STARTUP LEGAL PLAYBOOK

The founder’s guide to startup legal documents

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Read this if: you’d like to better understand your agreements, contracts and other documents

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With so many steps and legal documents involved in running a startup, founders often want to understand how critical certain agreements and contracts are to the success of the organization. The short answer is that having the correct paperwork in place will save you time and money as you scale. Below are the most common documents you will come across, and why they matter.

Articles of incorporation and corporate records

If you are at a stage where you are hiring team members or attracting interest from investors or customers, it is recommended you incorporate your startup and file articles of incorporation. This is a legal process that creates a legitimate business separate from the owner. It allows you to conduct business under your corporate name either nationally (federal incorporation) or provincially (provincial incorporation). It also ensures the correct company structure is in place to issue proper shares to the founders (or even a solo founder), and lets you formally transfer all IP to the company. If you plan to do business in another country, you will have to incorporate there separately.

Corporate records are documents that detail the formation of your entity (i.e., the incorporated company), plus its bylaws and other critical information. You are legally required to maintain corporate records. The government and future investors will want to ensure that your company is correctly set up and meets market standards.

Founders agreement

If you are a single founder then you do not need to implement a founder agreement. But if your startup has multiple founders, it is important to have a mechanism to manage exits and pull back shares from founders if they depart early—a founders agreement can cover these issues. It is the first agreement that governs your relationship with your co-founder(s) and sets out each of your rights and responsibilities. Most importantly, the agreement covers your equity and how it is treated. You will be issued shares as founders at incorporation or shortly thereafter. The founders agreement will govern how those shares are granted, managed, and accessed, and will outline mechanisms to protect the company and other founders.

One common issue that founders agreements deal with is what happens to the shares of a founder who leaves the company. Under a concept called vesting, there are restrictions on founder shares for a certain period of time. Once the shares vest (i.e., the founder gains ownership of the shares after that time has passed), those restrictions fall away. The typical vesting period for a founder is four years with a one-year cliff. This means that for a period of one year, none of those shares can be transferred to a third party, pledged to a bank, or acted on in certain other ways.

Vesting is important because it protects you from having a significant shareholder on your cap table who does not make any active contributions to the company. For example, if one founder leaves after six months and there is no vesting mechanism in place, the company can't take back shares from that founder. This is especially true for early-stage startups, where the most valuable thing that you can offer employees and venture capital funds is equity. When you go out to venture capital investors, they will expect these agreements to be in place, so they know exactly who owns what in your company before they invest their money.

Restricted share purchase agreement

A restricted share purchase agreement is an agreement that is used to issue shares in the startup to founders. Applicable to both solo founder and co-founder startups, it should be entered into at the formation of the company (i.e., once it has been incorporated). It gives the company the right to buy back shares from any founder who leaves the company early. This is known as the repurchase right.

The agreement also ensures that a founder who forms a startup but then leaves shortly after its launch does not own an outsized number of shares in the company. Having a vested period (i.e., a waiting period) before founders fully own the shares promised to them incentivizes all founders to stick around and contribute to the company's growth to maintain ownership.

Employment contracts

Everyone who works for your startup should sign an agreement that clearly outlines the terms of the working relationship, including relevant benefits and restrictions. Whether this agreement is an employment agreement or an independent contractor agreement will depend on whether the person is an employee or a contractor.

Whether to hire employees or contractors depends on the specific needs of your startup and the kind of work you will hire the person to do. It is important to make sure your team is properly categorized, as this decision (i.e., employee vs. contractor) will determine the kind of agreement you enter, what your responsibilities to them are, and vice versa. Misclassifying employees as contractors will also make you liable to your tax authority for failing to make the proper source deductions, and you can become subject to claims from misclassified employees.

Intellectual property assignment agreement

All the IP your company is developing should be assigned to the company itself. Your startup's value comes from your IP, so not clearly showing what it owns can open you up to a host of issues at a later stage. Each person who works for, or with, the company (you, your co-founders, employees, contractors, or any other party) should sign an IP assignment agreement.

Employment agreements and independent contractor agreements should also include clear clauses about IP ownership that state all IP created by the employee or independent contractor for the company will be owned by the company. In Canada, the company is the default owner for IP developed by an employee (unless the contract says otherwise); however, the opposite is true for contractors and consultants. Read more about how to build an IP strategy.

Shareholders agreement

A shareholders agreement governs the way in which the company will operate and the restrictions, rights, and responsibilities placed on all shareholders of the company. This includes information on how shares can be transferred, protections for minority shareholders, and restrictions on the powers of the directors to manage the business and affairs of the company. This is important as it provides a roadmap to follow if any shareholder issues come up, and it reassures shareholders that the company will treat them fairly and transparently.

Non-solicitation agreement

A non-solicitation agreement in an employment contract prohibits an employee from soliciting—or actively pursuing—clients, customers, vendors, business partners, or other employees of their employer, during the employment relationship or after the employment relationship has ended. The non-solicit agreement often, but not always, applies only for a specified period after the end of the employment relationship.

Non-competition agreement

This kind of agreement is put in place to restrict employees from being directly hired by a competitor within a certain time. Non-competition agreements are no longer legally permissible in some markets (e.g., Ontario), so it is important that your employment agreements only include a non-competition clause if it is allowed. If a non-competition agreement or clause is permissible, it should define the timeframe and geography in which it is to be adhered to, be limited to employees related to the services being provided under the agreement, and exclude situations where an employee responds to a general recruitment advertisement.

Service agreement

A service agreement should clearly describe the services that will be provided by the company. For example, will your service include software licences, hardware, software, professional services, training, installation/integration, or maintenance and support? The agreement should be clear about allocating responsibilities, development milestones that need to be met, and milestone deadlines.

Key items to cover in service agreements

- **Confidential information:** The definition of confidential information typically covers any information disclosed by or on behalf of a party to the other party that is marked as confidential or that reasonably should be understood to be confidential. Confidentiality terms are crucial to ensure that the person you are negotiating with won't steal your secrets.
- **Customer data:** If you are dealing with customer data as a part of your service, be prepared to answer questions about privacy and security. Customers will likely want to know what security requirements you have in place to protect their data. If you will be collecting, accessing, using, or disclosing personal information, consult a privacy expert to ensure that you're compliant with appropriate privacy laws. Certain jurisdictions, such as the EU, UK, Switzerland, and California, have specific requirements that companies must follow if they deal with individuals in those jurisdictions.
- **Disclaimers:** Disclaimers notify your users that you will not be held responsible for certain damages from their use of your website, products, or services. They need to be carefully structured to have legal effect. One that is too broad may be struck down by a court as ineffective. Well-crafted disclaimers go a long way in protecting a business from liability.

- **Indemnification:** Put simply, an indemnification clause requires one party to compensate the other for putting that party in harm's way. For example, if you are a software developer, your customer may ask you to indemnify them if they receive a copyright infringement claim for using your software. You would be asked to "step in the shoes" of the customer and manage the dispute. If you agree to offer an indemnity, you should limit the categories of claims that you are willing to indemnify for, put caps on the damages, and consider purchasing insurance to limit your financial risk and exposure.

- **Limitation of liability:** Limitation of liability clauses allow parties to limit the amounts owed by one party to the other in the face of a claim. The type of damages due or claims brought can be limited. This allows a party to avoid a "bet the business" situation by allocating risk between the parties. There are typically three parts to a limitation of liability clause to look out for:

  - *Waiver of indirect damages:* This clause states that a party will not be liable for any indirect damages that arise under the agreement, including any damages for lost revenue, lost savings, or lost profits.

  - *Cap on direct damages:* Agreements typically limit the maximum amount of damages that can be claimed as direct damages. This amount is typically tied to the fees paid under the agreement.

  - *Exclusions:* The parties may agree to exclude certain types of damages from the above circumstances. If these types of claims occur, whether directly or indirectly, the party will be exposed to unlimited liability. Parties will typically negotiate excluding claims for gross negligence, willful misconduct, or fraud.

- **Governing law and forum:** The agreement should state which substantive law governs the rights and obligations of the parties and which country's courts will hear disputes. You should consider the most practical and convenient jurisdiction if a dispute arises. If you choose a jurisdiction that is not your home jurisdiction, make sure you are comfortable with their procedural system and how difficult it may be to enforce a foreign judgment domestically.

- **Subcontracting:** A contract is between two parties, and typically the rights and obligations under the contract cannot be imposed on a third party. However, third parties can sometimes be brought under a contract. For example, a subcontracting clause can be used to allow a party to assign or outsource part or all of the obligations under a contract to a third party. You may need to rely on this clause if you have a third-party hosting provider or even independent contractors working for you. Take note of the language that requires you to obtain the customer's consent before subcontracting (or to notify the customer in advance).

- **Assignment:** An assignment clause governs whether and when a party can transfer the contract to a third party. While agreements typically limit the ability of a party to transfer the contract without some form of prior consent, startups should ensure there is language that permits it to assign the agreement to a purchaser of its assets or shares without a customer's consent.

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

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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.