HIRING EMPLOYEES FOR STARTUPS: THE MILESTONE THAT COULD TURN INTO A STUMBLING BLOCK

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A strong and dedicated team is the backbone of any successful startup. Developing your employee base is an important step in the development of your startup and hiring the right team involves many considerations. Given the unique pressures start-ups face, we have compiled a list of employment related pitfalls to watch out for when you and your team are considering hiring your first employee. We're here to help ensure that hiring your first employee is a milestone rather than a stumbling block.

1. Poaching talent may expose you to liability

People with experience growing and running a successful startup can be a great addition to your team. Particularly if your startup operates in a specialized industry, you might be considering hiring those with a specialized skill set. But it is important to note that your new hires may owe obligations to their former employers, and you could expose your business to liability if there is a breach of those obligations.

All employees owe a duty of confidentiality to their former employer. If the employee breaches that duty of confidentiality by revealing confidential information to their new employer or using such information, the new employer could also be liable. An employer may be held vicariously liable for their employees' wrongful actions committed while acting within the scope of their employment. Note that there is a distinction between confidential information (such as trade secrets) and general know-how and skills learned at a previous job. The general know-how and skills learned at a job belongs to the employee and they are free to pass that information along to whomever.

If your new employee breaches the duty of confidentiality, a Court may grant an injunction against your business to prevent further use of the confidential information. This could significantly delay product development and business growth. Further, your business may also be liable for damages and be ordered to compensate the other business for the damage it suffered. Additionally, your business may be ordered to account for the profits it gained as a result of the wrongdoing, and be ordered to give up the profits to the other business.

Example: Confidential information generally fall into two categories; information regarding how a business is

run and information regarding products and services. Confidential information for the former could include: identity of suppliers and the agreed upon terms, identity of customers, marketing plans, business development strategies, pricing structure. Confidential information for the latter could include: secret formulas, manufacturing processes, algorithms or code in software and other trade secrets.

Takeaway: It is certainly beneficial to hire someone with previous experience in the industry and someone who gets your business. However, the individual you want to hire likely has confidential information that could be relevant to your business. If you decide to hire this individual, impress upon her or him the consequences of disclosing confidential information and prohibit the employee from using or disclosing such information.

2. Mischaracterizing the relationship Part I: your contractor might actually be your employee

Uber's employment related litigation in the U.S. demonstrates that potentially mischaracterizing an employee as a contractor can cost a business hundreds of millions of dollars. In Canada, the common law provides more rights and protections to employees than contractors. Employees are also entitled to the rights and protections provided by various employment standards legislation. Mischaracterizing an employee as a contractor may result in your startup being in violation of those laws.

Courts will look at all of the surrounding circumstances to determine if someone is an employee or a contractor. Even if both parties thought the relationship was a contractor relationship, this is not determinative. Regardless of whether the contract explicitly uses the language of "independent contractor", the courts will still weigh a variety of other factors to determine the proper classification. The non-exhaustive factors courts will likely consider include:

1. the degree of control the employer is entitled to exercise over the individual
2. whether the individual provides their own equipment or tools
3. who bears the chance of profit and the risk of loss
4. whether the individual receives a fixed and regular amount of remuneration, group insurance benefits, pension or other benefits
5. whether the individual hires their own helpers
6. whether the individual is paid while away from work (i.e. vacation pay)
7. whether the individual provides services for any other entity or whether they are prevented from working for competitive entities

Example: You hire Melanie and the agreement between your business and Melanie states that she is an independent contractor. She is responsible for going door-to-door with promotional material and selling your product. Her pay is entirely commission-based and she receives some training on how to appropriately sell the product. She is required to wear a t-shirt with the company logo while working. In this situation, Melanie could

be considered to be an employee rather than a contractor. The Ontario Superior Court of Justice in 2016 certified a class action of individuals similar to Melanie, who claimed against a company for mischaracterizing them as contractors, and thus violating minimum employment standards.[1]

Takeaway: If you are considering hiring a contractor, go through the list of factors above for each contract. If you think there is any risk the contract could be close to the line, it is a good idea to speak with a lawyer, particularly since the factors are not exhaustive. Be wary that the analysis will change as the relationship develops and as the work changes. Someone could begin a contract as an independent contractor and over the course of the work, shift closer to an employee relationship or dependent contractor relationship. It is prudent to reassess the situation at least annually and the longer the relationship continues, the more risk the person will be found to be an employee or dependant contractor.

3. Mischaracterizing the relationship Part II: your intern might actually be your employee

Similar to mischaracterizing an employee as a contractor, some employers incorrectly assume that their obligations towards their interns differ from employees. Many jurisdictions in Canada have imposed restrictions on who may be considered an intern, and these may differ from province to province.

In Ontario, unpaid internships are impermissible unless the internship falls under one of the three narrowly construed exemptions provided by the *Employment Standards Act*, 2000:

1) Internships that are part of a program approved by a secondary school board, college, or university;

2) Internships that provide training for certain enumerated professions, including architecture, law, public accounting, veterinary science, dentistry, and optometry; and

3) Internships that meet the six conditions required for the intern to be considered a "trainee".

In British Columbia, unpaid internships are also impermissible unless the internship falls under one of the following narrowly construed exemptions listed in the *Employment Standards Regulation*:

1) Many employment standards, including minimum wage, hours of work, overtime, rest periods, etc. do not apply to professionals, or people training to be professionals, in designated fields such as doctors, lawyers, nurses, engineers, and accountants.

2) Students who are enrolled at a secondary school who are engaged to work at the secondary in which they are enrolled, in a work study, work experience, or occupational study class, are excluded from the *Employment Standards Act* (“ESA”).

The Employment Standards Branch (“ESB”) makes a key distinction between what they consider a practicum

and an internship. Generally, a practicum is a part of a formal education process for students enrolled in a public or private post-secondary institution that involves the supervised practical application of previously classroom taught theory related to course study. The ESB considers a practicum to be hands-on training that is required by the curriculum of the program, and will result in a certificate or diploma. As such, a practicum is not considered to be "work" for the purposes of the ESA.

Internships however, are considered on-the-job training offered by an employer to provide a person with practical experience. As such, internships are generally considered "work" for the purposes of the ESA, and must be paid in accordance with the minimum standards as set out therein, including hours of work, minimum wage, overtime pay, vacation pay, etc.

There are no exemptions for start-ups.

Example: If Susan does not fit into a specific category in the province in which she is working, then Susan is not an intern, even if you and Susan both thought she was. In this situation, Susan is entitled to the same rights as any other employee, including minimum wage, overtime pay, vacation pay, etc.

Takeaway: If you wish to take on an intern, ensure that you know what the requirements are in advance.

For more information on internships, please see the following McMillan bulletins for Alberta, Ontario, British Columbia, and Quebec.

4. Your after-the-fact employment agreement might be void

Startups can begin as just a loose collection of people working towards an idea. It is not uncommon for a startup to have employees without any documentation. If you do not yet have a standard employment agreement, you might be considering hiring a few employees and formalizing the details into a written agreement later. If the employee begins work without a written contract, but you want them to sign a written contract after-the-fact, be aware that the written contract will be void unless consideration (i.e. something of value) is provided to the employee.

It is important to recognize that even without a written contract, an oral contract exists at the time the offer of employment was accepted. Therefore, any contract that is made after the initial oral agreement may be interpreted as an amendment to the original contract. In order for the amending contract to be valid, the employer needs to provide additional consideration than what the original contract provided. Simply promising continued employment, without anything more of value passing to an existing employee, is not consideration for a new promise that is disadvantageous to the employee.[2]

Example: Julie accepts an offer of employment during a conversation with you, and together, you discuss the

basic terms of the agreement. Two months after Julie starts working, you want Julie to sign a formal written contract, which also contains a non-solicitation clause. Since the non-solicit clause was not discussed in the original offer, this written contract is an amendment to the original verbal agreement. In order for this written contract to be valid, there must be additional consideration flowing from you to Julie to compensate for the fact that Julie will be disadvantaged by the non-solicit clause. Additional consideration could take the form of a pay raise, new benefit, stock option, bonus, etc., but should be something more than a minimal amount (e.g. $1). Even if Julie signs the contract, without additional consideration, the contract is invalid. In return for Julie's promise not to solicit, something must pass to Julie, beyond which Julie is already entitled to under the original contract.[3]

Takeaway: Have your employment agreement ready when you are offering employment, or make the offer conditional upon signing the agreement. If the employee has begun work before signing an employment agreement, it is prudent to consult a lawyer. Otherwise, you may find that years later, the written contract was not a valid contract.

5. Your non-competition agreements might be unenforceable

It is a good idea to protect your intellectual property at the outset of the employment relationship. One method is by including restrictive covenants into the employment agreement that each employee signs. Restrictive covenants include intellectual property, non-competition, non-solicitation and confidentiality provisions. Non-competition agreements generally prevent former employees from working for a competitor or opening their own business as a competitor. Non-solicitation covenants prevent former employees from soliciting your clients, customers or employees. Confidentiality agreements prevent the former employee from using your confidential information after leaving the organization.

A poorly drafted restrictive covenant risks being struck down in its entirety. A court will assess the covenant to see if it is reasonable at the time it is entered into. If the covenant is unreasonably broad in scope in terms of the type of activity being restricted, the duration of the restriction or the geographical scope of the restriction, the covenant will be unenforceable.

Example: Suppose your standard employment agreement includes a clause which prevents your former employees from competing with you within the "Metropolitan City of Vancouver". This clause will likely be unenforceable since the term "Metropolitan City of Vancouver" is ambiguous and not a clearly defined geographic area.[4] Also, if the agreement contains a clause preventing former employees from soliciting business from any "entity which was a customer of the company during the time of the employment", this may be unenforceable particularly if the employee could not possibly know all the customers of the employer.[5]

Takeaway: You will need to ensure that your restrictive covenants are not broader than what is reasonably

necessary to protect your legitimate proprietary interests. This is not an easy task as many factors affect whether the covenant is reasonable. Legal counsel should review the covenant to help ensure it is enforceable.

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[1] *Omarali v Just Energy*, 2016 ONSC 4094.

[2] *Kohler Canada Co. v Porter*, [2002] OJ No. 2418 at para. 31 (ONSCJ).

[3] *Techform Products Ltd. v Wolda* (2001), 56 OR (3d) 1 at para. 24 (ONCA).

[4] *KRG Insurance Brokers (Western) Inc. v Shafron*, 2009 SCC 6.

[5] *Mason v Chem-Trend Ltd. Partnership*, 2011 ONCA 344.

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.