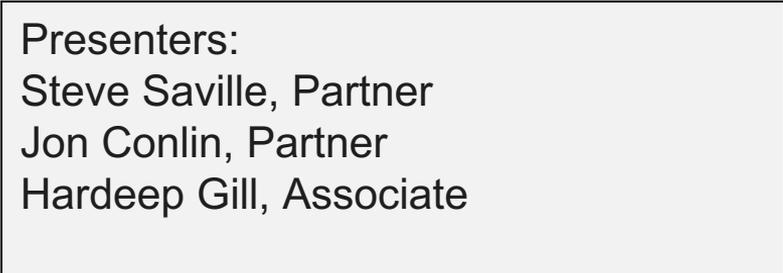


Innovate BC New Ventures Corporate and Legal Agreements May 1, 2019



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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.

▼ Overview

There are two areas we will focus on:

- Corporate Structure
- Legal Agreements

▼ Corporate Structure

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

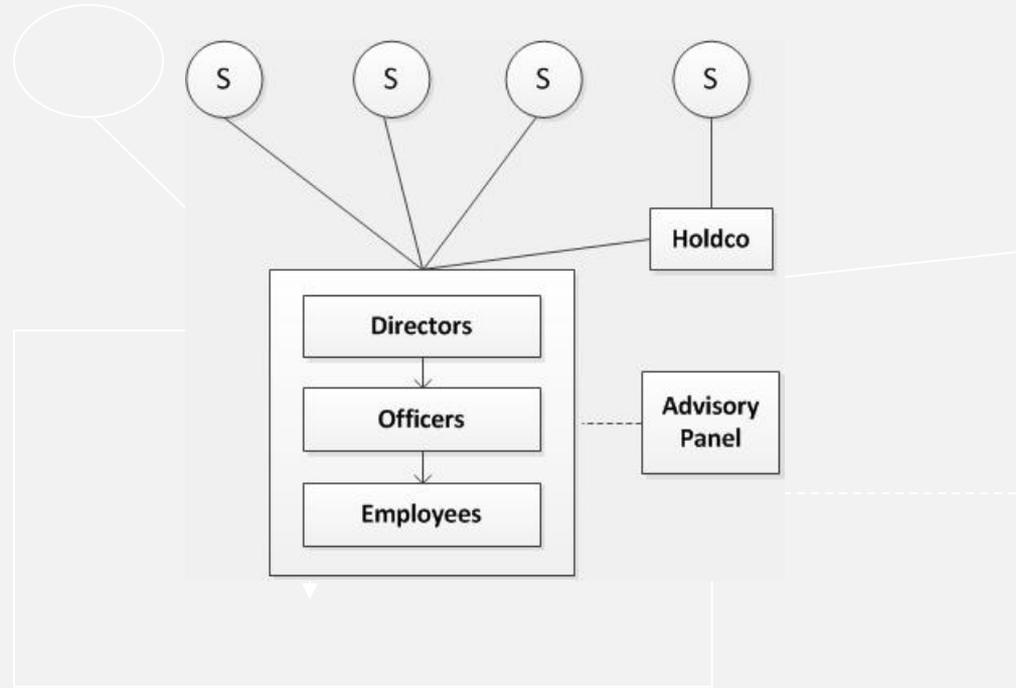
▼ Legal Agreements

- Documenting the foundation and development of your venture.
- Internally: Shareholders' Agreement, IP Assignment Agreements, Consulting Agreements, Employment Agreements, Reverse Vesting Agreements, 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!)

▼ 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
 - anti-dilution, down round protection

▼ Shareholders (cont'd)

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

▼ The Policy Setters

Directors

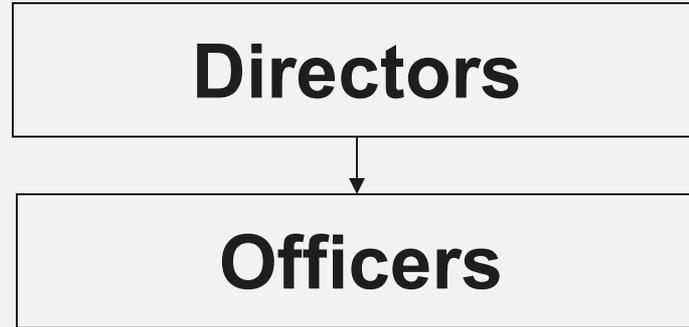
▼ Directors

- Elected by the shareholders
 - (but the directors can fill “vacancies” and increase number in certain circumstances)
- At least one
- If BC, no 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

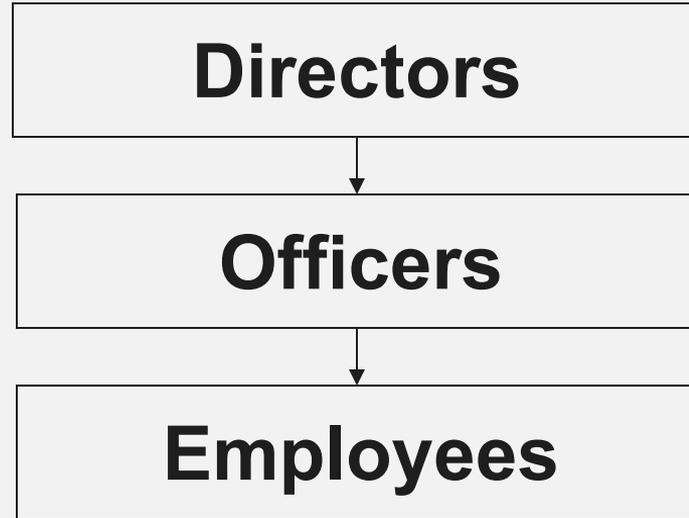
▼ The Instructors



▼ 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

- Form of relationship determines how worker is taxed
 - Consultants run a business (expense deductions allowed, but no benefits)
 - Employees realize employment income (more restrictive, but statutory benefits and security)
- CRA will look at actual arrangement to determine type of relationship
 - Agreement still key in this analysis

▼ Compensation and Incentives

- Cash
- Shares
- Options

▼ Compensation and Incentives – Tax Considerations

- Various payment structures all have different tax effect
 - Cash salary
 - Dividends (for employee shareholders)
 - Stock options/shares
 - Deferred salary plans
- Generally, salary and dividends are equivalent in tax rate (integration)

▼ Compensation and Incentives – Stock Options

- Can be issued to founders or employees
- Align incentives of recipients with venture
- Advantageous tax treatment
- Typically full value of anything received from employer is fully taxable
 - Stock options are the key exception

▼ Compensation and Incentives – Stock Options - CCPCs

- No tax on grant of options or shares to employee
 - As long as there is agreement to issue
- No tax on exercise of options if resulting shares are held by employee for 2 years
- On sale of share, effectively get capital gains tax treatment (1/2 taxable)
- Different tax results if not CCPC

▼ Compensation and Incentives – Stock Options – Non-CCPCs or Non-employees

- Different tax results if company not CCPC
 - End result -- $\frac{1}{2}$ of benefit equal to FMV of share in year option exercised is included in income (if not paid for)
 - Capital gains inclusion at sale of resulting share

▼ Compensation and Incentives – Stock Options – Non-CCPCs or Non-employees Cont'd

- Different tax results for consultants who receive options (from CCPC or not)
 - FMV of options in year of issue is income
 - Arguably no tax event on exercise

▼ Employees and Consultants– Non-residents

- Employing or retaining non-residents can cause additional tax compliance issues
- Non-resident employees who work outside of Canada should be avoided
- Non–resident employees working in Canada, subj. to “reg 102” withholding
- Non-resident contractors subject to “reg 105” withholding requirement

▼ The Advisors

Advisory Panel

▼ 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
- Public v. Private

▼ 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 shareholders' loans.
- Using multiple share classes.
- Incorporating offshore.

▼ Initial Corporate Structuring – Tax Considerations

- Different tax issues may arise for different forms of financing
- Issues:
 - Equity or debt?
 - Structure for delivery of equity to financier?
- Decisions depends on context
- Generally, best to start with simple but easily adaptable structure

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

- CCPC = Canadian controlled private corporation
- Important for many tax advantages:
 - Small business deduction
 - Capital gains exemption
 - SR&ED benefits
 - Stock option deferral/deduction

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

- Restricts who can receive equity
- Public corporations or non-residents cannot own more than 50% shares
- No public corporation or non-resident may control
- There is a VCC exception from the above which may be important for some start-ups

▼ 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, or providing for “reverse-vesting”.
- Issuing them to the wrong people.

▼ Preparing a Financing Plan

Determine a “Road-Map” for financing:

The company determines its developmental “milestones”:

- What they are.
- By when they will be met.
- How much funding is needed to meet them.

The milestones are integrated with the budget and a timeline to determine how many tranches of financing will be needed and when.

This info is used to prepare a sample capital structure table - a “road map” for the financing trail (e.g. – to raise \$5.0M).

▼ Sources of Financing – Debt/Grants

Non-equity financing might come from:

- **Government grants/credits/refunds:**
 - NRC/IRAP, SRED.
 - Telefilm Canada and other industry specific organizations.
 - Environmental/“green” grants.
- **Quasi-governmental organizations like:**
 - BCIC, BDC

▼ Sources of Financing - Equity

Initial (equity) seed financing may come from:

- The “Founders”.
- Their “Friends and Family”.

Follow on rounds (pre-public) from:

- Angels.
- Venture Capitalists.
- Investment bankers (both private and institutional).
- Underwriters (i.e. brokers).
- **Public financing - Initial Public Offering.**
- **Strategic Partners.**

▼ Sources of Equity Financing – Revisited

- **Categories of Financiers:**

• Founders:	Variable
• Friends and Family:	\$50K – \$150K
• Angels:	\$250K - \$500K
• Venture Capitalists:	\$1.0M - \$3.0M
• Underwriters:	\$1.0M - \$5.0M
• Strategic Partners:	Variable

- **Match potential investors with your Financing Plan to maximize chance to secure investment.**

▼ 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

▼ Break

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▼ 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
- \$150,000
- Start-Up Crowdfunding
- Offering Memorandum
- Employee, Director, Officer & Consultant Exemption

▼ 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

▼ \$150,000 Exemption

- Under the \$150,000 exemption, a company can sell securities to **non-individual** investors without providing any disclosure to the purchaser, provided the purchaser buys at least \$150,000 worth of securities.

▼ Start-Up Crowdfunding Exemption

- Can raise up to \$250,000, twice a year
- Investors can invest up to \$1,500 each
- Need to publish an offering document online that sets out certain information
- Need to raise money within 90 days of publishing that document
- Need to hit minimum goal before any money is released from trust

▼ Offering Memorandum Exemption

Issuer can sell securities to anyone in B.C. in any amount if Issuer:

- Delivers an offering memorandum in the prescribed form
- Obtains a signed Risk Acknowledgement from the purchaser

▼ Risk Acknowledgement/Liability

- Clear, blunt statement of risks of investing in exempt market securities
- Issuer must give a copy of the signed Risk Acknowledgement to purchaser prior to making investment
- If the offering memorandum contains a misrepresentation, the purchaser has:
 - A right of action for rescission
 - A right of action for damages

▼ 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 – usually shares
- 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

▼ Convertible Debt

- Debt investment that can be converted into equity, usually upon a future financing of at least a specific size
- Repayment requirement at end of term
- General security agreement
- Inter-lender agreement
- Usually not eligible for EBC tax credits

▼ SAFE

- Simple Agreement for Future Equity
- Not debt – no interest, no maturity date
- Company does not have to settle on a valuation
- Eligible for EBC tax credits

▼ 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.



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:

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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