The One CAN to Rule Them All



Entrepreneurial Law - 2016

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UNIT 1:

- Clements
    - You'll be a lawyer for a business – think about things that you should know as a lawyer to advise a business client

Statutory Provisions

- **none given in class**

Common Start-Up Structures (Pros vs. Cons)

- ??Worth including??

UNIT 2: Choosing a legal structure and form

- Clements
    - Difference between legal structures and forms, when to use one or not, etc.
    - **Note:** No need to give section numbers, but **bonus marks** if you are able to give section numbers (same goes for general cases)
    - **PAY ATTENTION for the practical tips in this section**
        - **Same goes throughout the exam… but especially this section

Statutory Provisions

- ..

	Structure	**Liabilities**	**Tax**	**Other**
SP	- SP owner	- Unlmt. Personal liabilities	- @ SP's marg. Tax - biz losses written off against personal income	- must register trade name (s 110 *PA*) - does not give legal rights to protect trade name… may prevent being found partnership
Corp	- Owned by s/h - operated by directors (appointed by S/H) - directors can delegate to officers	- separate legal entity - D+O FD to corp (122(1)(a)) - D+O DoC to corp (122(1)(b) - S/H may have other statutory liab. - corp may indemnify D+O (124(4)(a)) **except** to extent of 122(1)(a) and (b)	- @ marginal corp tax rate - 17% (<500k sales); 39% (>500k) - may deduct biz losses from only biz income (not personal inc)	- NUANs search req'd (12) - **risk of "passing off"
Partnership	- 2+ entities (people/corps) operating "with a view to profit" (*PA* s 1) - s 4 *PA* → receipt of profits is *pf* proof of partnership - each partner agent of (firm) and other partners (binding)	- J+several liab to other partners in partnership (debts and obligations of firm *while partner is a partner*) - several liab. Only for deceased partner's estate	- Profits/losses flow to partners @ individual partner's tax rate	- profits/losses shared equally unless agreed upon
LP (GP)	GP + LP - GP = "thinly capitalized" shell corp (1+ persons)	- GP (56 *PA*) = same as a "partner" (rights/liabs) **except** admit GPs or LPs;	*see Partnership*	***Haughton Graphic*** **{**GP/LP partnership control test from 64 *PA***}**

	- LP = contributes capital + receives flow thru profits (1+ persons) - may be same person	carry on GP's interest after death (w/o permission) - LP (57 *PA*) = only liable to initial/agreed upon capital ****unless acts as GP** (64 *PA*)**		***Bates v Brownstones East II** {**LPs have less protective mechanisms for LPs than corps under *ABCA*} ***Nordile* {**LPs found not to be GPs, despite acting as mgmt, since there was agreed stmt of facts}
LLP	-can be used by: lawyers, dentists, accountant (CPA's), chiropractors, optometrists (*LLP Act*): cannot operate under a corporate structure -e.g. Cannot be engineers or psychologists	-joint liability - partners NOT liabl. (indiv) for other Ps for: negligence, wrongful acts/omissions/mal practice/misconduct → of other Ps or employees of P **in ordinary course of carrying on practice** (12, *PA*)	*see Partnership	
"Contractual" (JV, License, Franchise)	-contract between 2 or more parties -indicate express intention to form JV -mutual control and management -need indemnity clauses in JVA against 3rd party claims to avoid being deemed a partnership	-same as partnerships?	???	-co-contractors should not act as agents for each other

Bates v Brownstones East II Properties Ltd

- LPs tried to oust GP, which was allowed in the contract… but they req'd a meeting of all LPs and the LPs did not have any power to obtain a list of o/s LPs from the GP
    - *Limited Partnership Act* does not have same prescribed mechanisms to obtain corp info as in *ABCA, CBCA*, etc.

Haughton Graphic

- Two partners go bankrupt over printing a magazine issue (~$130k). Partners presented themselves as an LP – one argues they are not liable as a LP.
    - This section (s. 64) only applies if both are met
        - (1) person be LP; **and**
        - (2) they take part in control of the business
        - **Note:** this section does not apply if ****read para 40

Nordile

- N sells to LP (Arman). GP = Arbutus / LP = B. N sells property to Arman and obtains a 2nd VTB (effectively taking 2nd position in priority in the form of a second mortgage)
- LPs **not found liable**, despite taking part in management (agreed statement of facts saying LPs were solely arbiters and directors...so of limited precedent outside narrow scope)

Structural Comparisons

- SP vs. Corp
    - Liability limitations (unit personal vs. limited)
    - Tax deferrals (
    - Perpetual existence
    - Number of people
    - Costs
    - Flexibility of structure
    - Tax losses
    - Financing options
- Corp vs. LP
    - Re: passive investors want to be either; **not** partnership
    - **COPY SLIDES???
- JV considerations

Organizational Considerations

- Creation of share classes
- Restrictions on share transfer
- Name
- Number of directors
- Corporate bylaws

Structural Considerations

- Employees/future financing
- Future planning + IPOs (exit)
- Control
- Gov't programs + initiatives

Jurisdictional Considerations (*ABCA* vs. *CBCA*)

- USAs
- Scope/registration
- Other??

UNIT 3:

- Clements
    - Debt vs. equity
        - When to use, nature, hybrids
        - Cases re: hybrids
        - Why do firms like debt vs. equity
        - What happens on dissolution vs. wind-up
        - Preference rules
    - Creditor protection rules to protect against debt in the *ABCA*

Statutory Provisions

- Director Liability
    - s 118(3) -- J+S liabl for distribution in contravention of solvency tests or other prohibited transactions in the *ABCA*
        - **Defense:** s 123(3) -- if director exercises care, diligence, and skill of reasonably prudent person in comparable circumstances incl. "good faith" reliance of fin. stmts or expert report
    - s 119 -- J+S liab to employees of corp for all debts < 6 mos wages payable, during time you were a director
    - s 123 -- Director present @ meeting is deemed to have consented to any resolution or action from the meeting **unless** dissent noted
- **"Fundamental changes"**
    - Special resolution of s/h (⅔ prescribed voting threshold) for:
        - Amending articles (s 173(1))
        - Amalgamations (s 183(1))
        - Extraordinary sales (s 190(1))
        - Voluntary liquidation (s 212(1))

Debt vs Equity vs HB-Pref vs HB-Conv. Pref

	Debt	**Equity**	**HB-Pref Shares**	**HB-Conv. Pref**
Character.	- ST (trade credits) or LT (Notes, Bonds, Debentures) -legal obligations to pay a fixed rate of return (regardless of corp. success/failure) - often secured - terms dealt with by contract **(See *BCE*)** - Not often available to startups (w/o securing… e.g. personal guarantee; pledge	- recorded as "stated capital" (s 28 → $ received) - E = Ass. - Liab - no specified right to be repaid; no legally enforc. right to divd. pmts in non-profitable case (unless RE of divd. → oppression) - few terms, if any (see Articles) -represents share in time value of corp - S/h approval for "fundamental" changes (Part 14)	- HB of equity (may have right to vote; check Articles) and debt (agreed yield %) -right to participate in earnings; fixed divd; return on capital - "straight pref" = no voting nor participation	-divd. (if profitable)

	house as collateral, etc.)			
POV - Issuer	**Pros** - Tax benefits (i.e. debt tax shield) - Raise funds w/o losing equity control **Cons** - Fixed legal obligation - May require SI - May require abiding by covenants - Relatively expensive (vs. equity or others)	**Pros** - Permanent capital; no obligation to repay - no mandatory divd - increases borrowing capacity -often cheaper for company to issue **Cons** - shares = forfeit of control - minority s/h rights to consider -more expensive, relatively, than debt (since paid out of after-tax profits)	**Pros** - Flexible based on mkt/investor desires -No mandatory voting -No return of principal (unless retraction rights) -Reduce net asset value of common shares (i.e. A = L + E… and pref take up part of E). -Likely cheaper to raise $$ than debt **Cons** -Fixed divds -Priority to repayment before common stock -May require retraction to be marketable	**Pros** –Lower divd. rate -issue when common share performance is poor (can b/c of yield); –No immediate dilution of common share capital; –Common share convertible price at premium to market at time of pref issuance; –Rids company of obligation of retraction **Cons**
POV - Investor	**Pros** - Legally enforceable obligations, protected by contract - Ability to force bankruptcy to receive pmt - ?Safe? source of income, if debtor has stable cash flows -Exemption from withholding tax (unlike 25% w/holding tax for divds -Interest paid on debt	**Pros** - preferable tax treatment of equity on sale (capital gain, @ 50% gain incl. In income and taxable) - $813,600 (indexed) lifetime capital gains exemption for qualifying small business corporations *ITA* (s. 110.6(2.1) (subject ot holding period and asset test) - angel capital rollover (*ITA* s 110.6(1)) → individuals (**not** corporations or trusts) who dispose of an eligibile small business corporation" to defer toas on the gain if	**Pros** -Fixed cash flow (divd) obligations -Ranks > common shares in dissolution -May contain retraction rights (e.g. conversion rights per s 29) **Cons** -No divds payable if firm fails either	**Pros** –investor has "call" on common shares at predetermined price; –Potential for significant upside gain; –If commons outperform → convert at a discount; –Shares yield a fixed rate of

	is tax deductible (*ITA*) **Cons** - Return on debt is capped (i.e. return of interest 5) - Don't give $ if liability concerns (get accountant to sign off on books) - Interest earned taxed at recipient's ordinary rate of income (vs. lower capital gains for dividends)	proceeds are invested in another ESBC within 120days of year end -able to participate in upside! **Cons** **-** dividends taxed at lower rate for recipient	solvency test -Ranks behind debt (often receives pennies on dollar) -May contain preemptive right of corp redemption (s 36)	return on investment while conversion privilege is unexercised; –Until conversion investor usually has priority over common holders for dividends and return of capital. **Cons**
B'cy Priority	1 - Paid first (debt simply repaid, if sufficient $$ remain)	3+ - Paid last (common shares) (unlmt right to *pro rata* share of property upon dissolution... after paying creditors	2 - Paid after debt (unless Common shares → last) (participation on dilution = redemption value + unpaid divs)	2 - Paid after debt, usually before common (unless Common shares → last) ***conv pref ?? > pref ??**
Stat. Provisions	**Liquidity test** → the corp. is or would be unable to pay its liabilities **Solvency test** → realizable value of the corps assets < aggregate L + SC Found in: 34 (retraction), 36 (redemption), 43 (pay dividends) "sc" → s 28	(1) Rights attach to common shares (s 26(3)) (2) Creditor protection → cannot pay dividends if fail either **{Liquidity + Insolvency tests}** (3) Div. pmts (s 43) **Fundamental changes** (Part 14-ABCA) by "special resolution" s 1 **lifetime capital gains exemptions** $813.6K **Requires** (1) taxpayer to own shares for 2+ yrs before	(1) May incl. retraction rights (s 34)... or purchase for cancellation in open market (solvency tests) (2) May be redeemable by corp (s 36) (subject to liquidity + insolvency tests → or FD liab.) (3) May incl. conversion rights (s 29) (4) Contravention of solvency tests in redemption = director liability	(1) ss 29 and 31

		disposition; (2) company must be using all or substantially all assets in active biz primarily conducted in Canada (3) during 2 yr holding period, at least 50% corp assets used in active biz primarily in Canada		
CL	***BCE*** **{**creditors protected by contract… so negotiate your protection / creditors owed DoC??**}**			
When to use?	- When you can actually obtain it… i.e. collateral to pledge, stable cash flows, benefit from tax shield, etc.			

Capital Structural Considerations

- Dilution vs. debt
    - Many entrepreneurs don't want to issue equity (dilutive)... but equity is cheaper (you can basically just issue it)
    - Identity of investor
    - Small PrivCo common to issue s/h loas as initial capitalization → permits founder to take out profits in tax-advantaged manner (i.e. debt repayment)
    - GrowthCos don't like it where founders debt ranks ahead of investor in b'cy (negative signalling)
    - Non-resident investors prefer convertible debt to equity
    - Investors often like to see manages with "skin in the game" (stock)
    - Exit strategy
    - Debt allows for easier exit for investors… not tied to success of start-up
    - Debtholders can force liquidation if not being repaid (or as a tactic, if callable)
    - Debt lowers attractiveness of equity issuance (since debt > equity, in b'cy)
        - So make sure you don't need equity for a while.. Or that your company is attractive despite debt
    - Capital structure and control
    - Capital structure (debt vs. equity) = control of corpoartion
    - Common mistakes
        - → giving significant share position to a person
        - → giving founders all equal shares (~ s/h stalemate)

Agency Problem

- Agency problem in corporation → owners are also officers.. With a say in their compensation
- Protection against agency problem
    - debtholder's → protected by contract (e.g. *BCE v 1976 Debtholders*)

Founders' Shares (Tax issues)

- If founders are issued shares @ same time as investors, then CRA considers founder share value to be = investor share value… this can create tax liabilities for founders
    - … who are now req'd to bring value of shares into taxable income
    - **Potential solutions**
    - S. 85 *ITA* rollover → rollover of property by founder in exchange for founders shares
        - Defers tax on capital gain until time founder sells shares
    - Issue common shares to founders, pref shares to investors (different share classes could warrant different valuations)
    - Take position that company instantly became more valuable when founder received shares and entered into emplyoment agreement.. But risk in CRA's eyes

Share Issuances

- How many shares to issue?
    - Common knowledge → $0.50/share (or less) if goal is to issue in public markets
    - Issue lots of shares at lower amounts, so there's no need to obtain s/h approval to issue further shares (e.g. w/ down round financing)
        - Also guards against future dilution, since there is no need to issue further nominal amounts of shares down the road
- **Real value ($) must be received for shares that are issued!
    - I.e. if you issue shares @ $0.10/share, then this is the "stated capital amount"
    - … may give rise to creditor liability (s 38(4)**
        - **this "stated capital" account cannot be reduced when a corporation fails either solvency/liquidity test (s 38)

Cases

Case Name	Issue	Decision/Takeaway
Canada Deposit Insurance Corp v Canadian Commercial Bank, SCC 1993	Whether an instrument is debt vs. equity? Can it be both?	● **Held:** this instrument is more like equity ○ ****loan indemnification, in case it was not repaid (i.e. rebuts obligation to repay) suggests this is more like equity**** ● **Held** instruments can have both equity and debt characteristics ● **Test:** look at whether the instrument in question is <u>in substance, factually representative of debt or equity</u> ● **Equity characteristics** ○ *pro rata* share in profits (tied to portfolio performance), potential for unlimited returns; potential for unlimited control for warrants ● **Debt characteristics:** ○ Documents said money would be guaranteed to be repaid ○ Contingently liable to pay interest on amounts "loaned" (extended) ○ Financial statements accounted for extension of funds as debts
Re Central Capital Corp, ONCA 1996	Can preferred s/h force the company to exercise retraction	● **NO!** Pref s/h remain shareholders until they convert shares into debt ("in substance shareholders and not creditors") ○ **Equity characteristics** ■ Shares recorded under equity on balance sheet

	rights in bankruptcy? (To become debtholders)	(some evidence) ■ Also had the option to initially take "preferred shares" instead of another type of instrument to make them clearly creditors ● Company is unable to redeem shares when it fails to satisfy the liquidity and solvency tests (s 36 *ABCA*) ○ ~company can redeem preferred shares only if "not contrary to law" (which this would be)

Unit 4: Shareholder Agreements

General USA Info

- W/o SHA whoever has majority has total control (elects board).
- USA transfers rights away from D to SH
- Special Resolution required for fundamental changes (s 173)
- Abrogate or restrict power of directors = increase SH liability
- CBCA requirement to restrict power of directors
- USA - deemed party rules - if buy shares to a Co with USA then you are a party BUT can rescind (statutory right), if SH had no knowledge of USA → right to FMV
- Need unanimous written consent under ABCA for amendment or termination
- Alternatives to USA: SHA, pooling agreement (s 145), voting agreements, voting trusts, escrow agreements
- USA makes management fiduciaries

Operating Provisions: s 146, ABCA & CBCA

Provisions	Pros	Cons	Structure
Share Escrow/Vesting	Corporation ● Tie key people to corp ● Protect against equity tag-alongs ● Right to repurchase unvested shares at OPP if founder leaves or terminate w/cause	SH/Employee ● Wait for equity ● Risk of losing equity even w/accelerated	Performance Goals ● Better incentive ● Difficult to define/measure Timed Vesting ● Schedule (i.e. 25% per year x 4) Accelerated Vesting ● 50% min. For death, divorce, or exit + 50% for term. w/o cause or constructive dismissal
Board Control			● Process to elect BoD (short list, voting process, support req'd) ● Growth Company: avoid restrictive covenants re: new share issue, additional financing, sale of assets, amendment to by-laws/articles
Pre-Emptive Rights	Shareholders ● Participate pro-rata in future rounds of financing (anti-dilution)	Investor ● Anti-dilution unattractive to soph. investors Corporation ● >10% can block takeover bid	● Do not include in Articles (per s 30) ● Right should extinguish when founder leaves/term. ● Sunset clause ● Exclude small issuance from triggering
ROFR	Shareholders ● Prevent 3rd party becoming		● Selling SH must offer to other SH ● Hard ROFR = offer from 3rd P ● Soft ROFR (ROFO) = offer to other

	involved in corp		SH, then offer to 3rd P
Piggyback Rights	Shareholders ● Allow SH to participate pro-rata in sale to 3rd party	Corporation ● Delay and difficulty for exit ● Disincentive to find buyers for shares	● Use sparingly
Drag-Along Rights	Corporation/Majority ● Key for smooth exit: MSH opt-out of right to dissent (s 191) Minority Shareholders ● Entitled to FMV	● uncertainty around legality of opting-out of right to dissent (s 191)	● Exit Transaction = Special Resolution (⅔ approval) ● TO bid = 90% SH approval ● Should apply to exit transactions & TO bids ● Min. 1 triggering event (approval of # of founders or % of SH)
Shot-gun	Shareholders ● Divorce from other SH ● Prevents low-ball offers	Shareholders ● Could backfire ● Wealthy SH Advantage (price below FMV but > offeree can pay) ● Shotgun circle ● Passive SH @ disadvantage ● Risk of being bought out b4 success ● Numerical superiority	● SH dispute mechanism ● Buy at X or sell at X ● Clause for only one shotgun being triggered at a time ● Consider: only allowing triggering SH to buy from selling SH
Puts/Calls	Minority SH ● Put option to sell at strike price, exercised against majority SH Majority SH ● Call option to buy at strike price from minority SH	Tax Implications: ● Holder of option is deemed to own shares even when not exercised (*ITA*)	
Borrowing/Cash Calls	Corporation ● fundraising	Shareholders ● Increase risk ● Deter investors ● Consequences: dilution of equity, termination of agmt., lose voting rights ● Neg. impact on share price	Generally: sub. For additional shares, loan, transfer of ppty ● If included: if triggered founders/SH will contribute pro rata - if not they lose participation in divd.

Mandatory (Involuntary) Share Sales	Corporation/Other SH ● Call option on SH ● Protect against unwanted SH		● Company has first right upon: Death, divorce, bankruptcy, breach; then other SH ● Good to have in USA
Valuation Provisions			Process to value shares Avoid: ● Fixed $ amount per share (if using then tie to latest transaction) ● Periodic agreement ● Mathematical Formula Do: ● Set price low (i.e. $0.0001) ● Reference last arm's-length transaction or use CBV
NCA, NSA, NDA		Corporation ● NCA can deter investors	● Not in USA, use as stand-alone ● NCA & NSA typically apply to employees not SH
Termination/Wind-up			Level of consent varies depending on USA or SHA Practical: consider giving right to corp. In SHA
Organizational Clauses			Material Decisions ● Fundamental change requires ⅔ special resolution
Dispute Resolution	More important if no shotgun		● Mechanisms for: unilateral acts by SH; settle disputes ● Process: Neg - Med - Arb (state can only be in one at a time)
Independent Legal Advice	CRITICAL		

*Practical Note: Key-man insurance for key personnel. If they die the corp. gets the money through the capital dividend acct. = tax free

Problems with USA's

-no way to get out of liability for shareholders other than to sell
-inclusion of every shareholder can hinder growth companies

Clements

- Still on the final exam – some USA stuff
- Know what USAs are, different rules between *CBCA* vs. *ABCA* rules
  - **Note:** no other provinces (e.g. not *OBCA*) covered
  - There are material issues between *CBCA* vs. *ABCA*

        - i.e. for *CBCA* you need to abrogate director powers to be a USA
        - i.e. *ABCA* you explicitly need unanimous consent (but NOT CBCA); USA can be found w/o abrogating powers (e.g. buy-sell agreements, etc.)
- When wouldn't you want a USA
- Alternative agreements aside from USA
- Why are USAs important or valuable
    - i.e. Tingle writes his book for growth cos… so you may want a USA for unique growth cos (e.g. tightly contained number of s/h may be OK and mitigates issues w/ significant number of s/h)
        - USAs may be valuable for non-growth cos
- No case law challenging USAs that have voting @ less than unanimous
    - E.g. this agreement can be terminated by unanimous agreement *or if the company goes into insolvency* (no case law on the *latter*… but you should consider the fact that the statute has black letter law ❼ s. 146(9))
        - Directors' powers do not need to be abrogated
        - **BUT SEE s. 146(8)** and amendment/termination cannot occur without <u>unanimous</u> approval of all parties that approved
            - … despite the fact that some director powers have been abrogated
    - **Ambiguity in *CBCA***
        - You need **<u>all</u>** s/h to form a USA in the *CBCA*… but it does not explicitly state that you need **<u>all</u>** s/h to terminate a USA
            - i.e. you can often see supermajority req'd to terminate *CBCA* USAs
- **General tip** ❼ give advice; come to conclusions (advocacy can support most positions… so be conclusive)

UNIT 5+6

Forming an Effective Board and Understanding Corporate Governance

- Clements
  - Practical rules re: board formation and operation
    - Director roles/duties
    - Heads of liability
    - Defense to liability / rules / limitations to liabilities
    - Rules re: conflicts
    - ****cases re: SCC are important here****
      - ***BCE, Peoples', Kerr v Danier*** **re: FD's owed, DoC owed, differences, balancing competing interests, Biz Judgment Rule**
      - **Note:** you can distinguish yourself by citing cases that are skipped over

Number of Directors: s 101(2)

- Non-distributing corp. = 1+
- Distributing corp. = 3+ (2+ not officers/employees of the corp or affiliates)
- ¼ Canadian Resident Requirement

Election and Appointment of Directors

- D's named in articles, then after elected by ordinary resolution (50+1%)
- Can hold office for up to 3 yrs (must be in Articles/USA per ABCA)
- If not present, must accept D w/in 10 days in writing or by acting as D
- Resist founder dominated boards (restrict ability to raise capital)
- Resist investor dominated boards (self-interested)
- Avoid friends and family
- Best to have balance or shifting board comp.depending on diff. events
- Use incentives (i.e. options) to attract good D's

Corporate Governance for Startups

- Founder proofing
- Mitigate conflicts for D's b/w responsibility to corp. and self-interest as SH/employee

Two Problems:

1. Controlling SH vs everyone else
2. Restrain mngt. when no controlling SH

Advisory board member used when II/VC does not want to appoint to BoD but still oversee

Oppression Remedy: s 242

Case Name	Issue	Decision/Takeaway
Burnett v Tsang, ABQB, 1985	SH kicked out brings oppression claim for wrongful dismissal	• Wrongful dismissal is not oppressive behaviour • No probity so no "just and equitable" remedy as SH

Stech v Davies, ABQB 1987	Oppression? D taking prejudicial actions against other D	• Oppression successful: D unilaterally increased own salary, gave mngt. less, created own shareholder acct. • Use USA to prevent these situations, esp. w/controlling SH
BCE v 1976 Debentures, SCC 2008		
Peoples Department Stores Inc (Trustee of) v Wise, SCC 2004		
Fiorillo v Krispy Kreme Doughnuts, Ont SCJ 2009		
PWA Corp v Gemini Group Automated Distribution Systems, Ont SC 1993		
Abbey Glen Property Corp v Stumborg, ABQB 1975		
Kerr v Danier Leather Inc, OJ 2004		
R v Blondin, ONSCJ 2012		

UNIT 7:

- Clements
    - Employment *** definitely on exam
        - Understanding tips re: employment agreements in startup context
        - Rules for each
            - Constructive dismissal
            - Drafting tips
            - IC vs. Employee vs. Hybrid relationships
            - Severance issues
                - Stock options
                - Cases on this
                - IP ownership
    - **Put yourself in the shoes of a lawyer advising a startup**
        - Focus on the practical slides in this section re: giving advice

General Drafting tips (emplmt agrmts - consolidated)

- Keep agreements as general and simple as possible
    - avoid constructive dismissal (with general responsibilities)
    - + responsibilities will change over time (start up context)
- **Have emplmt agreement entered into as condition of being offered employment**
    - Present employment agreement + anciallary contracts *as part of employment offer*
    - +Encourage them to seek ILA
- **Do not have an employee sign an "offer letter" before work.. Then NDAs, etc. **(unenforceable)**
    - Don't pay additional considerations for imposing additional obligations on employee? (May be CD claim)
- Incorporate separate agreements into employment agreement (reference them)
    - E.g. reference stock option agreement, share subscription agreement, NDA, NCA, etc.
- Include an "integration clause" ("entire agreement" clause) in employment agreements
- *Contra profetentum* will apply → i.e. ambiguities interpreted against drafter (i.e. employer)
- **Remove judicial discretion! Outline termination provisions properly!**
- NCAs → Rather than geography, define specific jobs and types of competitors that will trigger it
- **Customize each restrictive covenant **per employee**
- IP Matters
    - Negate *GD Searle & Co*, above
    - Incl. a term obligating employee to do w/e acts are required by employer to protect and confirm ownership of the innovation (e.g. they may need to physically sign things as inventor, etc.)
    - Obtain waivers of moral rights periodically OR whenever employee completes a major project

Constructive Dismissal

- Successful claim for CD results in
    - Employee may resign from employment but retains entitlements as though dismissed w/o cause (incl. Entitlement to pay in lieu of notice)
- Changing job function could be CD… but not necessarily
    - **See *Ferdinandusz v Global Driver Services Inc,* ONCA 2000**
- **Test for CD**
    - (1) Was an express or implied term of the employment contract breached?
    - (2) What the breach in question sufficiently serious to give rise to constructive dismissal?

Unenforceability for want of consideration

- common to see an employment agreement entered into as a condition of being offered employment…. This is **enforceable**
- signing an "offer letter" (sets out salary and job duties) only to be req'd to sign an NDA and other forms when you start work… **NOT enforceable**
    - courts generally do **not** uphold the latter, NDA contracts signed
    - Why? Original agreement was offer, acceptance, and consideration
        - Offer – "offer letter"
        - Acceptance – signature
        - Consideration – employment
    - See ***Francis v CIBC***
- Therefore, **new agreements = require fresh consideration**

Termination Provisions

- If your contract is silent, then the CL prevails (OFTEN higher than statutory scheme)
- If your contract outlines termination provisions (re: notice), then the contract may prevail
    - (i) Contract must be equal to or greater than the statutory provisions
    - (ii) Possibility of receiving less than statutory amount = void ab initio
        - E.g. "severance = 1 month's wages"
        - … if a person *were* to work there for 8 years, then this would likely be less than the statutory amount and is therefore void ab initio
- How much is enough? (Quantum of severance)
    - See ***Machtinger v HOJ Industries,* SCC 1992**
- **Specific drafting tips**
    - Make it clear that employee may be terminated at discretion of the company
        - Otherwise there's a judicial trend to find obligations of continued employment in the absence of contract
    - Don't draft termination provisions with even mere possibility, at some point in the future, to be less than the statutory (minimum) requirements
    - Notice may still be required for independent contractors
        See ***Marbry v AV Fecon International Inc, BCCA 1999***

Employee vs. Independent Contractor

- Employee vs. IC
    - See ***Wiebe Door* Test (5 - Factors)**
- ITA Def'n of "salary" or "wages" excludes pmts made to a corporation
    - **Q:** *Will this work to have an employee incorporate as a 1-man company to get around this?*
    - **A:** it could… be you risk being deemed a "personal services" corporation
        - I.e. (highest tax rate) w/ disallowance of most company business expenses… PLUS penalties+interest on unpaid taxes
- "Intermediate relationships" (dependent contractors)
    - Hybrid category, along a spectrum
    - Look @ the facts of the employment arrangement!
        - Look at: duration and permanency of emplmt relationship, degree of reliance or closeness, degree of exclusivity of contract, inability to find replacement work
        - Court may find that the relationship is *more* like Employee//IC, and award more/less notice as a result
        - See ***Marbry v AV Fecon International Inc, BCCA 1999***

Restrictive Covenants (NCAs, NSAs, and NDAs)

- Severability and the **Blue pencil **TEST****

- *Canadian American Financial Corp*
- Non-compete covenant (NCA)
  - General Test → See ***Elsley Estate*** **(SCC)**
    - Para 13 - A covenant restraining trade is enforceable only if is reasonable between the parties and wrt public interest
    - Para 19 - "reasonableness" of the restrictive covenant →
      - Look @ the overall assessment of the clause, the agreement where it is found, and all surrounding circumstances of the business
  - Employer breaches employment agreement? → ***Atkinson Rule***
    - Employee obligations under emplmt terminates on breach of agrmnt by employer
  - When are such covenants enforceable?
    - Most likely to be upheld during a business sale
  - Why is this less effective against growth and tech companies?
    - Because they can operate anywhere in the world, provided they have an internet connection
  - Do these apply to former directors?
    - … they may be subject to duty not to compete arising from status as fiduciaries of the company (**Note:** not litigated, so use contractual non-compete to supplement these fiduciary obligations)
  - Don't present "standard form", non-customized covenants to ***every*** employee
    - See ***IT/Net Consultants v Rajwanai,*** **Ont Gen Div 1997**
  - **Nesting or collapsing NCAs** → make sure severable, in case the whole thing is void
- Non-solicit covenant (NSA)
  - NDA Drafting tips
    - Restrict covenant to <= 1 year (this should be enough time for the employer to protect these relationships)
    - ○ Don't use clauses to prevent employees from contacting any business/person with whom employer does biz
      - Use clauses which prevent employee from soliciting individuals with whom employee personally worked and developed relationship in the course of employment
    - Clearly differentiate from non-competition provisions
      - i.e. draft two separate clauses if you need to do both, as both may be struck together
    - Include severability clause, so if non-compete is void, the rest of the contract remains in force
- Non-disclosure (NDA)
  - Define what is "confidential info" (i.e. anything that becomes public through no fault of the parties = non-confidential info")
  - Define length of time (be reasonable… 2-3 years is likely ample)

Intellectual Property and Employees

- Who owns what? (inventions)
  - General presumption → **Presumption that employee owns the invention (*GD Searle & Co*)**
    - Employer can rebut by showing:
      - (a) There is contract that stipulates otherwise;
      - (b) The employee is senior officer (and therefore fiduciary) and invention relates to business of company; **or**
      - (c) The employee was employed specifically for the purpose of inventing and innovation
  - Who owns [other forms of IP -- not patents or inventions]?
  - General presumption → owned by employer
    - … unless produced outside the workplace, on the employee's own time, or **not within the true course of employement**
  - Ownership of "work produced in the course of employment" **Test**
    - (1) Would the worker have broken her contract by not producing the work?; AND

        - (2) Would the acquisition or retention of the copyright by the worker be inconsistent with her duty of good faith and loyalty to her employer?
        - ***Both yes = employer owns; No = employee owns***
- Who owns moral rights?
  - Belong to author of copyrightable work (NOT the owner) → arise automatically upon creation
  - May not be assigned (ONLY waived)... May only be waived **until acquired** (invalid if done earlier)
- Trade secrets
  - Trade secrets are protected under the common law (no statutory protection for this IP)
    - Protected by CL breach of confidence action
    - **Effect**: CL permits company to restrain employee/former from disclosing trade secret if company can show info is a secret that the employee owes a duty of confidence to employer
  - Duty of confidence
    - Arises automatically if employee is a fiduciary of company (i.e. likely only directors and senior officers)
    - May incl. lower employees (e.g. if employee has access to sensitive client info)
    - This ceases when employment ceases (vs. directors FD's continue)

Amending employment contracts: forbearance from dismissal

- **General rule** → courts are reluctant to enforce employment terms that are introduced after signing employment agreement… without new consideration
  - **Solution:** provide new substantive consideration (beyond a peppercorn)
    - E.g. promotion, raise, signing bonus, options or shares
    - May include forbearance from dismissal… if genuine
      - There needs to be clear evidence of a prior intention to dismiss the employee on proper notice if the agreement is not signed…
      - See ***Wolda v Techform Products Ltd***

Employer Protections + Remedies for Breaches

- 3 protections
  - 1) CL duty of **fidelity** (or duty of loyalty)
    - Implied term of **all** employment relationships
    - i.e. **DUTIES to** act in good faith towards employer; duty to **avoid conflicts**; duty not to compete w/ employer; maintain confidentiality of employer's proprietary info (trade secrets/customer lists)
    - **Conflict of interest?** NOT doing above
  - 2) Contractual relief via **restrictive covenant** (NCA, NSA, NDA)
  - 3) Doctrine of employee **fiduciary duty**
    - May arise for officers and key personnel; senior management; even lower employees (e.g. sales employees) **(may arise automatically!)**
    - "Key personnel" ? → "employer's vulnerability" (size of employer; employee position; length of time employed; closeness w/ customers; access to personal records)
    - **DUTY TO** not quit to take advantage of corp opportunity (w/o disclosing to employer+giving them chance to exploit); not to compete with former employers for a reasonable time period (incl. NSA prohibition)
- Remedies to employers for employee breaches of duty (loyalty and FD)
  - Just cause for termination of employment relationship
  - Lawsuit for damages (competition, use of confidential info, breach of duty of loyalty and/or FD)
  - Injunction for continuing violations

Cases

Case Name	Issue	Decision/Takeaway
Ferdinandusz v. Global Driver Services Inc., ONCA 2000	What is "**constructive dismissal**"?	● NOT CD ○ Employee given new role could be CD ○ BUT this guy was offered trucking jobs to replace his old route (he did not accept any) and was offered a new "full time" position (he also rejected)
Francis v CIBC (ONCA)	Why was the second (employment) contract not binding?	● Second employment contract not binding for **want of consideration** ● Advice re: startups (basically - para 30) ○ Have **<u>one</u>** letter saying employment offer is conditional **on accepting standard terms of employment agreement** ● **Note:** **amendments unenforceable *without* fresh consideration**
Machtinger v HOJ Industries Ltd, SCC 1992	Was there enough contractual "notice"?	● Contract notice provisions are generally upheld if they do not contradict statutory notice periods (anything less than statutory prescription will be void for public policy reasons) ● **Notice period in contract must be >= statutory notice period ○ Failure? = void ○ ***Possibility*** of failure = void
Shore v Ladner Downs		*Theoritical possibility to restrict severance below statute, **<u>at any time</u>** during the potential term of agreement = **void *ab initio***
Wiebe Door Services Ltd v MNR, SCC 2001 (FCA in class)		***Wiebe Door* Factors:** 1. Degree of autonomy ("control" test); 2. Who bears responsibility for profit and loss? ("economic reality" test); 3. Who owns the equipment necessary to do the work? 4. Whether the worker is expected to be available on an ongoing basis or to achieve a specific result ("specific results" test); 5. Degree to which the worker is enmeshed in the company's organizational structure ("integration" test);
67122 Ontario Ltd v Sagaz Industries Canada, 2001 SCC		****Elaborates on *Wiebe Door******
Marbry v AV Fedcon International, BCCA 1999		● Where a company asserts control over an independent contractor, where a contractor has worked mostly exclusively for a company and where the contractor's business is tightly integrated with the company's business, the courts will impose notice period on severance unless this is adequately covered in a written contract between the parties
Elsley Estate v JG Collins Insurance Agencies Ltd, SCC 1978		● (1) Covenant must be reasonable (between employee/wrt public interest) ● (2) What is "reasonable"? Consider the whole context of employee, business, etc., incl.: ○ Did employee have significant control over clients?

		○ Was temporal or spatial features of clause too broad? ○ Is covenant unenforceable as being against competition generally (not limited to protection former-company's clients)?
IT/Net Consultants Inc v Rajwani, Ont Gen Div 1997		● Don't present "standard", non-customized covenants to every employee ● No attempt to customize may = unreasonable and not upheld
Canadian American Financial Corp (Canada) Ltd v King, BCCA 1989		● Don't use "collapsing" or "nesting" provisions – simply agree to the scope @ the time of contractual employment ● **Blue Pencil Test →** i.e. a contract can be severed if parts are independent of one another, and can be severed without this affecting the meaning of the remaining parts… like running a 'blue pencil' through these parts"
GD Searle & Co v Novopharm Ltd, FCA 2007		● Presumption **employee** owns invention, whether or not subject to patent protection: ● Employer can rebut by showing: o (a) There is contract that stipulates otherwise; o (b) The employee is senior officer (and therefore fiduciary) and invention relates to business of company; **<u>or</u>** o (c) The employee was employed specifically for the purpose of inventing and innovation
Physique Health Club Ltd v Carlsen, ABCA 1996		● Trade secrets Includes only info that is "special or peculiar" to the employer; not general knowledge acquired during employment
Wolda v Techform Products Ltd		● Requires clear evidence of a **prior** intention to dismiss the employee on proper notice, in order to count as true "forbearance from dismissal"

UNIT 8:

- Clements
    - Options vs. stock vs. etc
    - When they're formed, mechanics, etc.
    - Other exam thoughts
    - Share grants = income
    - Options = not income
    - RSUs, etc. = ??income??
    - What is a share grant
    - Why use
    - What is an option
    - How is an option formed
    - Severance and reasonable notice on options **important**
    - Why are they used so often
    - RSU vs. DSU?
    - Not literally… more likely in this scenario, what potential equity arrangements could be used?
    - **Exam**
    - If an employee is terminated
        - (1) what's the set notice period in contract?
            - Is it below statute? CL?
        - (2) then assess how many shares are/not exerciseable (i.e. expire)

Employee Participation -- Share grants

- Share grants
    - Issuing shares to employees when they join a company → most effective method of aligning interest of D+Os with s/hs
    - **Tax treatment:** reduced capital gains (50% incls. rate only); lifetime cap gains exemption ($813,600 in 2015); angel cap gains roll over provision
    - **Tax disincentives:** s. 7(1) *ITA*
        - Share grants incl. in income from employment if new shares issued from treasury
        - CRA permits 10-20% discount
- ABCA re: share grants (s. 27(3)
    - Cannot issue shares unless corporation has **already** received consideration for them
        - i.e. can **only** issue shares for "past" performance.. not future service
    - Way around?
        - Give share issuance as a bonus to an employee for consideration w/ employment contract OR as a bonus (on past performance)
- Why do employees even want illiquid shares (that may be taxed)?
    - It's a tangible interest
    - Shares persist past the employee's relationship with the company
- Different way shares are given
    - (1) founder transfer (employee "purchases" shares from founders -- so no immediate tax implications; shares purchased at founder's original ACB @ low rate)
    - (2) founders "bank" extra shares and agree on pro rata contribution towards equity of key employees
    - (3) back date issuance of new shares to key employees
        - Technically legal
        - **Problems:** If corp takes money from investors that were unaware of existing, but non-crystallized, employee backdating shares

Employee Participation -- Stock options

- Option agreement
    - Usually has milestones (~passage of time; certain events)
    - ****unvested options expire if unexercised****
        - Subject to clarification/exceptions, below
    - **TSX-V Options**
    - Listed companies must have an option plan
    - Listed companies' options plans must be approved annually by s/h
    - Cannot list companies with issued options >= 20% of outstanding shares
    - No person may receive options in any one-year period that is > 5% of outstanding shares of the company
    - No options to non-officers/directors/employees/consultants (i.e. not w/in these exemptions)
    - **Max term** → 10 years before expire
        - Anything > 10 years = offside
        - i.e. if you're public with 12 year expiration… then you go public, then you will be offside
    - "Termination" and vesting of options
    - Termination according to "law" see ***Gillies v Goldman Sachs Canada Inc,*** **BCCA 2001**
        - I.e. discharged employee`s employment does not end until expire of CL or statutory notice period
        - I.e. options that vest after employee is "fired" but before end of relevant notice period may **still be exercised**
    - Liability during termination notice period
    - Termination without cause? Look @ employment agreement and statute re: severance and termination obligations (i.e. immediate loss of option not yet granted; limited window for exercise of vested options; etc.)?
    - **Damage claim** → Difference {option price of shares and market value on date court determines employee would be likely to sell their shares on the market}
    - Drafting considerations
    - Stock option plans
        - Reference to "termination" in a stock option plan means "lawful termination"
        - … i.e. occur at the end of a reasonable notice period
    - If you want contrary
        - … you would likely want to put this info explicitly in the employment agreement and advise to seek ILA (e.g. *Participating employee may only exercise stock options exerciseable as of that actual date that the employment was terminated*"
    - Summary: benefits of options
    - No up front payment for employees
    - Encourage employee loyalty (at least until options vest + exercised)
    - Attract talented employees (equity)
    - Investor retains control (options have no voting rights)
    - More tax efficient than share grants
    - Increased upside equity exposure (since issued shares dilute; options do not until exercised)
    - Encourages employee loyalty until exit event
    - Allows startups to attract better employees, since they get an interest in the enterprise (w/o giving up voting control through actual shares)
    - Problems w/ stock options
    - Less tangible interest in the company
    - Less valuable if FMV of company's shares is < option exercise price (i.e. out of the money)
    - Corporation req'd to determine FMV of stock options on the date they are granted and to amortize the expense over the vesting period of the option
    - May induce extreme senior mgmt risk-taking (to meet their incentive strike prices)
    - Business and legal issues surrounding options
    - Planning for an acquisition
        - Options generally triggered (vest) on a "change of control" in the Option Agreement

        - Exception: Don't become triggered by a reverse takeover
            - i.e. when private company goes public, by taking over a public company
        - **Note:** acquisitions + triggered options is where a lot of people become rich
- Discouraging early exercise of options
    - Drafting mechanism to discourage early exercise (… NOT judicially considered)
        - If an employee leaves, the company within a certain period after exercising options, that employee must return the economic value of those options to the corporation
        - May be void for public policy
    - Better approach → tie to a non-compete (not judicially considered, as well)
        - i.e. employees return economic benefit of options if they leave to work for a competitor within a certain period (may be void for public policy)
        - **BETTER:** tie options to NCA and require return of econ. benefit of options if employee goes to competitor within a certain period of time
- Re-pricing options
    - What is share price falls below option price? (out-of-the-money)
        - Cancel and issue new options?
            - TSX-V → transaction is an amendment to exercise price and must be approved by s/h
        - Issue new ones with more attractive share prices?
            - Allowed IF there's room in pool of unissued stock options
- Granting options to founders
    - Doesn't generally occur – founders usually get shares
    - ****Affects TSX-V rules re: max pool of 20% options WRT outstanding shares****
- Avoiding option related lawsuits
    - Usually rare in Canada
    - Ways to be triggered
        - Management talking an employee out of exercising their options
            - Negligent misrepresentation that was reasonable to rely on
        - Decisions to terminate an employee on the eve of options vesting or immediately prior to an exit event (IPO)

Alternative Structures (SARs, RSUs, and DSUs)

- **SARs (Stock appreciation rights)**
    - Rare in growth companies
    - Mechanics
        - Gives holder the spread between FMV of # of shares (on grant date) and value on exercise right
        - Analogous to options, except no requirement for employees to pay cash when exercised (as they do not result in any share issuances)
        - Corp basically pays amount equal to incr. In share value over relative term
- **"Restricted Stock Plans" (RSUs) or "Phantom Stock Plans"**
    - Mechanics
        - Similar to SARs except holder of units (~economic equiv of shares) is entitled to dividends on underlying stock
        - **Not** taxed like options → **Taxed** like income
- **Pros and cons of SARs and RSUs**
    - Pros
        - Employees don't receive taxable benefit without ability to pay for it;
        - Provides equity incentives, but doesn't create a minority shareholder;
    - Cons
        - Options have American style exercise (employees like the control);
        - Taxed as income not as a capital gain;
        - Cost born to company (straight cash outlay)

- **"Deferred Stock Unit" (DSU)**
    - Mechanics
        - RSU that is common in Canada (for larger companies), especially w/ directors
        - Grants unit to entitling employee on satisfaction of certain conditions, to receive a share or cash equivalent
        - **Cannot** be paid out until holder's role w/ company is terminated (*ITA Regs*)
            - **Creates incentive for employee to leave, in order to collect**
            - Euro style → Exerciseable at the end of the term
        - **Taxed** as ordinary income; NOT capital gain

Tax Treatment of Options

- Better tax treatment than share grants
- Receiving option is not taxable event → deemed to receive income {diff: option price vs. FMV} @ exercise
    - I.e. if you exercise, you should sell the shares (unless you can hand incr. to taxable income OR unless you qualify for certain tax treatment)
- CCPC incentives
    - **Employee incentives →** If business is CCPC, then realizable amount from exercising shares (=FMV-grant price) is **not** taxable on exercise, and is not taxable until the year that the underlying shares are sold
    - ****This favorable tax treatment continues for CCPCs, even if they lose their CCPC status****
- Non-CCPC
    - Tax is calculated and due **@ date option is exercised**
    - Withholding tax req'd by company in connection w/ exercise of stock options
    - ...therefore generally expected for employees to sell underlying shares upon exercise of options
    - **SARs and RSUs →** NOT taxed as options (so employees only taxed when they receive cash)

Cases

Case Name	Issue	Decision/Takeaway
Gillies v Goldman Sachs Canada, BCCA 2001		• If options vest <u>before</u> "reasonable notice period" (CL or statutory), then an employee can participate in an IPO ○ **Note:** CL applies if the employment contract is silent (which has to be >= statute) • i.e. options that vest after employee is "fired" but before end of relevant notice period may **still be exercised**

UNIT 9:

- Clements
    - Everything Matt Olson taught on is testable
    - Everything on crowdfunding is testable
        - i.e. general state of the law
    - How do you raise money?
        - Staying onside securities legislation
        - Raising funds from different people
        - ****Know of exemptions****
            - E.g. implications from using your offering memorandum as the first way to raise money… can you use a private issuer exemption to raise funds **after** this?
                - **NO!**
                    - NI 45-106 s. 2.4 ❼ cannot offer shares to public, to utilize the private issuer exemption
                    - **SO YOU KILL THE PRIVATE ISSUER EXEMPTION ONCE YOU OFFER shares to the public**
                - i.e. you must find a new way to raise funds after this
    - **For exam**
    - Client → "Can I do crowdfunding in AB?"
    - Answer → "In AB – no… in other provinces, you may be able to under various securities laws (instruments)
        - **Note:** you can proceed under the "donation", or "rewards" model… but cannot proceed under the "investment/equity" model

Overview of Canadian Securities Regime

- Two bedrock principles
    - **Registered dealer:** no one may buy or sell shares unless a registered dealer (i.e. iBank) is involved in the sale
    - **Prospectus:** Must be used every time a corporation distributes its shares to investors
    - Problems w/ two bedrock principles
    - (1) registered dealers are expensive and generally not interested in high risk startups and small rounds of financing (small fees)
    - (2) prospectuses are very expensive to prepare -- process is too long and expensive to be viable source of raising capital for startup
    - Que exemption regime

Main Prospectus Exemptions

- Main "prospectus and registration exemptions" → ***NI 45-106***
    - Private issuers
    - Family, friends, business associates
    - Accredited investor
    - Offering memorandum
    - Employees, directors, senior officers, and consultants
    - Minimum amount exemption (institutions)
    - (1) Private issuer exemption
    - Application: initial distribution of shares to founders (works auto, provided certain provision are in the constating docs of the corp)

- Requirements
  - Company cannot be a reporting issuer;
  - The articles, by-laws, or USA (the "constating documents") must restrict the transfer of securities;
  - **No more than 50 people**, excluding employees and former employees can hold designated securities;
  - The company has not distributed shares to the **public**;
    - **Important Point → Exemption Only Allows Distribution to:** directors, officers, founders, "control person" or their close family members, close personal friends or business associates, or accredited investors.
      - *** "control person"** rebuttable presumpt. for any person (or concert of persons) owning/controlling > 20% of the voting shares
  - Restrictions on finder's commissions
- **Note:** if you issue shares outside the exemption, then you may lose private issuer status
- (2) "Friends, family and business associates exemption"
- Similar to private issuer exemption
- May help you get outside the 50 s/h max under the private issuer exemption
  - **Family:** (spouse/parent/grand parent/ brother/sister/ child of director or officer or control prsn)
  - **Close personal friend:** knows director/founder/officer/control person well enough and for long enough to assess their trustworthiness
  - **Close business associate:** indiv. who had prior biz dealing and can assess trustworthiness
    - ****more than just one-off deal****
- (3) "Accredited Investor Exemption"
- Common under US law
- Several categories of this type of investor within
- **General Test:**
  - Indiv. w/ **net** financial assets >$1m
  - NI before taxes > $200k in **each** two most recent years (or NI w/ spouse > $300k in **each** two most recent years)
  - Person or company, alone or w/ spouse, w/ net assets > $5m
  - Indiv. who beneficially owns fin. assets w/ net realizable value (assets - liabs.), before taxes > $5m
- (4) "Offering memorandum exemption"
- When you've exhausted family and friends, don't know any accredited investors, cannot afford a full prospectus
  - **Note:** give purchasers enhancedrights to sue for damages and rescission, incl. Rights to sue D+Os
- **May be used in connection w/ distribution under another exemption (e.g. accredited investor)**
  - … then silent on form this should take, therefore common to see "business plan" or "executive summary" in conjunction with an accredited investor exemption, for example
- (5) Employees, directors, senior officers, and consultants exemption
- Specifically for trades by issuer w/ (empls, D+O, and consultants that spend "significant amount of time" working with company"
- **Must** be voluntary for participation
- (6) "Minimum amount exemption"
- Exemption for minimum $150k investment in securities (**not for individuals**)
  - **Only** for instututions
- **Note:** AB has a local rule where individual investors trying to seek this exemption can be req'd to use the more extensive offering memorandum (??longer prospectus??)
- **Reselling securities**
- Once a private company has sold shares to an investor, the investor can only sell shares in certain cases:
  - (a) company first becomes "reporting issuer" (PubCo); or
  - (b) investor makes use of a prospectus exemption (**not OM**)
- Becoming a reporting issuer
- PrivCo → (a) IPO (w/ filing a prospectus); (b) combining w/ existing PubCo; or (c) making application to ASC to become a reporting issuer (rare)

Crowdfunding

- Different models
    - Donation
        - Donation with no company pledge except a promise to complete a project
    - Rewards mode
        - Funders contribute funds in exchange for some sort of reward (product/discount on final product/etc)
    - Investment/equity model
        - Investors provide money in exchange for an interest in profits
- Current state of the law
    - *MI CSA Notice 45-316*
        - Most provinces, NOT ON and AB
    - Exemptions
        - Provide exemptions for "funding portals" (quasi-dealer)
    - Requirements
        - Non-reporting issuers
        - Must provide a funding portal (w/ startup registration exemption OR operated by registered dealer)
        - Head office in Canada
        - Must have some sort of offering memorandum document (but not quite)
        - Must not raise more than $250k per distribution; @ most 2 distributions per calendar yr
        - Indefinite hold period on sold securities
    - State of law in AB
        - ASC did **not** want to implement crowdfunding exemption
            - … said that we can do it without a MI exemption
            - … then they went back on this a while later
        - AB – not limited to crowdfunding
            - Proposed exemption would permit funds to be raised through a portal
    - State of law in ON
        - ON is working proposed crowdfunding instruments (*MI 45-108*)
    - **For exam**
    - Client → "Can I do crowdfunding in AB?"
    - Answer → "In AB – no… in other provinces, you may be able to under various securities laws (instruments)
        - **Note:** you can proceed under the "donation", or "rewards" model… but cannot proceed under the "investment/equity" model

Non-Institutional Financings

- Non-institutional financings
    - Typical for startups, eve if they obtain venture financing
    - Non-Inst. financings will rely on one of the prospectus exemptions
    - E.g. "love money"; angel and retail investors; OM
        - "Love money"
            - close friends and family
            - When to use? ...when nobody else wants to invest in your dreams :(
            - **LAWYERS investing in love money subscriptions:**
                - Incl. risk acknowledgement and list of risk factors in the subscription agreement (so as to not mislead an unsophisticated investor)
                - Advise friends/family to receive ILA (incl. Acknowledgement that they sign)
                - Conflicts potential! Advise both sides in a dispute that you will have to withdraw from representing either of them
        - "angel investors" or retail investors
            - Angels → (~100k investments)

        - Retired/semi-retired entrepreneurs (likely wants board set)
        - **In practice in AB →** primarily use the Accredited investor exemption
    - Retail → middle/upper middle class (<$50k) (likely passive investor)
        - **In practice in AB →** primarily use OM and "friends and family" exemptions
- Use of financial projections or forecasts
    - New (Current) regime
        - If you advise an issuer with forecasts… ****then advise them to strictly adhere to the forms** and to incl. in OM (if one is to be used)**
        - Safe harbours exist which exempt company from statutory civil liability if forecasts are accompanied by cautionary language + factors/assumptions in creating forecasts
- Leading case on forward-looking forecasts
    - **See *Kerr & Danier***
        - ****material change def'n** (biz itself … not changes to results of biz)**
        - *******"forecasts" need to be reasonable **<u>on the date that they are made</u>*****
        - **** BJR does NOT apply to directors' duties re: securities law (i.e. disclosure)**
- Prohibited representations
    - Can't say application to list securities on public market has/will be made (*Securities Act,* 92(3)(b))
    - Can't make representations of future value or price of a security wrt sale
        - … therefore any valuation is grounded in the expected *future* value of its equity (not DCF forecasts…)
- Rules dealing with advertising **for securities**
    - **General Rule →** No promotion or financing on radio/TV (only discussion of tech/company)
        - **TIP:** … no interviews should generally be given during/immediately before distribution
    - **Print ads?**
        - Ads restricted during prospectus offerings
        - Cannot be solicitation… must only be factually accurate (no promotional statements!)
        - No specific photo (beyond logo/generic graphics)... may reference OM in ad
    - Agents/commissions
    - Paid on commission bases (5-10% of cash raised)
    - 3 main categories
        - (a) registered dealers or brokerage firms;
            - Largest number of investors… professionals
            - VERY RIGID! They want whales… not petty startups (often)
            - **Not interested often in private companies or LT engagements**
        - (b) smaller capital raising/brokerage firms
            - More flexible; custom approach (like serving on board)
            - Registered as "exempt market dealers"
        - (c) angel networks; investor forums; gov't programs
            - Opportunity for investors and companies to find each other by inviting them to the same place at the same time
            - Low cost; if any

Cases

Case	Issue	Ratio(s)
Kerr v Danier Leather, SCC 2007		**"Material change"** Only to a material change in corp's biz or operations; not material change of *the results of the operations* **"Forecasts impliedly reasonable on date they are made"** **Not** extended to closing (i.e. only @ date made) **Biz jdgmt rule does NOT apply to directors' duties under securities law** BJR does NOT apply to disclosure obligations I.e. court will defer on biz matters, but NOT on legal matters

UNIT 10: Seeking Funds from Sophisticated Investors for a Start-Up

- Clements
    - Mezz debt
    - **NOT testing on valuation models**
    - **NOT testing on what Darryl does**
    - ****** Criminal rate of interest******
        - Rules
        - Rate – 60% EAR
            - Incl. other fees, profits, sharing arrangements, etc.

Background - Institutions and VCs

- Relatively rare in Canada
- Benefits of sophisticated investors
    - Higher cash from institutions when startups go public
    - Higher employment and sales growth
    - Assistance in subsequent rounds of financing
    - Help w/ strategic planning
    - Recruiting additional management team members
- Private VC fund objectives
    - Syndicated (multiple VCs pool and invest)
    - Independent exits – often have defined terms for themselves to exit (e.g. 10 years)
    - Avg. VC investment in Canada = $2m
    - Tips in choosing a VC partner
    - Speak w/ lawyers and industry pros (accountants) to get a feel for firm
    - Speak w/ execs from other companies in VC's portfolio (general signs/vibes)
    - … VC will also research the entrepreneur themselves

Founder-proof a company

- Def'n → generally means putting the company in the best position to succeed
- Most important operational tips
    - Pick one CEO – give them the largest equity position
        - Don't have a large founder base w/ equal share ownership
    - Have clear lines of responsibility
    - Investor incentives to "founder proof" a company
    - Create strong incentive regime to shift risk of failure from investor to entrepreneur
        - + Give significant stock positions; low salaries
        - - may involve "high powered incentives"
            - sacrifice CEO reasonable salary for equity
            - subject to NCA and NDAs
            - Shares may be escrowed or subject to vesting provision
            - Delays and setbacks can lead to termination, liquidation, or retraction rights
        - **HPSs may lead to self-serving behavior** to protect individuals' jobs/financial well-being
    - **Better**: "low powered incentives" to align investor interest w/ entrepreneur
        - Allow entrepreneur to keep his/her equity, even if terminated
        - Avoid use of liquidation preferences or ratchets
        - Paying executives fair wage
        - Explain high power incentives to founder... Before letting them accept

Mezzanine Debt

- Why use mezz debt?
    - Larger debt reliance for financing in Canada than traditional VC networks in the US
    - Kinds of mezz debt
    - Straight debt? **Rare** → aside from line of credits backed by personal guarantees
    - (Mostly) convertible debt or debentures, accompanied by share purchase warrants
    - Bank debt? **Rare →** mostly by institutions that are similar to VCs
- Overview
    - What is mezz debt?
        - Subordinated debt (unsecured, notes, etc.) or preferred shares (only superior to common shares) (appears near redeemable prefs on balance sheet
            - **Subordinated…** i.e. ranks below senior debt (e.g. bank loans)
    - Characteristics of mezz debt
        - More expensive that ordinary debt/stock
            - Since unsecured (higher interest) or some sort of convertible debt (may come w/ "equity sweetner")
            - Interest ~12-15%
        - Usually has an equity component
            - "convertible preferred shares"
                - – converts into common shares
            - "convertible debenture"
                - – starts as debt à converts to common shares
    - Terms and control issues
        - Investment terms are similar to VCs (see next unit)
        - Mezz lenders similarly concerned about control issues as VC
        - Mezz lenders want to be informed about the biz, similar to VCs (expect extensive info rights requested)
        - Lender reps on board of directors???
            - **Conflicts of interest **

Choice of equity (re: Mezz lender)

- Critical component → otherwise, why take the risk as subordinated lender??
    - I.e. size, nature and exercise price of equity component are integral parts of mezz structure
    - Most common instruments
    - (a) Share purchase warrants
        - Warrants attach; debt still exist (warrant is a "kicker")
        - Warrant can be separated from debt and sold independently
    - (b) Convertible debt
        - When converted, debt disappears
        - Covenants *may* continue → whereas they disappear when straight debt is extinguished
    - Differences between convertible debt and warrants
    - Debt disappears when convertible debt exercised // warrants may be exercised, but debt remains
    - Warrants → collection of contractual remedies and rights survive the sale of investors' equity
    - Warrants can be sold apart from debt (though rare)
    - Different treatment on stock exchanges (**generally favors convertible debt)**

Calculating interest

- Effective rate (annual; no compoundingl; **incl. All other costs imposed on borrower)** vs. nominal (stated)
    - EAR sometimes **must** be listed
    - *Interest Act* s 4 → written contract for pmt of interest < 1 year, it must state equivalent EAR
        - **No interest >5% EAR is chargeable <u>unless</u> contract contains express statement of EAR**

- "True cost of borrowing"
  - Must incl. aggregate of **all** fees and additional charges to be a part of the EAR
- Penalty interest → mezz loan, secured by real property, is **not permitted to** have the interest rate increase on an event of default (*Interest Act* s 4)
  - … no clear answer if lender permitted to charge additional cash fee for "monitoring" after default

Criminal interest

- Defined in *Criminal Code* s 347
  - Two elements of illegality
    - (a) Enter into agreement or arrange to receive; **or**
    - (b) Receive pmts for advancing credit **exceeding 60%** of total value of credit advanced
    - 60% based on effective rate of interest
  - Policy considerations
    - Legislative intent – eliminate/curb predatory loans ("loan sharks")
    - Economic argument against – tries to curb capitalist system / should be a market to accept a loan (i.e. stop being so paternalistic)
- Almost **any fees** by a borrower has been interpreted as part of effective fees
  - E.g. legal fees, broker commissions, finder or standby fees, bonus fees, monitoring fees, penalties, commitment fees, etc.

- **Q:** *What if contract does not violate s. 347* CCC *at face value, but could in application? (e.g. early pmt)*
- **A:** see ***Garland v Consumers' Gas Co,* SCC 1998**
- Common problems with *Garland*?
  - What if you have to pay up-front fees and expenses, and if loan is repaid shortly after, fees, along with interest, it will push the loan past the criminal rate (since the criminal rate is calculated based on the annual interest charged)?

Lawyers' Tips to deal w/ risk of s. 347 *CCC*

- Attach "black out" periods when loans cannot be repaid by borrower
  - **See** *Garland v Consumers' Gas Co,* SCC 1998
- Doesn't attach to prepayment periods (only to forced repayment… so incorporate this)
- Careful encouraging borrower to repay at times when interest on loan could be >60% EAR
- Careful structuring deals that could be interpreted as loans (i.e. anticipate profit secured by mortgage)
  - **See** *Artell Developments*
- Incl. provision to prohibit lender from receiving interest under agreement at a rate > what is proscribed by statute… ("notional severance")
  - Remember "blue pencil" vs. "red pen" re: judicial severance
    - **Red pen** → void *ab initio*
      - (most strict; whole agreement would subvert s. 347/illegal purpose)
    - **Blue pencil** → illegal provision struck out… rest remains, so long as this can be severed without affecting the meaning of the remainder of the contract
      - Cure bad… keep good
    - **Notional severance** →
      - **available** as remedy for cases under s. 347 of *CCC*
      - I.e. "read down" x-% rate to something less than 60% EAR
      - **Problem (dissent):** charge 1000% and deal with whoever litigates...
    - **See** *Transport North American Express Inc*, SCC 2004

Taking Security

- Mezz debt = subordinated to senior debt facilities
  - … you only take the risk so that company can achieve critical mass to develop cash flows to pay debt off

- Sometimes mezz debt is given a "first charge" (superior charge to senior lenders) by agreement, with room to be subordinate to future lenders
    - Why would senior lenders do this?
        - To get more $$$ in a company! Increases chances of corp's (and bank's) success
- Share pledges
- If bank has SI over all assets, why would mezz lender want SI in share pledge?
    - (1) gives mezz lender possibility (+ ability) to control and manage biz
    - (2) Banks won't take → don't want to control shares (not equipped to manage biz)
- SI in IP
- Legal issues
    - IP difficult to secure (much of IP is know-how and trade secrets)
    - Limited legal life (patent -- 20 yrs; copyright author`s life + 50 -- ™ = 15 registration.. Can be renewed)
    - Limited economic life (useless after a few years potentially)
    - Uncertainty re time, enforceability, etc.
    - Uncertainty of insolvency of a licensor of tech used by borrower
    - Issues ww/ properly waiving moral rights
- Mechanics
    - Mezz lenders lend against patents or copyrights source code well before they are lucrative commercial products
- Interlender agreements
- Early stages might only have mezz lender → loan docs will subordinate mezz lender to any future senior lender
    - Low risk bank will lend excessive amount of money or attach much value to mezz collateral
- Sets out relative priority between various lenders wrt borrower's assets
- Communications provisions (big deal!)

Cases

Case	Issue	Ratio(s)
Smith v Canadian Tire Acceptance Ltd (ONCA, 1995)	When do interest rates need to be disclosed?	• "Disclosure of nominal rate" required ○ Written contract requires pmt of interest for less than 1 year? ○ **Must** incl. equivalent EAR, where interest rate >5% per annum… **otherwise** no interest is chargeable
Garland v Consumers' Gas Co, SCC 1998	Does early pmt ("deferred pmt") constitute criminal rate of interest?	• deferred pmt" ~ advancing credit ○ *CCC* s. 347 applies, since this is effectively credit ○ **Application:** utility company didn't enter into an agreement to advance credit… but the application of advancing credit (permitting these deferred fees) effectively leads to a **<u>receipt of credit by advancing funds</u>** ■ **Conclusion:** pmts void *ab initio* • "Interest" = "aggregate of **all** charges and expenses, in any form, that are paid or payable for advancing credit under an agreement or arrangement" ○ ... i.e. any value of goods/services/benefits advanced under agreement **minus:** fees/commissions/similar charges incurred by the creditor • **Note:** this involved a (deemed) **unilateral**

		extension of credit by utility company to late-paying customers (Bastarache Dissents against this)
677950 Ontario Ltd v Artell Developments Ltd, SCC 1993	Can a mortgage to secure profits = a loan?	● $1.6m advanced = $300k (deposit/loan) + **$1.3m interest!** ○ D made it clear that this was **not** an investment (no JV or partnership) ○ ~ loan… with $1.3m mortgage to be repaid **within 3 months** of deal close ● ******$1.3m "interest" was in anticipation of profits… but **not contingent** on profits or a sale even being realized (~interest) ● $1.3m was due on an advance of $300k deposit, **3 months** after loan ○ = +1400% interest EAR ● **Held:** Agreement barred by s. 347
Transport North American Express Inc… SCC 2004		● Majority ○ **Notional severance** available as a remedy for s. 347 *CCC* cases ■ I.e. "read down" so that something <=60% EAR is charged, where it might be otherwise higher ○ Appropriate → agreement only *inadvertently* violated s. 347 (parties were commercially sophisticated… negotiated at arm's length; no inequality of bargaining power; both had ILA) ■ **Court's goal →** Most appropriately cures illegality while remaining close to parties' originally contracted intentions ○ **Dissent (Fish J)** ■ This basically provides incentives for lenders to charge 10,000% and wait to see who actually litigates this… BAD POLICY!

UNIT 11:

- Clements
    - Know different provisions within term sheets…
    - ****Scenario:** client brings in a term sheet and asks you to explain what the implications are**
        - **Know how to explain this to a client**

Basic Terminology

- Term Sheet → LOI, memorandum of understanding, agreement in principle, etc.
    - Used to negotiate material terms of a deal
- Legal effects
    - **General rule:** NOT a binding agreement -- must have actual docs, due diligence, other closing conditions
        - **EXCEPTION:**
            - Confidentiality (e.g. NDAs -- can't disclose deal terms, confidential info, OR even *existence* of a term sheet)
            - Exclusivity → cannot shop around for a better deal while it is in place
    - **Practical Tip:** deals rarely stray from term sheets, but they are deliberately not binding

VC Term Sheets

- VC's interests
    - Covering their assets down the road – incentivizing entrepreneurs
    - Control agency costs
    - Provide investors w/ an exit
- Entrepreneur's interests
    - Ensure VC doesn't use considerable power to advance its interest @ expense of corporation
    - "Adverse selection problem" (entrepreneurs are worried VCs will be incompetent @ mgmt)
    - "Moral hazard problem" (VCs acting in their own best interests → i.e. force exit (IPO) when company is not ready to mitigate risks)
        - Also: entrepreneurs fear transaction will favor VC prefs over common shares
- Lawyers role in term sheet negotiation
    - Minimize agency costs of both parties (point out deficiencies… resolve)
    - Protect **your** client (i.e. likely *corporation*)
    - Make provisions clear; crystallize everybody's intent
- Balancing interests
    - Commonality for interests for all parties
    - Use debt structures -- i.e. have entrepreneur assume some risk
    - Customize term sheet for **THIS** deal (don't opt for "standard form" anything)
- Staging investments
    - Provide just enough capital to reach the next definable future
    - Combined with a VC-ROFR, this effectively gives the VC a call option and therefore monopoly on future financing
    - All of these gives VCs immense power to get concessions from the company/founders
        - ...also minimizes VC risk of capital exposed
    - ****Legal strategy**** establish milestones that require VCs to advance a defined further financing at a defined valuation (~creates a put option for the corp, i.e. VC must accept corp's "offer" and pay prescribed price)
        - **VCs will try to resist this -- don't want to be too tied down!**

Preferred Shares

- Convertible prefs vs. common share issuances
  - US - Almost exclusively convertible prefs
  - Canada → Mezz debt (often); underdeveloped VC market
- Why convertible prefs?
  - Allow for cumulative dividend appreciation, independent of exit transaction
    - I.e. generate healthy return along the way
  - Ranks ahead of common s/h payout in bankruptcy
    - Signalling effects (paid out before mgmt); powerful way to reduce agency costs (i.e. nothing left if founders mess up)
  - Generates some returns, even during "Living dead" scenario (stagnation)
  - **potential VETO granted to the preferred share class
    - **"Significant asset sales"** (*ABCA* s. 176) requires **separate** vote for the preferred class
    - **"Compulsory acquisition"** (*ABCA* s. 194)(takeover bids) gives pref a veto over attempts by a squeeze out amalgamation
      - I.e. compulsory acquisition of shares by offeror under takeover bid if >=90% shares of **that** class have tendered to the bid (10% dissenters forced acquisition)
        - **BUT!** You can get your own vote (effective veto) if you hold a separate class of shares
        - **Other benefits:** "oppression remedy" = preferential treatment of s/h over others **in the same class**…
          - Therefore, new class (pref shares) = different treatment (i.e. can amend deal w/ more attractive terms to reduce risk of triggering oppression suit from other classes of shares
    - **effect: you can stop amalgamation w/ minimal total equity ownership*

Retraction rights (retraction vs. redemptions) and put options

- Rationale for inclusion:
  - VC investments have specific time horizon for each of their "pools" (investment groups)
  - Retraction rights and put options allow for VC exit (potentially w/in this time frames)
- General
  - Retraction → held by s/h (investor forces retraction)
    - Embedded in terms of the shares
  - Redemption → held by company (i.e. corp can forcefully redeem o/s shares)
  - *Put option* → right for investor to sell investment via side agreement
    - "Option agreement" or "pooling agreement"
- Differences
  - Retraction
    - **requires** different class of shares (...otherwise all s/h have same right)
      - **MI 62-104** requires reporting issuer to make an offer to **all** s/h when it repurchases it's own shares… **EXCEPT** if company acquires its own shares in accordance with terms/conditions attaching to a class of securities
      - **no clarity on whether this applies to put options in CL or statutes*
    - **Benefits:** easier to amend puts than retractions (latter requires s/h approval)
  - ****NOTE:** Both puts and retraction are subject to liquidity/solvency tests**
- Exercising and Enforcing Repurchase Rights
  - Typical for VCs to want right to force corp to repurchase shares after a certain date if an appropriate exit has not yet happened
    - This may **not** save VC if pref shares (w/ retraction rights) are not exercised prior to bankruptcy
    - ****remember corp cannot pay dividends when insolvent → *ABCA* s 36***
      - See *Re Central Capital Corp*

- Redemption rights (~similar to corporate call options)
    - Effectively operates as a corp. Call option, since the corp can oblige the s/h to sell his or her shares at an agreed upon price
    - VC context → redemption usually set at a predetermined multiple of the original price

Dividends

- Rationale for dividends
    - VCs want guaranteed rates of return… so dividends will be paid (or accrued)
        - VC worried investor exits before other s/h through retraction rights or pref payout on insolvency
        - Accrual → no actual dividend pmts expected… goal is to cover VC's ass in case they need something upon insolvency
    - Dividends can be cumulated as something similar to debt
        - i.e. all cumulative dividends must be first paid out on prefs **before** any other common dividends can be paid
    - ****interest rate risks****
        - *risk of dividend being classified as debt → subject to statutory (criminal) interest rate*
            - Recall, things can be classified as having debt **and** equity characteristics
            - See *CDIC v CCB* in **UNIT 3**
        - *risk of interest being non-chargeable if it is classified as "interest" and not stated if > 5% EAR*
            - See *Smith v Canadian Tire Acceptance Corp*, **UNIT 10**
- ****remember corp cannot pay dividends when insolvent → *ABCA* s 36***

Anti-Dilutive Rights ("ratchets")

- What are they?
    - Provision in convertible securities that provide for an adjustment in the number of underlying shares obtained on conversion of instrument
    - **Purpose:** ensure convertible security holders obtain the same % of corp had they converted shares before the new transaction
    - **Triggers:** not just by "paper" transactions (e.g. 2:1 stock split), but also future financings @ prices below what the VC received
- "Ratchets"
    - Allows pre-existing s/h retain their share ownership by recalculating price per share at subsequently, down-round financing
        - **Trigger:** when new money invested @ pre-money valuation ($/share) lower than the VC's previous financing round
    - 3 Types
        - (a) Broad based weighted average
            - Adjusts conversion price in event of subsequent dilutive financing
            - **Effect:** gives VC conversion ratio to reflect their (new) price per share = weighted avg purchase price of all subsequently issued **and outstanding** shares
                - E.g. VC issued shares @ $1/share; future financing @ $0.90/share; average price per share for **all shares @$0.50/share**
                - Conversion ratio = VC now gets 2:1 shares (based on existing)
        - (b) Narrow-based weighted average
            - Adjusts conversion price **only taking into account** the price of new and subsequent shares
        - (c) Full ratchet
            - Adjusts conversion provision in event of a down round financing to give VC lowest price given to **any subsequent purchaser** (effectively dilutes non-VC purchaser and founders)
    - Use of ratchets in practice
        - Contested (many counsel dont think these are fair)

        - Limited use in early financing rounds (may make company less attractive in later financings)
    - **Lawyers tips**
        - Negotiate them early (or not) -- before other investors have left the table
        - Limit severity
            - Carve out basic exceptions (not triggered for employees, consultants, share issuances for equipment leases, etc.)
            - Set prescribed $ or % of shares before ratchet triggered
            - Incl. sunset provisions (e.g. only benefits VC for 1-2 years; e.g. expires @ next financing)
            - Incl. pay-to-play provision → i.e. VC must also participate in subsequent financings to retain ratchet protections
    - "Death spiral" or "toxic financing"
        - Where anti-dilution rights kick in as a result of deliberate actions by the investor holding those rights
        - **Only really applies in public company context**
        - Example
            - VC makes investment in PubCo in form of convertible prefs
                - These related VC investors start short selling the stock (price declines)
                - Non-related investors see decline and sell shares (i.e. put shares on market)
                - VCs now have cheaper stock to close short-sold positions
                - Company profits difference of lower price and acquires company for reduced price

Conversion Rights

- VC w/ pref (share) financing has goal of converting prefs to common equity… when it's worth it
    - VC pref share holders will have discretion when conversion takes place
    - ***VC may be able to force conversion* ("automatic conversion")**
- Auto conversions are common
    - Not contentious (IPOs) vs. Contentious (Offer to purchase company)

Liquidation Preferences

- Liquidation preferences
    - Ordinary case → statutory liquidation preferences, based on share class
    - VC case → ask for more
        - E.g. **multiple liquidation preference** (1.5-3x share price); **participation right** (receive multiple liquidation preference AND participate *pro rata* in w/e is left of company on liquidation)
    - **Trigger:**
    - Prefs ordinarily rank before debt, so nothing is often left behind for prefs after paying out debtholders
    - therefore, liquidation preferences often triggered by other situations (e.g. buy-outs)
        - I.e. if triggered, then VC receives > proceeds than proportional shares held
- Issue/governance conflicts
    - Liquidation preferences shift the risk and corporate risk tolerance, such that VCs stand to **lose more than gain**, so a VC dominated board will opt for safer or less risky ventures in these cases
- **Lawyer tips**
    - "Cap" return on pref → incentives prefs to convert to equity, rather than relying on liquidation preferences
    - ****look @ "change in control provisions"** → ensure "deemed liquidation" does not happen in equity investment involving > 50% of shares
    - Liquidation preferences should **not** be triggered on successful exits (e.g. IPOs) if valuations > certain amounts

Pre-Emptive Rights (i.e. "ROFRs")

- Rationale
    - Give VC right to participate in future financings (to prevent dilution of position)
- Two types

- (a) *pro rata* participation;
- (b) take entire future financings, if VC chooses

- Problems w/ ROFRS
  - Impair corp's ability to attract diverse investor base
  - Notice provisions quite burdensome (30-60 days)
  - Huge deterrent to future investors if they see this in due diligence (e.g. few will spend time and $ conducting further due diligence if preemptive rights exist)
  - Lawyer tips
  - Limit pre-emptive rights to major investors only
  - Rights expire if investor loses x-% interest in corporation
  - "Pay-to-play" provisions (expire if investor does not participate in down round financings)
  - Notice period kept as short as possible (**less than 30 days**)
  - Should permit corp to propose financing terms to investor **before receiving *bona fide* 3P offer**
  - Non-financing stock issuances (e.g. employees, options, etc.) should not trigger pre-emptive rigths

Management Control Rights (Covenants; Board composition)

- General --. Permits investor w/ direct say in corporate operations
- Covenants
  - Positive covs = must (positively) do
    - E.g. regular reporting, review + approve budget
  - Negative covs = must not do
    - E.g. prevented from selling assets or assuming additional debt (w/o permission)
- Lawyer tips: Negotiating covenants
  - Object to **any** covenant that is not clearly and obviously linked to maintaining company's current level of risk
    - E.g. "prohibition on all future equity financings w/o investor approval" (NOT reasonable)
    - E.g. "absolute prohibition against adding debt" (NOT reasonable)
      - … versus "prohibition on incurring debt above x-% Debt:Equity threshold" (MORE reasonable)
  - Reject any covenant that gives investor disproportionate power WRT his equity position
    - E.g. don't give many board compositions concessions unless significant s/h
- Legal issues w/ covenants
  - Agency problem → individuals w/ management powers by contract do not have FD to corp
  - Certain director duties cannot be delegated, per *CBCA*
    - E.g. appoint directors/auditors where there is a vacancy
    - E.g. issue shares (except as auth. by board)
    - E.g. purchase or redeem shares
    - E.g. approve annual financial statements or certain disclosure
  - ****CL voids any agreement that has effect of unduly fettering director discretion****
    - … unless in the form of USA (for example)
- Control over Composition of the Board of Directors
  - Balance → VCs and Mgmt do not want either to have complete board control
    - **Solution:** Place balance of power in hands of 1+ independent directors
  - Legal issues re: board control provisions
  - Contracts can bind s/h to vote in a certain way… but directors **must** act in best interests of corporation (once elected as director)
  - Ideal size → 5-7 (even = potential for paralysis)
  - Quorum requirements → VC often requires their board representative to be present to meet quorum (effectively gives VC veto over board)

Co-Sale rights combined w/ ROFR

- What are co-sale rights?

- **Co-Sale Rights:** Contractual provisions that regulate the basis that a founder/key member can exit
- **But** **Law forbids contractual provisions that bind a person to labor for the company**
    - i.e. Co-sale attempting to control departure indirectly may be voided
- **Lawyers' tips**
- When founder wants to sell to a 3P, they must give notice to VC
- …If VC also wants to sell, then both sets of shares are sold *pro rata* based on each holder's ownership
- Co-sale combined w/ ROFR
- Makes departure more complex…
- ROFR (gives VC right to buy shares outright from founder) … which could lead to interpretation issues if the VC also holds co-sale rights
- **Consider drafting so co-sale and ROFR cannot be used simultaneously** (ROFR then Co-Sale)

Drag along ("piggy back") rights

- Rationale
    - Give possessor right to compel dissenting s/h to participate in exit transactions, once a certain % of s/h approval threshold has been met
    - Drag along rights in conflict in VC deals (per Tingle)
    - ROFRs (by their very nature) can't be "dragged along" (or, the party being dragged along cannot exercise their ROFRs)
    - **must clarify when ROFRs apply in presence of drag-along rights**

Other things (info rights, key employee, etc.)

- Info Rights and Key Employee Provisions
    - VCs want to see… monthly/quarterly financing performance, business plans, board materials, minutes and budgets
    - Right to inspect company's offices/facilities/meet execs and attend board meetings
        - FD nature of director can lead to conflicts … ****use confidentiality agreements****
    - VCs will also want to tie key employees to the company
        - E.g. employment agreements, escrow regimes, option vesting provisions, NCAs/NDAs,etc

Cases

Case	Issue	Ratio(s)
Re Central Capital Corp, ONCA 1996	Are preferred shares treated as debt (paid first) or equity (paid after) in bankruptcy? Does a "right of retraction" change this?	● Pref shares have debt or equity characteristics, but they were more like equity in this case ○ While convertible, they were pref shares at time of corporate bankruptcy ○ Lender could have also asked for convertible **debt** if it wanted to start with this position ● **Effect:** corp cannot make dividend pmts/corp cannot redeem shares when it fails either insolvency test (**s 36 *ABCA***) ● ****a right of retraction attached to pref shares is NOT a debt provable in bankruptcy*** ○ So no debt claim either in b'cy

UNIT 12:

- Clements
  - Spotting high level IP issues
    - E.g. what is copyright? How is it formed? What is trademark? What is patent? Does it have a CL right? (NO – only statutory)
    - Understand the heads of IP and spot potential issues
  - **Do NOT need to know details of patent or TM application process**
  - **Consider the 15 most important concepts for each unit**
  - How do we deal with ownership?
    - Do assignments need to be written?
    - Rules re: employees vs. IC for ownership

Terminology

- Assignment → transfer or sale (or ~lease for fixed term); generally must be in writing
- License → Permission to do something that is otherwise an infringement
- Waiver → no transfer or rights or interest, it's a waiver of an otherwise enforceable right

Copyrights

- Purely a creature of statute
  - Protects the *form* of an idea/concept (not the idea itself)
- What is protected?
  - Literary works, dramatic works, musical works, sound/video recordings, performances, etc.
  - Arises by creation by an author → No need for registration *per se* (good idea to register anyways)
  - Rights → Right in form of work itself; subsidiary rights (translation, novelization, etc.)
    - **slide 9 for "scope of copyright"
  - Limits →
    - expired term (life of auth. + 50 years following death of author)
    - performers/record producers/broadcasters = flat 50 years
    - Limited for works created and first published in countries NOT members of Canada's copyright treaties
    - Does **NOT** extend to facts/ideas/processes/works in public domain
- Requirements
  - Originality (subject of skill and judgment), fixation, and connection with Canada (directly or via treaty)
- Exemptions
  - "Fair dealing" (private study, research, parody) "educational purposes" (in-class), **data** (not subject to copyright unless sufficient originality, but may be protected by contract as a trade secret)
- Ownership
  - ****on exam****
    - In master-servant relationship, **employer is first owner** for work created in the course of employment (and in context of contract for service as an employee)
      - Presumption may be changed by agreement
      - **Must** be employee (not freelancer or IC)
    - ****ICs presumed to own copyright** → therefore you need appropriate assignment**
  - Creator (or assignee or beneficiary) is vested w/ 2 statutory rights
    - (1) moral rights; and (2) pecuniary rights (re: monetization)
    - **Moral rights →** (1) attribution; (2) integrity; (3) association
      - **Note:** these 3 cannot be assigned… **but they can be waived**
- Assignment/waiver
  - Copyright may be assigned or transferred, in whole/part, **but must be in writing** (*Copyright Act*)
    - **Infringement →** arises from "substantial part" of work being copied
  - **moral rights can only be waived after they arise, not assigned or transferred**

        - Need not be in writing; may be waived in whole or part
- **Lawyer tips:**
    - Many startups should register their copyrights ($50) as a matter of evidentiary proof (creates a presumption of validity)
        - **(but not req'd under *Copyright Act*)**
    - © may be required under the *Universal Copyright Convention* to obtain protection in some countries (e.g. © Michael Murray, 1990)
        - … but © may even be used where not registered
    - Other problems to avoid
        - (a) to avoid imputed founder income
            - i.e. founders receive shares @ low valuation; 2 weeks later investors come in @ higher valuation → CRA may find an imputed income, in the absence of evidence to the contrary
            - Evidence to contrary → assignment of copyright (in writing) to company in the interim period
        - (b) part of ordinary employment agreement
            - Must assign rights (and employee receives consideration) at regular times

Ownership Questions relevant to Start-Ups

- "Consultants" (graphic designers, programmers, engineering plans, etc.)
    - → true IC owns (presumption)
    - Rebut presumption clearly in a contract!
- What is "work produced in the course of employment"?
    - Not everything "done" @ work satisfies this def'n (e.g. what if the worker was not req'd to do the task as part of their job?)
        - **Two key questions:**
            - **(1)** would the worker have broken her contract by not producing the work?
            - **(2)** would the acquisition or retention of the copyright by the worker be inconsistent w/ her duty of good faith and duty of loyalty to the employer?
                - **Both yes → employer owns**
                - **Both no → employee owns**
- What about one-person corporations or "closely held corporations"?
    - **General rule →** copyright in company's benefit will be owned by <u>company</u> (not *alter ego* person)
- What about computer programs?
    - *Copyright Act* → **includes:** source and object codes, screen display, component routines
        - **… does not include:** language (not part of instructions)
- What about photographs in marketing materials or websites
    - **Contextual analysis**
    - Does this protect amateur + professional?
    - Photoshopped images… is this entirely new work or copyright violation?
        - E.g. shirts with unauth. production of Crocodile Dundee logo were stopped

Industrial Design

- Statutory carve-out protection in *Copyright Act* for "useful designs" that are mass produced
- Protection? → ***Industrial Design Act***
    - Requirements: original feature of shape, configuration, pattern or ornament applied to a finished manufactured article
        - *visual features* → less concerned w/ function of design
    - ***Registration*** must be registered <u>for protection</u> on industrial design register ***after*** an application for it is examined + accepted by Canadian intellectual property office
- Who can apply?
    - Only proprietor of design can apply for protection

- Ownership
  - Created "in course of employment" → **employer is default owner, unless agreed to contrary**
  - Joint ownership can exist
  - 10 -year protection (after registration)
  - **Designs must NOT have been published anywhere in the world, for more than one year prior to application**

Trademarks

- Protected at CL (by use) and by statute (*Trade-marks Act*, RSC…)
  - S. 2 → "trade-mark" ~means to distinguish your work from others (or proposed ™)
- Types of trademarks
  - "Word mark" – e.g. common words, letters, numerals, or punctuation without an indication of a special form or appearance
  - "Design mark" – e.g. contain elements not found in the word mark, designs, symbols, etc.)
  - "Certification mark"
  - "Distinguishing guise" -- e.g. unique shape of package (e.g. coke bottle)
  - Slogan -- "you deserve a break today" (McDonalds)
  - Sounds -- NBC chime
  - Scents
- Rights arise from *use* of the trademark
  - i.e. continual use is required (other jurisdictions require actual registration)
  - Must be "distinctive" (per *Trade-Mark Act*)
    - … must apply to goods of particular trader; not goods in general
    - Must indicate to purchaser the source of goods (not identity necessarily, but one identifiable source itself)
- Scope of trademark rights
  - **Registration of ™** provides the following: (1) exclusive right to ™ use; (2) right to be free of use of confusingly similar ™ by another; (3) right to prevent others from dep'c goodwill associated w/ ™
- Registering TM
  - Effected by making an application on one of four grounds:
    - (a) use of mark in Canada; (b) making the mark known in Canada (foreign applicant); (c) use and registration in a foreign country; **or** (d) proposed use in Canada
  - Priority → registration granted to first applicant
  - Different types
    - ® is registered – ™ says CL use
- Length of protection
  - Lasts 15 years for initial period – may be renewed (s 46) for subsequent 15-year periods indefinitely
  - **registration can be invalidated by loss of "distinctiveness" or abandonment (s 18)
  - **Note:** must be continually used to protect, even if you are within the 15 year periods (initial/renewed)
  - Benefits of registration
  - Stronger + broad protection
  - National protection (vs. limited areas where "use" can be proven"
  - Easier to enforce
  - Deterrence to would-be infringers
  - Incontestable ownership (5 years after registration unless other party can prove registration was w/ knowledge of their rights)
  - Ease of foreign registrations
- Protection of unregistered trademarks
  - **Where an unregistered TM is infringed → sue in "passing off" [TEST] (requires proof that..)**
    - (1) TM is associated in minds of public w/ goods of Pl. **alone**;
    - (2) the "use" of the TM by the D will cause confusion in public mind re: source of goods;
    - **And** (3) D's activities have/will likely cause damage to the owner (e.g. suffer a loss)
  - **difficult to prove all 3…**

- **Limited in geographic protection** (where it was in “use”)
- **Tip** → Consider Canada vs. US trademark lookups

“Trade Names”

- Defined in *Trade-Marks Act* (s 2)
  - = name under which any business is carried on, whether or not it is the name of a corp/prtnshp/individual
  - Registration?
  - “Trade name” **cannot be registered** under *TM Act*; but can be registered as TM (when a trade name is used as TM)
  - Trade name can be registered under the *Partnership Act*
    - Registration **does not** grant any rights to the trade name
- Corporate names → **s. 10-12 *ABCA***
- Tiers of protections
  - Trade mark is the highest level of protection
  - Trade name is less protection

Internet Domain Names

- Any biz in Canada that is using a “.com” or “.net” or “.org” domain name may need to be concerned with whether it is infringing a US Trademark
  - Top level domains set up to be used by commercial, networking and non-profit entities
- **Lawyers Tips**
  - See .com/.net/.org? → Advise clients to search for US Trademarks that may be a concern before they spend further
    - May require registration of US TM… provided use of the mark in the US
    - **Note:** this might not be a significant issue… but it could be worth looking into for GrowthCos with larger prospects
  - Balance being cautious vs. deal-killer

Trade Secrets

- **Def’n** → any info/item/body of knowledge that gives its owner a commercial advantage over others
  - advantage derived from info that is not generally known
  - subject to reasonable efforts to maintain secrecy
  - Provides some sort of economic benefits on its holder
- **Action:** Breach of confidence (or contract, if it exists) ****on exam****
  - Breach of confidence **requires proof of the following:**
    - (1) info was a trade secret and reasonable steps were taken to maintain its secrecy
    - (2) if info was disclosed, it was under circumstances w/ an obligation of confidentiality
    - (3) party has used/misused info so that damage has been suffered
  - **Note:** NOT comment to have employment contracts in AB… but there are still certain liabilities
- How to protect?
  - Contract! (NDA, confidentiality agreement, etc.)
  - Customer lists or biz plans can be subject to copyright or secret device might be patentable
    - **Enforceable** in many jurisdictions, even without registering a patent in **each**
- Length of time?
  - Can last forever → **as long as it remains a secret**
  - Enforceable in many jurisdictions without registering a patent in each
- **Very easy to lose protection**
  - Other parties need to independently or innocently come up with the same idea
  - ****Value = derived from first-mover advantage****

Patents

- **Def'n** → bargains between gov't and inventor for invention protection (full disclosure of invention = monopoly to make/use/sell invention for predetermined time in Canada)
    - *Patent Act* → **no CL protection** for patents
- Requirements
    - "any **new** and **useful** art, process, machine, manufacture or composition of matter, or any new and **useful improvement** in any art, process, machine, manufacture or composition of matter"
    - {i.e. new / useful / **not obvious to person skilled in the art or science that it pertains**}
    - Protection
    - No one can sell or use the invention, even if they arrive at it independently without knowledge of the patent
    - Patents may be licensed
    - **No such thing as int'l patents** (only valid in the country where it is issued)
- Length of protection
    - 20 years from date of filing the application → first to file wins any dispute
    - **keep ideas as confidential as possible** (until application is made)
- Patentable inventions
    - method/process (e.g. method to recover oil from resevoir)
    - System (e.g. non-living mechanistic product)
    - Composition of matter (mix of ingredients + chemical compounds)
- **NOT patentable**
    - Scientific principles of abstract theorems
    - Methods of surgical treatment (.. but products are patentable)
    - Higher life forms (.. but modified genes are patentable)
    - Computer programs (... but methods involving steps performed by computer *can* be patentable)
- **Public disclosure**
    - Public disclosure can significantly impact the ability to obtain a patent
        - *Patents cannot be filed internationally if first filing (e.g. Can/US) was made **after** public disclosure or publication
    - **Canada:** public disclosure starts a 1-year clock to file a patent (before it invalidates patent app)
    - **US:** Similar 1-year timeframe in the US
    - **LPT**
        - Consider the implications of public disclosure at a road show or raising funds from investors… so obtain NDAs wherever possible
- Examples of public disclosure
    - Verbal or printed publication describing the invention
    - Public demonstration of invention (e.g. tradeshows)
    - Sale of product where invention is discoverable
    - Distribution of invetntion without confidentiality restrictions (SIGN NDAs!!!)
- Limitations
    - Patent does not grant the owner the right to make, use or sell a product that incorporates the invention → **other licenses may be required**
- Ownership ****Patents and employees****
    - Who owns what (re: inventions)?
        - → Presumption **in favor of employee owning invention**
            - **See *GD Searle & Co v Novopharm*,**
    - Employer may rebut by showing
        - Contract that stipulates otherwise (assignment of rights)
        - Employee is senior officer (therefore FD) and invention relates to business of company; OR
        - Employee was employed specifically for the purposed of creating this invention

Practical NDA Tips

- Encourage client to protect against casual disclosure of IP → **use NDAs wherever possible**
    - Elements of NDAS
    - Mutual (shared) vs. unilateral (here's my idea)
    - Who is bound by NDA? (reps, agents, etc.)
    - Def'n and use of "confidential information"
    - Term of confidentiality
    - Watch out for restrictive covenants!
- VC investors typically won't sign NDAs in early stages of negotiation… however it is not necessary to disclose all IP when making an investment pitch

Woodruff IP Presentation

What IP are you relying on?

- (a) Selling products
    - IP is less important…
        - Patents keep out competitors
        - TM's protect brand and market position
- (b) Selling/licensing **IP**
    - Strong IP is essential
    - Need to protect what you plan to license
    - (c) consumer products
    - … most filled w/ 3P distributors… not manufacturers (so consider IP appropriately)
    - (d) clothing
    - Style and trademark are key!!
    - Consider industrial design!
    - Choosing a trademark might be tough though…

UNIT 13: Legal Practice Concerns (conflicts, ethics, ILA, etc.)

- Clements
    - Know what came up today more generally

Serving on a (client's) board of directors

- *Law Society of Alberta Code of Professional Conduct*
    - Duty to avoid conflict of interest (r. 2.04(1))
        - ~a lawyer must not act/continue to act when there is a conflict, except as permitted in the Code
        - Know general need to avoid conflicts
            - Conflicts w/ former clients (i.e. basically limited to protecting confidential info)
            - Conflicts w/ current clients → based on FD
        - ****Keep this in mind for when you serve on the board of a client/your firm's client****
    - Duty to hold confidential info… (r. 2.03(1))
        - Lawyer must keep info learned through solicitor-client relationship confidential
- Perform all legal services undertaken to the standard of a competent lawyer (r. 2.01)
    - Lawyer must provide competent legal services
    - … lawyer may provide non-legal advice and must point out any lack of experience or qualification in the field ****and clearly distinguish legal from other advice****

Benefits of lawyers on a client's board

- Boards deal w/ complex issues that lawyers are trained in
    - Many boards discuss legal issues (e.g. corporate agreements, employment matters, leasing, transactions, governance, etc.)
    - Lawyers can effectively communicate to external or in-house counsel about this
- Improve networking relationships w/ client
- Keep lawyer better informed about client w/o "billable hours"
- Creates an overall more sophisticated and knowledgeable board and enhances board decision quality

The Case Against Lawyers Serving on Boards. PERIOD.

- … though some firms see the risks/downsides of lawyers serving on a client's board as worse than benefits
    - See ***Allen v Aspen Group Resources*** → WeirFoulds being sued for partner on client's board
        - **Lawyer's tip** → In ordinary cases, you can likely avoid trouble by saying "the law firm and I do not provide legal advice while serving as a board member"… but that might not save this lawyer since he signed a takeover bid circular **himself**
- Case against serving on boards…
    - There is a fundamental conflict
        - Director – (i) FD to company to make good business judgment, act honestly, in best interests of company; and (ii) duty of care
    - Lawyer – FD to give proper legal advice **which is not the same as business advice**
        - Difficult to distinguish between business and legal advice
        - Likely to interfere with your ability to be a good lawyer
    - Potential loss of solicitor-client privilege
        - I.e. from communications when lawyer acting as director → **NOT** privileged
        - Discussion could be inadvertent waiver of client confidentiality

Tips and Discussion: Non-Client Boards

- More tips
    - Seek company indemnity and D&O insurance
    - Approve several corporate resolutions
        - you are **NOT** there to give legal advice; board will **not** look to you for legal advice
        - board chooses legal representation **<u>without your vote</u>**
    - External counsel present at meetings
    - … be careful w/ casual discussions
- If you do choose to serve on a client's (firm's) board
    - More sure corporation is information re: potential conflicts of interest
    - … and potential loss of solicitor-client privilege
    - Loss of your representation if proceedings are commenced
    - Avoid losing solicitor-client privilege → clearly define what is legal advice and what is business advice
    - ****get appropriate indemnification and insurance protection****

The Case FOR/AGAINST Equity Billing

- Accepting shares or option as payment for legal services
    - *Law Society rules*
        - R. 2.04(13) commentary (to conflicts of interest) → payment of fees
            - Remuneration paid to lawyer, by client, does not give rise to conflict of interest
            - Where a client proposes to pay for legal services by transferring an interest in a corporation, property, investment or other enterprise, the lawyer must, **<u>at a minimum</u>**, recommend that the client **<u>receive independent legal advice</u>**
- Argument **<u>in favor of equity billing</u>**

- FD argument → aligns long-term interests between clients and lawyers
- Low cost source of financing
- Practical reality
  - Provides a lifeline to support clients that might not otherwise survive that
  - Gives these small companies a fighting chance where they might not have been able to even get off the ground
- Lawyers can provide connections between their networks and clients
- Lawyer can strengthen bond with client and is perceived as a vote of confidence
- Reduces the "moral hazard" that a lawyer faces
  - i.e. the client doesn't know that it takes 4 hours to draft a doc… so you *could* bill them for 4.5 or 5 hours
  - BUT with equity incentives, there's an argument for you to be as efficient as possible, since you aren't billing $$ per se
- Lawyer more like to refer investment idea to people in their network (since they have a stake in it)
- Other professionals do this (i.e. iBankers do this all the time)

- Argument **against equity billing**
  - Fundamental premise of lawyer-client relationship = provide sound legal advice, not tainted by lawyers' concerns
    - … equity billing may compromise this
  - Skill and negotiation gap (i.e. lawyer perceived > client), therefore recommend ILA
    - HIGH RISK OF CONFLICTS
    - E.g. you draft a USA w/ shotgun clauses → there's a moral hazard since you can manipulate the agreements to favor you
  - Fiduciary argument fails → leads to desire to get deal done rather than giving objective, ILA
  - HUGE RISK TO LAW FIRMS w/ BILLS
    - It's safer to get paid in $$ rather than in illiquid and potentially worthless shares
  - Scope of retainer may be undefined
  - High chance of uncertain valuations + discounted shares to get out
    - E.g. you may have to take a haircut to sell your shares
      - ****THIS IS WHY CLIENTS SHOULD OBTAIN ILA****
  - Practical considerations
  - How do you value the stock? When do you value it? What if it can't be reasonably valued?
  - Is it a reasonable fee if the company becomes wildly successful? Does this matter?
    - We are supposed to charge a "reasonable fee"!
    - … but there's no law society rule re: what is a reasonable fee
  - Is it like a contingency fee?
    - i.e. this could be analogous to a contingency fee
    - Arguments against this?
      - i.e. bad optics from Tony Merchant taking ~$100MM from residential school claims… even though he took big risk to help and it might have failed
  - Who is the client? Does this give rise to another layer of conflicts?
  - **NOTE:** <u>This is **NOT** against the code of conduct!!</u>
    - **This comes down to your professional judgment**

Key Issues involving clients (representation, joint, business, etc.)

- **Who is the client?**
  - *Law Society Code of Professional Conduct* → r. 2.02(6)) … when client is an organization
    - May receive instructions from officers, etc. but **<u>you represent the corporation</u>**
    - This corporation is a legal entity that is **<u>distinct</u>** from other individuals in the company
    - **Must ensure people giving instructions have authority to give instructions**
      - **Lawyers tips →** pull directors' names from minute books; view the corporate minute book; get ID from every person involved
- Advising concurrent clients

        - **FIRST**: get all concurrent clients written consent to retain a law firm in respect of same business opportunity
            - concurrent **non-competing biz/econ interests** OR competing clients whose legal interests are not directly adverse
    - *Law Society Code of Professional Conduct* → r. 2.04(4)(a) and (b) concurrent clients
        - **Assuming concurrent clients want to retain you, then a lawyer or law firm must:**
            - (1) disclose that it is acting for other business competitors and the risks associated with concurrent representation
            - (2) provide the client with the opportunity to seek ILA
            - (3) ensure that each client is represented by **different lawyers** in the law firm
                - If you're a sole practicioner, you should not take the case on
            - (4) implement measures to protect confidential info
            - (5) withdraw from the representation of all clients in the event a dispute arises that cannot be resolved, in relation to the subject matter of the concurrent representation
            - ****info from each client treated as confidential and not disclosed to other clients****
    - **Commentary**
        - A conflict will arise where, for example, commercial competitors simultaneously seek to retain the same lawyer or lawfirm for the same corporate biz opportunity
            - … **but** the same law firm can handle these two clients, if each is represented by different lawyers and existence of concurrent retainers is disclosed to clients
    - **Note:** the "conflicts" process in every law firm will often not be able to identify concurrent clients
        - This is more likely to be a subjective analysis undertaken by you as a lawyer
- Joint retainers (r. 2.04(5))
    - Before a lawyer acts for more than one client in the same matter, the **lawyer must:**
        - (1) obtain consent of clients following disclosure of pros/cons of joint retainer;
        - (2) ensure joint retainer is in best interests of each client;
        - (3) advise each client that no info received in connect w/ matter from one client can be treated as confident WRT other clients; and
        - (4) advise each client that, if a conflict develops that cannot be resolved, the lawyer cannot continue to act for any of them and may have to withdraw completely
    - Doing business with a client (r. 2.04(13))
    - Lawyer must not enter transaction w/ client who does not have ILR unless transaction is fair and reasonable to the client and the client consents to the transaction
        - **"Independent legal representation"** → retainer which client has separate lawyer acting for the client in the transaction
        - **"Independent legal advice"** → retainer which client does not wish to have full ILR, but receives advice about legal aspects of transaction + advisability
        - **"Transaction"** includes, lending/borrowing $$, buying property, giving security interest in a company, recommending an investment, and entering into a common business venture
        - **"Related persons"** are incl. In this, such that individuals connected to the lawyer by blood/marriage/CL/adoption, or a corporation owned by the lawyer (or these people) are incl. In these considerations
            - **Conflict may arise w/ "related persons"** transaction w/ lawyer's client
            - Conflict will NOT arise if client is entering transaction w. PubCo that the lawyer has an interest in
    - ****If you are going into business with a client, then that client should have independent legal representation... not just ILA****
        - **Minimum:** lawyer must recommend client seek ILA
            - … client can waive ILA, but lawyer must make independent assessment whether to proceed or not
    - Transacting w/ client → lawyer must act in good faith and make full disclosure to client re: material facts to the transaction
        - Incl. must disclose actual/potential conflicts to client

        - **Cannot disclose material fact w/o breaching another's confidentiality?**
            - Then you must not proceed w/ transaction
- Approaching companies with existing legal representation
    - *Law Society of Alberta Code of Conduct* → r. 6.02(10)
        - You should not talk w/ another lawyer's client… or employees of the org, or someone who regularly deals with the counter-party's lawyer
    - LPT – if you're out hustling and somebody says that they have legal counsel, then you should "back away" and give deference to existing legal counsel…
        - … BUT the client controls the lawyer, so ***the client can approach you***
    - Example
        - Clements is doing an asset deal for a client (vendor) with the buyer by email
            - Buyer does not have ILRep? = get joint retainer
            - Buyer **<u>has</u>** ILRep? = **must cc other lawyer**
                - You should be conversing with the other parties' counsel at all times!
                - Old lawyers will get very pissed with you
- Concurrent profession/business/occupation (r. 6.03(2))
    - must ensure your practice of law is not impaired from your concurrent profession or outside work
    - **"Outside interest"** → covers widest range of activities, incl. activities that overlap w/ practice of law...
        - e.g. engaging in mortgage biz/acting as director/writing on legal subjects
    - ... or in lesser connected activities
        - E.g. career in business, politics, broadcasting, etc.

Cases

Case	Issue	Ratio(s)

Allen v Aspen Group Resources, ONSC 2012	Is WeirFoulds vicariously liable in negligence **<u>or</u>** for a breach of s 131 of the *Securities Act*?
	
	If a lawyer (private practice) sits on a client's board, can this be a part of ordinary course of business for the law firm? **(If Lawyer signed takeover bid circular certificate, when it was later found to have misrepresentations)**
		• They **<u>may</u>** be → … it was common for partners to sit on client boards
		• **Held:** this matter should not be dismissed on summary judgment and should proceed to trial
		  ○ This liability was foreseeable in the course of business (of the law firm)
		  ▪ **Note:** Weirfoulds has D&O insurance
		  • ?Is this in the ordinary course of business?
		  ○ Only time will tell

Clements' Fact Patterns:

Clements' Fact Patterns → "Cars as billboards"

www.4doorsad.com analysis (Exam Practice)

Targets

- Drivers
  - Anyone that wants to earn revenue, subject to putting ads on their cars
- Customers
  - Anyone that wants to advertise

Business model analysis

- Existing
  - Able to place ad anywhere on car, depending on where you want to put
- Drivers'
  - "Quality control"
    - How do you prove that a person is actually using the ad? And where they're driving?
  - Automation
    - Can you build in some GPS monitoring device?
  - Costs to monitor, automate, etc.

Drivers' Issues	Customers' Issues

Quality control
• Prove quality of drivers' advertising?
• Automation?
• Costs?
• GPS/driving/monitoring
	• Longevity
	• Costs
	• Insurance ???
	  ○ Legal issue
	• Matching/niche
	  ○ $150/month
	  ○ … who's going to put an ad on the car for *only* $150/month?

  -

Legal Issues

- ABCA vs. CBCA
  - E.g. company is incorporated in NS and MB and AB…
    - CBCA still need to register extraprovincially… (per *Constitution Act*, s. 92(13) still in provs' hands)
- Vicarious liability for drivers
- Bylaw issues
  - Can you do this in the municipalities/provinces??
- Given this company will be capital intensive, may need to attract outside VC
  - So a USA may not be appropriate
    - … but could be mitigated
- Insurance legal issues
  - Does this make the vehicle a commercial vehicle? (since it's earning $$)
  - Are clients liable for car accidents?

- Tradename
    - Incorporate to protect trade name?
- Privacy legislation
    - Collecting info for drivers' licenses, etc. in city

Company wants to incorporate and needs funds in the future

- Don't make complicated share structures
    - Articles will be amended at some point
- Careful issuing shares
    - Remember *NI-45 106* needs private exemption + share transfer restrictions
    - See Unit 4 slides
- Don't proceed with a USA
    - General advice
        - Non-compete embedded in the USA vs. in individual agreements

Clements' Fact Patterns → Naming a company… problems

- What problems may affect a company with a new name?
    - *Partnership Act* = naming…
- NUANS search – **"Joe's Plumbing Inc."**
    - 3 important components (1) distinctive (**Joe's**); (2) descriptive (**Plumbing**); (3) legal (**Inc.**)
- Testable component for this course
    - You must be able to advise as a lawyer
    - **Test →** cannot be too similar, so that it's misleading
        - i.e. could an objective person be misled into believing that they are dealing with another business, rather than yours?

FACT PATTERN # 1

- Property management company wants to be **"Link Property Management Inc."**
- NUANS
    - *Link Management Inc.*
    - *Link Inc.*
    - *Link Investment Management Inc.*
- What would your thoughts be, as a lawyer?
    - (1) look into what each company does!
        - Pretend all 3 are property management companies (or at least *Link Management Inc.* is)
    - (a) advise there's the possibility of damages;
    - (b) inform that you may be able to get consent pursuant to the *Regs*; or
    - (c) do a new NUANS and pick a new name

FACT PATTERN 2

- Nature of the business
    - Former football player wants to bring little league from US to Canada
    - Start a mega-franchise
- NUANS
    - Business proposed → "We Play Football Inc."
    - NUANS
        - Clean… **raise alarms**
    - BUT what issues are there?
        - Let's do a trademark search – this could be a significant business model and we don't want to have any future issues

- "Play Football" is a registered trademark by the NFL… this could wreck your business LT
- NUANS *CBCA* vs. *ABCA*
- Remember: CBCA requires registration in **every province**, though there's a federal NUANS under the *CBCA*
- Takeaways
- Consider the scope of your client
  - Potentially large client → be diligent; be more thorough
- Growth company?
  - More likely to be diligent, similar to scope argument above
- Consider word associations
  - "Football" → think NFL

FACT PATTERN 3

- Facts
- 3 individuals want advice with a startup. All 3 are employed by one employer.
- Immediate questions on this alone
- What's their startup idea? (and what are they doing for work now?)
- **Issue:** i.e. are they using work time to build an app for a startup? Are there any issues arising from their occupation (e.g. movie ticket punches vs. Cineplex executives)
- Facts modified
- 3 employees that currently do executive search; they want to start a new executive search company
- Three important things to consider:
- (1) restrictive covenants
- (2) duty of fidelity
- (3) FD
- How do we analyze these 3 things? (i.e. what do we need to know)
- Positions –
  - managing director (no rest. Cov.)
  - non-equity partner (6 mos non-solicit)
  - account manager (no rest. cov.)
- Application -- **analyze each individually**
  - M.D. → definite problems
    - 100% FD (given his position)
    - Duty of fidelity for sure
  - NEP
    - Potential FD
    - Definitely fidelity
  - AM
    - Definite fidelity
    - Potential FD → based on harm to company
      - Note: only 4 employees in the office + AM has access to most files… There's significant potential for harm
- Conclusion
  - Given they want to start this business… what do you say?
    - (a) Take a brief hiatus from the current roles
      - E.g. 6 mos – 1 yr (to get rid of any potential CL non-compete)
        - CL ~ 1 yr
        - Safe ~ 6 mos
    - (b) after the cooling-off period, target a new market segment
      - E.g. current employer targets oil+gas execs
        - … so target PE or VC execs (i.e. non-O+G execs)
    - (c) don't use proprietary info/processes/etc.
      - i.e. don't use proprietary methods (come up with your own)

        - i.e. don't take existing client lists
        - i.e. don't actively solicit existing clients (may be OK if obtained publicly, through non-solicitation… after the cooling off period)

Clements' Fact Pattern -- "*The Next Great App*"

- Facts ("we have a Steve Jobs – we need a Steve Wosniak")
  - Client is developing an app for Oculus Rift ("OR")
  - 2 founders (X and Y) go talk with Z (app developer)
  - XY offer Z roughly amount of money (no contract for any of this)
    - ~roughly allude to "participation"
    - ~allude to options/equity….
  - ~Entrepreneurs induce discussion about equity for someone else to build their company à nothing is in writing, etc.
  - Z starts working… Z needs money and XY do not have money to give
- Issues
  - **exam distinguishing will be based on how many issues that you can spot**
    - ***Make headings to attack/unpack questions***
  - Structural/Form
    - Inc? partnership?
  - Risk assessment
    - → ow this leads to director liability
      - Severance?
      - Withholding?
    - ***think: what flows from legal uncertainty***3
  - ○ What is Z? (IC v EE v etc.)
    - IC?
    - EE?
    - Hybrid?
    - *Wiebe Door* 5 factors
      - …
      - …
      - ..
      - ..
      - ..
      - List + apply
  - Intellectual Property [Ownership]
    - IC vs. employee (assumptions)
      - IC → assumption: IC owns property
      - EE → assumption: company owns property
    - How to transfer ownership?
      - In writing?
      - Moral rights? (what are these)
  - Contract formation?
    - Is a contract formed? Does it exist?
      - What if we don't have a contract…?
      - We probably have a contract…
        - Offer/acceptance/consideration … meeting of the minds??
      - Tie this into IP ownership above
    - Does this need to be in writing?
      - Employment vs. IC à no (just offer/acceptance/consider – no need to write)
      - Options/equity

        - **If not in writing – no NCA/NDA/NSA/etc.
    - New employment contract = requires new consideration

Clements' Fact Pattern -- Starting a Tattoo Parlour

- Facts:
- A+B start a company → laser tattoo removal
    - A → sole director
    - B → sole s/h
- 5 year lease (1.5 years into this venture)
- B is in big personal debt
- A is in school
- Concerns:
- Equity
- Personal guarantees → piercing corp veil
    - Some type of creditor wants to pierce the personal guarantee debt
- Duties
    - Q: Has A fulfilled his duty (reasonable prudence)?
        - A: [i.e. at least underwent due diligence to ascertain some of these problems]
        - If issues? Then Director (A) should resign
    - A is a director but has no clue what's going on in the company
    - Not acting in the best interests of the corporation
        - Duty of Care → operate company reasonably
        - FD → honesty, best interests
        - Note: these two can give rise to liability
- Statutory duties
    - Employee wages
    - Issuing dividend while technically insolvent
        - If B sends out money, contrary to liquidity/insolvency test, then A could be liable
- Taxes
    - GST/taxes paid? Owed?
- [Specifics/extent of resolution on an exam]
- If clements asks for specifics, answer them specifically
- If clements says "please advise" (Sprysak), the treat it like this question above