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Goodmans LLP

Venture Capital Investing in Canada: Legal Considerations for U.S. Investors

2015 was a banner year for the Canadian technology sector. On the heels of Shopify's highly successful IPO, a number of successful Canadian startups, including Lightspeed Retail, Kik Interactive, Hootsuite, Desire2Learn and Vision Critical, may be poised – subject to a return to more favourable market conditions generally – to enter the public markets at significant valuations. At the same time, venture capital activity in Canada increased meaningfully in 2015 relative to 2014, with the number of deals up 4% and the amount invested up 11% according to Thomson Reuters. Over the past five years, total venture capital investments in Canadian companies have doubled to US$2.6 billion, with 2015 representing the best year in terms of total capital invested since 2002.

Against this encouraging backdrop, Canadian tech companies that require significant amounts of growth capital continue to face challenges when obtaining financing from domestic sources. There are relatively few Canadian VC investors who can lead meaningful later stage financings (OMERS Ventures and Georgian Partners being two of the most prominent recently), resulting in many Canadian entrepreneurs looking to the U.S. for funding. For example, the biggest beneficiary of Shopify's IPO was Bessemer Venture Partners, a prominent Silicon Valley-based VC firm. Similarly, Hootsuite's largest investors are reported to include Accel Partners and Insight Venture Partners.

For U.S.-based VCs, investing in Canadian technology companies can be attractive for a number of reasons, including:

- Canada has a large pool of highly educated, highly motivated entrepreneurs and engineers who have proven that it is possible to build world class technology companies north of the border;

- it is often easier (and far less expensive) to attract engineering talent in Canadian technology centers such as Vancouver, Ottawa, Kitchener-Waterloo, Toronto or Montreal than it is in Silicon Valley;

- the significant weakening in the Canadian dollar relative to the U.S. dollar over the last couple of years means that investment dollars tend to go further in Canada than they do in the U.S.; and

- in some cases, competition for deals may be less intense in Canada than in the U.S., sometimes resulting in lower valuations.

One additional advantage associated with investing in Canada - at least relative to other non-U.S. jurisdictions - is that, for the most part, Canadian corporate and securities laws are similar to U.S. laws. U.S. investors will be on fairly familiar ground when it comes to structuring and holding investments in Canadian companies. Perhaps most importantly, the traditional venture capital preferred share investment structure can be used, with relatively few changes, in Canada.

There are, however, some legal differences that can impact, to varying degrees, the way deals are done in Canada. The following is a summary of some of the differences we are most frequently asked about when representing U.S. investors who are funding Canadian companies.

Corporate Law

Director Residency Requirements

Some Canadian companies (including those incorporated in Ontario and under Canadian federal corporate legislation) are subject to Canadian residency requirements for directors. These requirements mandate that at least 25% of the company's directors must be Canadian residents (and not just merely Canadian citizens). In addition, for a meeting of the directors to be properly constituted to conduct business, at least 25% of the directors present at the meeting must be Canadian residents.

In most cases, these requirements do not create any significant problems as there will typically be at least one Canadian resident - e.g., a founder, executive or investor representative - who can serve as a director (and would likely be on the board in any event). We have seen situations, however, where the preferred board composition or the investors' ability to freely exercise their nomination rights, or both, was inconsistent with the Canadian residency requirements.

U.S.-based investors who want to ensure they can place non-Canadian representatives on the board of a Canadian portfolio company that is subject to director residency requirements, should consider requiring "first dibs" on nominating non-Canadian directors. Alternatively, the entire issue can be avoided by moving the company into a Canadian jurisdiction (such as British Columbia) that does not impose Canadian residency requirements on directors.

Unlimited Authorized Capital

Unlike Delaware, Canadian corporate law allows a company to have unlimited amounts of authorized share capital. The vast majority of Canadian companies take advantage of the flexibility this provides and will include an unlimited number of shares in their authorized capital.

Investors are sometimes concerned that this flexibility means the company could issue additional shares and dilute their ownership interest without the investors' consent. This is typically addressed by including protective provisions in the company's articles or in an investor rights agreement that require an appropriate level of shareholder approval before the company can issue additional shares, except in certain customary circumstances. Given the practical difficulties that can be involved in amending a company's articles (see "Shareholder Consents" below), this is usually preferable to fixing a specific number of authorized shares and having to call a shareholder meeting to amend the articles if it is later either desired or required that the company issue additional authorized capital (at least when it comes to common shares).

It is less likely that investors will be comfortable with the company's authorized capital including an unlimited number of convertible preferred shares. It is accordingly relatively common for the authorized number of each series or class of preferred shares to be capped at the amount required to be issued to investors in the financing round in question.

Classes vs. Series of Shares

Canadian companies, like those in the U.S., may issue preferred shares in series. However, Canadian corporate law generally prohibits any series of shares from having a priority over any other series of the same class of shares with respect to the payment of dividends or return of capital. As a result, Canadian startups will often issue separate classes of preferred shares rather than series (e.g., Class A Preferred Shares, Class B Preferred Shares, etc.) to allow for liquidation preference priorities amongst investors in different rounds of financing.

Class Voting Rights

Canadian corporate statutes provide shareholders with separate class voting rights in respect of certain transactions (such as a sale of all or substantially all of a company's assets or certain amendments to the company's articles of incorporation) - even if the shares of the class in question do not otherwise carry voting rights generally. To ensure that the investors' negotiated approval rights are not pre-empted by these statutory requirements, investors should ensure that (i) statutory class voting rights are waived in the company's articles of incorporation to the extent permissible by the relevant statute and (ii) contractual arrangements relating to voting rights address any statutory class voting rights that cannot be waived (e.g., by requiring that any such class voting rights are exercised in a manner consistent with the result that would otherwise follow the contractual approval rights negotiated with the company).

Shareholder Consents

Canadian corporate law is less flexible than Delaware when it comes to obtaining shareholder consents. If, under the corporate statute, a company must obtain shareholder approval for a proposed action (including, for example, amending the articles of incorporation to create a new class of preferred shares to be issued in a financing round), that approval must be obtained either (i) at a duly constituted shareholder meeting or (ii) by way of a written consent signed by all shareholders. The requirement for unanimous written consents does not apply to matters that require shareholder consent only as a result of contractual approval rights.

The unanimous written consent requirement means that Canadian companies, especially those with large numbers of shareholders, may be forced to hold a shareholder meeting to obtain shareholder approval for a financing or other proposed corporate action. To minimize potential delays and uncertainties associated with the more cumbersome Canadian shareholder approval requirements, investors and companies can consider mechanisms such as having as many shareholders as possible enter into voting trusts, or giving the lead / controlling investors powers of attorney over their shares. In addition, the company's by-laws should provide that shareholder meetings can be held on relatively short notice to minimize any delay that may arise if holding a shareholder meeting is unavoidable.

Nominee Directors

The directors of Canadian companies have fiduciary duties that are very similar to the fiduciary duties of the directors of U.S. companies.[1] This requires a director to act in the company's best interests even if he or she has been nominated by a specific investor to represent that investor's interests on the board. Nominee directorships can create potential difficulties when the nominating shareholder's interests are at odds with the company's interests as a whole. Nominee directors must also be careful about how they handle confidential information they receive in their capacities as directors as their fiduciary duties generally require that this information not be disclosed to third parties – including a nominating shareholder - without the company's prior approval. Since most startups (and their investors) will assume that information provided to directors is shared with the investors who nominated them, it may be advisable to explicitly set out the ground rules around information sharing (e.g., what information may or may not be shared, requirement for the investor to sign an NDA, etc.) in the investor rights / shareholders agreement.

Subject to certain limitations, Canadian companies are permitted to indemnify directors against liabilities they incur as a result of serving as such. These indemnities are typically reflected in the by-laws and supplemented by indemnity agreements with the company. As in the U.S., indemnity agreements will, among other things, provide for the payment of a director's costs associated with defending a claim against the director and require the company to maintain a D&O insurance policy. Forms of director indemnity agreements used by VC investors for their U.S. portfolio companies can usually be adapted for use in Canada without much difficulty.

Oppression Remedy

The "oppression remedy" protects stakeholders in Canadian companies against corporate actions that unfairly prejudice their interests or disregard their reasonable expectations. An oppression remedy claim is often based on the same kinds of conduct that lead to breach of fiduciary duty allegations but is a distinct equitable remedy that can be pursued independently. If a court finds that a stakeholder's interests have been oppressed, it can fashion virtually any order it believes is appropriate in the circumstances. Directors of, and investors in, Canadian companies should be mindful of conduct that could inadvertently create "reasonable expectations" that later prove problematic (e.g., repeatedly assuring common shareholders that the company would not pursue a liquidation event that would wipe out their interests) and consider the potential for oppression claims when pursuing transactions that certain investors or stakeholders would oppose.

Unanimous Shareholder Agreements

In Canada, a unanimous shareholder agreement is an agreement among all of the shareholders of a company that is given quasi-constitutional status under corporate law. While it is still a contractual arrangement, it is also viewed as one of the company's constating documents ranking equally, in some respects, with the articles and by-laws.

[1] Although in Canada fiduciary duties are owed to the company itself, taking into account the interests of all stakeholders, as opposed to shareholders directly.

Two of the primary advantages of unanimous shareholders agreements are:

- they are binding on subsequent purchasers of the company's shares (in some cases subject to the share certificates containing a legend that gives notice of the agreement), even if the purchaser does not sign the agreement; and
- they allow shareholders to limit the authority of the company's directors to manage the company's affairs, allowing the shareholders to effectively bypass the board and manage the company directly.

Unanimous shareholder agreements are widely used by Canadian private companies. Because of the special status given to these agreements under Canadian corporate law, they also tend to cover in one document all of the corporate governance, voting and shareholder rights that in the U.S. are commonly addressed in multiple agreements (e.g., voting agreements, investor rights agreements and registration rights agreements). The quasi-constitutional nature of these agreements also means that things like board nomination rights and veto rights are customarily found in the unanimous shareholder agreement and not the articles of incorporation (although there is nothing wrong with including those rights in the articles, and Canadian companies will generally be prepared to do so if their U.S.-based investors prefer that approach).[2]

Securities Law

Provincial Regulation

Canadian securities law is regulated at the provincial, rather than the federal, level. Although provincial securities laws are largely harmonized and there is an ongoing effort to create a national securities law regime, Canadian companies still face a somewhat unwieldy system in which each province has its own securities laws and regulates securities activities within its borders separately. For most startups, this has relatively limited practical consequence while they remain private but can take on more significance following an IPO.

Crowdfunding

Crowdfunding is now a viable option for Canadian startups thanks to recent changes to Canadian securities laws. Under the new rules, companies are allowed to raise limited amounts of capital through crowdfunding activities that are conducted through regulated funding portals. Investors must receive certain prescribed disclosure and basic continuous disclosure such as annual financial statements. While it is still too early to tell if crowdfunding will gain any significant traction in Canada, it is at least an option that can be considered for early stage companies having trouble attracting angel or seed capital through more traditional means.

Employee Options

Canadian securities laws allow employees to receive (and exercise) options on a prospectus exempt basis, even if the options are issued by a U.S.-based parent company. Options can also be issued to consultants, but only if they are engaged pursuant to a written agreement and spend a significant amount of time on the company's business.

Take-Over Bids

Acquiring a private but widely held Canadian company can sometimes become complicated by virtue of a technical securities law issue: if the company has 50 or more non-employee shareholders, then acquiring the company in a share purchase transaction constitutes a "take-over bid" (tender offer) that must comply with public company formal take-over bid rules. These rules include requirements to make the offer by way of a take-over bid circular that is mailed to all shareholders and to keep the offer open for acceptance for at least 35 days. To avoid these cumbersome requirements, these transactions must be structured differently (e.g., as a one-step "merger" by way of plan of arrangement or an asset sale).

Resale Restrictions

As in the U.S., shareholders of a private company in Canada are subject to significant resale restrictions. Private company shares are not freely tradeable and may only be resold on an exempt basis to qualified purchasers (including "accredited investors", which is defined in Canada in essentially the same

[2] One potential reason to avoid putting board nomination rights and veto rights into the articles of incorporation is that articles of incorporation are publicly available whereas shareholder agreements are not.

way as it is in the U.S.). However, if a company completes an IPO in Canada, investors who acquired their shares on an "exempt" basis (i.e., other than under a prospectus) can generally freely trade their shares after the expiry of a four-month hold period[3] and the company does not need to separately register or otherwise qualify the shares before they can be sold to the public. Because of this fairly short hold period, registration rights are generally less important in Canada than they are in the U.S. (but are still commonly provided to investors as part of VC financings).

Tax

Dividend Tax

Dividends paid by a Canadian company to a non-Canadian shareholder, as well as amounts paid to a non-Canadian shareholder on a redemption / repurchase of shares in excess of the "paid-up capital" of such shares, will generally be subject to Canadian withholding tax (deducted from the amount otherwise payable to the shareholder). The rate of withholding tax is 25%, but is generally reduced to either 5% or 15% if the investor is eligible for benefits under the Canada-U.S. Tax Treaty, depending on the size of the investor's ownership interest in the company's voting stock. In addition, the company can be subject to an additional tax when it pays or is deemed to have paid dividends on certain types of shares.

While very few startups actually pay dividends, financing terms can sometimes include "put" rights for investors or "call" rights for the company, either of which would result in a redemption that could be subject to Canadian tax. There are various strategies that can be considered to mitigate or eliminate withholding tax on an exit transaction.

SRED Tax Credits

The federal Canadian government provides tax credits to companies for qualifying R&D expenditures in Canada pursuant to the Scientific Research and Development (SRED) tax credit program. Some provinces have similar programs.

SRED tax credits are particularly helpful to startups because a portion of the credits are refundable – i.e., if the company does not generate sufficient taxable income to fully use the credits, the government will pay the refundable portion to the company and the credits effectively become a source of funding. Importantly, however, only "Canadian controlled private corporations" (CCPCs) are eligible to receive the refundable tax credit. To qualify as a CCPC, a company must not be controlled by any combination of non-Canadians and public companies, either legally (i.e., by virtue of ownership of a majority of the outstanding voting shares) or in fact (i.e., after taking into account, among other things, board representation rights, contractual approval rights over corporate actions, etc.). If a CCPC completes a VC financing that results in the company losing its CCPC status, it will no longer be eligible to receive refundable SRED tax credits.

Employee Issues

No "At Will" Employment

The concept of "at will" employment does not exist in Canada. If a Canadian company wishes to terminate an employee without "just cause" (which, unless specifically defined in an employment agreement, can be difficult to establish), it is required to provide "reasonable notice" of termination, which may be satisfied by "working notice" or pay in lieu of notice.

What constitutes reasonable notice of termination is determined by provincial employment standards legislation as well as common law requirements. In Ontario, the statutory requirement is generally one week of notice for every year of employment, up to a maximum of eight weeks, plus severance pay (if applicable) of one week of base salary for every year of employment, up to a maximum of twenty-six weeks. Common law requirements can be significantly higher in some circumstances (up to two years in some cases), especially for long serving or executive level employees.

Employers can contract out of the requirement for reasonable notice by means of a well-drafted employment agreement. This is often done with senior management personnel. An employment contract will bind the parties to a pre determined amount of severance (which cannot be less than the statutory minimums).

[3] A shareholder who owns 20% or more of a public company's outstanding shares is subject to additional restrictions on trading, including a requirement to provide advance notice of any proposed non-exempt trade.

Restricted Stock

Restricted stock awards are not commonly used by Canadian companies beyond their very early stages as a means of providing equity compensation to employees. In certain circumstances, employees can be required to pay tax on the fair market value of restricted stock on the date of grant, even if the stock is later forfeited by the employee. Instead, many Canadian technology companies rely on a combination of traditional stock options and restricted stock units to provide equity compensation as a strategy to ensure that employees are not subject to immediate taxation when receiving equity-based compensation.

Non-Competition Covenants

Non-competition covenants that are tied to employment arrangements are difficult to enforce in Canada as courts generally view them as being contrary to public policy.[4] To increase the likelihood that a non-competition covenant can be enforced, the covenant should (i) clearly define the nature of the restricted activity and (ii) be limited in duration and scope to only what is reasonably required to protect the employer's legitimate business interests. If a non-competition covenant is viewed by a court as going beyond what is reasonably required in the circumstances, the usual result is that the entire covenant will be struck down. Canadian courts give greater latitude to non-solicitation and non-interference covenants and confidentiality covenants are generally enforceable.

About Goodmans

Goodmans is internationally recognized as one of Canada's pre-eminent business law firms. Based in Toronto, the firm has market-leading expertise in M&A, corporate and transaction finance, private equity, real estate, tax, restructuring, litigation and other business-related specialties.

The firm represents a broad range of Canadian and foreign clients from entrepreneurial businesses to multinational corporations, financial institutions, pension funds and governments and has a reputation for handling challenging problems, often international in scope, which demand creative solutions.

At Goodmans, our lawyers excel in their fields to help our clients excel in theirs - ensuring exceptional levels of service and business success. We deliver intelligent results, responsiveness, energy, talent and determination to get the deal done.

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[4] In contrast, Canadian courts are generally more willing to enforce non-competition covenants that are given in the context of the sale of a business.