# Tips for Technology Start-Ups

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## Are You Starting New, or With Baggage?

The questions I most frequently receive continue to focus on start-up issues, whether new products or technologies. So, in the interests of demystifying some of the legal issues involved with technology start-ups, I've decided to address the main topics in a 10-part series on start-up issues. Let's get started.

One of the first legal questions for the budding entrepreneur is, what did you used to do? I ask this not to determine whether you've got the stamina for the start-up life. That may be a good question, but it's not really for me to ask. Rather, the question is aimed at determining whether you have obligations to your previous employer which might restrict what you want to accomplish in your start-up venture.

These obligations can take several forms. The first step is to confirm whether you had a letter confirming your hiring and setting out the terms of employment, or or whether you signed an employment contract, confidentiality agreement, non-disclosure agreement (NDA), or had any other agreement with your employer. The key things you're looking for are confidentiality, non-compete or non-solicitation covenants, or an assignment of any intellectual property rights you may have acquired as an employee. These covenants can be embedded in any type of agreement, so don't assume they're not there just based on the formal name of the agreement. If you do have any such agreement, you're probably well advised to consult your lawyer as to the scope, and duration, of any restriction.

Even if you didn't have an agreement with your former employer, that still does not mean you're completely off the hook. If you were a director, officer or key employee, you may owe fiduciary or "key employee" obligations to your former employer. Unfortunately, there's no "bright-line" test as to when these obligations apply. Generally, if the employee was a director or officer, or if the business would be particularly vulnerable to the actions of the employee (such as a key salesperson), or if the employee was the company's primary contact

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with customers, or had a high level of responsibility for sales or revenues, or had access to critical customer information or differentiating business strategies, then the employee is likely to be found to owe a duty to the employer even after termination of the employment relationship. In this situation, you can still compete with the company, but you can't do so "unfairly". That means you cannot use the company's confidential information, or solicit the company's customers or employees. And beware, the new employer, and other third parties who might profit from your breach of these obligations, also may become liable. There are strategies for avoiding liability in these situations, but it admittedly can become a little tricky. You should seek legal advice if you find yourself in this situation.

## Choosing the Right Business Structure

Although there are three or four options to choose from, the real decision is between using a corporation or a partnership. For technology start-ups, the corporate structure is almost always the right decision. Why? There are several reasons.

Technology start-ups almost always require government assistance programs to get through the seed and early stages of development, and many government programs, whether in the form of grants, loans or investment tax credits (ITCs), are only available to corporations. For example, the ITCs available under federal and provincial SR & ED programs are only available to corporations, with enhanced ITCs being available to Canadian controlled private corporations (CCPC) under the Income Tax Act; and Manitoba's Small Business Venture Capital Tax Credits are only available to eligible investors in respect of investments in eligible small business corporations.

Other advantages to using the corporate structure include the fact that, through stock options, founders can use company shares as currency for attracting key employees and directors; and founders of a CCPC may be eligible for the one time "750,000 capital gains exemption" under the Income Tax Act when qualifying shares are disposed of. As well, venture capital and private equity investors will only invest in the securities of a corporation.

Occasionally a client will have a business model that is service oriented, with one or more financial backers with high incomes and a desire for tax write-offs. In this situation a limited partnership can be effective. In a limited partnership, the liability of the general partner is unlimited, but the liability of the investor limited partners is limited to the amounts of their contributions of capital or property to the partnership. Income or losses of the partnership are determined, for tax purposes, at the partnership level, but are then allocated to the partners and are taxable in their hands, and the allocations need not be proportionate to the amount of capital invested by them. This allows the losses incurred by the partnership in the early years to be allocated to the investor limited partners, which then can be used by them to offset income from other sources.

A decision to proceed with incorporating will drive other decision-making, such as: Should you

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incorporate federally or provincially? What type of share structure should your corporation have?

The main advantage of a federal corporation is that when you get your company name reserved for federal use, you then have the right to use that name Canada-wide. Registering to carry on business in other provinces can also be a little easier with a federal corporation. Getting a federal name approved, however, can be more a difficult and time-consuming process than a provincial name approval. And a federal name approval is not an absolute guarantee that someone else has not established a prior right to use that name in another jurisdiction.

What type of share structure should you company have? You should keep it relatively simple. Down the road you may find yourself having to amend your share structure if a venture capital investor finds it too complicated. You should make sure, however, that your company's articles meet the requirements of a “private issuer” for securities law purposes, so that the company can rely on the “private issuer exemption” for the sale of company securities without the need for a prospectus.

## Capital Structure and Founders' Shares

Let's assume that you've chosen to move ahead with your start-up using a corporation, for some or all of the reasons we discussed in the last post in this series. Two issues you then will have to address are the company's capital structure and issuing shares to the founders.

The capital structure of your company refers to the different types of shares, called classes of shares, that your company is going to have available for issue to founders, employees, directors or other investors. The ownership of the shares represents ownership of the company.

Unless the articles of the company provide otherwise, each share of the company entitles the holder to three fundamental rights: (i) the right to vote, (ii) the right to receive any dividends declared by the company, and (ii) the right to receive the remaining property of the company on a winding-up or dissolution. A company may have many different classes shares, but if it has more that one class, its articles must specify the rights attaching to each class.

The two basic classes of shares are common shares, which can be voting or non-voting, and preference shares. Preference shares are shares that have one or more preferences over the common shares, such as the right to receive dividends prior to dividends being paid on common shares, the right to have the shares redeemed, or the right to convert the shares into common shares upon the happening of certain events.

Determining the capital structure of the company is an area where the entrepreneur tends to rely on the advice of legal counsel. But you have to be careful here. In a recent Harvard

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Business School article **“Top Ten Legal Mistakes Made by Entrepreneurs”**, Harvard Professor Connie Bagley lists as the #8 mistake, hiring a lawyer not experienced in dealing with entrepreneurs and venture capitalists (VCs). This is a mistake that often comes home to roost with respect to the capital structure and the issue of founders’ shares.

Angel and VC investors can differ in many respects, but one common feature is that they tend not to like complicated share structures. There are a couple of reasons why you might want several classes of shares; you may want a class of non-voting common shares so you can income-split with a spouse not actively involved in the business, or you may need a class of preference shares to give to a founder who transfers assets to the company in exchange for shares on a tax-deferred “roll-over” basis. If these reasons do not exist, stick to one or at most two classes of shares. An angel or VC investor typically will want to invest in convertible preferred shares, but don’t bother trying to anticipate the terms of the conversion rights in advance of negotiating a deal with an angel or VC. You will have to amend your share rights to reflect the terms of the angel or VC deal.

There are two mistakes to avoid when issuing shares to founders. Unfortunately both are relatively common.

The first mistake is not issuing enough shares to the founders. An inexperienced lawyer will assume that it doesn’t matter how many shares are issued, as long as the percentage ownership as between the founders is accurate. So, typically you will see something like 100 common shares being issued to each of founder A and founder B for nominal consideration, say $1.00 per share. Lawyers experienced in dealing with angel or VC investors on the other hand, will work with the entrepreneur to determine the optimum share structure assuming the angels and VCs are already in the deal. That may result in 10,000,000 common shares being issued to founder A and founder B, also for nominal consideration, say $0.00001 per share. In each scenario, founder A and founder B acquire 50% of the company for nominal consideration, but in the second scenario the founders are better protected against future dilution, while creating room for other potential shareholders, such as employees and directors as well as angel and VC investors.

The second mistake entrepreneurs make is being careless on the matter of who should receive founders’ shares and what percentage each should receive. While issuing shares to a less involved colleague “just because” may not seem like such a big deal when those shares are worth $0.01 each, you might not feel the same way a couple of years into your venture. Equally important is the fact that it may come back to haunt you that you gave up more control over your business than you should have.

## 10 Questions Your Shareholder Agreement Should Answer

Business start-ups are tough, and research shows that entrepreneurs do better when they have business partners to share the load. However, many entrepreneurs question the need

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for a shareholder agreement when they are first starting out. There are a number of reasons for this: there is no cookie-cutter agreement, so costs can be high; they have unbounded optimism about the strength of their partnership; and they have little cash. It often is only in hindsight that they see the merits of addressing these issues at the outset.

Entrepreneurs should understand that a corporation is a simple legal structure with some basic features, but details about the rights and obligations of the shareholders to each other generally are "add-ons" that need to be contractually defined. For example, when it comes to regulating share transfers, a shareholder agreement can be likened to a prenuptial agreement, in that it provides mechanisms for "undoing" the shareholder relationship.

So, what are the top 10 questions that your shareholder agreement should answer?

1. Board Composition and Decision-Making. Who is going to be on the board of directors and are there restrictions on what the board can do? Restrictions might include certain types of decisions that need to be approved by shareholders rather than directors. Certain types of investors, such as VCs, may prefer observer rights rather than a board seat, at least until there is a default in certain covenants.
2. Procedural Rules. What are the procedural rules? These rules are often contained in the company by-laws. You want to pay attention to these rules, and vary them if necessary. For example, you may want to set special quorum requirements to ensure certain classes of shareholders must be present to make certain kinds of decisions.
3. Founders and Key Employees. Are the founders and/or key employees required to have employment agreements, that include non-disclosure and invention assignment, and non-solicitation or non-compete covenants? There are two issues here: employment and share ownership. Many angel or VC investors will require employment agreements, where even founders' employment can be terminated for cause or non-performance, with non-disclosure, invention assignment and non-solicitation or non-compete covenants. Typically employees (not necessarily founders) must divest shares on leaving employment.
4. Distribution Policy. What is the distribution (dividend) policy? Whether or not you have a distribution policy, and its terms, will depend on whose interests you are catering to. Investors may want to know that there will be no dividends until net income reaches a certain threshold and that any dividends that are paid will be within an acceptable range.
5. Company Commitments. What covenants (promises) do you want/need from the company? A shareholder may want the company to agree in advance to certain things, such as obtaining D & O insurance, placing key-person insurance, paying director expenses, providing the maximum indemnification coverage, requiring all employees to sign NDAs with invention assignment provisions, etc.
6. Dispute Resolution. Is there a process to resolve disputes among shareholders or do you have to resort to court proceedings? Court proceedings are very public, expensive and time-consuming. Arbitration can be expensive and time-consuming, but generally far less so, and can be made confidential. It also can lead to a mediated resolution of the dispute.
7. Capital Formation. If the company needs to raise additional capital, how does it intend to do that (debt or equity, on what terms) and what rights/obligations do you have in connection with that? If the company seeks debt financing, shareholders may be asked to provide a guarantee. If the company seeks to raise equity, are you required to participate, and will you get diluted if you do not participate?
8. Share Transfers. Almost all companies restrict shareholders' ability to sell their shares. Having said

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that, under what circumstances can you sell your shares, under what circumstances are you required to sell your shares, and can you force the company to buy your shares under certain circumstances?
9. Majority Sale. What happens to your shares if there is an offer to purchase all of the assets, or a majority of the shares?
10. Determination of Price. For all of the share transfer mechanisms in the shareholder agreement, how is the share price to be determined? This can be the most difficult question to answer, but it is also the most important to know in advance. It is good to develop an agreed-upon formula, or an agreed-upon methodology, before it becomes an issue. The price, or the mechanism used to determine the price, could be different depending upon the circumstances. For example, the price the company must pay to purchase the shares of a departing employee might be less than the price paid by the remaining shareholders under right of first refusal.

## Common Provisions Regulating Share Transfers

Almost all companies restrict the shareholders' ability to sell or transfer their shares, either in the articles of incorporation, the by-laws or under a shareholder agreement.

A typical regime for regulating share transfers will include a provision in the articles of incorporation prohibiting share transfers, except with the approval of the board of directors.

Despite the general restrictions on transfers, however, the shareholder agreement should provide for situations where share transfers will be permitted. The shareholder agreement should provide sufficient flexibility so that shareholders can deal with their shares in an efficient manner for tax planning purposes. For example, where the shareholder is an individual (for example a founder), the shareholder agreement should permit him or her to transfer his or her shares to a corporation wholly owned by the shareholder or his or her family members; and institutional investors should be able to transfer shares to affiliates, and the like.

In the case of any permitted transfer, the shareholder agreement should provide that the transfer will be conditional upon the transferee agreeing to be bound by and become a party to the shareholder agreement.

So what kind of share transfer provisions might you find in a typical shareholder agreement? Here are a few of the most common provisions.

Right to Repurchase. Founders' or employees' shares are often issued under a vesting regime, for example, over three years in quarterly installments, to ensure the founders or the employees stay engaged with the business. Investors may want to see a reverse vesting regime, so that if the founder or the employee leaves the company, the company can buy back the unvested shares at a nominal price. Investors may also want to include a repurchase right on the death, disability or insolvency of the founder or employee, or on the founder's or employee's termination of employment.

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Pre-Emptive Rights. Investors typically will require that they be given the right to participate in any subsequent offering of shares, options, warrants, or other securities. However, on granting such rights there certain things you want to watch out for, such as extinguishing the right if an employee leaves the employment of the company, or excluding the issue of shares under a stock option plan from the pre-emptive rights.

Right of First Refusal (Hard or Soft). A hard right of first refusal requires the selling shareholder to first obtain a bona fide offer from a third-party before the right of first refusal kicks in; under a soft right, a shareholder may make an offer to the other shareholders and may only make an offer to a third-party, on the same terms, if the other shareholders do not take up the offer within a specified timeframe.

Co-Sale or Piggy-Back Rights. A piggyback right entitles a certain group of shareholders (typically, the minority shareholders) to participate in any sale made to a third party by another group of shareholders (typically, the majority shareholders).

Drag-Along Rights. Drag-along rights permit the holders of such rights (typically, the majority shareholders) to compel another group of shareholders (typically, the minority shareholders) to sell the shares to a third-party was made an offer to the majority shareholders.

Put Options or Call Options. These are mechanisms to allow a shareholder to require the company to buy his, her or its shares upon the happening of certain events, or to allow the company to buy the shares of the shareholder upon the happening of certain events, at a price or formula set out in the agreement. For example, the company may want the right to call an investor's shares upon the earnings of the company reaching a certain threshold, or an investor may want the right to put his, her or its shares to the company after specified period of time.

## Protecting Intellectual Property

Entrepreneurs often struggle with the question of when to protect their intellectual property and how much doing so is going to cost them. It is important not to blow your IP budget too early.

The development of an IP strategy should assist you. An IP strategy should include an assessment of whether you have knowledge assets that are protectable, whether you need to engage in processes to convert your knowledge assets into protectable IP, and the impacts you are hoping to achieve with your IP, whether on markets, partners or investors. Once you determine that you have protectable IP, you will want to develop your patent strategy, and focus your efforts on areas of strategic importance to your business.

It is also important to guard against casual disclosure of your IP. To the extent that you share any information about your IP, you will first want to obtain a non-disclosure agreement (with

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exceptions for VC investors). You also will want to protect your IP from claims by employees. This means obtaining invention assignment agreements from your employees before they begin work on, or with, your knowledge assets. Canadian courts recognize that IP created by an employee in the course of employment belongs to the employer, but no company wants a dispute as to whether an invention work was created in the course of employment. The same holds true for third party contractors.

A VC investor typically will not sign a non-disclosure agreement during the early stages of negotiation. However, it is not necessary that you disclose all your IP to a VC when making an investment pitch. What investors want to know at that stage is whether or not you have IP, and what your IP strategy is.

## Valuing a Pre-Revenue Company

Entrepreneurs considering offering equity to employees, raising equity capital from third party investors, or trying to sell their start-up will be faced with having to determine the value of their business. If you are faced with the tricky prospect of valuing a pre-revenue company, you will want to seek advice from someone with experience. That could involve sourcing comments from experienced angel or VC investors, or from another entrepreneur who has been through the process. You will quickly learn that valuing pre-revenue companies is more of an art than a science.

Two of the most common valuation approaches used by angel and VC investors for valuing pre-revenue companies are known as the “VC Shortcut Method” and the “Berkus Milestone Method”, but some investors prefer a simpler ”rule of thumb” approach.

Under the VC Shortcut Method, valuation is based on an investor achieving required returns. In an example given in a Canadian Innovation Centre article, if a company has a forecast value of $5 million in year five, then discounting this back (at 30%) would mean that the post-money valuation is $1.35 million. If the investor invested $350,000, then the pre-money value would be $1 million ($1.3 5 million – $350,000), and the investor would want 26% of the company ($0.35/$1.35).

Under the Berkus Milestone Method (developed by a so-called “super angel” Dave Berkus), there is an assumption that most companies fail to meet profit or revenue targets and therefore valuations based on future forecasts are inherently flawed. The methodology then looks at five factors that, if they exist, positively impact the valuation, and adds an amount per factor (to a maximum of $500,000 per factor), to reflect the degree of that impact. The five factors are (i) a sound idea (ii) a prototype (iii) a quality management team (iv) strategic relationships, and (v) product rollout/sales. Thus, under this method the valuation will not exceed $2.5 million. If it does, invariably an angel investor will decline to invest.

One “rule of thumb” approach used by angel investors in valuing companies is that the value

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of the company is 1.5 times the amount needed to get to the next significant value-increasing milestone. So, for example, if the company needs $1,000,000, the pre-money valuation is $1.5 million.

An entrepreneur looking to raise investment capital needs to become familiar with valuation techniques and practices. While it is important not to undervalue your business, it is equally important not to overvalue it.

There are numerous tools out there to assist entrepreneurs with valuation. The Kauffman Foundation has several sites with material that addresses this question at **www.entrepreneurship.org** and www.angelcapitaleducation.org. The Canadian Innovation Centre also has some useful information at www.innovationcentre.ca.

## Start-Up Legal Documents

What are the key legal documents you will require to start and grow your business? For this discussion we will assume you are going to carry on your business activity through a company, for the reasons discussed in other posts.

**Incorporating Documents.** To begin, you will need to incorporate, by preparing and filing Articles of Incorporation, either provincially or federally (the differences between the two have been discussed in an earlier post). To do this, you will need to decide upon and reserve your business name, or incorporate with a number name and decide on your business name later. You also will have to decide whether you want to trademark the name. You will need to decide upon the initial directors, the share structure, who the founding shareholders are going to be, and whether there are to be any special vesting provisions on founders' shares.

**Share Ownership Agreements**. These agreements can take many forms.

If the founders' shares are to have vesting restrictions, then you will want a Share Purchase Agreement (with Vesting), that essentially gives the company the option to repurchase the shares upon the founder ceasing to be employed by the company for any reason (including death), with the number of shares being subject to the option declining in increments over time. If there is more than one founder, this Agreement typically also would include a general restriction on transfer of shares, a right of first refusal to the company in the event of any proposed transfer of shares, a right to the company to repurchase shares upon an involuntary transfer (such as divorce), and other provisions.

If there are no vesting restrictions, but more than one shareholder, then rather than the Share Purchase Agreement (with Vesting) you will want a Right of First Refusal and Co-Sale Agreement. This Agreement would include many of the same provisions outlined above, without the repurchase option that comes with the vesting restriction. It also would include piggy-back rights and carry-along provisions, discussed in an earlier post on shareholder

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agreements.

If the shareholders want to restrict the ability of the directors of the company to manage the business and affairs of the company, then you will need a Unanimous Shareholder Agreement (“USA”). Why would you want that? Well, if the shareholders are not, or not all, going to be actively involved in the business, they may want to restrict the ability of the directors to make certain kinds of decisions; for example, deciding to raise debt or equity capital, or issue security. In such a case, the agreement would provide that those types of decisions can only be made by the shareholders. In order to be legally valid, however, such an agreement must be entered into between the corporation and all of its shareholders (no matter how large or small), and notice of the existence of a USA must be filed with the applicable government office. This is because the public is entitled to know that there may be some restriction on the ability of the directors to manage the business and affairs of the company.

**Employee Stock Option Plans and Stock Option Agreements**. Where a company wants to issue stock options to a large number of its employees, it will want to do so through an Employee Stock Option Plan. The Plan document will set out the general terms of the Plan, while the actual allotment of options to employees would be accomplished through individual Stock Option Agreements issued under the Plan. The company also may want to use a Plan approach where it does not want to enter into share ownership agreements with its employees. In this case, the Plan would contain provisions restricting transfer of the underlying stock and providing repurchase options to the company (among other things). Where the company only intends to issue options to a few of its key employees, then Stock Option Agreements will be sufficient. Again, however, the Agreement should compel holders to enter into a form of share ownership agreement restricting transfer and providing repurchase options to the company.

The vesting and exercise provisions of the Plan and Stock Option Agreements must be carefully drafted. For example, the company would not want an employee whose employment has been terminated to continue to have the right to exercise options.

**Securities law requirements** regarding the issue of securities by the company will have to be complied with in each jurisdiction where the company has employees who will be receiving options. The most important requirement to be immediately aware of, however, is that participation by an employee in a stock option plan must be voluntary – an employee cannot be induced to purchase securities by expectation of employment or continued employment.

**Employment Agreements**. Every company, large or small, should have written employment agreements with its employees. It will save the company money in the long run. The agreements need not be complex; they can even be in letter form. There are a number of matters that any employment agreement should address. Obviously, duties and scope of employment, and compensation and employee benefits, are two of the most important areas

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to be covered.

However, for many companies, and certainly for any technology company, it also is critically important that the employment agreement either contain provisions related to confidentiality, non-disclosure and invention assignment, or compels the employee to enter into such an agreement with the company. Presenting a confidentiality, non-disclosure and invention assignment agreement to the employee for signature after the commencement of employment, where it was not required by the initial terms of employment, may trigger a claim of constructive dismissal by the employee against the company.

**Consulting Agreements.** Again, it is important for the company to ensure its arrangements with consultants are set out in writing. Obviously, any consulting agreement should be clear about terms such as scope of services, territory, payment terms, treatment of expenses, term and termination, supervision, exclusivity, and the like.

Two of the more important provisions from a legal perspective, however, relate to the nature of the relationship between the consultant and the company, and confidentiality, non-disclosure and invention assignment.

If a consultant is determined after the fact to have been an employee rather than a consultant, then the company will be liable for withholding taxes, employment-related premiums (such as WCB), wage-related payments (such as overtime or vacation pay), notice on termination, and possible fines and penalties. On a dispute, the courts will look beyond the agreement itself, and will examine how the parties behaved in relation to each other to determine the true nature of their relationship. There are a number of factors the courts will consider when making this determination, and the company would be well advised to take these factors into consideration when structuring its consulting relationships.

The second point is that, generally speaking, intellectual property generated by a consultant will belong to the consultant unless the agreement otherwise provides. Thus, it goes without saying that any consulting agreement should have explicit provisions relating to confidentiality, non-disclosure and invention assignment. This can get complicated. What if the consultant has employees? You will want to know that the consultant has agreements with its employees ensuring that any IP they generate does not belong to them, and that there is a legal chain facilitating transfer of any IP back to the company.

**Confidential Information and Invention Assignment Agreements**. Hopefully, the sheer number of posts in this Tech Start-Ups series related to circumstances when explicit provisions related to confidentiality, non-disclosure and invention assignment are required will have driven home the point that the company needs to pay attention to its IP protection. Generally, these agreements are important for anyone who works on, or with, the company’s IP. The form of these agreements will vary depending on whether you are dealing with employees or consultants, and must be drafted carefully to ensure they cover employees and

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contractors of consultants.

**Mutual Non-Disclosure Agreements**. These agreements are critically important in circumstances where you have to your share proprietary information with another party in order to conclude a business arrangement. Without it, you could lose your IP protection. Unless specifically adapted, however, this type of agreement generally is not by itself adequate where the other party is going to be generating IP for you. In that circumstance you will want to ensure that any IP generated by that party (or their employees) must be assigned to you.

## Raising Capital

Most new companies eventually face the need for additional capital that cannot be funded, or "bootstrapped", by the founders. Raising and managing capital is the biggest challenge for any business, and is particularly so for the technology start-up. It is a time-consuming, frustrating and continuous process. Understanding the components of the fundraising process will help you prepare better, save time and hopefully produce better outcomes.

The capital the company is seeking can consist of debt, equity or a hybrid of the two (convertible debt). What's right, or available, for your company will depend on the company's stage of development and its stage of financing and the capital cost

The relative cost of the various types of capital is determined on a risk/return basis, as illustrated below. Equity capital is expensive, and dilutive, but often is the only type of available capital if the company is early-stage, has no hard assets, is facing rapid growth or is engaged in new product development.

The common sources of capital for tech start-ups are the founders, friends, family and close business associates of the founders ("inside persons"), government assistance programs, employees, angel investors, suppliers or other strategic investors, and venture capital and private equity investors. Occasionally, at some stages of development, traditional financial institutions will be a source of capital.

Pre-seed and seed debt and equity capital will depend on founders and inside persons, although financial assistance for this stage often can be sourced from government programs.

Beyond founders and inside persons, it would be unusual to find investors interested in debt financing in any of the early stages.

Angel investors may invest at the seed stage, but more typically want to be involved at the early stage, which often is pre-revenue. Series A and, if required, Series B round early stage financing often comes from angel investors. Venture capital investors may invest at the early stage, but typically only if the company has good management, with early adopter customers

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and its business plan demonstrates very fast, very high growth.

Some strategic investors may be willing to invest at the early stage if the investment is consistent with the investor's overall business strategy. Start-ups should take the time early on to identify potential strategic investors.

It has to be recognized that raising capital is difficult. Data from the U.S. demonstrates that less than 1 in 10 start-ups obtain angel funding, less than 1 in 10 angel deals see VC money, less than 1 in 100 start-ups are venture financed, and less than 1 in 10,000 new companies go public.

## Securities Law Considerations

Companies seeking to raise capital from investors will have to become knowledgeable about the securities law considerations. Canadian securities law requires that any securities issued by a company must be qualified by the filing of a prospectus, unless an exemption from the prospectus filing requirements is available. The company will want to avoid the prospectus filing requirements whenever possible, as the preparation of a prospectus is time-consuming, expensive and comes with a fair degree of legal risk.

Securities law also requires that persons "engaged in the business of trading in securities" must be registered. Generally speaking, a company that sells its own securities on an infrequent basis and does not hold itself out as being "engaged in the business of trading in securities" will not be considered to be in the business of trading and will not have to register as a dealer.

The most common types of exemptions from the prospectus filing requirements are (i) the private issuer exemption, (ii) the friends, family and business associates exemption, (iii) the accredited investor exemption, and (v) the minimum investor amount exemption.

The following is a summary of each of the above exemptions. Please note that this is a summary only. In many cases there are extended definitions and special rules that apply, which are not listed here. You should consult your legal advisor before you embark on an issue of securities.

**Private Issuer Exemption.** The private issuer exemption allows a company whose securities are subject to the so-called "private company restrictions", to raise capital by selling its securities to a fairly narrow group of individuals. A company is subject to the private company restrictions when its Articles restrict the number of shareholders to not more than 50 people (not including employees), its securities are subject to resale restrictions either in its Articles or by agreement, and its securities have been issued to a limited class of persons.

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The private issuer exemption permits the sale of securities without the need for a prospectus to such people as the directors, officers, employees, founders or control persons of the issuer (called “inside persons”), spouses, parents, grandparents, brothers, sisters or children of the inside persons, close personal friends of the inside persons, close business associates of inside persons, and various other permutations of these relationships; but all have the common element that they are so intimately connected to the principals of the company that they will be protected by virtue of the nature of the relationship itself.

The other class of permitted investors for a private issuer exemption is an “accredited investor”, which is a defined term in securities law (discussed below). Unlike the closely connected individuals, these persons have no connection at all to the principals of the company but they are presumed, by virtue of their worth, experience or resources, to be able to assess the merits of the investment on their own.

**Friends, Family & Business Associates Exemption**. The friends, family & business associates exemption permits trades to a slightly narrower group of inside persons than is the case with the private issuer exemption, and also is subject to the proviso that no commission or finder’s fee may be paid to any director, officer, founder or control person in connection with the distribution.

**Accredited Investor Exemption.** Under the accredited investor exemption, a company can distribute securities to persons who meet one of the criteria set out in the definition of “accredited investor”. The more frequently used accredited investor exemptions are those based upon the investor having a high net worth. The qualifying tests generally are:

(a) individuals who beneficially own (alone or with a spouse) financial assets (excluding the value of real property assets) with an aggregate realizable value (before taxes but net of related liabilities) in excess of $1 million dollars;

(b) individuals with a net income before taxes in the past two years in excess of $200,000 in each year (or combined with a spouse, $300,000) and who in either case reasonably expects to exceed that level in the current year;

(c) individuals who (alone or with a spouse) have net assets of at least $5 million;

(d) a non-individual other than an investment fund that has net assets in excess of $5 million as shown on such entity’s most recently prepared financial statements of net assets.

The financial thresholds are bright line tests (they must be strictly complied with) that have to be satisfied at the time of the trade. Financial assets consist of cash, securities or a contract of insurance or a deposit that is not a security.

**Minimum Amount Exemption**. The minimum amount exemption is limited to those persons who can invest more than $150,000, again operating on the premise that such a person is

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sophisticated enough to know what information to obtain from the company and has the leverage to access it.

This exemption is available where a person purchases the securities as principal and the security has an acquisition cost to the purchaser of not less than $150,000 paid in cash at the time of the trade. The trade must be in the security of a single issuer and the purchaser must not have been created or used solely to purchase securities in reliance on the exemption.

**General.** The issuing of securities in Manitoba is governed by The Securities Act (Manitoba). The regime for exempt distributions generally is set out in National Instrument 45-106 – Prospectus and Registration Exemptions, with some exceptions. The rules must be strictly followed, so it is recommended that you obtain legal advice before engaging in an exempt market distribution. The company (not the purchaser) is responsible for ensuring that the particular exemption the company is seeking to rely upon is available to it, so you must obtain evidence that your purchaser complies with the requirements of the particular exemption.

A Manitoba company selling its securities to a purchaser resident other than in Manitoba must comply with the securities law requirements in each jurisdiction in which the trade is deemed to occur. If that other jurisdiction is a Canadian province, then the issuer must comply with NI 45-106, as well as with the local rules in Manitoba and in that other jurisdiction.

## "The Art of the Start" and "The Lean Start-Up"

There are two books on start-ups that I really like, and I think you might find them interesting.

The first is Guy Kawasaki's "*The Art of the Start: The Time-Tested, Battle-Hardened Guide for Anyone Starting Anything*", published in September, 2004. This is a practical, informative book, intended to be the definitive guide for anyone starting anything. It builds upon Kawasaki's experience as an entrepreneur, and later as a venture capitalist who found, fixed, and funded startups. In Kawasaki's words "it cuts through the theoretical crap, theories and gets down to the real-world tactics of pitching, positioning, branding, recruiting, bootstrapping, and rainmaking."

The second is Eric Reis' "*The Lean Startup: How Today's Entrepreneurs Use Continuous Innovation to Create Radically Successful Businesses*", published in September 2011. Reis first coined the term "lean startup" in a blog post in September, 2008. His inspiration was the Japanese lean manufacturing process, which he applied to the entrepreneurial process. Says Reis, "Startup success can be engineered by following the process, which means it can be learned, which means it can be taught."

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The basic lean startup idea is to move quickly, and reduce waste. How that plays out in entrepreneurship is to launch as quickly as possible with a “minimum viable product” (MVP), a bare-bones product with just enough features to allow feedback from early adopters. The company can then refine its product with incrementally improved versions based on early adopter feedback. This mitigates against wasting time on features nobody wants. Lean startups don’t invest in scaling up the company until they have achieved a product/market fit (PMF), when they finally have a solution that matches the problem. In the course of achieving a PMF, the company may find, based on customer feedback, that it has to make a significant change in approach; in effect a quick fail or “pivot”. The change could be in the product, or in the underlying business model. In framing the process in this way, the inherent tension between the founder’s vision and the market reaction is illuminated, and thus can be more readily managed.

*This article was written by Jan Lederman, former Partner of TDS.*

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