

BUSINESS LAW FOR STARTUPS

IMPORTANT CONSIDERATIONS FOR STARTUP BUSINESSES

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Overview

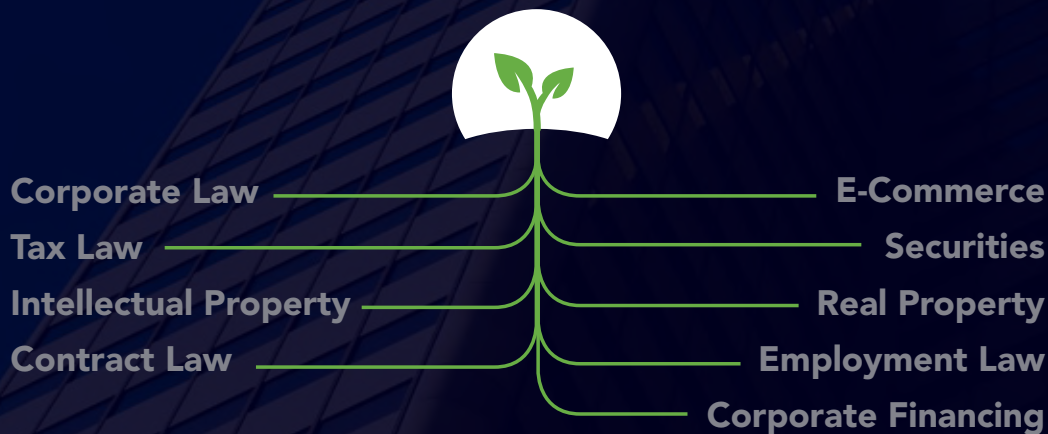
Decided to take the plunge on a new business idea? Or maybe you've already got your toes in the water, and you're thinking about diving off the board? Either way, congratulations- starting a business is an exciting and potentially rewarding journey (intellectually and, hopefully, financially).

That said, every journey begins (or should begin, anyway) with a good plan. We all love a success story, but the fact is that startup waters don't always allow for smooth sailing. Like many things, initial missteps may not present themselves until much later, which can lead to costly and sometimes painful solutions.

Never fear. With the help of a team of professionals (including lawyers, accountants and business mentors), you can plot the right course from the start. It's cliché, but an ounce of prevention really is worth a pound of cure.

The purpose of this whitepaper is to raise, at a high level, some of the legal challenges that we've seen startups experience. Since prevention and foresight are key, it's important to be able to turn your mind to some of these issues, and to flag any potential troubles- before they arise. Consider this whitepaper your map, as you head down the startup path.

Key Areas of Law Involving Startups



CORPORATE LAW

Forming the building blocks for any startup, corporate law plays a significant role in your business structure (incorporation, partnership, sole proprietorship, or otherwise) and also sets the ground rules for how the business is run, on a day-to-day basis. Key documents such as articles of incorporation, bylaws and shareholder agreements should spell out how key decisions are made, by whom and what happens if there is disagreement among the key stakeholders of the business. Regardless of the business structure that is chosen, ongoing legal maintenance will also be required (such as annual returns and resolutions, as well as renewals of business name registrations).

TAX LAW

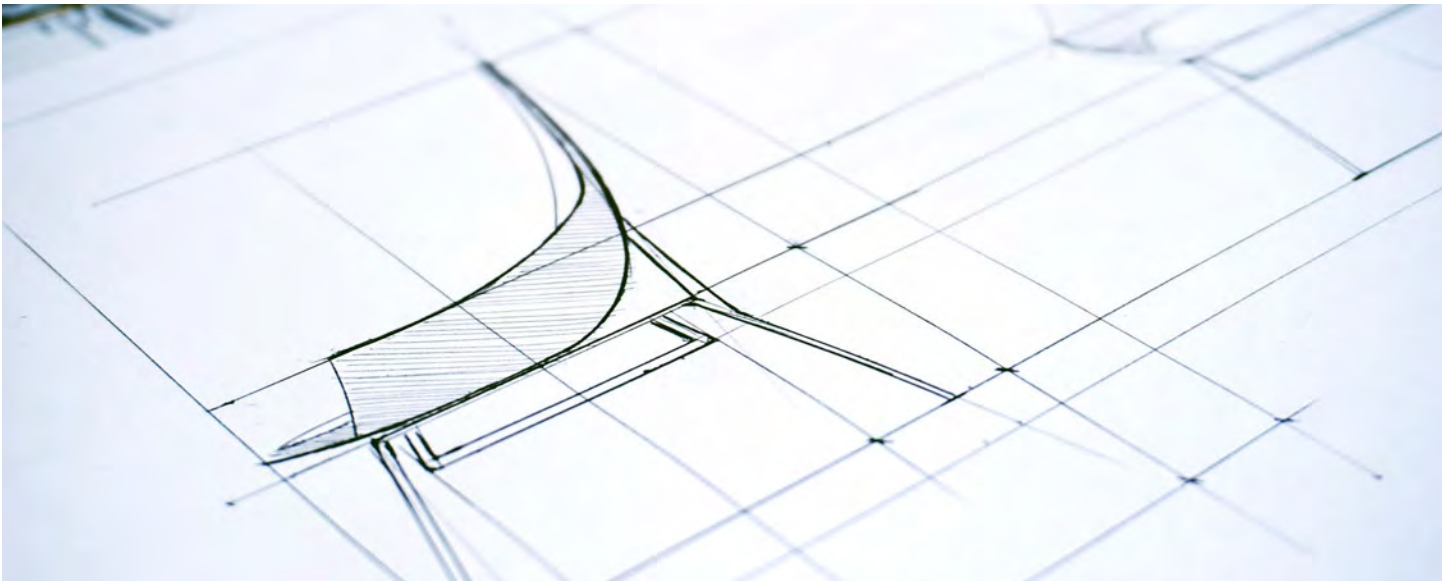
This is a ride-along with corporate law, especially at the incorporation stage. Many initial decisions involving corporate structure are ultimately driven by tax considerations, including short-term planning (how can I apply initial losses against other income?) and long-term planning (what's my tax-efficient exit strategy?).

INTELLECTUAL PROPERTY

Also known as IP, this is the lifeblood of many startups (whether in the form of tech products or services, creative content, or general knowhow). Fixed expressions of creative content (such as software code, art, books, websites, guides, and so on) can all be protected by copyright. Brands, slogans, logos and other things associated with goodwill are protected by trademark laws. Inventions, meanwhile, may be protected by patents.

CONTRACT LAW

Put two people together, have them agree to something, and voila- you've got a contract. Some contractual relationships are obvious, but others are less so. It's important to document these relationships so that each side knows its and the other side's obligations- and also what happens if things don't work out as planned. Common early-stage contracts include client agreements, agreements with suppliers and also IP-specific agreements, such as nondisclosure and confidentiality agreements.



E-COMMERCE

Businesses which operate in the electronic realm (think online, mobile and pop-up stores) experience unique legal issues, which may not apply to traditional bricks-and-mortar operations. Agreements such as terms of use (or terms of service) and website privacy policies are critical, if your business drives customers through its website. Businesses which find and maintain clients electronically also need to consider Canada's Anti-Spam Law (or CASL), which applies to e-communication as well as the installation and operation of computer programs (among other things).

SECURITIES

This area of the law controls how companies are able to issue shares, together with other forms of investment, such as convertible debt securities. Every issuance of shares is subject to two basic requirements- the issuance of a disclosure document to the potential shareholder (called a prospectus), and the registration of the company which is issuing the shares with the applicable securities regulator. Most share issuances by privately held companies fall within exemptions to these obligations, but it is important to ensure the company's articles of incorporation and its share issuance practices allow the company to claim one of these exemptions.

REAL PROPERTY

Most startups will not own any land (at least, initially). Real property laws are still important, since any dedicated space upon which the business operates will likely be leased from a landlord. It's important to understand how these laws apply to a company's obligations as a tenant under that lease.

EMPLOYMENT LAW

Even though the law regards a company as a distinct legal entity, separate and apart from its owners, a company is a creation of law which can't do anything on its own. Rather, a company needs to act through representatives. If those representatives meet the legal test for employment- which is based on the company's degree of control over the worker, among other things- then an employment relationship has been created.

As with other agreements, it's best to document the key terms of that relationship, in a written employment agreement.

CORPORATE FINANCING

Businesses need money. Financial institutions and other lenders exist to provide financing to businesses. However, there's no such thing as a free lunch, and these lenders will want to protect their interests by doing things such as securing a loan (for example, where the bank stakes a claim to your home until you repay your mortgage) and taking guarantees that the loan will be repaid from the business's principals or related companies.

Common Areas Startups Overlook or Neglect & Where They Make Mistakes

Business Structure

Give careful consideration to your business structure. In Manitoba, there are three common types of business structures: sole proprietorships, partnerships and corporations. While incorporation has its benefits, it's usually more expensive than the other options and it's not always the best fit. Carefully review the pros and cons of each structure, consider not just where you are, but where you're going, and pick the structure which is best for you:

- **Sole proprietorship.** This is the simplest form of business structure, and as a result, is the quickest and cheapest to get up and running. All you need to do is start carrying on your business. In most cases, the only legal step that's required is to register a business name, with the Manitoba Companies Office. The downside to a sole proprietorship is that you are the business, which means that while you have the right to receive all of its profits, you are also personally exposed for all of its risks, debts and liabilities. In addition, any money you receive is subject to tax at your personal income tax rate, which may be higher than if the money was earned through another form of business structure.
- **Partnership.** This business structure is formed when two or more people agree to combine their financial resources and skills, to form a business. The basic rules for how partnerships are governed are set out in The Partnership Act (Manitoba). Many partnerships choose to customize these rules with their own partnership agreement, which governs how the partnership will operate and how the partners will deal with each other. Keep in mind that, like a sole proprietorship, a partnership can be unintentionally formed, as soon as two or more people act in a way that gives rise to a partnership. In addition to the benefit that comes from combining different partners' perspectives, partnerships are also advantageous because they can increase opportunities to access external funds. In Manitoba, partners can enter into what's called a limited partnership, which can limit the exposure of individual partners to their individual contributions to the partnership (whereas in a "regular" partnership, each partner is responsible for all of the debts, obligations and acts of the partnership, and can therefore face liabilities which were incurred by the other partners). Limited partnerships are often used as a tax planning tool, because losses can then be offset against other sources of income. Moving to the disadvantages of partnerships (on top of the potential for unlimited personal liability for the partnership's debts), another downside is that forming a partnership usually requires an initial investment of money and time. As a result, it's a slower and more expensive option than a sole proprietorship.

• **Incorporation.** This is the process by which a corporation (or company)- which is treated by law as a legal entity which is distinct from its owners- is created. A company has three key groups of stakeholders: the shareholders, who own the company and elect the board of directors; the directors, who are responsible for overseeing the management of the company and appointing officers; and the officers, who are responsible for overseeing the company's day-to-day operation (though officers typically hire employees and other representatives to do this work). The major advantage of incorporation is what's called "corporate personhood" - since the company is a separate legal entity, it (rather than its owners or employees) is able to enter into contracts, buy and sell property and pay taxes. This provides a layer of insulation for its owners, who are not in the usual course liable for the corporation's actions; their liability is limited to their investment in the corporation. In addition, companies can raise money through the sale of shares, which provides another option which is not available to sole proprietors or partnerships. There are also far more tax planning options available to companies when compared to the other two forms of business structures. On the cons side of the ledger, companies are more expensive to set up than the other two forms of structures, which can make them less attractive for new entrepreneurs (though, companies can start with a basic structure, and add customized options down the road). Once a company is incorporated, there are also ongoing corporate maintenance costs (such as annual returns and annual resolutions) which are not applicable to the other business structures.

Don't wait too long. Yes, picking a business structure can be a daunting task, which requires careful consideration. That said, it is also important to organize your business while it is still in the early stage of development. From a practical perspective, it is always better to have a plan in place, from the outset (even if it is just a loose plan). On the legal side of things, while it is possible for a company to adopt contracts which preceded its incorporation, the longer you wait to incorporate after you start carrying on your business, the more clean-up work will be required. Agreements such as leases that may have been entered into under a different business structure will need to be transferred to the new entity, which may require negotiation with the other party to the contract. As well, key assets that may have been purchased or developed may also need to be transferred to the new company. These transfers need to be carefully documented in order to avoid unwanted tax consequences.

Consult other professionals, too. A lawyer is only one part of your business development team. Key incorporation documents such as articles of incorporation are heavily influenced by tax considerations, so it's a good idea to connect your lawyers and your accountants, to ensure all of the bases are covered. Every business needs money to operate, and for this, a good relationship with your banker is key. Depending on what your business entails, you may have other professionals with whom you also consult. Make sure your network of professionals talks to each other, because the decisions of one professional frequently influence the options which are available to another.

Consider key governance issues and exit mechanisms. Any entrepreneur who's worked with a lawyer has probably been told that they need a shareholder agreement. There's good reason for this advice. While corporate law (in Manitoba, The Corporations Act) provides a default set of rules for how companies are governed, these basic rules leave many holes which should be filled. For example, you might be comfortable having most decisions being made by a majority vote of your board, but are there key decisions (issuing new shares, selling shares, borrowing money, etc.) which should require unanimous approval (and if so, by whom- the board or the shareholders)? Do you want to lock in who will sit on your board? What happens if a decision results in a tie? How can a shareholder leave the company (voluntarily or otherwise), if it just isn't working anymore? For these sorts of decisions, bylaws and a unanimous shareholder agreement (so-called because all shareholders must agree to it) are required. While a shareholder agreement takes time and money to prepare, it is far easier to go through the exercise early (when everyone is getting along, and there aren't big dollar signs attached to the decisions), rather than later in the company's life.

Beware the boilerplate. Why pay a lawyer to incorporate a company when so many of the necessary documents are available online? It is true that you can get articles of incorporation from the internet, or pay a company a small fee to file them for you. But keep in mind that template documents could come from any jurisdiction, and may not be well suited to (or even comply with) Manitoba law. A good lawyer will be able to pick out things that shouldn't be in your documents, but much more importantly, they will be able to tell you what isn't in your documents (but should be). Lawyers also provide valuable advice which can help you customize your documents to fit your needs (do you need a preferential dividend rate, to attract investors?) and to ensure you comply with your legal obligations (have you met the private issuer exemption, in order to issue shares?). We can (and have) cleaned up self-incorporated companies, after the fact, but that solution is often costlier than if the entrepreneur had simply consulted us in the first place.



Tax Considerations

Don't forget the tax. As mentioned above, tax issues heavily influence how a company is structured. No corporate structure is set in stone, but making changes costs money, and may be constrained by your ability to get approval, from all of your stakeholders who've already invested in the company. So many aspects of taxation are interwoven into a company's structure that, at the very least, an initial conversation with your accountant and your lawyer is warranted. Some of these issues include:

- The tax implications of a particular business structure;
- Appropriately addressing both negative and positive income flows (for example, finding ways to use the business's losses to reduce other taxes);
- Structuring the business to involve your family members;
- Structuring the business to isolate your business risks from your personal assets;
- Preparing the business to be sold, in a tax-efficient manner;
- Planning for, and then executing, your retirement.


Jurisdictional issues. Let's say your business is located in Winnipeg, but you have customers all over the world. Maybe you have satellite offices elsewhere, or maybe you're selling everything online. Where do you need to pay taxes, at what rate and how can you reduce what's owing? Day-to-day tax issues. Not all tax issues arise at the outset or end of the business's life cycle. You should also be seeking advice about ongoing tax issues, such as:

- What kind of tax returns does my business need to file?
- Do I need to charge GST? Do I need to register for a GST number? Is there a way to recoup the GST my business has paid? How do I do all of this stuff?
- What about PST? Are the rules different than GST?
- What's HST, and do I need to worry about it?
- What about my payroll?

Intellectual Property

Document, document (and then document some more). Businesses (and not just those in the tech sector) are routinely tripped up by a failure to document their IP. Here are three questions every business should ask itself:

- What IP forms a part of my business?
- Who developed the IP?
- Who owns (or should own) the IP?



There are default laws which apply to IP ownership and usage, but falling back on these defaults can lead to uncertainty and, sometimes, completely undesirable results. The first step is identifying what IP is necessary to the operation of your business (both in terms of ensuring you have all necessary permission(s) to use the IP, and also in terms of identifying IP as a key asset of your business). Next, you need to get a handle on where the IP came from- who developed it, and under what terms? Finally, understand who owns the IP- and if it's not your business, should it be? Once you've answered these questions, it's time to put pen to paper, to document your business's IP. In some cases, the necessary language will go into a standalone agreement (such as an assignment and waiver of moral rights or a licence agreement). In other cases, the language should be added to an existing agreement (such as a client agreement, or an employment agreement).

Protect your IP. Let's say you've developed a report which sets out your findings on a particular research topic that's key to your business. Having gone through the exercise above, you're now reasonably confident that your business's ownership of the IP has been adequately documented. Now you need to move to the protection stage, which involves a few aspects. First, consider documenting ownership by registering copyrights and trademarks, as appropriate. Second, consider supplementing your ownership claims with additional protection, such as confidentiality and non-disclosure agreements.

Pre-clear your IP. Many businesses put a substantial amount of time and money into establishing a brand, at the outset. But how confident are you that someone else hasn't already registered the domain name or business name which you've got in mind? It's always prudent to spend a bit of time conducting pre-clearance searches, to make sure you're not faced with a nasty cease and desist letter from an existing trademark holder. In addition to anything else which could come from that, you may find yourself back at square one, trying to re-establish goodwill under a new name.

IP and the internet. Just because you pulled something off the internet, doesn't mean that IP laws don't apply. IP laws apply to things on the internet. Naming the source of that picture or song you're using isn't good enough. End of story.

Open source software. Do you have code? Does it use open source software? If it does, have you considered how this affects the marketability and commercialization of your products or services? There is nothing wrong with incorporating pre-existing code into your code, but you need to make sure the licence which is attached to that pre-existing code fits in with what you've got planned. In particular, be wary about using code which is subject to a so-called "copyleft" licence, which may require you to open up your own proprietary code, for the entire world to see.

```
function hex2rgb($hex2rgb) {
    $hex_str = preg_replace("/^[^0-9A-Fa-f]/", '', $hex_str); // Gets a proper hex string
    $rgb_array = array();
    if (strlen($hex_str) == 6) {
        $color_val = hexdec($hex_str);
        $rgb_array['r'] = 0xFF & ($color_val >> 0x10);
        $rgb_array['g'] = 0xFF & ($color_val >> 0x8);
        $rgb_array['b'] = 0xFF & $color_val;
    } elseif (strlen($hex_str) == 3) {
        $rgb_array['r'] = hexdec(str_repeat(substr($hex_str, 0, 1), 2));
        $rgb_array['g'] = hexdec(str_repeat(substr($hex_str, 1, 1), 2));
        $rgb_array['b'] = hexdec(str_repeat(substr($hex_str, 2, 1), 2));
    } else {
        return false;
    }
    return $return_str;
}
```

E-Commerce Issues

If you have a website, you need a terms of use agreement and a privacy policy. You wouldn't sell a house without a written agreement, so why would it be any different for anything you sell from your website? When you do business online, there are all sorts of potential sources of liability that need to be addressed: what kinds of warranties come with the product you're selling (if any); is your liability to your customers limited (and if so, how); where (and how) are disputes settled; and what are the rules for taking payment? These and other issues need to be addressed in a terms of use (or terms of service) agreement. If you have a website, you are also likely collecting personal information from your users, and for that, you need a website privacy policy.

Be especially wary of "borrowing" other terms of use agreements. These agreements are highly customized, and e-commerce laws are subject to considerable variation, based on the jurisdiction in which a business operates. Be warned that all of those terms are in that agreement you've found for a reason, and many of those reasons may not apply to Manitoba businesses. So, don't copy and paste another website's terms of use. No one likes a plagiarist, and that aside, a copied terms of use agreement is not likely to provide you the customized protection you need, anyway.

Coping with CASL. CASL is pervasive. So much of what a business does is dependent on communicating with its customers (either existing or potential). If that communication is done electronically, it is likely that CASL will apply. Do you know what your CASL obligations are? (Hint: it's more nuanced than ensuring you have consent to send emails.) Yes, you need to consider if you need consent, and if you do, whether you have it. If you don't have consent, what do you need to say in order to get it? Consent aside, you also need to include certain information in each email or other electronic message you're sending (such as information that identifies your business and an unsubscribe mechanism). CASL is a lot of work, and it should not be casually addressed with a clause or two that's tossed into a privacy policy as an afterthought. CASL requires a comprehensive strategy, which is best reflected in a standalone internal policy.

Is e-contracting OK? Can you enter into contracts electronically? Is an electronic contract "in writing"? Can it be "signed"? There is a complex and evolving body of law that deals with these questions, as well as others, such as best practices for creating systems which comply with legal standards and which preserve evidence for future purposes (whether that's litigation, or otherwise). So yes, you generally can e-contract, but you need to pay close attention to the unique rules and requirements which may apply.



Securities Issues

Shares aren't to be handed out like candy (part 1). Many businesses (and some lawyers) don't realize that the issuance of shares is subject to a complicated regulatory framework. Fortunately, most shares of closely held companies are issued in circumstances that comply with the requirements of securities laws (even if businesses aren't aware of them). Still, securities laws matter, and should always bear consideration. You don't want to find yourself on the wrong end of a disciplinary action from a securities regulator.

Shares aren't to be handed out like candy (part 2). Maybe you have a contributor you want to pay, but your business is short on cash. Or, you want to buy a product or service from a third party but you don't have the funds on hand to pay the bill. In circumstances like these, some companies simply issue shares, as consideration for whatever good or service they're receiving. This isn't prohibited by law, but it's important to remember that by so doing, the business is giving away an ownership stake. It might not be worth much, now, but it could be, in the future. In addition, issuing shares raises the prospect of involving others in the corporate decision-making process (even if the shares are non-voting shares). Finally, keep in mind that shares must be issued for consideration, which means whatever goods or services are being provided (in return for the shares) must have some sort of a defensible value attached to them (the company must also meet basic solvency obligations when it issues shares, but that's a separate issue).

Shares aren't to be handed out like candy (part 3). Some businesses like to reward employees by giving them an ownership stake. The process by which this occurs can have many names, but the most common one is an employee stock ownership plan (or ESOP). ESOPs have many benefits, but they also have hard and soft costs which are often glossed over. Implementing an ESOP requires careful (and sometimes expensive) legal and accounting planning. ESOPs may provide for an option to purchase shares rather than an automatic right to purchase shares, so issues such as when that option vests, and on what terms, need to be considered. Existing shareholders must either be prepared to have their ownership be diluted, or to purchase additional shares, to offset the issuance of shares as part of the ESOP. Consideration also needs to be given to the effect of employee shareholders, on the corporate decision-making matrix. What happens if an employee leaves the company? Finally, any ESOP should also contemplate what happens if the company is sold.

Employment Agreements

Written employment agreements are a worthwhile investment. We understand that at the outset of a business's life cycle, funds and time are in short supply. No one has an unlimited budget for legal advice. That said, you should invest in the creation of a written employment agreement, sooner rather than later. Employment agreements are necessary to clearly set out the employee's duties and other obligations (such as the protection of confidential business information and a prohibition against soliciting the business's customers), as well as the grounds upon which the employment relationship may be terminated, by whom, and what happens if it is.

Do you have an employment relationship, in disguise? A business's obligations with respect to its employees are different than its obligations to contractors. For example, an employer must issue a T4 to an employee, and also collect and remit taxes and other source deductions, to the CRA. There is a four-part legal test which is used to determine whether an employment relationship has been created, which looks at: control; ownership of tools; chance of profit/loss; and the worker's integration into the business. The application of this test requires careful consideration and may require legal advice from a lawyer who has experience with employment law issues.

Client Agreements

Document, document and document (again). Many of the issues we deal with arise from confusion which could have been resolved by the creation of a carefully written client agreement. In addition to creating an agreement, the process of negotiating and documenting the agreement is helpful in and of itself, because it forces the parties to consider all aspects of the agreement and to turn their minds to previously unforeseen consequences (which can then be addressed proactively).

Key issues to be addressed. Some of the issues which should be addressed in a client agreement include:

- Who are the parties to the agreement?
- What does each side have to do, under the agreement?
- If the agreement involves an ongoing relationship, what are the rules by which that relationship will be governed? Who makes the decisions and on what grounds?
- Who owns the IP which will be used and/or created? Is third party IP involved?
- What kinds of warranties (if any) are being given, as to the quality of the goods or services which are being produced?
- Are one or both parties incurring expenses? Are they going to be reimbursed? On what terms?
- Is a party allowed to use subcontractors, to deliver goods or services?
- Are changes to deliverables or services permitted? Under what process?
- Does the agreement require key personnel to be involved?
- Are there milestones or deadlines for deliverables? What happens if they aren't met?
- Is there a process for sign-off and acceptance, for products and services which are developed as part of the agreement?
- What happens if there is disagreement about something related to the agreement?
- Who can end the agreement, and how? What happens once the agreement ends? Are refunds payable?

Are you thinking about starting a new venture? Looking for advice about an ongoing business? Have questions about anything you've read?

Startups face many important legal challenges. Knowing when to ask for help can turn those challenges into opportunities. Schedule a consultation with Andrew today, and learn how we can help with matters related to your business.

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The content of this paper is intended to provide a general guide to the subject matter. Legal advice should be sought about your specific circumstances.