

Technology Startup Guide

Goodmans^{LLP}

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An Overview of Legal Issues Faced by Founders of Technology Startups | November 2019

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■ Introduction

This “Goodmans’ Technology Startup Guide” (the “**Guide**”) provides an overview of the following primary legal issues that founders of technology startups should consider:

					
Choosing the Right Business Structure	Protecting Intellectual Property	Building a Strong Foundation	Raising Capital	Building the Right Relationships	Interacting with the Public

Ignoring legal issues can stifle the growth or even destroy the potential of promising high-tech companies. A business must address legal issues in a practical manner at the outset to build a strong foundation and create every opportunity for it to achieve its full potential.

For ease of reference, definitions for the legal and financing terms used in this Guide are included at Appendix “A”.

Disclaimer

This Guide sets out general advice for the founding and financing of a technology startup but cannot substitute for advice provided by a professional, tailored to each unique circumstance. Understanding and navigating legal concerns in an efficient and practical manner with the help of a professional allows entrepreneurs to focus on building their business without being burdened or derailed by legal complications.

The discussion in this Guide is confined to the provincial laws of Ontario, and the federal laws of Canada that apply in Ontario, as of June 1, 2016. As the laws and policies of governments and regulatory authorities may change, some of the information may not be accurate after that date. **This Guide should not be relied on as legal advice.**

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■ Choosing the Right Business Structure



Different Structures

One of the first and most important legal decisions when starting a new business is the type of business organization most beneficial for the particular business. The type of business 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. The most common business structures are sole proprietorships, partnerships and corporations. Though a high-growth tech business typically benefits most from organizing as a corporation, understanding the other options is important to making an informed decision.

Sole Proprietorship

A sole proprietorship is an unincorporated business with an individual as the sole owner. The owner is personally responsible for all of the obligations of the business and receives all of the profits derived from its operation. The main advantages of organizing as a sole proprietorship are the relatively inexpensive startup costs, control of the sole owner over decision-making, the ability to deduct business losses against other personal income and the low regulatory burden. The main disadvantage of organizing as a sole proprietorship is that the liabilities of the business become the liabilities of the owner, which means the owner could be at risk of losing personal assets to settle the business' obligations.

Partnership

A partnership is a relationship between two or more individuals, corporations or other entities carrying on a business in common with a view to a profit. The rights and obligations of partners as among themselves are usually set out in a formal partnership agreement, though, absent an agreement, the relationship is governed by presumptive rules set out in Ontario legislation. The primary advantage of organizing as a partnership is that income and losses are taxed in the partners' hands. This means that each partner can apply its share of losses from operating the business against other income sources. The primary disadvantage of organizing as a partnership is that a partnership has no separate legal identity from its partners. As a result, depending on the type of partnership structure being used, a partner may carry unlimited personal liability for the business' obligations.

Corporation

Tech startups most commonly organize as corporations. A corporation has a separate and distinct legal personality from its shareholders and management, and has all of the rights, powers and privileges of a natural person. Moreover, a corporation can hold property, carry on business and enter into contractual relationships.

The main advantages of incorporating are: (i) the owners of the corporation (its shareholders) maintain limited liability; (ii) the corporation does not cease to exist upon the death or exit of its founders; and (iii) there is greater flexibility to raise capital. The main disadvantages of incorporating are: (i) the higher costs of organizing, and (ii) the increased burden of regulatory oversight. The advantages of incorporating typically outweigh the disadvantages for tech businesses with high growth potential.

A business is incorporated under provincial or federal legislation. In Ontario, a company is incorporated under the Business Corporations Act (OBCA), while federal incorporation occurs under the Canada Business Corporations Act (CBCA). The process of incorporating is quite simple. Those wishing to incorporate a business must file articles of incorporation and other supporting documents (including the results of a corporate name search of the intended business name) with the appropriate government authority along with the applicable filing fee. Once a business has completed the filing requirements, it will be issued a certificate of incorporation.

Protecting Intellectual Property



Types of Intellectual Property Relevant to Tech Startups

Intellectual property refers to creations of the mind, such as inventions, literary and artistic works, designs and symbols, names and images used in commerce. The forms of intellectual property most relevant to tech startups are patents, trademarks, copyrights and industrial designs.

Patents provide a time-limited, legally protected, exclusive right to make, use and sell an invention.

Trademarks are any combination of words, sounds or designs used to distinguish the goods or services of one person or organization from those of others in the marketplace.

Copyrights protect literary, artistic, dramatic or musical works (including computer programs) and other subject-matter such as a performer's performances, sound recordings and communication signals.

Industrial designs are distinctive attributes of a product that are judged solely by eye and include either features of shape, configuration, pattern or ornament or a combination of these features.

The Importance of Intellectual Property to Tech Startups

A tech startup's competitive advantage resulting from a novel technology will quickly disappear, and the business could lose value, if it fails to properly protect its intellectual property. While soliciting investment, it is important to assess and account for the risks of releasing information about the business' products or services. If not careful, a tech startup could lose control over its intellectual property rights in a rush to raise capital. This is a fundamental consideration for potential investors.

Ensuring Confidentiality

A non-disclosure agreement (or confidentiality agreement) is a legal contract between two or more parties that signifies a confidential relationship exists between them. The agreement often refers to information that is to be shared between the parties that otherwise would not be made available to the general public. Diligent tech startups should endeavour to have employees or potential investors sign a non-disclosure agreement before sharing information. **Don't forget that the best way to keep your secrets is to keep them secret.**

Assigning Intellectual Property to the Corporation

Tech startups that incorporate, typically assign intellectual property rights from the founders to their corporation. Clean ownership of intellectual property is critical to raising capital, successfully operating the business, and assuring investors that the business legally owns the intellectual property. All such assignments must be complete and effective.

Maintaining Rights Over Work Done By Employees, Contractors and Third Parties

Employees, contractors and other parties are often involved in developing the business' know how, products or services. Unless proper steps are taken, rights to the intellectual property created by these parties are not necessarily owned by the startup. It is important to ensure that all parties working on the startup's behalf enter into properly drafted contracts that provide the startup with all rights to the intellectual property.

■ Building a Strong Foundation



Building a Strong Foundation: Agreements Between Stakeholders and the Capital Structure

Founders who do not set out clear legal rights and obligations for themselves and for other stakeholders at an early stage risk losing value and increasing conflict, potentially jeopardizing the future of their business. Some of the agreements that tech startups typically use to formalize the rights and obligations of stakeholders are listed below.

Articles of Incorporation

The articles of incorporation set out a corporation's purpose, regulations and share structure and are filed with the government (either provincial, territorial or federal).

Shareholders Agreement

A shareholders agreement is a private document that provides commercial terms of the arrangement between shareholders, including details on the key terms of the investment. The primary purposes of the agreement are: (i) to set out the rights and obligations of shareholders, and (ii) to govern shareholders' relationship with each other and the company.

Founder Restriction Agreement

A founder restriction agreement contains provisions regulating the use of the founders' shares. These agreements often contain vesting arrangements that dictate when founders have unrestricted access to their shares. Tech startups employ these arrangements to ensure that founders who stay with the company for only a brief period of time are not overcompensated for their contribution to the company.

■ Raising Capital

Choosing the Right Type of Financing

Businesses commonly raise capital by equity financing, debt financing or a combination of both.

Equity

Equity financing is a method of raising capital through the issuance of additional shares in the capital of a corporation or units of a limited partnership or trust. Various classes of shares or units may be issued such as preferred or common shares. The rights and privileges attaching to each class of shares or units will depend on the requirements of the issuer and the investors. Preferred shares may be convertible into common shares in certain circumstances. In the event of the dissolution or insolvency of a corporate issuer, capital can be returned to shareholders only after all debt holders have been paid in full. The advantage of share or unit ownership is that the investor can share in the issuer's success by receiving dividends or through an increase in the value of the shares or units.

Simple Agreement For Future Equity (SAFE)

A SAFE allows investors to convert a cash investment to equity when the business raises capital through an early round of equity financing. SAFEs contain provisions dealing with the company's dissolution and change of control, and may also contain preferential provisions for the investors over the founders. A SAFE may not have a maturity date so it is possible that the investment may never be converted to equity. SAFEs are typically short and easier and more convenient to use than other forms of investment, including convertible notes.

Debt Financing

Debt financing is a method of raising capital by borrowing from shareholders, partners or third parties such as banks and other financial institutions or debt investment funds. Depending on your stage of growth, financing may be available in Canada from Canadian chartered banks, Canadian subsidiaries of foreign banks, and other financial institutions including merchant banks, loan and trust companies and life insurance companies, as well as funds focusing on debt investments. Lenders to a corporation who do not have a personal interest in the corporation usually require that a certain level of equity investment be maintained by the corporation's shareholders. In some cases, the debt may be convertible into equity. Lenders may also require personal guarantees from shareholders of small private corporations. Tech startups will have difficulty obtaining debt financing in early stages from sources different than "friends and family" if they do not have assets to secure the debt or sufficient revenues to make principal and interest payments. One of the advantages of debt financing is that the startup's founders maintain their ownership interest in the startup.



Government Funding and Grants

There are many different opportunities for startups to take advantage of government grants, funding and tax benefits for various projects. For any of the available programs listed below, there is often a large amount of supporting documentation required in the application process. For many reasons it is very important for startups to implement a project management system that allows for accurate tracking of project milestones and timelines. The application processes become much more efficient when a business has a comprehensive record of its project planning, research, development and testing phases, along with the time spent on the various aspects of the project by each team member.

The various programs available to Canadian startups include: the Scientific Research and Experimental Development Program (SR&ED), the National Research Council Industrial Research Assistance Program (IRAP), the Ontario Media Development Corporation Programs (OMDC), the Canada Media Fund Programs (CMF) and the Sustainable Development Technology Canada Funding Programs (SDTC).

Complying With Securities Laws and Exemptions

Registration and Prospectus Requirements

The issuance of securities and trading in securities between investors is governed by legislation intended to create orderly markets and protect investors. The term “security” is broadly defined and includes any document evidencing title to or an interest in the capital, assets, property, profits, earnings or royalties of a person or corporation and any document, instrument or writing commonly known as a “security”. Shares, bonds and options are common forms of security.

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 (i.e. sales to “accredited investors”). A prospectus is a document describing in detail the business and affairs of the issuer, the type of security involved and other relevant information.

Exemptions

Completing a prospectus offering can be prohibitively expensive for early-stage companies. However, it is possible to raise capital by selling securities in reliance on one or more exemptions from the registration and prospectus requirements. Some of the most commonly used exemptions for tech startups include the following:

i) 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, executive officer, a founder or control person of the issuer, accredited investors or security holders of the issuer or other persons that do not constitute the “public” vis à vis the issuer). Most tech startups qualify as “private issuers” in the early stages.

ii) 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. For instance, a “specified relationship” includes a spouse, sibling or close friend of a director or executive of the business. The majority of tech startups raise money from friends and family using this exemption at early stages of development.

iii) Accredited Investor

This exemption allows an issuer of securities to raise any amount of funds from any number of investors provided that each investor meets the definition of an “accredited investor” (i.e. is an institutional investor or other person or company that meets certain minimum income or asset tests).

iv) Equity Crowdfunding

Equity crowdfunding is a new method of funding projects or ventures by raising (typically) small amounts of money from a large number of investors through a registered online funding portal. An issuer can raise up to \$1.5 million in any given twelve-month period under Ontario's Equity Crowdfunding Exemption.

v) Offering Memorandum

Issuers distributing under the Offering Memorandum Exemption must provide investors with an offering memorandum that includes prescribed disclosure that is less comprehensive (and less expensive to compile) than what is required in a prospectus. There are no limits on the amount an issuer can raise under the Offering Memorandum Exemption. Individual investors are subject to investment limits of \$30,000 for eligible investors and \$10,000 for non-eligible investors over any given twelve-month period.

■ Building the Right Relationships



Employment Contracts

It is crucial to clearly define and document the relationship between employees and the business from the outset of engagement. A comprehensive employment contract will ensure that the startup (the employer) and its employees clearly understand the terms and conditions of employment, and can minimize uncertainties in the event of a dispute. A well-drafted employment contract should address, among other matters: (i) the term of employment; (ii) the nature and description of the job; (iii) expectations of the position; (iv) any employee benefits; (v) the ownership and rights to any work product of the employee; (vi) how and when employment can be terminated and employee entitlements on termination; and (vii) how disputes will be resolved.

It is also important to understand that each province and the federal government have enacted their own employment standards legislation that provides specific workplace standards, such as 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. These are minimum standards with which employers must comply and they cannot be contracted out of or waived.

Contractors v. Employees

Whether an individual is an employee or an independent contractor depends on a number of factors reflecting the relationship between the business and the individual. The main factors include:

1. the degree of ongoing control by the business over the individual's project, including the individual's ability to control hours and sub-contract the work;
2. the business' provision of facilities and equipment used to carry out the work;
3. whether or not the business assumes the risks of default; and
4. whether the individual is employed on an ongoing basis with varying assignments ("contract of service"), or is hired and compensated for the completion of a particular task or project ("contract for services").

Where there is an employer-employee relationship, an employer will incur ongoing administrative costs, such as processing and reimbursing employee expenses, as well as withholding employees' income tax from their paycheques. While those costs may be avoided in the case of independent contractors, certain Canadian legislation regarding intellectual property assigns rights over work created by employees in the course of their employment to the employer. In both cases, it is prudent for a startup to provide clear language regarding intellectual property rights in any agreement with employees and independent contractors.

Intellectual Property Rights

Employees and contractors may play a large role in generating intellectual property throughout the course of employment or service. It is best to ensure that such parties enter into a formal agreement regarding the ownership of such intellectual property. Generally, these agreements will 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 to ensure those rights are protected.

Equity For Employees

Tech startups commonly offer equity in the startup to attract and retain talented employees. Additionally, businesses with limited cash flow may be able to preserve cash on hand by offering equity in exchange for the employee accepting a below-market salary. Equity compensation may be offered in a number of ways, but is commonly granted in the form of stock options or as restricted stock.

Though compensating employees with equity can provide great benefits, these plans can be extremely complex, require continued compliance with applicable securities legislation, carry tax implications and can bring about a number of other unforeseen issues. To avoid common pitfalls associated with granting equity, a tech startup 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.

■ Interacting with the Public



Terms of Use and Privacy Policy for Your Website/App

Often, the main interaction between a tech startup and the consumer is through its website or mobile app. This means that commonly the only agreements between the startup and the consuming public will be the terms of use and privacy policy found on its app or website.

A tech startup's terms of use agreement outlines the terms and conditions required for people using its website or app, while its privacy policy sets out how it will collect, use and share personal information gathered from the user. It is integral that comprehensive policies are drafted to address any number of possibilities that may occur when the public engages with an app or website. Well-drafted policies will reduce uncertainty in the event of a dispute with a user, and can limit liability for the business, its employees, officers and directors.

Harmonized and Provincial Sales Tax

Each province in Canada (other than Alberta) levies a sales tax on most sales of property and services provided within the province. Several provinces (including Ontario) have harmonized their provincial sales taxes with the GST to form a single Harmonized Sales Tax (HST). The tax regime for the GST and the HST is generally the same. The HST uses the same registration number as the GST and is reported on the registrant's GST return. The combined federal and provincial components of the HST result in a combined rate of 13% in Ontario. Quebec's provincial sales tax mirrors, but is not harmonized with, the federal GST. When selling to the public, businesses may be required to register and remit HST and GST.

Goodmans Technology Group



To assist clients in the technology sector, Goodmans brings together our acknowledged expertise in corporate/commercial, private equity, corporate finance, mergers and acquisitions, outsourcing, licensing, intellectual property, privacy, regulatory and media, cleantech, tax, litigation, human resources, corporate restructuring and administrative law. We do so both for innovative businesses in their start-up phase and for well-established businesses of all types. Goodmans continues to lead in the technology sector and is partnered with the DMZ at Ryerson University. The DMZ is a leading business incubator (selected by UBI as the top-ranked university incubator in North America, and third in the world), which connects its start-ups with resources, customers, advisors, investors and other entrepreneurs. Goodmans is also a proud partner of IDEABOOST, an initiative of the Canadian Film Centre's Media Lab, building the next generation of technology-based media entertainment products, services and brands. Through these partnerships, Goodmans provides legal advice, mentorship and networking opportunities to assist start-ups in maximizing their potential.

Goodmans is also an internationally recognized leader in other aspects of technology law and transactions. From our thought leadership, through participation on the Boards of associations such as CanTech (Canadian Technology Law Association), CORE (Centre for Outsourcing Research and Education), CIEG (Canadian Institute for Exponential Growth, which organized the Summit) and iTechLaw (International Technology Law Association), to our involvement in major technology procurement, joint venture and outsourcing transactions, to our representation, in court proceedings and in arbitrations, of major technology providers, and users of technology, in ground-breaking cases, our Technology Group is consistently at the forefront of leading technology transactions and cases.

Members of our Technology Group are recognized as leading technology lawyers in *Chambers Global*, *Lexpert*, *Legal 500 Canada*, *Legal Media Group's The Best of the Best*, *The Best Lawyers in Canada*, *Law Business Research's The International Who's Who of Business Lawyers*, and *The Lexpert/American Lawyer Guide to the Leading 500 Lawyers in Canada*, teach internet and communications law at Canada's largest law schools, are regular lecturers at technology industry events and legal conferences, and have published articles in the technology law field.

Appendix A – Legal/Financing Terminology



The definitions below are provided to assist you in navigating and understanding this Guide and should not be relied upon for any other purpose.

Capital: In general, refers to the financial resources available for the company's use.

Capital Stock: The issued common and preferred shares of a company.

Copyright: The legal right to publish, produce, reproduce or perform in public any original literary (e.g., novels, magazines and computer programs), dramatic (e.g., films, videos, scripts and plays), musical (e.g., music, lyrics and instrumental compositions) or artistic work (e.g., paintings, photographs, sculptures and architectural works).

Debt Financing: A method of raising capital by borrowing from shareholders, partners or third parties such as banks and other financial institutions or debt investment funds.

Equity Financing: A method of raising capital through the issuance of shares of capital stock of a corporation or units of a limited partnership or trust.

Incorporation: The process of forming a corporation by filing the required documents with the appropriate government agency.

Intellectual Property: Creations of the mind, such as inventions, literary and artistic works, designs and symbols, names and images used in commerce.

Issuer: A person or company that sells, offers to sell or has outstanding securities held by shareholders.

Founder(s): A person (or persons) who establishes the company and is an original subscriber to shares of that company.

Founder Restriction Agreement: An agreement regulating the use of founders' shares to ensure that founders who stay with the company for only a brief period of time are not overcompensated for their relatively minor contribution to the company.

Non-Disclosure Agreement (NDA): A legal contract between two or more parties which restricts the disclosure of confidential information.

Patent: A document that grants the patent holder the time-limited, legally protected, exclusive right to make, use and sell an invention.

Prospectus: A document in respect of a public offering of securities that describes in detail the business and affairs of an issuer, the type of securities involved and other information relevant to the offering.

Restricted Stock: Shares of ownership in a company that are not transferrable until the holder of the shares meets certain conditions. Conditions attaching to restricted stock may include maintaining a pre-determined length of continuous employment or the requirement to achieve certain performance milestones.

Security: A broadly defined term that includes any document evidencing title to or an interest in the capital, assets, property, profits, earnings or royalties of a person or corporation and any document, instrument or writing commonly known as a “security”.

Shares: Units of ownership in a company that entitle the holder to a portion of the company's profits.

Shareholders Agreement: A private document that provides commercial terms of the arrangement between shareholders, including details on key terms of the investment.

Simple Agreement for Future Equity (SAFE): An agreement that allows investors to convert their investment from debt to equity when the business raises capital through a round of equity financing.

Stock Option: The option to purchase securities of a company at a stated price at a designated time or for a period of time in the future.

Trademark: A combination of words, sounds or designs used to distinguish the goods or services of one person or organization from those of others in the marketplace.

Vesting: The process whereby a founder or employee gains control over stock incentives (typically restricted stock or stock options). Vesting usually occurs after the founder or employee has achieved a pre-determined length of continuous employment or accomplishes certain performance milestones.

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