A Primer for Start Up Businesses

This Primer for Start Up Businesses provides an overview of primary legal issues that founders, private equity funds and venture capital funds should consider.

SECTION 1: BUSINESS STRUCTURES

One of the most important legal decisions when starting a new business is determining the type of business organization that is most beneficial for your particular business. The type of organization will have important legal implications, including how the business is taxed, the ways in which it can raise capital, and the personal liability of the individuals controlling the business. This Primer sets out the most common business structures, which include sole proprietorships, partnerships, and corporations.

SOLE PROPRIETORSHIP

- A sole proprietorship is the most basic form of business organization and can be used in a wide variety of circumstances. A sole proprietorship exists whenever an individual carries on business for their own account without the involvement of other individuals, except as employees. The owner is personally responsible for all of the obligations of the business and receives all of the profits derived from its operation. Finally, as the sole proprietor is the one who owns the assets of the organization, the sole proprietor has to transfer ownership of the relevant assets, not the sole proprietorship. This results in the dissolution of the sole proprietorship.
- Sole proprietorships are relatively inexpensive to set up and require few legal formalities. Some other advantages of organizing as a sole proprietorship are the control of the sole owner over decision-making, the ability to deduct business losses against other personal income, and the low regulatory burden.
- A major disadvantage of sole proprietorships is that there is no limited liability for the owner. This means that all business and personal assets may be seized in satisfaction of the sole proprietor’s business obligations and liabilities. The owner may limit their personal liability exposure by contract or through insurance. Another disadvantage is raising capital. It is not possible to divide up ownership of the sole proprietorship which means that the sole proprietor would only be able to borrow money to raise capital.

PARTNERSHIP

- A partnership is created when two or more individuals or corporations carry on business together with a view to profit. The members of the partnership are called partners. The partners carry on the business themselves directly since the partnership is not a legal entity separate from the partners. The rights and obligations of the partners are usually set out in a formal partnership agreement; however, absent such agreement, the partnership is governed by the rules set out in Ontario legislation, including the *Partnerships Act* and the *Limited Partnerships Act*.
- Partners may be admitted to the partnership if all other partners consent. A partnership agreement may further set out requirements to become a partner, including financial contributions to the partnership. It is also common for new partners to agree to take on the existing liabilities of the partnership. A partnership agreement may also set out the rights and obligations of departing partners, including instances in which a partner must leave the partnership. Ownership in a partnership may be transferred; however, certain restrictions may be set out in the partnership agreement.
- A partnership is relatively inexpensive to set up and there are few legal formalities required to create it. In addition, income and losses are taxed in the partners' hands, meaning that each partner can apply its share of losses from operating the business against other income sources.
- Since a partnership has no separate legal identity from its partners, depending on the partnership structure being used, a partner may carry unlimited personal liability for the business' obligations. Instead, individuals may set up a limited partnership where there is one or more "general partners" whose liability is unlimited and one or more "limited partners" whose liability is limited to the amount they have contributed or agreed to contribute to the partnership business.

CORPORATION

- A corporation is the most common form of business organization. It is a legal entity separate in law from its owners and can own property, carry on business, enter into contractual relationships, possess rights, and incur liabilities. Although the shareholders own the corporation through their ownership of shares, they do not own the property belonging to the corporation, and the rights and liabilities of the corporation are not the rights and liabilities of the shareholders.
- A corporation may be incorporated under federal or provincial legislation. In Ontario, a company is incorporated under the *Business Corporations Act* and in Canada, a company is incorporated under the *Canada Business Corporations Act*. A federally incorporated company has the right to carry on business and use its name in all provinces. By contrast, a company incorporated in Ontario can only carry on business in Ontario unless it obtains a license under the extra-provincial licensing statute of another province. In order to incorporate, a business must file articles of incorporation and other supporting documents and fees to the appropriate government authority. Once the articles have been filed, a certificate of incorporation will be issued.
- Shareholders' liability is limited to the value of the assets they have transferred to the corporation in exchange for shares. In addition, a corporation continues notwithstanding

the death or withdrawal of a shareholder by the sale of their shares. Lastly, there is greater flexibility to raise capital.

- Some disadvantages include the higher costs of organizing the corporation and the increased burden of regulatory oversight.

BENEFIT CORPORATIONS (B CORPS)

- A “Benefit Corporation” is generally understood to refer to a for-profit corporation where the directors are empowered by the articles to act ‘beyond’ the best interest of the business, and to ‘conduct business in a responsible and sustainable manner and promote the company’s specified public benefits.’ It has a different statutory meaning under Ontario law governing not for profit corporations.
- Currently, British Columbia is the only Province to expressly allow incorporation of a Benefit Corporation (June 30, 2020) though such companies are common in the USA since 2014. Also, there is some opinion in Canada that a regular for-profit corporation can act as a good corporate citizen with a view to the interests of a broad range of stakeholders (and not just the shareholders) without the need for specific legislation.

SECTION 2: RAISING CAPITAL

A corporation needs to raise capital in order to finance its operations and future growth. There are several different ways to raise capital, but the corporation has to ensure that it complies with the securities laws in the jurisdiction where it undertakes its fund raising activities.

TYPES OF FINANCING

There are a few different types of ways one can finance their business, which include debt financing, equity financing, or a combination of both.

Debt Financing

- This is a method of raising capital by borrowing from shareholders, partners, or third parties (i.e. banks and other financial institutions or debt investment funds). An advantage of debt financing is that the start-up’s founders maintain their ownership interest in the corporation.
- In most cases, security for borrowings from a third party will be required, and in certain cases, guarantees of the shareholders or other related parties will also be requested. During the early stages of a company, it may not be possible to borrow money from a bank or other commercial lender due to the lack of revenue necessary to make payments on the debt.
- Shareholders and other individuals may advance loans to a company. It is recommended that such parties obtain security so that they may have priority over the claims of unsecured creditors.

Equity Financing

- Equity financing refers to the raising of capital through the sale of a corporation's shares and/or other securities, or units of a limited partnership or trust.
- In the case of start-up corporations, the class of shares or units offered to investors will typically be created as part of the financing and will be given attributes that are specifically tailored to the requirements of the investors.
- The advantage of share or unit ownership is that the investor can share in the corporation's success by receiving dividends or through an increase in value of the shares or units. However, it is a riskier form of investment as there is no guarantee that the value of shares or units purchased will increase, or that a buyer will step forward to purchase the shares or units when the investor wishes to sell their shares or units instead.

Hybrid

- While raising capital, there may be instances where both debt and equity financing elements are used. For example, where an investor offers to lend money on the condition that it may be converted into equity upon the occurrence of certain defined events. A convertible loan gives the investor the security associated with traditional debt financing, while allowing for participation in the corporation's growth through the conversion to equity.

COMPLYING WITH SECURITIES LAWS

In Canada, there is strong emphasis on protecting the public from fraud, which imposes an obligation on any corporation, financial advisor or financial dealer to provide adequate disclosure to the investor who provides financing to a corporation. These disclosure requirements and obligations are set out in each province's securities laws.

Registration and Prospectus Requirements

- The issuance of securities and trading in securities (i.e. shares, bonds, debt instruments, etc.) between investors is governed by legislation. Such legislation is intended to create orderly markets and to protect investors. Any person or corporation engaged in the business of trading in securities or giving advice about securities must be registered under the relevant provincial securities legislation.
- In addition, distributions of securities must be qualified by a prospectus filed with and cleared by the relevant provincial securities regulatory authority, unless the distribution is subject to an exemption. A prospectus is a document describing in detail the business and affairs of the issuer, the type of security involved, and other relevant information. Issuing a prospectus offering can be quite expensive for an early-stage company, and many companies may use one or more of the prospectus exemptions to avoid such costs.

Prospectus Exemptions

As noted above, it is possible to raise capital by selling securities in reliance on one or more of the following exemptions from the registration and prospectus requirements:

- Private Issuer: This exemption permits "private issuers" to sell securities to certain categories of persons (e.g. a director, officer, employee, founder or control person of the issuer or specified family members thereof, close personal friends, or close business associates of a director, etc.).
- Family, Friends, and Business Associates: An investor who purchases as principal and is in a "specified relationship" with the business may be exempt from the prospectus requirement. Such a relationship includes a spouse, sibling, or close friend of a director or executive of the business.
- Accredited Investor: An accredited investor is an institutional investor or other person or company that meets certain minimum income or asset tests. Using this exemption allows an issuer of securities to raise any amount of funds from any number of investors provided that each investor is an accredited investor.
- Crowdfunding: Corporations can raise small amounts of money from a large number of investors through a registered online funding portal. This is a common exemption for start-ups and businesses that are in the early stages of development.
- Offering Memorandum: Issuers under this exemption must provide investors with an offering memorandum that includes prescribed disclosure that is less comprehensive than what is required in a prospectus. The offering memorandum outlines a company's business and affairs.

SECTION 3: PROTECTING INTELLECTUAL PROPERTY

Intellectual property refers to creations of the mind, such as inventions, literary and artistic works, designs and symbols, names, and images used in commerce. By protecting a company's intellectual property assets, a corporation will be able to fully realize the value of its ideas and creations. Types of intellectual property that we address below include trade secrets, patents, copyrights, trademarks, and industrial design.

TYPES OF INTELLECTUAL PROPERTY

Trade Secrets

- A trade secret is information, expertise, or know-how that provides an economic or competitive advantage to its owner because the information is not generally known or available to third parties. Such types of trade secrets include formulas, drawings, patterns, compilations, programs, devices, methods, techniques, and processes.
- Trade secrets are not registered anywhere, but are secured by deliberately maintaining the desired information internally as a secret so that it is known only by one or a relatively small number of persons within the organization.

Patents

- A patent provides the patentee the exclusive right to make, use, or sell an invention in Canada. In order for the patentee to have such exclusive right to make full use of such invention, the patentee must publicly disclose the invention with the Canadian Intellectual Property Office.

Copyright

- Copyright protects original works of authorship, including literary, dramatic, musical, artistic, and certain other intellectual works. Copyright protects only the expression or form of ideas, and not the ideas themselves.

Trademarks

- A trademark is a word, name, symbol, colour, sound, moving image, hologram, 3-D shape, scent, taste or texture, or other device used to indicate the source or origin of goods and distinguish the goods of one party from those of another.

Industrial Design

- An industrial design is a right based on the visual features of shape, configuration, pattern or ornament, or any combination of these features, applied to a finished article made by hand, tool, or machine.

CONFIDENTIALITY/NON-DISCLOSURE AGREEMENTS

- Unregistered intellectual property may have substantial value, and may not have the legal protection of registered intellectual property (ie. Patents, trademarks, copyright, etc.). In order to protect the unregistered intellectual property, it is essential that the business owners manage the disclosure of such unregistered intellectual property. The ways to manage such disclosures are to enter into confidentiality agreements and non-disclosure agreements.
- A confidentiality or non-disclosure agreement is a written agreement where one or more party(ies) agree to disclose confidential information to the other party(ies) on the condition that the use and further disclosure of such confidential information is limited in a manner so that the confidential information that is disclosed to the other party(ies) is protected.
- It is important for employers to enter into confidentiality or non-disclosure agreements with their employees and contractors. These agreements can stipulate that the business will own the rights to all intellectual property created by the employee or contractor, and that the employee or contractor will cooperate with the organization to ensure those rights are protected. Section 6 of this Primer further discusses the role of employees and contractors.

SECTION 4: START UP LEGAL DOCUMENTS

Every corporation involves the participation of several actors, which may include founders, creditors, shareholders, or employees. The interplay of each actor's rights and obligation require proper legal documentation in order to mitigate any risk of future conflict or loss of corporate value. The following are some legal documents that each corporation should consider putting in place in order to regulate and govern the rights and obligations of the parties involved in a corporation.

ARTICLES OF INCORPORATION

- The articles of incorporation set out a corporation's purpose, regulations, number of directors, and share structure. Articles of incorporation are required in order to incorporate a business. The articles of incorporation are filed with the appropriate government authority and once the articles have been filed, a certificate of incorporation will be issued. A corporation may easily change their articles of incorporation by filing articles of amendment with the same government authority.

SHAREHOLDERS' AGREEMENTS

- A shareholders' agreement provides commercial terms of the arrangement between the shareholders of a corporation, including details on the key terms of the investment. A shareholders' agreement is not legally required for a corporation to operate. However, it is generally encouraged to enter into a shareholders' agreement as it sets out the rights and obligations of shareholders and governs the shareholders' relationship with each other and the company. A shareholders' agreement primarily deals with rules on when shares can be transferred by a shareholder to third parties and rules about corporate governance.

PARTNERSHIP AGREEMENTS.

- A partnership agreement sets out the details of a partnership and can be used to avoid defaults of the partnership legislation. Entering into a partnership agreement is good practice, but not mandatory for general partnerships. Limited liability partnerships are required to have a partnership agreement. Partnership agreements includes, but is not limited to, the scope of the business, the firm name, restrictions on carrying on a competing business, requirements for the admission of new partners, and dissolution of the partnership.

STOCK OPTION PLANS

- Stock option plans are used by corporations to grant stock options of the benefit of employees, insiders, including directors and officers, and service providers. It is a form of security-based compensation arrangement to compensate, retain, and attract employees, or to compensate directors and other service providers. These plans and options are contracts between an issuer and the optionees that give optionees the right to buy a specific number of the issuer's securities at a fixed price within a certain period of time, and often vest over time. Such stock option plans can be very complex and it is recommended that corporations should carefully consider the type of equity it wishes to grant to its employees, and the timing and restrictions it wishes to place on the vesting of options or restricted stock.

SIMPLE AGREEMENT FOR FUTURE EQUITY

- A simple agreement for future equity (SAFE) is a financing contract that may be used by a start-up company to raise capital. A SAFE gives the investor the right to receive equity of the company on certain pre-agreed triggering events, such as the sale of the company. A SAFE remains outstanding indefinitely and investors receive only a right to convert their SAFEs into equity at a lower price than investors in the subsequent financing.

SECTION 5: DEALING WITH EMPLOYEES OR CONTRACTORS

Employees and contractors are a key source of value of any corporation. It is crucial to understand the statutory and contractual rights awarded to employees and contractors in order for the corporation to manage these relationships effectively and to minimize risk in the event of disputes.

EMPLOYEE RIGHTS

- The federal government and each provincial government have enacted their own employment standards legislation that provide specific workplace standards that are uniform to all places of work. Such standards include maximum hours of work, minimum wage rates, overtime, compulsory public holidays, minimum vacation time and vacation pay, rights to pregnancy and/or parental leave, minimum notice of termination, and severance pay requirements (although the exact standards can vary somewhat depending on the applicable jurisdiction and certain exemptions may apply to particular employees and industries). These are minimum standards with which employers must comply and employers cannot contract out of or waive such standards. Employers must keep such minimum standards in mind when hiring employees.
- Employees also generally have additional rights (and in some cases obligations) under other types of employment legislation relating to human rights, occupational health and safety, workers' compensation and labour relations. Employers must be aware of the requirements of all types of employment legislation in their dealing with employees.

EMPLOYMENT CONTRACTS

- It is recommended that all employers enter into employment contracts with each employee. Employment contracts ensure that the employer and its employees clearly understand the terms and conditions of employment, and such agreements can minimize uncertainties in the event of a dispute between the employee and employer. Most employment agreements address the following provisions:

  1. the term of the employment
  2. the nature and description of the job
  3. expectations of the position
  4. employee compensation, benefits and vacation
  5. the ownership and rights to any work product of the employee

6. how and when employment can be terminated, and employee entitlements on termination
7. how disputes will be resolved

- It is not uncommon to have a founder be a shareholder, as well as an employee. In multi-founder businesses, it may be helpful to determine each founders' rights and obligations in their capacities (as an employee or shareholder) in the beginning of the start up in order to avoid future disputes.

CONTRACTORS

- It is important to note that independent contractors differ in numerous ways from employees. Employees have certain statutory rights (as noted above) that the employer must ensure are maintained. However, such employer responsibility is not required for independent contractors. Also, ongoing administrative costs, such as processing and reimbursing employee expenses, as well as withholding employees' income and payroll taxes from their paycheques may be avoided in the case of independent contractors. There is also more flexibility around the termination rights of independent contractors as compared to employees.
- There are a number of different factors which can help an employer determine whether an individual is an employee or an independent contractor. Some factors include:
    1. the degree of ongoing control by the business over the individual's project, including the individual's liability to control hours and sub-contract the work
    2. the business' provision to the individual of facilities and equipment used to carry out the work
    3. whether or not the business assumes the risks of default
    4. whether or not the individual has a risk of profit or loss in providing the services
    5. whether the individual is employed on an ongoing basis with varying assignments, or engaged and compensated for the completion of a particular task or project

SECTION 6: REGULATORY CONSIDERATIONS

A corporation must consider regulatory regimes when it seeks financing from third party sources. These regulatory regimes include the *Investment Canada Act* and the *Competition Act*.

INVESTMENT CANADA ACT

- The purposes of the *Investment Canada Act* are "to provide for the review of significant investments in Canada by non-Canadians in a manner that encourages investment, economic growth and employment opportunities in Canada and to provide for the review of investments in Canada by non-Canadians that could be injurious to national security".[1]

- If you are not a Canadian citizen or a permanent resident and wish to establish a new Canadian business or to acquire an existing Canadian business, then you must either (i) file a notification, or (ii) file an application for review of the investment. You must file a notification each and every time you commence a new business activity in Canada as well as each time you acquire control of an existing Canadian business where the establishment or acquisition of control is not a reviewable transaction.

COMPETITION ACT

- "The purpose of the *Competition Act* is to maintain and encourage competition in Canada in order to promote the efficiency and adaptability of the Canadian economy, in order to expand opportunities for Canadian participation in world markets while at the same time recognizing the role of foreign competition in Canada, in order to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the Canadian economy and in order to provide consumers with competitive prices and product choices."[2]
- The *Competition Act* prohibits various criminal offences relating to competition, including, cartels, bid-rigging, false or misleading misrepresentations, offences in relation to telemarketing, deceptive prize notices, double ticketing, multi-level marketing, and pyramid schemes. In addition to criminal prosecution, engaging in a competition offence exposes a party to civil liability for damages.

Sundeep Sandhu
Partner
ssandhu@blaney.com
416-597-4878

Hasan S. Naqvi
Partner
hnaqvi@blaney.com
416-593-3973

The authors would like to acknowledge and thank Blaney McMurtry LLP associate, Angelique Bedford, for her substantial contributions to this Primer.

Last Modified 05/21

[1] *Investment Canada Act*, R.S.C. 1985, c. 28 (1st Supp.), s. 2.
[2] *Competition Act*, R.S.C. 1985, c. C-34, s. 1.1.