASE AGREEMENT

Assuming the parties have agreed to the high-level terms in an LOI, the buyer has completed their due diligence, it is time to move to negotiating and finalizing the terms of a purchase agreement (either a share or asset purchase agreement).

Generally, the lawyer acting for the buyer drafts the first version of the agreement. The drafter would use the LOI as the framework, taking into account any adjustment to the terms agreed upon following due diligence. For example, sometimes due diligence results in the parties agreeing to adjust the purchase price, the payment terms, the allocation of the purchase price etc.

Representations & Warranties

While we will not cover every section of a purchase agreement, and every agreement has its own unique set of facts to account for, in my experience the section which often results in further negotiation, is the reps and warranties section. That is, what reps and warranties is the seller willing to make about the business?

Many LOI's simply state that the purchase agreement will have 'standard representations and warranties' about the business. That is vague and what is 'standard' may be different in the context of each business. This usually leads to a spirted negotiation on the scope of those representations and warranties, which the purchaser's counsel will include in the first draft.

Smart buyers will want extensive reps and warranties about the business. This could allow the buyer to hold the seller to account if something disclosed during due diligence turns out to be untrue or misleading.

Common reps and warranties found in purchase agreements include representations on:

- The accuracy of financial statements;
- The business having been operated in compliance with applicable laws, rules and regulations and having all necessary licences to operate etc.
- The authorized, issued and outstanding shares in the corporation, and any options or similar rights are accurately reflected in the agreement;

- The corporation owning all material assets (including IP), which may even be listed as a schedule;
- Whether there are any encumbrances on those assets;
- The employees and independent contractors, including the amounts for all salaries and other perks or benefits (like group life policies, pension plans etc.), the duration for which they have been employed etc.;
- Insurance coverages;
- Inventory levels;
- The value of accounts receivable and payable;
- The list of liabilities and material contracts;
- Tax accounts with the relevant tax authorities (CRA etc.) and any reassessments or audits; and
- The status of any existing or anticipated lawsuits or proceedings.

That said, the above list only touches the top of the iceberg in terms of the scope of reps and warranties that may be sought. Different reps and warranties may also be sought based on the nature of the business, where it is located and other factors. The scope of the reps and warranties can also impact the price a prospective purchaser is willing to pay. Consider Tim Ferriss' comments on his blog:

> *Several chess moves into price negotiation, after the suitor and I had arrived within 10% of each other, I offered to reduce the asking price 20% in exchange for the elimination of most "reps and warranties." This would give me a clean break, financially and emotionally, and it would dramatically speed up the sales process. I don't regret that apparent "concession" and would make the same decision in a heartbeat.*

In short, Ferriss was willing to shave the purchase price, for a cleaner break and less prospective liability post-closing.

Indemnifications and Liability

After the representations and warranties, the next critical section in a purchase agreement is indemnification. This clause outlines the procedure and extent to which one party (typically the seller) compensates the other (the buyer) for losses arising from breaches of the reps and warranties. Negotiating the scope, duration, and cap on indemnification obligations can be vital for sellers. Sellers seek to limit their liability, while buyers aim for comprehensive protection.

Again, while there are many other provisions of a purchase agreement, the above sections were covered to highlight where many deals get hung up.

CLOSING NOTES

If you made it this far, you must be serious about either becoming a founder, or growing an existing business. So, congrats! In my view, you are now better informed on the legal issues founders face than most.

This book aimed to bridge the legal knowledge gap faced by founders on their way to operating a profitable business. By now, you should feel more equipped to navigate legal challenges that arise with founding and growing a business. The examples and case studies provided were not just stories; they are lessons learned at the expense of others. They are intended to help you avoid pitfalls others faced.

While we have covered important topics, there are, undoubtably, other legal issues your business will face. Your journey as a founder is unique, and so are the legal challenges you will meet. I encourage you to continue learning about the law as it constantly evolves, asking questions, and engaging with lawyers who understand and support your vision.

While us lawyers are good at highlighting legal risk, providing legal opinions and fine-tuning contracts - don’t let your lawyer dissuade you, or force you to lose sight of your vision. In many situations, it’s your lawyer’s job to tell you what the risks are, it's your job to decide whether you will take them.

If you are passionate about your idea, find a path forward and most of all, have some fun with it. Being a founder can be a rewarding experience, regardless of the level of financial success you have. You will meet interesting people along the way and have all sorts of ups and downs. Keep your eye on the prize and don’t forget why you started your business in the first place; which for many is the freedom that goes with being your own boss on the way to success.

Keep after it.

ABOUT THE AUTHOR

John Wires is a Canadian corporate lawyer. In 2013 he opened his own corporate law firm (Wires Law) offering legal services to founders, investors, and businesses across Canada.

John advises companies, founders and shareholders of software enterprises, app developers, e-commerce retailers and platforms, consulting firms and digital media companies. John's clients and their executives answer to boards of directors and shareholders, hire and fire employees, negotiate and sign contracts, invent new products, license technologies, raise capital and deal with a host of legal issues every day.

John helps clients reduce legal risks in their daily decision making and in the agreements they enter. His services range from setting up and protecting businesses to closing M&A transactions for clients selling their businesses. As a former website builder, John has a passion for technology always playing with the latest tech to see how it can integrate into the practice of law.

John was an advisor to the National Crowdfunding Association ("NCFA"), a not-for-profit working hard to promote crowdfunding as a means for Canadian businesses to access capital. He has been covered in the Globe and Mail, Toronto Star, CBC News, TechVibes and the Canadian Bar Association's National Magazine on Crowdfunding in Canada. He has also been a guest lecturer at Ryerson University and Communitech. He is a former NCAA Division I and OHL hockey player.