



New Ventures BC

Introduction to Corporate, Securities and Tax Issues for Start-Ups

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▼ About Fasken Martineau DuMoulin LLP

- A Canadian leader in the practice of business law and litigation representing clients nationally and internationally
- We offer customized legal advice in over 30 practice areas, our greatest value to any client is achieved through our commitment to understand their business, culture, and people.

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Partners on your startup journey

Working with you from ideation to exit

With thousands of startups helped, our team has a depth of experience working with entrepreneurs and deeply understands the challenges that startup clients face. We are here to work with you throughout your company's lifecycle and guide you along the path to success.

GET GAME-CHANGING VALUE

We care. We are your partners. And we want to work with you.

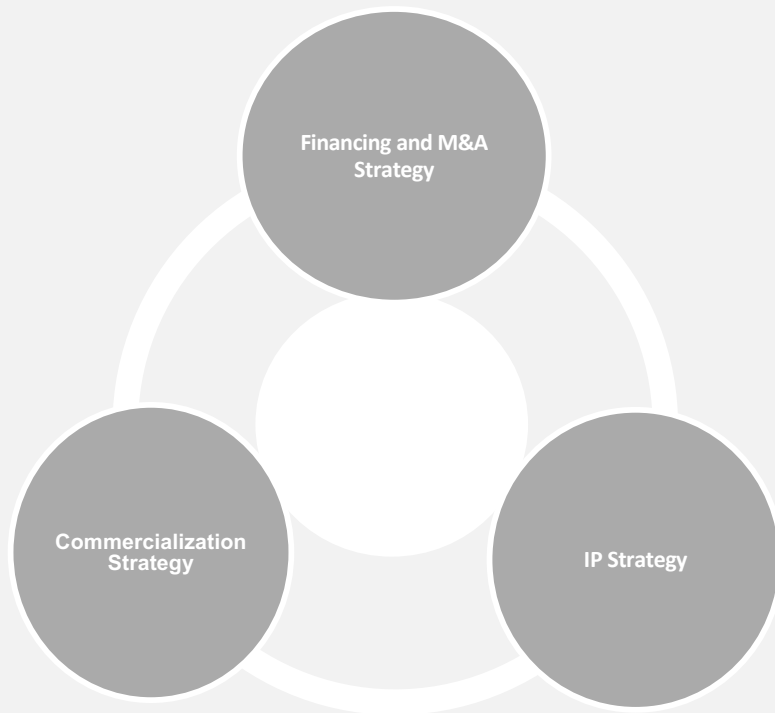
With over 80 dedicated legal relationships and in-house EIRs, working with our team offers you a serious competitive advantage.

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▼ The Fasken Emerging Tech Roadmap

From inception to the moon

Fasken offers a structured process around three areas of expertise:



Establish **an action plan with priorities and timelines aligned with your business needs** and your level of development. This strategic approach includes implementation steps and monitoring of the action plan.

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Our Experience

Over the past year, our Emerging Tech team has advised in excess of **180 venture capital funded equity financings and tech M&A** with aggregated deal value in excess of **\$13.5 Billion**. We are a clear leader in Canada when measured by various independent league tables.



Ranks Fasken as
#1 in Canada,
leading all VC law
firms in the number of
financings in 2021



Ranks Fasken as
#1 in Canada,
and #11 in the world for
VC rounds as advisors to
companies in Q1 2022



Ranks Fasken as
#5 in the world
for VC deals (most active in
the rest of the world* for
companies) in Q1 2022

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▼ Overview

There are two areas we will focus on:

- Corporate Structure
- Legal Agreements

▼ Corporate Structure

- How to set up your company
- Equity ownership
- Attracting and retaining team members
- Attracting and closing financing

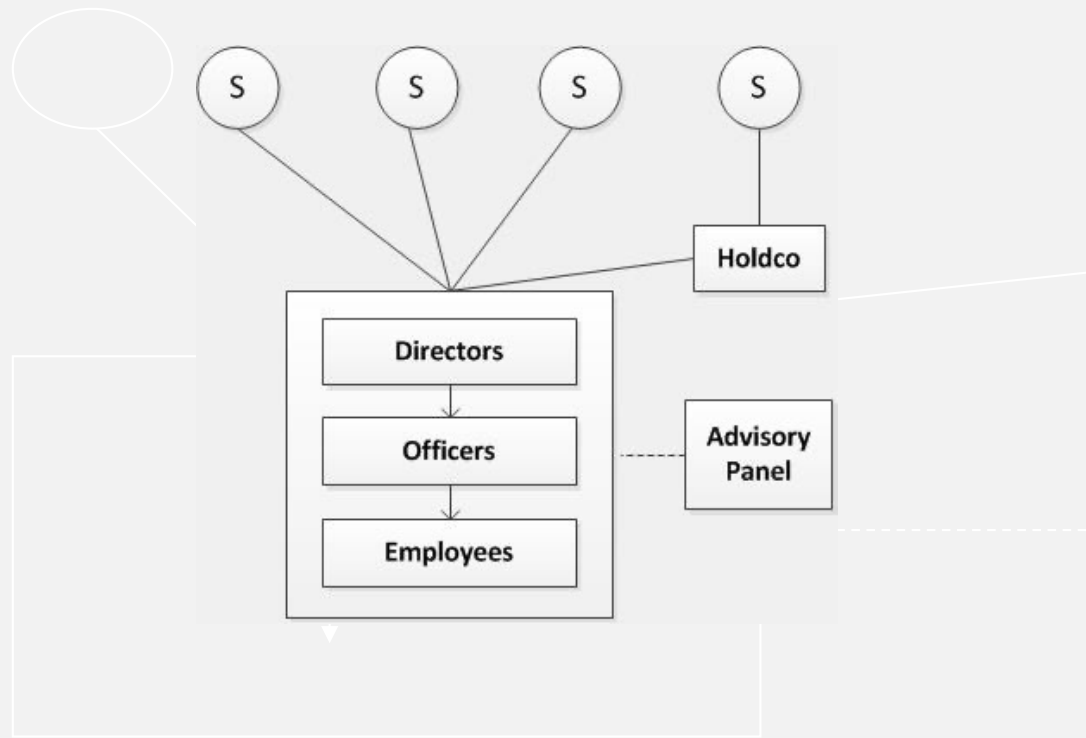
▼ Legal Agreements

- Documenting the foundation and development of your venture.
- Internally: Shareholders' Agreement, IP Assignment Agreements, Consulting Agreements, Employment Agreements, Reverse Vesting Agreements, Stock Option Plan, etc.
- Externally: Term Sheet, Non-Disclosure Agreements, License Agreements, etc.

Options for Association

- Proprietorships
- Partnerships
- Limited Partnerships
- Joint Ventures
- Companies
 - Provincial
 - Federal
 - International

▼ The Structure



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▼ Shareholders

- Anybody can be a shareholder
 - individuals
 - companies
 - partnerships
- As many as you want
 - rules change at 50 “people”
 - rules on how you find your shareholders (ie: see a lawyer!)

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▼ Shareholders (cont'd)

- No liability aside from the initial investment in the shares of the company
 - (unless a contract says otherwise - ie: shareholders' agreement, guarantee)
- Variety of share classes, rights, restrictions
 - common, preferred
 - voting, non-voting
 - dividends
 - participating/non-participating
 - pre-emptive rights
 - anti-dilution, down round protection

▼ Shareholders (cont'd)

- Exclusive right to elect directors
- Relationship governed by Articles, Shareholders' Agreements, Subscription Agreement

▼ The Policy Setters

Directors

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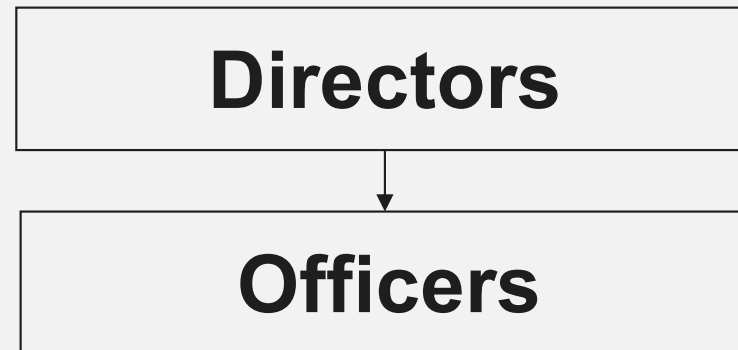
▼ Directors

- Elected by the shareholders
 - (but the directors can fill “vacancies” and increase number in certain circumstances)
- At least one; no limit
- Residency requirement
- Qualifications

▼ Directors (cont'd)

- Power to manage the affairs of the Company
 - (subject to articles, shareholders' agreements, etc.)
 - determine policy
- Duties to the Company and the “shareholders as a whole” to act fairly and diligently
- Potential personal liability
 - breaching duties
 - taxes, wages
- Appoint the Officers

▼ The Instructors

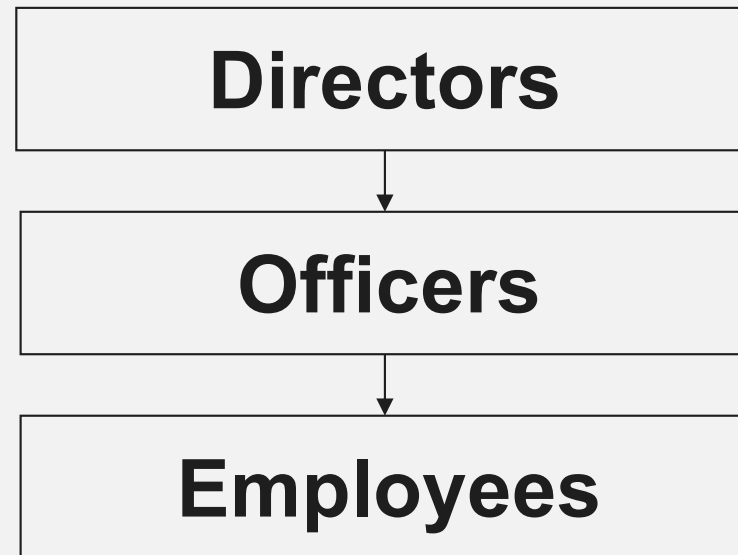


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▼ Officers

- Appointed by the Directors
- As many as you want, any titles at all:
 - President, Chairman, CEO, COO, CTO, VP, Secretary, etc.
- In charge of day-to-day affairs of the Company

▼ The Doers



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▼ Employees

- Master-Servant Relationship
- Entitlements
- Indefinite vs. Fixed-term
- Statutory Obligations

▼ Employment Agreement

- Confidentiality
- Assignment of intellectual property
- Non-competition
- Non-solicitation

▼ Consultants

- Not employees – not entitled to benefits or other statutory entitlements
- Generally allowed to contract with other companies at same time
- Use of own equipment
- Onus on consultant to withhold, collect and pay tax

▼ Consulting Agreement

- Confidentiality
- Assignment of intellectual property
- Non-competition
- Non-solicitation

▼ Tax implications

- Tax treatment depends on substance of relationship
 - Consultants run their own business
 - Employee tax rules more restrictive, but they get benefits
- CRA will look at actual details of worker-payer arrangement
 - Agreement is important in framing this analysis

▼ Compensation and Incentives

Three main possibilities:

1. Cash
2. Shares
3. Stock Options

▼ Compensation and Incentives – Stock Options

- Can be issued to founders or employees
 - Align incentives of recipients with venture
 - Advantageous tax treatment
- Typically anything received from employer for services is employment (fully taxable on receipt)
 - Stock options are the key exception to this rule

▼ Compensation and Incentives – Stock Options for CCPCs (most start-ups)

- Grant – no tax
- Vesting – no tax
- Exercise – no tax
- Sale of share – tax at capital gains rate, if certain conditions are met

▼ Compensation and Incentives – Stock Options for Non-CCPCs

- Different tax treatment than for CCPCs:
 - Tax triggered on exercise of option
 - Capital gains rate only if FMV exercise price
 - Employer withholding on exercise

▼ Compensation and Incentives – Stock Options for Consultants

- Different tax treatment than for employees
 - Grant – FMV of share minus exercise price fully taxable as business income
 - Exercise – Increase in value from grant either fully taxable business income or half taxable capital gain

▼ “Cross-Border” Employees

- Can create tax issues for employer (and employee)
- Employee working outside Canada
 - File foreign tax return?
 - Pay foreign tax (PE risk)?
 - Withhold foreign tax?
- Employee working outside BC
 - PE risk
 - Withholding mismatch (province of employment vs residence)

▼ The Advisors

Advisory Panel

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▼ Advisory Panel

- Non-Director Experts
 - focused on the field in question
- Advise the Board
- Option-based Compensation

▼ Other Issues

- Conflicts of Interest
 - within the structure - ie: your role as Shareholder v. Director
 - within other companies - ie: director of this Company and director of contracting company
 - between the Company and the educational institution - ie: technology transfer/pricing/time
 - between investor and inventor

▼ Initial Corporate Structuring

Incorporation – U.S. v. Canada v. Offshore; Canada because:

- Financing Issues - Investors don't like offshore companies.
- Government grants – In most cases, only available to Canadian companies.
- Taxation and Employment issues - Are simpler if you are building the company here.

B.C. (BCBCA) v. Federal (CBCA):

- Either BC Business Corporations Act (BCBCA) or Canada Business Corporations Act (CBCA) are fine and both are investor friendly.

▼ Initial Corporate Structuring – cont'd

Create a structure with:

- Unlimited number of common shares.
- Unlimited number of “blank-cheque” preferred shares.

Financiers dictate financing terms:

- Debt vs. equity, price, preferences, terms of SHAG, etc.

If you can, avoid:

- Issuing secured debt.
- Using multiple share classes.
- Incorporating offshore.

▼ Initial Corporate Structuring – Tax Considerations

- Tax considerations depend on form of financing
- Equity
 - Sell existing founder shares?
 - Issue new treasury shares?
 - New class of shares (paid-up capital considerations)?
- Debt
 - “Thin cap” restriction (60:40 debt:equity) for NR lender

▼ Initial Corporate Structuring – Tax Considerations – “CCPC” status

- CCPC = Canadian-controlled private corporation
- Many tax advantages, particularly for start-ups:
 - Small business tax rate (11% instead of 27% up to \$500K)
 - Lifetime capital gains exemption (~\$900K on sale)
 - Enhanced SR&ED benefits (35% tax credit instead of 20%, refundable up to \$3M of expenditures)
 - Stock options (deferral, 1/2 deduction)

▼ Initial Corporate Structuring – Tax Considerations – “CCPC” status (cont’d)

- Corporation incorporated and resident in Canada
- Public corporations and non-residents cannot (in aggregate) own more than 50% of shares
- Public corporation or non-resident cannot have “de facto” control over corporation

▼ Founders' Shares

What are Founders' Shares?:

- Large block of shares issued at a low price to position the Founders.
- To recognize their “sweat equity” contribution.

What class of shares should they be?:

- Common shares.

At what price should they be issued?:

- Nominal - \$0.0001 to \$0.01 per share.

▼ Founders' Shares – cont'd

To whom should they be issued?

- Founders and senior officers.
- Not to employees or outside investors.

Common mistakes in allocating Founders' shares:

- Not setting aside enough Founders' shares at time of incorporation: 4.0M – 8.0M.
- Not considering future additions to the management team: 15% - 25%?
- Not vesting the Founders' shares: 2 - 4 years
- Issuing them to the wrong people.

Sources of Funding

- Non-dilutive
 - Grants; R&D credits
 - Government R&D funding programs; Government backed debt
 - Secured (bank / sophisticated angel) and unsecured debt
- Dilutive
 - Equity (common shares or preferred shares) – fixed pre-money valuation
 - Convertible instruments (convertible Note / SAFE) – generally simpler and can defer the valuation discussion



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▼ Sources of Capital

Founders / Friends and Family

- Early infusion of capital
- “Love” money
- Key to understand expectations, and advise of risks
- Often little to no diligence (based on trust)
- Founder investment shows commitment

Angel Investors

- Successful entrepreneurs and high net worth individuals who invest in start-ups
- High-risk, but high-reward
- Limited due diligence (but can vary)
- Angels often focus on relationship with and history of founders and industry focus
- Valuation is speculative

▼ Sources of Capital

Seed / Venture Capital Investors

- Professional investment funds
- Typically Preferred shares
- Investors will require certain rights
 - protect the downside, keep an option on the upside, influence on decision making and company direction, checks and balances
- Due diligence process can be extensive, docs are lengthy

Strategic Investor

- Company that makes investment as part of its business strategy
- Investor often becomes a customer, with certain special rights (such as for pricing, access to the tech)
- Often a path to acquisition
- Strategics often do not lead rounds and require a professional fund to do the diligence and price the deal

Equity Financing

- Pre-Seed (founders; friends and family; angels)
 - Convertible securities (Note / SAFE)
 - Common shares
- Seed (friends and family; angels; early-stage VC)
 - Convertible instruments (Note / SAFE)
 - Common shares or “Series Seed” (light) preferred shares
- Series A, B, C, etc. (VC / PE funds; strategic)
 - Preferred shares



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▼ Equity Financing

Non-Priced Rounds

SAFE

- "Simple Agreement for Future Equity"
- Defers valuation - SAFE converts to shares in connection with "qualified financing" or acquisition
- Key terms: valuation cap, discount, MFN
- Not equity: holder not a shareholder until SAFE converts
- Not a debt instrument, but has debt-like features in the event of dissolution and ranks equally with Preferred shares
- No interest rate or maturity date

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▼ Equity Financing

Non-Priced Rounds

Convertible Note

- Convertible into shares
- Defers valuation - converts in connection with 'qualified financing' or acquisition
- Key terms: valuation cap, discount, interest, maturity, security / subordination
- Conversion 'immediately prior to' the triggering event
- Can be secured or unsecured

▼ BC Venture Capital Programs

- 30% refundable tax credit for BC resident investors
- Very popular, often drives the deal
- Company needs to register as an 'eligible business corporation' and request an allocation of tax credits
- They run out every year

▼ Securities Legislation

Requirement:

- If you distribute a security, you must:
 - File a prospectus
- OR
- Rely on exemption from prospectus requirement

▼ Exemptions

- Family, Friends and Business Associates
- Accredited Investor
- Private Issuer
- Employee, Director, Officer & Consultant Exemption
- \$150,000
- Start-Up Crowdfunding
- Offering Memorandum

▼ Family, Friends & Business Associates Exemption

Can sell securities in any amount without any disclosure to:

- Director, senior officer or control person
- Family member of a director, senior officer or control person

▼ Family, Friends & Business Associates Exemption (cont'd)

- Close personal friend or close business associate of a director, senior officer or control person
- No limit on number of purchasers or amount that can be raised

▼ “close personal friend” or
“close business associate”

- Has known the director, senior officer or control person for a “sufficient period of time”
- Is in a position to assess the capabilities and trustworthiness of the director, senior officer or control person

▼ Accredited Investor Exemption

- “accredited investors” can purchase any securities in any amount at any time
- No limit on number of purchasers or amount that can be raised

▼ “Accredited Investor”

- Financial institutions
- Registered advisers or dealers
- Pension funds
- Mutual funds selling only under a prospectus or to accredited investors or persons buying at least \$150,000 of securities
- Corporations, limited partnerships, trusts or estates having net assets of at least \$5 million

▼ “Accredited Investor” Cont’d

- Individuals who have at least \$1 million in financial assets before taxes. (In calculating an individual's financial assets, any outstanding loans incurred to acquire those assets must be deducted.)
- Individuals whose net income before taxes exceeds \$200,000 (or \$300,000 combined income with spouse) in each of the two most recent years and who reasonably expects to exceed that net income in the current year
- Individuals who have at least \$5 million in net assets

▼ Private Issuer Exemption

Can sell securities in any amount without any disclosure to:

- Directors, officers, employees or control persons of the issuer
- family members (spouse, parent, grandparent, sister, brother or child) of the directors, senior officers or control persons
- Close personal friends or close business associates of the directors, senior officers or control persons
- Current security holders
- Family members of the selling security holder
- Accredited investors

▼ What is a Private Issuer?

- Is not a reporting issuer, mutual fund or pooled fund
- Has less than 50 security holders, excluding employees and former employees
- Has restrictions on the transfer of its securities in its articles, memorandum, bylaws or its shareholders agreement
- Has sold its securities only to the persons in the list in the last slide

▼ Loss of “Private Issuer” Status

- If you lose your Private Issuer status, you do not automatically “go public”
- You can still rely on the previously-mentioned exemptions
- Certain regulatory filings are now required

▼ Employee, Director, Officer & Consultant Exemption

- The sale cannot be based on a promise of continued employment, appointment or engagement.
- Narrow definition of consultant.

▼ Legal Agreements – Raising Money

- Non-Disclosure Agreement
- Term Sheet
- Subscription Agreement/
Convertible Debt/SAFE

▼ Non-Disclosure Agreement

- Mutual or One-Way
- All information designated confidential, or only what is marked confidential
- Length of time information must be kept confidential

▼ Term Sheet

- Type of security being offered (shares, units, convertible debt, SAFE, other)
- Valuation (pre-money and post-money, non-diluted vs. partially diluted vs. fully diluted)
- Use of proceeds
- Investors' rights
- Other

▼ Subscription Agreement

- Agreement setting out the terms and conditions upon which an investor buys securities
- Representations and warranties about the company and the shares being purchased – may require that the company make certain disclosures about its affairs and existing liabilities in a disclosure schedule
- Indemnification

▼ Stock Options

Recall: What are stock options?:

- The right to purchase a number of shares at a predetermined price.
- Used to incent the team building the Company.

How many should be issued?:

- 10% - 30% of issued share capital.

At what price should they be issued?:

- Last round of financing or higher.

▼ Stock Options – cont'd

Companies must plan for growth and make a notional allocation of their options.

Allocate stock options by category:

- Senior Management: 35% - 50%
- Remaining Employees: 25% - 35%
- Board of Directors: 13% - 20%
- Board of Advisors: 2% - 5%
- Contingency: 10% - 15%

Companies should:

- Integrate Stock Option Plan with their HR Plan.
- Vest all options over 2 – 4 years and consider a cliff.

Capitalization Table Founders Organize Company

	No. of Shares	Price	Funds Raised
Founders (3)	6,000,000	\$0.0001	\$600
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Total:	6,000,000		\$600

FOUNDERS' OWNERSHIP INTEREST:

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Capitalization Table

\$400,000 Friends & Family Round

	No. of Shares	Price	Funds Raised
Founders	6,000,000	\$0.0001	\$600
Family and Friends	400,000	\$0.25	\$100,000
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Total:	6,400,000		\$100,600

PRE-MONEY VALUE:

\$ 1,500,000

FOUNDERS' OWNERSHIP

\$ 1,500,000 (93.75%)

POST-MONEY VALUE:

\$ 1,600,000

INTEREST:

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Capitalization Table Stock Option Plan Added

	No. of Shares	Price	Funds Raised
Founders	6,000,000	\$0.0001	\$600
Family and Friends	400,000	\$0.25	\$100,000
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Total:	6,400,000		\$100,600
Option Plan	1,500,000	n/a	n/a

PRE-MONEY VALUE: \$ 1,600,000
 POST-MONEY VALUE: \$ 1,600,000

FOUNDERS' OWNERSHIP INTEREST (NON-DILUTED BASIS): \$ 1,500,000 (93.75%)

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Capitalization Table \$420,000 Angel Round

	No. of Shares	Price	Funds Raised
Founders	6,000,000	\$0.0001	\$600
Family and Friends	400,000	\$0.25	\$100,000
Angels	1,200,000	\$0.35	\$420,000
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Total:	7,600,000		\$520,600
Option Plan	1,500,000	n/a	n/a

PRE-MONEY VALUE: \$ 2,240,000
 POST-MONEY VALUE: \$ 2,660,000

FOUNDERS' OWNERSHIP INTEREST (NON-DILUTED BASIS): \$2,100,000 (79%)

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Capitalization Table \$1,500,000 Series A Round

	No. of Shares	Price	Funds Raised
Founders	6,000,000	\$0.0001	\$600
Family and Friends	400,000	\$0.25	\$100,000
Angels	1,200,000	\$0.35	\$420,000
Series A Round VC	3,000,000	\$0.50	\$1,500,000
Type of Investor (?)	?	?	?
Subtotal:	10,600,000		\$2,020,600
Option Plan	1,500,000	n/a	n/a
New Options	500,000	n/a	n/a
Total (Fully Diluted Basis):	12,600,000	n/a	n/a

PRE-MONEY VALUE:	\$ 4,800,000	FOUNDERS' OWNERSHIP INTEREST	\$ 3,000,000 (47.6%)
POST-MONEY VALUE:	\$ 6,300,000	(FULLY DILUTED BASIS):	

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Capitalization Table \$5,000,000 Series B Round

	No. of Shares	Price	Funds Raised
Founders	6,000,000	\$0.0001	\$600
Family and Friends	400,000	\$0.25	\$100,000
Angels	1,200,000	\$0.35	\$420,000
Series A Round VC	3,000,000	\$0.50	\$1,500,000
Series B Round VC	5,000,000	\$1.00	\$5,000,000
Subtotal:	15,600,000	n/a	\$7,020,600
Option Plan	2,000,000	n/a	n/a
Total (Fully Diluted Basis):	17,600,000	n/a	n/a

PRE-MONEY VALUE: \$ 12,600,000
 POST-MONEY VALUE: \$ 17,600,000

FOUNDERS' OWNERSHIP INTEREST \$ 6,000,000 (34.1%)
 (FULLY DILUTED BASIS):

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