STARTUP LEGAL PLAYBOOK

Employment law differences between Canada and the U.S.

AUTHORS

Torys' Emerging Companies and VC Group

Read this if: you are hiring a cross-border team and need to review U.S. and Canadian employment laws

You might also like: Cross-border funding for startups: top questions founders should ask

Go deeper: Going cross-border

If you hire team members from Canada and/or the U.S., you must ensure that you meet local employment law standards, regardless of where your startup's head office is located. We break down the key differences in employment law between the two jurisdictions.

Discrimination

In Canada and the U.S., discrimination in employment is prohibited on specified grounds, such as race, gender, ethnic origin, religion (creed), and age. Discrimination due to sexual orientation is prohibited across Canada and several (but not all) states in the U.S.

The most significant differences between the two countries relate to discrimination based on disability.

In Canada, disability-based discrimination is prohibited under human rights codes and the *Canadian Charter of Rights and Freedoms*. Employers have a duty to accommodate an employee's disability up to the point of undue hardship to the employer. This means that a Canadian employer must accommodate their employee's disability up to the point where the solution would be deemed to present too high a health and safety risk, or too high a cost to implement, therefore going above the "reasonableness standard". This is determined on a case-by-case basis.

Workplace drug and alcohol testing is generally restricted in Canada, and alcoholism and drug addiction are legally recognized as disabilities that require accommodation.

In the U.S., disability-based discrimination is prohibited under the *Americans with Disabilities Act*. Employers must provide reasonable accommodations to a disabled employee, unless doing so would cause undue hardship to the employer. Determining the "reasonableness standard" is done on a case-by-case basis, however some states have expanded the definitions of covered disabilities and reasonable accommodation in a bid to provide more uniformity across the court's decisions.

Workplace drug and alcohol testing are much more common in the U.S. and are generally legally permissible, although the requirements vary by state—with some allowing random testing whilst others limit tests to circumstances involving “reasonable suspicion” or “probable cause”. Alcoholism and being in recovery from drug addiction are recognized as disabilities.

Restrictive covenants

Restrictive covenants are clauses that are put into an employment agreement to restrict employees, or ex-employees, from carrying out acts that could harm the business after they cease to be employed. The two most challenging post-employment restrictive covenants in employment agreements are non-competition and non-solicitation clauses.

Non-competition clauses act to prevent employees from leaving their current job to work with, or launch, a business that is a direct competitor. Non-solicitation clauses are put in place to stop ex-employees from soliciting your team or customers to join them at a new company. When deciding if a clause is enforceable, the courts will assess, among other things, if its restrictions are set out for a reasonable time, if the geographic scope is clearly defined and fair, and if it was in relation to a protected business activity.

In Canada, non-compete clauses are presumptively unenforceable, except in limited circumstances (i.e., Canadian courts usually only enforce them for high-ranking employees such as C-suite executives), with the province of Ontario prohibiting employers from entering into a non-compete agreement with employees below the executive level.

Courts across Canada are generally more receptive to enforcing non-solicitation clauses, if they determine the clause was clearly and unambiguously drafted. Canadian courts do not modify restrictive clauses, so one that is vague or too broad will be struck out completely.

In the United States, the enforceability of restrictive clauses is dependent on state law. Courts in most states will generally enforce non-competition agreements if the clause is determined to be for a reasonable time and geographic scope. U.S. courts will also look to ensure that the restrictions are no greater than is necessary to protect the employer's legitimate business interests. For states that deem non-competition clauses unenforceable, it is usually due to public policy reasons. However, the FTC has proposed a rule that would effectively invalidate any non-compete agreements, superseding the current patchwork laws in place.

As with Canada, non-solicitation clauses are generally allowed. Some states will deem an overly broad restrictive covenant to be unenforceable in its entirety, while others will permit the modification of the terms of the clause, particularly if it contained a note allowing modifications.

Compensation disclosure for public companies

If you go public in either Canada or the U.S., you must publicly disclose the compensation made to founders, CEOs, and other high-ranking employees.

Shareholders may also vote on the compensation of executives (referred to as “say-on-pay”), however, how this is approached differs between Canada and the U.S.:

- In Canada say-on-pay is still voluntary, although the prevalence of say-on-pay is increasing among large public issuers.
- In the U.S., a non-binding shareholder vote on compensation (say-on-pay), as well as a vote on the frequency of say-on-pay, is mandatory.

Tax on options

In both countries, employee option holders are generally taxed when exercising stock options (i.e., purchasing shares under the stock option agreement). However, options to employees of companies that are controlled by Canadian persons can be deferred until sale of the underlying shares. The amount they are taxed on is generally the difference between the fair market value of the stock on the date of exercise and the exercise price (the option spread). The key difference between the tax on options in Canada vs the U.S. centers on who receives tax advantages.

In Canada, generally there is favorable tax treatment if the grant was made when the company was a CCPC or the exercise price was note less than fair market value. In certain cases, where a tax event is triggered for the recipient of the stock option, the company may have withholdings to make. This should be considered with tax and legal advisors. There is recent legislation that impacts the ability of a stock option recipient to take advantage of favourable tax treatment (which may or may not be otherwise available to the recipient). However, these limitations are generally not an issue for early-stage startups—for example, if the company has consolidated revenue in excess of $500mm, limitations on favourable tax treatment may apply.

In the U.S., options are typically designed either as incentive stock options, with the potential for preferential tax treatment, or as nonqualified stock options subject to ordinary income taxation.

Incentive stock options (ISOs) are generally not subject to ordinary income taxation upon vesting or exercise, and the employer cannot take a corresponding compensation deduction. Although ISOs have fallen out of favour in many industries in the U.S., due to statutory constraints and administrative complications, they remain prevalent in the startup ecosystem as they offer employees a more favourable tax result than nonqualified stock options.

Nonqualified stock options (NQSOs) allow the holder to recognize ordinary income upon exercise in an amount equal to the option spread, and the employer is generally entitled to a corresponding tax deduction.

Tax on restricted stock

Restricted stocks are employee stocks that are placed under a vesting schedule. This means that a specified amount of time must pass before restrictions on accessing the stocks are lifted and the employee can transfer their shares to a third party, a bank, etc. Founders should note that restricted stock is generally reserved for the initial founding team, and perhaps very key early employees. There are a variety of reasons for this approach. One of them is that a grant of restricted stock is a true grant of shares. As such, in most cases, the recipient must pay fair market value for such shares. Absent payment, the recipient would trigger a tax liability. Once the valuation of your company starts to move higher, most recipients no longer desire to pay for shares at the fair market value. That is the reason stock options are most commonly relied upon.

In Canada, employees are taxed on restricted stock at the time that they are granted it. If a Canadian employee would prefer to be taxed via ordinary income rates when the restrictions have lifted (which is like the U.S. approach), then the company must grant the employee restricted share units instead. These are notional units whose value is equivalent to the company's shares. However, restricted share units have deferral or deductibility limitations depending on the structure chosen and whether the restricted share units are settled in treasury shares, cash, or shares purchased on the open market.

In the U.S., as mentioned above, restricted stock is taxed via ordinary income rates each time there is a vesting event. To avoid having a tax liability crystalized at each vesting event, the recipient of the restricted stock must file an 83b election with the IRS, within 30 days of receiving the stock. Unfortunately, if the 83b election is not filed within 30 days, there are no practical solutions—the recipient will be subject to tax at each vesting event. Once the vesting event has occurred, or the recipient files an 83b election, the shares will be eligible for short- or long-term capital gains treatment. Share units can also be granted in the U.S. and are a relatively common form of equity incentive.

Termination of employment

In Canada, employment standards legislation requires you to give employees at least the statutory minimum amount of notice of termination or pay in lieu when they are dismissed “without cause”. In Ontario, you may also have to pay the terminated employee statutory severance pay. These amounts cannot be contracted out of and cannot be conditioned on a release.

In some cases, you may also be required to give lengthier notice, or pay in lieu, under common law, civil law, or the employee's employment agreement. Termination payments in excess of the statute can be conditioned on a release of claims.

In the U.S., employment is generally “at will”, which means an employee can be terminated at any time without cause. Generally, notice of termination is required only if it was included in the employment contract or is company policy.

Severance policies

Severance pay is compensation that an employer pays to an employee whose employment with the company is being terminated through no fault of the employee (i.e., they were not fired due to their behaviour/actions).

In Canada, plans and policies are uncommon, because they usually cannot override an employee's legal rights to notice of termination. In circumstances where severance does come into play, notice and entitlements are generally determined on an individual basis.

In the U.S., severance policies are more common, with the benefits they provide usually tied to seniority and/or length of service. Many U.S. employers do not maintain a formal, written severance policy. Instead, severance determinations are made on a one-off basis depending on the value related to the claims released by the employee in exchange for the severance payment. Companies will also sometimes establish severance policies for limited windows of time in connection with layoffs or reorganizations.

Employment litigation

Wrongful dismissal litigation in Canada is well-developed and tends to result in more predictable damage awards. As a result, it may proceed more quickly to resolution than in the United States.

In the United States, employment litigation against employers can include claims of discrimination under state or federal law. While wrongful termination litigation in the United States has gained a reputation for unpredictable damage awards resulting from jury trials, most cases settle out of court.

To discuss these issues, please contact the author(s).

← **Back to Startup legal playbook home**

Get to know our ECVC practice

→ Learn more about our team

We work closely with players across the startup ecosystem to advise founders on formation, scaling and exits, as well as connect investors to high-growth opportunities.

→ View our Startup terms glossary

Learn the ins and outs of the commonly used terms in the startup and VC ecosystem.