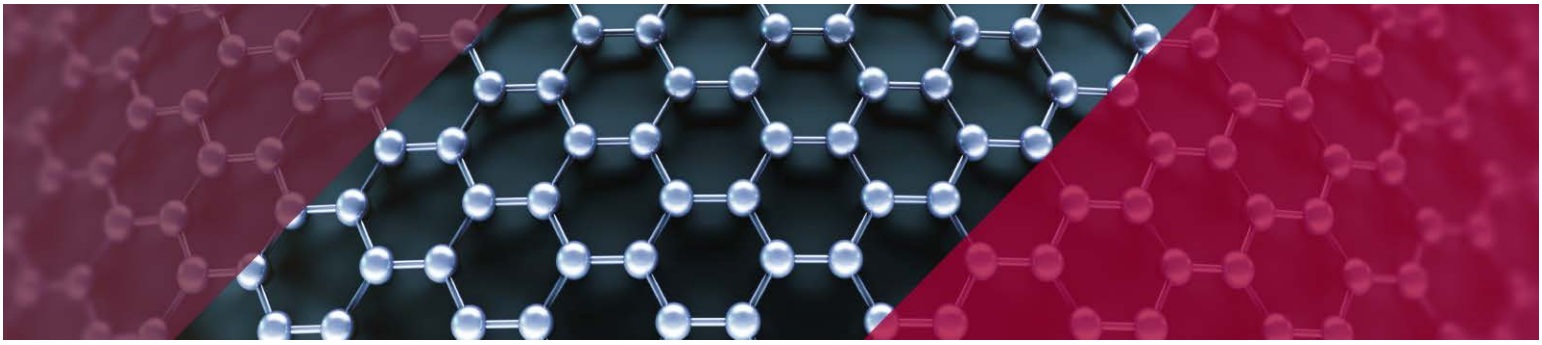

Canadian Technology Start-ups FAQ

Be it clean tech, life sciences or information technology, entrepreneurs are a driving force in Canada's economy. The technology industry is the third largest contributor to provincial GDP, with thousands of technology companies, employing over 84,000 people, generating revenues of C$23B.[1] The following are some of the most common legal questions we are asked by founders who are aiming to set their technology startups on the path to success.

Protecting Intellectual Property

Q | How do you protect trade secrets and confidential information?

A | All confidential information and IP should be protected by carefully drafted agreements between the company and all of its contractors and employees. While there is a presumption that the company owns IP that is developed by employees, the company should take further measures to protect its IP and confidential information in the employment agreements signed by each employee at the time of hiring.

With respect to independent contractors or consultants, there is a presumption that IP developed by a contractor or consultant in the course of its engagement will be owned by the contractor or consultant unless an agreement provides otherwise.

The company should also address confidential information and ownership and use of IP in agreements that are signed by all of its customers, investors, partners and prospects. If the company is providing any products or samples to the other party, these agreements should also include a prohibition against reverse-engineering.

Startup Program Offering

Stikeman Elliott's Vancouver practice offers a Startup Program that brings top-tier legal services to the startup community.

See page 4 for details

About Stikeman Elliott

Stikeman Elliott's mission has always been to deliver only the highest quality counsel as well as the most efficient and innovative services in order to steadily advance client goals.

As the firm has grown in prominence worldwide, we have remained true to our core values of: partnering with clients to ensure mutual success; finding original solutions grounded in business realities; providing clear, proactive counsel; recognizing that individual passion drives collective results.

Follow us

[1] BCTIA, Growing BC's technology industry: A 4-Point Plan for Growth, December 2014.

Q | What are the key issues that should be addressed in an IP licensing agreement?

A | The company should ensure the following issues are addressed in any licensing agreement:

- clear definitions of each party's background IP
- ownership of, and rights of use to, any improvement or other IP developed by either party, or both jointly, both during and after the term
- the application or field of use for the IP under license and whether the license includes development rights
- whether the license is exclusive, non-exclusive or a "sole" license (i.e. exclusive except for the licensor's own use)
- the term and geographic scope of the license
- whether the license may be sub-licensed or assigned by the sub-licensee
- the termination rights of each party
- indemnities and limitations of liability
- clear definitions of the royalties or license fees payable and audit rights to the licensor; and
- responsibility for preserving and maintaining the IP, including prosecution, maintenance and enforcement

Using Options as Incentives

Q | What are options?

A | An option is an instrument that gives a director, officer, employee or consultant the option to buy shares of the company at a set price for a specified length of time.

Q | What benefits are there in having an option plan and granting options?

A | Option plans set out the terms of the options that will be issued by a company, including expiry terms, minimum exercise prices and the total number of options that may be issued. Options are an inexpensive way for the company to incentivize people when it does not have cash to compensate them.

Q | What are the alternatives to granting stock options?

A | The company can issue restricted share units that provide employees with the right to a specified number of shares at no cost subject to achieving certain performance milestones or continuing to be employed by the company for a specified period of time. The company can also grant phantom stock options which are essentially a cash bonus based on the increase in value of a specific number of shares over a specified period.

Paying Attention to Record-Keeping

Q | What are the requirements for record-keeping?

A | The company must keep a minute book at its records office with up-to-date documents, including a register of shareholders, a register of directors and officers, minutes of meetings of directors and shareholders as well as consents to act, resignations and disclosures of interest of directors.

Q | Should we keep our own records to save on legal fees?

A | Many companies believe they will save money by keeping their own corporate records. In reality, record-keeping often falls to the bottom of management's priority list. While a company may get away with keeping inadequate records for a time, at some point, be it in preparing to take on a strategic investor, borrowing from a bank, going public, or staging an exit, a third party will carefully review the corporate records and insist that matters such as share ownership and changes in directors and officers be properly documented.

Repairing these deficiencies often costs companies much more than they saved by keeping the records themselves, particularly where shareholders and directors whose cooperation is required have moved on or become uncooperative.

Protecting the Board from Liability

Q | What is the role of a board?

A | The role of a board is not to micromanage, but to manage or supervise the management of the company's business and affairs. The general functions of a board includes approving all major decisions, such as the hiring and firing of senior officers, issuing shares, borrowing money and saying "no" to management when they propose something that is not in the best interests of the company.

Q | How can board members be protected from liability?

A | A director who fails to meet his or her duties to act honestly and in good faith with a view to the best interests of the company or to exercise the care, diligence and skill of a reasonably prudent person can be held liable. There are three main ways directors can be protected:

1. Each director should take an active, informed role in the board's deliberations, which should be recorded in minutes.
2. The company can purchase directors' and officers' liability insurance.
3. The company can indemnify its directors in its articles or in separate agreements.

Preparing for a Financing

Q | Will the company have to comply with securities laws when conducting a financing?

A | Yes. Under Canadian securities laws, a company issuing shares must file a prospectus with the applicable securities regulators unless a prospectus exemption is available. Generally, so long as the company is owned by no more than 50 shareholders, excluding current and former employees, a prospectus exemption is available which allows it to issue shares to certain persons, including employees, directors, officers, friends and family members of a director or officer of the company or "accredited investors" without triggering onerous disclosure and reporting requirements associated with filing a prospectus. Once the company has more than 50 shareholders, among other things, whenever it issues shares, the company will need to either file a prospectus or use another prospectus exemption and, in most circumstances, report issuances to the BC Securities Commission. When issuing shares to persons outside of British Columbia, a BC company will need to comply with the securities laws of that jurisdiction as well as those of British Columbia.

Q | What can the company do to ensure the financing transaction goes smoothly?

A | Due diligence is an integral part of any financing transaction and is often the cause of the greatest delay and cost escalation. Due diligence typically encompasses conducting searches of the public record for liens and security affecting the company's assets, reviewing title to all assets (including IP), authorized and issued share capital, accuracy of the company's books, records and financial statements, contractual arrangements with employees, contractors, customers, suppliers and others, compliance with all laws, and determining if any third party approvals or consents are required. Accordingly, the company should ensure these matters are properly attended to and documented on an ongoing basis.

In addition, founding shareholders should be realistic and balanced in their approach to negotiating the terms of any financing transaction to avoid protracted negotiations. The company should retain legal counsel who can provide guidance as to what are considered typical terms of financing transactions.

Q | Can the company pay finder's fees to people who find investors?

A | It is common for those who find investors to require the company to pay a finders' fee, which could be paid in cash, shares, warrants or a combination. Similar to options, warrants give the holder the right to purchase shares at a set price for a specified length of time.

Adopting a Shareholders' Agreement

Q | When should a company adopt a shareholders' agreement?

A | We advise our clients to adopt shareholders' agreements at the moment more than one person owns shares in a company. Founding shareholders should draft the agreement in a reasonable manner and in contemplation of the likely interests and demands of future investors and corporate needs.

Q | What are the pros and cons?

A | While shareholders' agreements bring an element of predictability and stability to the shareholders' relationship as joint owners, these agreements will limit the ability of the founders to do what they want when they want with their company.

Q | What issues should be addressed in a shareholders' agreement?

A | A shareholders' agreement can address or anticipate a wide range of issues, but the following four issues should always be covered:

1. Electing Directors

Every shareholders' agreement should answer the question of who gets to decide who controls the company? Strategic investors usually insist on having the ability to nominate directors based on their proportionate shareholdings, while founding shareholders try to retain the right to nominate a majority of the directors. The typical compromise is to appoint "independent" directors who can provide balanced and objective advice and direction, particularly where the board may become polarized due to the underlying interests of the shareholders.

2. Transferring and Selling Shares

Every shareholder should care who owns the other shares of the company. Therefore, every shareholders' agreement should set out clear limits on the ability of shareholders to transfer their shares, and any permitted transfer should be conditional upon the buyer becoming a party to the shareholders' agreement.

Some of the more common mechanisms used to regulate the transfer of shares include:

- Right of First Refusal: A right of first refusal ("ROFR") that gives the shareholders the first right to purchase any shares that a shareholder wants to sell;
- Drag-along Rights: Drag-along rights allow shareholders holding a minimum specified percentage of shares (usually 50%) to force all of the other shareholders to sell their shares to a third party who has made an offer to buy their shares on the same terms; and
- Tag-along or "Piggyback" Rights: Tag-along rights provide that if one or more shareholders holding a specified percentage of shares (usually 50%) sells their shares, the other shareholders have the right to sell their shares on a proportionate basis on the same terms.

3. Special Approvals

Founding shareholders and strategic investors often insist that a shareholders' agreement give them "veto rights" over certain key decisions of the company, such as hiring and firing the CEO, licensing IP, selling material assets, spending or borrowing over certain amounts, issuing shares, amending the shareholders' agreement or deciding to proceed with an exit.

Instead of granting blanket veto rights, it is better to set "special approval" thresholds that require, for example, a 662/3% or 75% vote of the avoid being pressured into setting these thresholds too high, as that could result in a single shareholder having an effective veto over critical corporate initiatives.

4. Family property

British Columbia, shares held by an individual may become "family property" if that shareholder separates from his or her spouse or common law spouse. A shareholders' agreement can protect the other shareholders in cases where the estranged spouse claims an interest in the shares by:

- providing that the ROFR applies to any shares that become subject to transfer to an estranged spouse;

- requiring that each shareholder must divide their assets with their estranged spouse by first offering the spouse the shareholder's other assets in any settlement; and
- requiring that any shares to be transferred to an estranged spouse be exchanged for non-voting shares.

For more information, please contact your Stikeman Elliott lawyer or the author:

Noordin Nanji
nnanji@stikeman.com

Startup Program Offering

Stikeman Elliott's practice in Vancouver is focused on serving the needs of local entrepreneurs and technology companies. Our Startup Program was established in 2012 with the aim of bringing top-tier legal services to the local startup community. Clients who participate in the program enjoy the following benefits:

- Legal Basics for Startups: One-on-One Meeting
- Access to Suite of Standard Legal Documents
- Electronic Corporate Records
- Legal Fee Deferral

For more information about our program, please contact one of the authors above or any other member of our Vancouver Technology Group:

John Anderson
janderson@stikeman.com

Jared Bachynski
jbachynski@stikeman.com

Annette Dueck
adueck@stikeman.com

Victor Gerchikov
vgerchikov@stikeman.com

Jennifer Honeyman
jhoneyman@stikeman.com

John Stark
jstark@stikeman.com

Michael Urbani
murbani@stikeman.com