HOW TO DO IT RIGHT: LEGAL NECESSITIES OF LAUNCHING A TECH START-UP

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In the fast-paced ecosystem of tech start-ups, emerging companies understandably focus on developing tech, growing the business, building their team and securing investment, often deferring legal matters. Trusted legal advisors who understand the tech community and have supported teams from the incubation stage to go-public and other successful exits are an integral part of the early-stage team. This bulletin provides an overview of the necessary legal components of tech start-ups including organizing capital structure and shareholders agreements, stock options and incentive compensation plans, intellectual property protection (often the key component of value), data privacy, employment and tax.

Organizing Capital Structure and Shareholders Agreements

Organizing Capital Structure

Start-ups considering their capital structure have a variety of options available including equity, debt and a combination thereof. The choice of which to use depends on numerous factors including the desire to preserve ownership of the business, the ability to access equity or debt capital and interest rates. When navigating these options, capital raising must be thoughtful and strategic, since a "clean" and conventional capital structure will enhance attractiveness to sophisticated and institutional investors as well as facilitate an ultimate exit or "liquidity event" such as a merger, acquisition or going public on a stock exchange.

Initially issued start-up shares are typically common shares for founders and early-stage employees. Companies may opt to issue more than one class of common shares with different rights, for example, voting and non-voting, although this is typically discouraged since the complexity causes subsequent institutional investors to find complicated capital structures uninviting. Preferred shares are typically issued later when a company undergoes a priced financing round, such as series A, with "arms-length" investors. Such investors in early-stage tech companies often favor preferred shares for consistent income (through a preferential, and sometimes fixed, dividend rate) and lower financial risk (by possessing preferential rights on liquidation).

In addition, it is crucial early-stage companies document and formalize all share or other equity issuances clearly and accurately, particularly respecting stock options. Too often at later stages when a company has

gained value there are disputes over whether shares were or weren't issued and whether options were or were not granted or did or did not vest, often resulting from lack of or unclear documentation.

Shareholders Agreements

Shareholders agreement define shareholder rights as well as obligations, indicate who is running the show and provide solutions for potential issues inevitably arising in the business relationship. These agreements may be adopted immediately early, even with a few shareholders and could include features such as business decision making, board appointment rights, and dispute resolution and exit rights.

While it is important to have the fundamentals in place at the beginning, once institutional investors (and especially venture capital firms) invest, these agreements are completely renegotiated to reflect industry norms for series A investors (which documents are published by the Canadian Venture Capital Association). These more involved shareholder agreements include additional provisions such as board approval rights, corporate governance veto provisions, pre-emptive rights on subsequent capital raising activities, information rights (financial statements and business plans), registration rights, co-sale (i.e. tag-along), drag-along rights and more detailed dispute resolution mechanisms.

Stock Options and Other Equity Incentive Securities

Stock options are a valuable tool for emerging companies to attract talented employees, advisors and consultants while preserving capital for growing the business. In addition, compensating with stock options aligns interests of option holders with those of founders as option holders have an enhanced interest in the growth of the company when compared to more traditional cash compensation.

Stock options give the holder the right to purchase a number of equity shares at a future date at, most commonly, market price or fair value of the shares at the time of the grant. The value of a stock option is derived from an increase in the value of the company's shares. Stock options vest (or become exercisable) after passage of time, or in some instances, on the achievement of certain performance metrics. Where an option holder is an employee of, options are not generally subject to Canadian income tax on grant, but are instead taxed on exercise (or, in certain circumstances, on the eventual disposition of the underlying shares). This tax deferral benefit is often a key factor in determining what type of incentive plan to implement.

Companies may also grant restricted share units ("**RSU**") and/or deferred shares units ("**DSU**"). An RSU, similar to a stock option, is an entitlement to receive a share but unlike a stock option, a RSU does not have an exercise price before it can be settled into a share. RSUs usually vest with passage of time. DSUs, similar to RSUs, do not have an exercise price and are an agreement by the company to issue shares upon the occurrence of an event, typically retirement, termination or death of the holder. Performance share units ("**PSU**") are similar to the

foregoing except they have performance hurdles that must be achieved before PSUs vesting occurs.

RSUs, DSUs and PSUs may be structured to allow for settlement in shares, the cash equivalent of shares or a combination thereof at the option of the holder or the company. The method and timing of settlement provided by the relevant plan is crucial to determining the tax consequences to the holder, including the timing of any tax realization event in connection with the award.

Holders of stock options, RSUs, DSUs and PSUs do not have the rights of shareholders such as voting rights and dividend entitlements until they are exercised or settled, as applicable into shares.

While it is tempting for founders and early-stage management to "load-up" on options and other equity incentive securities, they are dilutive to the equity base of a company and being overly-generous is a huge hurdle when seeking institutional investors (such as venture capital firms) who are valuing the shares based on the value of the company divided by the fully-diluted shares outstanding (i.e. assuming the exercise of all stock options, RSUs, DSUs and PSUs).

Intellectual Property

In many instances, a tech start-up's intellectual property is what makes that start-up attractive to investors and customers and represents most of the value of the company. Being innovative is only a part of the equation; start-ups must ensure they takes steps to protect intellectual property. Examples of intellectual property include inventions, literary works, artistic works, industrial designs, and "signs" used in commerce. Protection of intellectual property is not automatic and requires specific legal steps be taken by the company, with assistance from highly competent legal counsel, to obtain copyright protection, trademark rights, patent rights and the protection of trade secrets. These protections are also contained in employment agreements, assignments of intellectual property and other contracts with employees, contractors and others.

A "patent" is an exclusive right to make, construct, use and sell an invention. In Canada, patent rights expire after an exclusive twenty-year period, after which the invention is public.

A "trade secret" is information deriving commercial value from being secret. Trade secrets may last forever provided the information remains a secret however, trade secret protection ends once the secret is public. Therefore companies owning trade secrets must ensure they are safeguarded.

"Copyright" is the right to produce, reproduce, perform, or publish a work or any substantial part thereof in material form. Generally, an original work is automatically protected by copyright once the created and the protection period is the life of the author of the work plus 70 years.

A "trademark" is a sign (a word, design, colour, figurative element, etc) or combination of signs used or

proposed to be used to distinguish goods or services from those of others. Registering a trademark is highly recommended. Also, to limit the likelihood of having trademark rights misappropriated in a foreign jurisdiction where there is a probability of doing business, a trademark should be registered in a foreign jurisdiction in advance. Trademark rights last indefinitely provided the owner continually uses the trademark in commerce and pays necessary renewal fees.

Data Privacy

Data privacy is important for emerging tech start-ups, especially in the digital economy where personal information is highly valuable. Start-ups have data privacy obligations if they obtain personal information from or on behalf of customers[1] and when handling employee personal information. Data privacy considerations are relevant to all companies handling personal information, even if they are small, collect a small amount of data and have a small Canadian footprint. Nonetheless, privacy compliance is particularly important for start-ups processing large quantities of personal information or highly sensitive personal information (such as medical or financial information), as these companies fall under increased scrutiny from privacy regulators and/or customers.

Most tech start-ups are subject to Canada's federal *Personal Information Protection and Electronic Documents Act* (PIPEDA), which sets out the rules for collecting, using and disclosing personal information in the course of commercial activities. Alberta, British Columbia, and Quebec have enacted their own private-sector privacy laws with some differences from PIPEDA that are applicable to most tech start-ups operating in those provinces. Quebec's privacy law in particular varies significantly from others in Canada and start-ups should review our compliance checklist if they process any personal information of Quebec residents.

Basic Steps to Protect the Company

Start-ups should adopt fair information principles under PIPEDA as a framework for developing and implementing data privacy policies and practices.[2] These principles provide guidance on how to collect, use and disclose personal information fairly and transparently while respecting rights and expectations of individuals. Key requirements for PIPEDA compliance include:

- Appoint a privacy officer for overseeing privacy law compliance and responding to inquiries and complaints.
- Collect only personal information necessary for the identified purposes and do not use or disclose it for other purposes without consent.
- Obtain meaningful and valid consent from individuals before collecting, using or disclosing personal information. Consent should be clear, informed and voluntary and individuals should be able to withdraw or modify consent at any time.

- With complete, accurate and easy-to-understand privacy policies, inform individuals about your policies and practices respecting personal information, including what personal information is collected, how it is used and disclosed, how they can access and correct it, how they can file a complaint, and how they can contact the privacy officer.
- Ensure personal information is protected against loss or theft, unauthorized access, disclosure, copying, use or modification using appropriate physical, technical and organizational measures.
- Ensure third parties processing personal information on behalf of the company have adequate privacy policies and practices and are contractually bound to comply with the company's obligations under the privacy laws.
- Notify individuals of any transfers of personal information to another jurisdiction where it may be subject to different legal regimes or risks. In Quebec, a privacy impact assessment must be carried out prior to communicating personal information outside of Quebec.
- Comply with the requirements of Canada's Anti-Spam Legislation when sending commercial electronic messages (such as emails or texts) to individuals without consent or installing computer programs on their devices without consent.

Start-ups should embed these privacy considerations into the design and operation of their products, services and systems at early, as it may be more costly to later implement design changes.

Employment

Hiring the right employees is important for start ups as the right talent fuels business growth. Hiring employees brings numerous legal challenges start ups should be aware of, including entering into the right employment agreements (including protecting the company's intellectual property), compliance with employment standards legislation and developing workplace policies for the business. These challenges are more simply and cost effectively dealt with proactively than after the fact (for a more fulsome discussion, see here).

Entering into proper employment agreements with employee is particularly important for startups, as it saves substantial money if employees later need to be let go whether as part of a restructuring, they weren't the right fit or in connection with a merger or sale. A properly drafted employment agreement can be the difference between owing a dismissed employee the equivalent of two weeks' wages or as much as six months' wages if the former employee establishes a right to common law "reasonable notice" of termination.

In addition to termination clauses, startups should ensure they are properly protected with non-solicitation clauses preventing employees from diverting business or employees away from the company. In certain circumstances, startups may consider non-competition clauses preventing employees from competing against

the startup after their employment ends. This terms must be properly drafted and considered prior to being put in writing, as courts will not enforce agreements that are overbroad, ambiguous or unnecessarily interfere with an employee's ability to earn a living. The Ontario government has gone further, banning non-competition clauses for all non "C-Suite" employees (more detail here). Nevertheless, well drafted non-solicitation and non-competition clauses should be front of mind when hiring employees.

Tax

The federal *Income Tax Act* (Canada) (the "**ITA**") and corresponding provincial statutes impose tax on the world-wide income of Canadian resident corporations. The federal corporate tax rate is currently 15%, and provincial corporate tax rates generally range between 8-12%.[3] Canadian-controlled private corporations (i.e. corporations not legally controlled by non-residents or public companies) are generally entitled to preferential tax rates (both federally and provincially) on the first $500,000 of income annually. Of particular interest to start-ups in the technology space, Canada provides scientific research and development (SRED) investment tax credits to corporations conducting eligible activities, which credits can be used to reduce income tax payable. SRED credits are generally earned at a basic rate of 15% and are non-refundable. However, Canadian-controlled private corporations can be eligible to earn refundable SRED credits at an enhanced rate of 35% in respect of certain expenditures.

From a Canadian tax perspective, it is generally beneficial for a tech start-up company to maintain Canadian-controlled private corporation status for as long as possible. Accordingly, tech start-ups typically work closely with their legal and tax advisors to ensure the company's capital structure, shareholder base, board composition, and relevant shareholder agreements do not jeopardize such status.

If you have any questions regarding launching your tech start-up, members of McMillan's Capital Markets, Business Law, Intellectual Property, Employment, Tax and Data Privacy groups would be pleased to assist you.

[1] Contrary to popular belief, data privacy laws may still apply to sets of information that have been de-identified (i.e., names or other common identifiers removed). In order to truly anonymize personal information (such that privacy legislation no longer applies), there must no longer be a serious possibility of linking the information to an identifiable individual, either alone, or in combination with other information available. If large amounts of data is being processed, true anonymization may be very difficult, if not impossible to achieve. Moreover, under the current state of the law in Quebec, true anonymization may be impossible. If your business model relies on the processing of anonymized or de-identified personal information, legal advice should be obtained early on.
[2] These principles are accountability, identifying purposes, consent, limiting collection, limiting use, disclosure and retention, accuracy, safeguards, openness, individual access, and challenging compliance.

[3] Provincial corporate tax rates in the Atlantic provinces are higher at 14-16%

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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.