

focus

on

Employment Law

The logo for Fraser Milner Casgrain LLP, consisting of the letters 'FMC' in white on a blue square background, with a thin blue arc below it.

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Common Employment Pitfalls Facing Technology Companies

This focus piece has been prepared for the benefit of technology companies that carry on business in the province of Ontario.

In acting for technology companies and investors on venture capital financings and acquisitions, we have observed that some companies may not be completely aware of their legal obligations as employers. As a result, companies may be unnecessarily exposing themselves (and their directors and officers) to potentially significant liabilities and penalties by failing to fully comply with various employment law statutes and/or the common law. Such liabilities and penalties are not only problematic in their own right, but may also unexpectedly affect valuation in a sale or financing transaction.

Employment law liabilities concern investors and prospective acquirers for a number of reasons. Here are five of the key concerns:

1. Undisclosed liabilities can hit the company's bottom line. If a mass termination of employees is improperly executed, the liability can be significant enough to affect valuation.
2. In a share acquisition, unresolved employment law problems are "inherited" by the acquirer, who must bear the cost of fixing them or, more likely, pass the cost on to the target company and its shareholders by lowering the valuation.
3. A condition of some "distress" M&A transactions is the termination of some or all of the employees. To the extent that termination costs can be reasonably contained, there are more likely to be liquidation proceeds "left over" for shareholders.
4. Recently enacted provisions of the *Employment Standards Act, 2000* (Ontario) (the "ESA") provide for personal liability in the event a director or officer authorizes, permits or acquiesces in a company violation of the *ESA*. Penalties can include the reimbursement of "unpaid wages", fines of up to \$50,000 and/or imprisonment of up to 12 months. In most venture capital transactions, the investor already has or will have a director sitting on the board. The company's failure to comply with employment law standards can therefore result in personal liability for an investor's director representative. Moreover, although the *ESA* provides that an employer may indemnify a director for all costs, charges and expenses reasonably incurred by the director with respect to any civil or administrative action that may be initiated against the directors, it also provides that this is subject to the director: (a) acting honestly and in good faith with a view to the best interests of the employer; and (b) in the case of a proceeding or action that is enforced by a monetary penalty, having reasonable grounds for believing that the conduct was lawful.

5. U.S. investors and acquirers in particular are often surprised by the “generosity” of Ontario employment laws, especially in a termination context. Properly limiting entitlements can help to alleviate concerns of U.S. and other foreign investors operating in an unfamiliar regulatory environment.

With this background in mind, executives should manage employment liabilities in order to facilitate the inevitable “due diligence” review that precedes a financing or acquisition transaction. This focus piece will identify common employment pitfalls that technology companies face and suggest strategies to address them. Topics discussed below are:

- hiring process
- engagement of contractors
- changes to terms and conditions of employment
- termination of employment
- equity compensation
- regulatory compliance

THE HIRING PROCESS

Technology companies readily declare that their employees are among their greatest assets. Unfortunately, if the employment relationship is not properly documented from the outset, employees can also become one of a company’s greatest liabilities. Companies often hire employees without proper letters of hire or employment agreements. This does not mean that there is no agreement. What it does mean is that, at the end of the day, a court may end up defining the agreement for you. A proper letter of hire or employment agreement can avoid uncertainty and unexpected liability in the terms of employment. It should clearly address such matters as:

- job description and responsibilities
- term of employment
- specifics of any benefits
- limitation of entitlements upon termination of employment
- limitations on the employee’s ability to compete with the employer’s business once the employee leaves
- protection of the employer’s intellectual property, client lists and other confidential information
- ownership of the employee’s work product
- dispute resolution

Examples of failing to deal properly with these issues include the following:

1. Termination Clause: Some employers are uncomfortable addressing the employee’s entitlements on termination at the beginning of the employment relationship. These same employers often regret this initial discomfort when a decision is made later to terminate the employee. A signed employment contract (whether a letter of hire accepted by an employee or a more formal employment agreement) can limit the amount of notice, or pay in lieu of notice, that an employee will be entitled to receive in the event of a “without cause” termination. This contractual notice can be limited to the statutory minimum under the *ESA*, which is generally one week per year of employment up to eight weeks plus statutory severance (if applicable), or any other amount, provided that it meets or exceeds the minimum statutory requirements under the *ESA*. In the absence of such a clause, an employee will be entitled on termination to notice or pay in lieu of notice calculated under “common law” principles, which may considerably exceed the minimum standards under the *ESA*. Unlike the *ESA*’s notice provisions, the “common law” does not provide a fixed measure of what constitutes reasonable notice. At the upper levels, case law has awarded two years or even more to certain senior-level, long-term employees. These types of potential liabilities, when disclosed as part of a due diligence process, can surprise and concern investors or acquirers. A written agreement on notice period, or pay in lieu of notice, even if it is greater than the *ESA* minimums, will not only help to quantify termination obligations but will also help to avoid costly and time consuming wrongful dismissal claims based on “common law” entitlements.

2. US Contracts: Some U.S. companies establishing Canadian operations simply use their U.S. form of agreement as their employment contract. U.S. concepts like “employment at will” are not recognized in Canada and will not be enforceable. Furthermore, the use of such language may render the entire employment agreement invalid and unenforceable in Ontario, including provisions relating to intellectual property. Therefore, while company templates originating in the U.S. can be used as a base document, these forms should be revised in order to ensure compliance with Ontario employment law.

3. Restrictive Covenants: An important function of the employment contract is to restrict harmful or unfair conduct by a departing employee. This can be achieved through the use of restrictive covenants such as non-competition and/or non-solicitation clauses. It is crucial to craft such provisions with an eye to their enforceability. Sweeping, unreasonable prohibitions will generally not be enforceable in Ontario. In particular, while non-solicitation and confidentiality clauses will be

honoured if properly drafted, non-competition clauses are very difficult to enforce under most circumstances. It is important, through proper drafting, that the issue of the enforceability of a non-competition provision not poison other important provisions.

4. Intellectual Property Provisions: It is critical that employees agree to specific provisions aimed at protecting the company's intellectual property assets, including inventions. These protections are generally included in a separate intellectual property/confidentiality agreement signed at the time the employee enters into employment. For Canadian companies, the agreement must include a "waiver of moral rights" in respect of copyright, which is dealt with differently in Canada than in the United States.

5. Vacation Entitlements: Employment contracts should address an employee's vacation entitlements. Given each director's personal liability for certain amounts of unpaid vacation under the *ESA*, employment agreements must be carefully worded to avoid any uncertainty. Companies should also note their statutory obligation under the *ESA* to ensure that employees take a minimum of two weeks vacation per year, following the first year of employment. Lastly, companies may wish to specify whether employees are permitted to carry forward unused vacation entitlements from one year to the next.

While the terms of each employment agreement will vary from employee to employee, almost all of the concepts discussed above will be applicable to each employee in some manner. As such, all employees, regardless of their position, should sign a letter of hire or employment agreement and an intellectual property/confidentiality agreement before their first day of employment.

ENGAGEMENT OF CONTRACTORS

The engagement of contractors can be problematic for a number of reasons and therefore great care must be taken in this area. The following are a few of the issues that regularly arise:

1. Is it an Employment Relationship?: Courts and administrative bodies will generally examine an entire relationship in order to determine whether an individual is a true contractor or in substance an employee. Although the existence of an independent contractor agreement will be taken into consideration, it will certainly not be determinative on its own. Other factors that will be taken into account include, but are not limited to the following: whether the company withholds employee statutory deductions on the contractor's pay, whether the company monitors hours of work, whether the contractor is assuming its own profit or loss, whether the contractor provides its own tools and

workspace and whether the contractor is integrated into the workplace and enjoys benefits given to employees. Despite entering into so called "independent contractor" agreements, a company may face significant liabilities under various statutes and/or the common law for not meeting its obligations as an employer if it is determined that a contractor is in reality an employee. Some of the risks following a determination that an independent contractor is in reality an employee are as follows:

- payment to the Canada Customs and Revenue Agency for outstanding Employment Insurance and Canada Pension Plan contributions, with or without a fine pursuant to the *Income Tax Act* (Canada)
- fines pursuant to the *Income Tax Act* (Canada) for not withholding income tax at source
- payment to the Ontario Workplace Safety and Insurance Board of premiums, together with interest and/or fines levied against the company and/or directors, which can reach \$100,000 and \$25,000 respectively, pursuant to the *Workplace Safety and Insurance Act* (Ontario)
- payment of "wages" owing such as overtime pay, vacation pay, statutory notice and statutory severance upon termination and/or fines levied against the company and/or directors, which can reach \$500,000 and \$50,000 respectively, *per offence*, pursuant to the *ESA*
- pay in lieu of notice upon a contractor's termination of employment, if he or she is found to be an employee under the common law

2. Intellectual Property Rights: Unlike an employment situation, any intellectual property developed by the contractor will be owned by the contractor unless the agreement specifically provides that all intellectual property is owned by the company.

CHANGES TO THE EMPLOYMENT RELATIONSHIP

Employers have some latitude to make changes to an employee's terms and conditions of employment for business-related reasons. However, the following are examples of issues that may arise in the implementation of such amendments:

1. Unilateral Modifications: Employers should be cautious of unilaterally modifying an employee's terms and conditions of employment, as they may find themselves defending a constructive dismissal claim once those modifications become apparent to the employee. Such a claim may be alleged where, in the absence of

reasonable notice, a fundamental term or condition of employment is unilaterally altered by the employer in any manner detrimental to the affected employee. Actions of an employer that could amount to grounds for a constructive dismissal claim include any substantial change in remuneration, benefits, position, responsibilities, reporting duties or location of work. It is still open to an employer to make unilateral changes, even if they are substantial, without triggering a constructive dismissal claim. The manner in which those changes are announced and implemented, including concepts like staging and notice, can have a significant practical and legal effect on the actual liability facing a company.

2. Enforceability of New Terms: Any amendment to the terms of an existing written employment agreement should be in writing, preferably with the employee's consent and at least with the employee's knowledge. Furthermore, the employer should consider offering fresh consideration over and above the performance of existing contractual obligations in order to ensure future enforceability of the new terms of employment. Fresh consideration may consist of simply offering an employee a modest bonus or a one-time perquisite in exchange for agreement to the amendments. It is also effective to implement amendments as part of a promotion or a discretionary increase in compensation, including the granting of a bonus or options. Ordinarily, mere continuation of employment will not constitute adequate consideration. Moreover, it is clear that both parties to the employment contract must have full knowledge of the scope and nature of the change and must voluntarily assent to it without duress or coercion in order for the modification to be legally binding.

TERMINATION OF EMPLOYMENT

Proper termination practices and policies are imperative as every employment relationship will inevitably terminate and the legal consequences can be serious, especially for terminations that are unilaterally implemented by the employer. Despite the serious potential liabilities, we have observed that many technology companies are not fully aware of the *ESA*'s minimum requirements upon termination of employment, including but not limited to those governing the following entitlements:

- pay in lieu of notice of termination
- severance pay
- mass termination pay
- unpaid vacation
- employee benefits during the statutory notice period

Specific issues that have arisen are as follows:

1. Mass Termination: It is possible to inadvertently trigger the strict "mass termination" obligations under the *ESA*. These provisions will come into play in the event that 50 or more employees are terminated in any period of 4 weeks or less. For example, the "mass termination" provisions could be triggered if a company terminates the employment of 35 employees and constructively dismisses 15 more employees by unilaterally modifying a fundamental term of their employment, all in a period of 4 weeks. We have seen companies work hard to keep their number under 50, then inadvertently exceed the limit because of a couple of terminations in management ranks that they forgot to include. Mass termination requirements include, but are not limited to, a substantially increased notice period for each employee involved, and the filing of a report with the Ministry of Labour.

2. Insurance Benefit Coverage: Employees are entitled to receive their entire group insurance benefit coverage for the duration of their statutory notice period pursuant to the *ESA*. In the event an employer does not provide benefits continuance to the extent required by the *ESA* (due to the insurer's refusal or the employer's unilateral termination of the coverage), it may be found to be in violation of the *ESA*. Furthermore, in the event the employee dies or becomes disabled during the statutory notice period, the employer may become responsible for the proceeds of the life insurance policy or the disability benefits that would normally be in place, and payable, but for the termination of the coverage. As such, employers are advised to contact their insurance provider prior to the termination of employment, in order to obtain confirmation of benefits continuance and conversion possibilities (if any), in writing. Employers should also inform employees, in a termination letter, of the scope of the benefit continuance, the termination date of these benefits and the time limits for any conversion possibilities. This termination letter should also recommend that the employee pursue alternate coverage.

3. Manner of Dismissal: Employees may be entitled to an increased notice period where the manner of dismissal has adversely affected the employee's ability to find alternate employment. Such improper conduct may include an unsubstantiated allegation of misconduct, a harsh communication of the dismissal, or an unjustified refusal to offer an employment reference. As such, employers should review their termination procedures to ensure terminated employees are treated in "good faith" throughout the dismissal process.

A company can greatly limit its liability upon the termination of employment with the help of simple tools such as a proper termination letter and release.

EQUITY COMPENSATION

For most technology and emerging growth companies, equity incentives (including stock options *and* stock purchase plans) are an essential tool to attract, motivate and retain key employees. However, equity compensation plans are lengthy and complex, and we often encounter tax, securities, corporate or accounting concerns when examining these plans. The most frequently seen problems include the following:

1. Vesting after Termination of Employment: Management and investors often seem to assume that if an employee is terminated, the employee's options or restricted stock grants will cease to vest on the employee's last day of work for the company. This expectation - however common - does not reflect the current state of the law in Ontario. Ontario courts have taken the position that, unless a plan or option agreement provides very clear wording to the contrary, in the event of the termination of employment of an option holder, vesting will continue through the employee's notice period. As described above, if a terminated employee is entitled to common law notice, this can result in unintended lengthy periods of additional vesting after the employee has ceased to work for the company. It is possible to limit vesting to the period of actual service if a plan or option agreement contains the "magic words" that provide that vesting ceases on notice of termination. However, the wording that is necessary to effect this result is constantly subject to challenge in Ontario courts, so it is important to ensure that your plan reflects the most up to date state of the law. Similar issues arise with post-service exercise periods - that is, to the extent an option is exercisable after termination of employment, the clock on the exercisability period should "start ticking" on the last day the employee works for the company, not at the end of his notice period.

2. Corporate Law Restrictions: Holders of equity incentives are not just employees - they are also current or potential minority stockholders, and should be treated as such. From an investor standpoint, it is important that shares acquired under an equity compensation plan are subject to appropriate contractual restrictions. These include a right of first refusal, a drag-along, a "buy-back" of vested and/or unvested shares on termination of employment, and a post-IPO market stand-off agreement. Recently, we have seen a number of companies attempt to "short-cut" some of these restrictions by imposing a "voting trust" that purports to transfer voting power over the shares to an officer of the company. In our experience, even if these voting trusts are enforceable, they can put management in a conflict of interest position,

and should not be relied upon as completely effective replacements for traditional drag-alongs, powers of attorney, share escrows and other restrictions.

3. Securities Law Compliance: A company must comply with the securities laws of *each jurisdiction* in which it has executives, employees or consultants who receive securities under an equity compensation plan. Through the recent introduction of Multilateral Instrument 45-105, securities regulators in certain Canadian jurisdictions have liberalized requirements for equity compensation schemes for companies that are not reporting issuers. However, there is a continuing requirement that an employee's participation in a trade must be "voluntary", that is, an employee cannot be induced to purchase securities by expectation of employment or continued employment. For this reason among others, serious securities law (and employment law) concerns apply to schemes in which start-up companies purport to compensate employees with shares "in lieu of" salary. The consequences of failing to comply with securities laws can be severe. Ontario has recently introduced administrative penalties for non-compliance with securities laws of up to \$1 million *per infraction*, which can potentially apply not only to companies but to directors and officers who authorize, permit or acquiesce to the non-compliance.

REGULATORY COMPLIANCE

A due diligence review will include an assessment of the company's regulatory compliance. In addition to the other issues referred to above, we have noticed that a number of technology companies have faced the following regulatory problems:

1. Workplace Safety and Insurance Act Compliance: The *Workplace Safety and Insurance Act* (Ontario) establishes a comprehensive regime regarding the compensation of workers injured at the workplace. One of the basic requirements of this system is that mandatory coverage employers are required to register with the Workplace Safety and Insurance Board within 10 days after becoming such an employer. A company failing to register may be charged the outstanding amount due in applicable premiums, plus interest charged at the Bank of Canada rate plus 6%. Furthermore, the company may be found guilty of a provincial offence and fines may be levied against the company and/or directors, which can reach \$100,000 and \$25,000, respectively.

2. Joint Health and Safety Committee: Joint health and safety committees are required at any workplace that regularly employs 20 or more workers pursuant to the *Occupational Health and Safety Act* (Ontario). Failure to comply with this requirement is an offence under this legislation and, as a result, fines may be levied against the company

and/or directors, which can reach \$500,000 and \$25,000, respectively.

3. **Human Rights Compliance:** Employers must ensure that their human resources practices and procedures are in compliance with the *Human Rights Code* (Ontario). In the event of non-compliance, employers may leave themselves open to human rights complaints. A successful complaint can result in an employer being liable for damages for any losses that an employee has suffered (such as loss of earnings or job opportunities) and damages of up to \$10,000 for mental anguish.

4. **Privacy Legislation Compliance:** Employers need to be aware of the new privacy legislation that will be in effect in Ontario as of January 1, 2004, as it may have a substantial impact on the workplace and the manner in which employee and other information is collected and stored. We will be providing newsletters and offering seminars on this topic in the months to come.

This focus piece is designed to supply summary information only. The comments provided are, of necessity, brief and should not be relied upon as legal advice. We encourage you to contact any member of FMC's labour and employment group for further details or advice in the context of a particular situation.

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