

THE BASICS OF BUSINESS LAW

There are a number of different ways that a person or a group of people could carry on business in Ontario. The most common legal business forms that are used are a sole proprietorship, a partnership or a corporation. Although there are different forms of both partnerships (general, limited, limited liability partnerships, etc.), and corporations (private, public, not-for-profit, co-operative, etc.), this paper shall only deal with the simplest and most common of these forms. Each one of these ways of carrying on business has its own rules and guidelines that apply including guidelines for; the creation of the business entity; the way the business is operated internally; the relationships between the individuals in the business; the relationships with other entities; the taxation of its profits and distributions; the extent of the liabilities to which it, or the individuals involved in the business, are subject; and, many more aspects to each and every business structure.

There are advantages and disadvantages associated with each form of operating a business that must be considered in making the decision about which form your business should take. The form chosen dictates which rules and guidelines are applicable and must be complied with in the operation of the business. In addition, the form of business selected will affect the liability that the persons operating the business will be exposed to and determine the nature of any planning that may need to be undertaken by those persons for the future.

There are key commercial differences between the different forms of business entities and the tax treatment of the business and the persons that operate the business that may be applicable which is usually a large factor in making the determination of the business structure that is selected for the operation of the business.

Sole Proprietorship

The most basic way of operating a business is the sole proprietorship. In the case of a sole proprietorship a single person owns and operates the business. The owner and the business are one and the same party. A sole proprietorship is created as soon as an individual opens a business and can be carried on under the name of the business owner but if the owner wishes to use a different name then they must register the name they wish to use under the Business Names Act of Ontario.

A sole proprietorship does not have a legal existence beyond the individual who opens and operates the business. The owner is the legal person and must take any actions for the business personally. The business cannot sue or be sued in its name and only the individual that is the business can sue or be sued for the sole proprietorship. A sole proprietorship cannot enter into contracts under its name, cannot file its' own tax returns and cannot take any other action as the individual that starts the business must do each of these things on their own directly. As a result, sole proprietorships are usually small businesses with few employees.

Most people start a business as a sole proprietorship as it is the simplest form of business to commence. There are no formal requirements to set up a sole proprietorship if the name of the

individual is used for the business. If a name other than the individual's will be used then that name must be registered as indicated above and the business can be up and running almost immediately.

There are advantages and disadvantages to operating as a sole proprietorship which include:

- (a) The cost to create the sole proprietorship are usually less than creating a business through any other form. A sole proprietorship is easier to set up as a result and is subject to little regulation.
- (b) As the owner is the business, the structure is less complex and the owner has full control to make any decisions without the requirement to obtain further consents, approvals or consulting others.
- (c) An owner cannot also be an employee.
- (d) All benefits or profits accrue to the owner. However, the owner shall also be responsible for any losses or failures of the business and for any bills or liabilities that are part of the business.
- (e) The business does not own the assets and all assets of the business are assets of the owner.
- (f) Any tax obligations of the business are tax obligations of the owner.
- (g) A sole proprietorship is easy to dissolve as all assets belong to the owner and there are no stringent reporting requirements.

The Canada Revenue Agency does not see a distinction between the sole proprietorship business and the owner which means that any profits the business earns belong to the owner and any losses the business suffers can be set off against any other sources of income that the owner has to reduce their overall tax liability. The business income is simply treated as another source of income for the owner.

It is more difficult to raise capital that may be needed in the business for expansion as there are limitations to the personal credit or guarantees of the owner.

The main disadvantage of operating a business as a sole proprietorship is the legal liability to which the owner may be exposed. As the owner is the business, the owner is legally liable for any injury suffered by another during the operation of the business, including not only physical injuries but economic injuries as well that may be derived from a breach of a contract that the owner has entered into for the business. That liability is unlimited and exposes the owner's other assets to those liabilities.

In the event a person wishes to start a business with another individual they must do so in a form other than a sole proprietorship. The next most common form of business would be a partnership.

Partnership

A partnership is defined in the Ontario Partnerships Act as “the relation that subsists between persons carrying on business in common with a view to profit” but is without a corporate structure. The legal institution of a partnership can be created even contrary to the intentions of the parties as long as all indicia of a partnership are met. A partnership can be governed by an agreement between the parties in the partnership but if there is no such agreement then the partnership is governed by the provisions of the provincial legislation, including the Partnerships Act.

A partnership agreement is an agreement between the individuals that own the business and sets out the basic rights and obligations of the partners to the business and how the business will operate and the involvement of each of the partners. A partnership does not have a separate legal status and the partnership is not legally independent from the individuals that compose the partnership. The partners are working together toward a view to profit and each member of a partnership should have some degree of personal involvement even if they are not actively engaged in the partnership and are simply a silent partner.

In Ontario partnerships are governed mostly by the Partnerships Act and the Limited Partnerships Act which include the general requirements for carrying on business in this form. The partners can be individuals, corporations or other partnerships and the relationship between the partners is governed by the legislation unless there is a partnership agreement that does so. Although there are three types of partnerships in Canada, being a general partnership, a limited partnership and a limited liability partnership, a discussion of the limited or limited liability partnerships is too involved for the scope of this paper and will not be discussed herein in any detail.

A general partnership is created when two or more individuals, or persons, come together to run an unincorporated business. As a partnership is not a separate legal entity it cannot enter into contracts or protect its owners from legal liability. All partners have joint and several liability for the actions of the partnership which means that they are all equally liable for the partnership’s actions and liabilities. Each partner’s personal assets are subject to the liabilities of the partnership as with a sole proprietorship.

Unless all parties wish to be governed by the provisions of the legislation, it is very important to ensure that the understanding between the parties is reduced to writing in the form of a partnership agreement. A partnership agreement may include any provisions that the parties agree to including, but not limited to the following:

- ✓ the name the partnership shall operate under which must be registered under the Business Names Act
- ✓ the nature and address of the business

- ✓ the duration of the partnership
- ✓ the financial structure of the business
- ✓ how profits and losses will be shared and allocated between the partners
- ✓ the management of the business and voting rights of each partner
- ✓ provisions for retirement from the partnership
- ✓ provisions for the settlement of disputes
- ✓ procedure for the introduction of new partners or departure of existing partners
- ✓ the duties of each and every partner in the partnership

There are advantages and disadvantages to operating as a general partnership which include:

- (a) The costs to create the partnership will depend on the nature of the partnership and the agreement between the partners and are usually less than starting a business through incorporation of a corporation but are greater than starting a sole proprietorship. Unless the partners wish to be governed by the provisions of the Partnerships Act the partners may require the assistance of a lawyer and accountant to determine the structure of the partnership to ensure it meets the intention of the partners.
- (b) As the partners are the business, the structure can be less complex and the partners have full control to make any decisions. As there is more than one partner there may be requirements that must be met to obtain further consents or approvals to any actions taken by the partnership.
- (c) A partnership agreement can be very flexible and reflect the different needs and interests of each of the partners and can allocate the income or losses incurred by the partnership to the partners as agreed to by all partners.
- (d) All benefits or profits accrue to the partners. However, the partners shall also be responsible for any losses or failures of the business and for any bills or liabilities that are part of the business.
- (e) The partnership has the flexibility of adding new partners to meet any need for new capital requirements.
- (f) Any tax obligations of the business are tax obligations of the partners. The business keeps accounts of all income and expenses and calculates its profit or loss for apportionment between the partners in accordance with the terms and provisions of the partnership agreement and then each partner includes their share of the profits or losses in their individual tax returns.

Like the sole proprietorship the Canada Revenue Agency does not see a distinction between the partnership business and the partners which means that any profits the business earns belong to the partners and any losses the business suffers can be set off against any other sources of income that the partners have to reduce their overall tax liability. The business income is simply treated as another source of income for the partner.

The main disadvantage of operating a business as a partnership is the legal liability of the partners. As the partners are the business the partners are legally liable for any injury suffered by

another during the operation of the business, including not only physical injuries but economic injuries as well that may be derived from a breach of a contract that the partnership has entered into for the business. That liability is unlimited and exposes the partners' other assets to those liabilities. Each partner acts like an insurer for the mistakes of the other partners as they may be liable for any losses incurred by a single partner's error.

A limited partnership can have one or more general partners and one or more limited partners. The limited partners usually provide the partnership with money or other resources in exchange for a share in the profits and are limited in their involvement in the partnership. Their involvement does not attract liability for the partnership's obligations and their liability is limited to the investment or participation that they have made without endangering their own personal assets. The general partners are treated as the partners in any other general partnership and as noted in the previous paragraphs. A limited partnership can only be created by filing a declaration under the Ontario Limited Partnerships Act.

The limited liability partnership is only available to certain professionals, like lawyers and accountants, whose professional regulatory bodies allow them to use this framework for working in professional partnership arrangements and is created by registration under the Business Names Act. The characteristics are similar to general partnerships but the partners are not liable for the professional negligence of the other partners.

Corporations

An individual may also start a business by incorporating a company to run the business. The creation of a corporation is the creation of a distinct legal person that operates independent of its owners and has all of the rights and obligations of an individual. A corporation continues to exist even if the underlying individuals pass away.

The full discussion of all issues regarding corporations is very complex and beyond the scope of this paper. The contents herein can only provide a brief summary of some of the basic concepts and principles of corporations associated with operating a business. Corporations can be created under both provincial legislation under the Ontario Corporations Act or the Ontario Business Corporations Act, or federal legislation under the Canada Business Corporations Act and can be created to run any type of business. Corporations can be for profit and not-for-profit and there are different types of corporations that can be created under provincial or federal laws. The concepts discussed herein shall be limited to those associated with the operation of a for profit business by an Ontario corporation created under the Ontario Business Corporations Act although many general corporate concepts will be applicable to any type of corporation.

A corporation is a separate and distinct legal person under the law from any of the individuals involved in the corporation, including the incorporators, the shareholders, the directors or the officers. Although each of these is a distinct and separate role within the corporation an individual can fulfill one or more of these roles and one individual may even be all of these roles in small private corporations.

The incorporators are the individuals that create the corporation and the shareholders are the owners of the corporation. The shareholders have the right to vote in the election of the directors and to share in the profits of the corporation. The directors are responsible for making the major decisions and directing the mind of the corporation and the officers are responsible for the day to day operations under the supervision of the directors.

A corporation is created by filing Articles of Incorporation which set out the name, registered office, share provisions and any special restrictions that may be required. Once incorporated the shares are issued to the shareholders and the corporation can then proceed to start and carry on a business under its corporate structure.

As a separate and distinct legal entity, the corporation can enter into and be bound by contracts, own property, or sue or be sued in its own right and independent of the shareholders, directors, officers or employees. This is a central concept in corporate law as it allows the corporation to be solely responsible for any debts or obligations without extending such liability to the persons involved in the corporation in any other capacity. There are certain corporate obligations that do create liability in the officers or directors but we will not be discussing such obligations in this paper.

One of the main reasons an individual may decide to incorporate is to take advantage of this limited liability associated with the persons behind the corporation. This concept allows individuals to create and operate a business without the risk of exposing any other personal assets that they may own to the risks and obligations associated with such business.

In addition to limited liability the following are further advantages that may be realized by operating a business through a corporate structure:

- (1) As corporations can have any number of shareholders it may be easier to generate capital for the operation of the business if the resources of additional individuals are available rather than only the resources of the founder. Shares can be issued to any person, including other corporations with some limitations, which expands the pool of resources that may be available.
- (2) The federal and provincial tax rates for active business income are lower than personal tax rates thus resulting in payment of reduced taxes as long as the funds are retained and reinvested in the business. However, any funds taken out of the corporation by the shareholders, officers or directors attract additional tax obligations and thus tax planning should always be discussed with a qualified tax professional when deciding on the treatment of any revenue generated by the business.
- (3) The corporation has perpetual existence and will continue to exist regardless of the status of the underlying shareholders as the shares of the corporation are owned by the shareholders, and not the underlying corporate assets, and they can be transferred to new shareholders in the event of the death of a shareholder. The

corporation has a continuous existence unless terminated by the shareholders or dissolved by the government.

- (4) As the ownership of the corporation is reflected in the shareholdings the transfer of ownership is easier to accomplish than other forms of operating a business. The shares can be much more easily bought and sold without interrupting the operations of the business thus allowing more flexibility for the introduction or removal of individuals from the business.

It is not uncommon for individuals to start a business as either a sole proprietorship or partnership and then transition into a corporation as the process of incorporating and structuring a corporation can be costly and involves more regulatory hurdles than starting a partnership or a sole proprietorship. In addition to the initial costs, maintaining a corporation includes annual record keeping and tax filing requirements which are more complicated and involved than other business structures. Although there is the possibility to reduce taxes that may have to be paid through a corporation one must also be careful to avoid any potential double taxation when the profits of the business are withdrawn from the corporation and the tax planning that goes into dealing with a corporate business can be more involved and expensive as a result.

As with a partnership, the relationship between the individuals that are involved in the ownership of the business should be reflected in an agreement between them. In the corporate setting this is done through a shareholders agreement which may include any provisions that the parties have agreed to. It is an enforceable contract that governs the relationship between the parties. If there is no shareholders agreement the relationship between the parties is governed by the legislation which may not be in accordance with the shareholder's understanding or agreement between them. Having a shareholders agreement is a very important part of any business that is operated by more than one individual through a corporation.

Contracts and Intellectual Property

Lastly, there are two additional issues that are commonly encountered when creating and operating a business, being contractual relationships that may be created and intellectual property rights.

Every business will have to enter into a number of contracts in dealing with either their customers or suppliers. The formation of a contract requires an intention to create a legal relationship, an offer and acceptance of such offer, some form of consideration and the contract must be for a legal purpose to be enforceable. A contract is an agreement between two or more individuals and can be created verbally or by the actions of the parties and does not have to be in writing, with some exceptions like contracts for the purchase and sale of real property.

There are any number of contracts that may be encountered in a business, including, employment contracts, service contracts, leasing contracts, contracts for the purchase or sale of an item, insurance contracts, or others. Contracts are governed to a large extent by common law which is the law that has developed over time through interpretation by the courts. There may be

government legislation that affects, or applies to, certain types of contracts and that should be reviewed with a lawyer in the event there are any questions to a contract of that nature.

Although a contract can be verbal or inferred by the actions of the parties, if the parties wish to ensure that there is a full understanding and agreement regarding the terms of such contract it should be in writing. The ability to enforce a contract may be better if the terms and provisions have been reduced to writing. A written contract is intended to clarify the business dealings between the parties, prevent unexpected and undesired results and provide for dispute resolution between the parties in the event of a disagreement or dispute.

Some common types of contracts include partnership agreements, shareholder agreements, and employment agreements. Typical issues that may be dealt with in any of these contracts deal with the relationship between parties, death, distributions of any profits, sale of the business or the shares, the allocation of expenses in the business and the breakdown in the relationship between the parties.

Although most contracts are not required to be in writing, a written contract is preferred in most cases as it provides the parties with a record of their agreement as to their rights and obligations and provides proof of the terms that were agreed to in the event of a dispute or disagreement between the parties. Enforcement of the rights and obligations encompassed in a contract is easier if the terms and provisions are set out in writing.

Non-disclosure agreements, confidentially agreements or non-competition agreements may be used to protect business secrets or keep employees from using information developed by the business in a manner that would harm the business.

The law associated with contracts and their interpretation and enforcement is extensive and any contracts should be reviewed by a lawyer to confirm the parties' intentions are reflected therein and to ensure the enforceability thereof. In addition, the breach of any contract has consequences that need to be considered at the time of entering into the contract to avoid any potential negative implications that may not have been understood when the relationship is established, including consideration of the extent and amount of any potential damages that may result from a breach of the contract.

The intellectual property rights that may be involved in the creation and operation of a business revolve around the protection of trademark, patent and copyright rights over assets owned by the business.

Trademarks protect the words, letters, symbols, designs or pictures or any other distinguishing marks that are associated with the business name, its brand or products and distinguish one party's goods or services from others. Both registered and unregistered trademarks are protected under common law and trademark legislation and are determined by usage. A trademark can be protected indefinitely as long as it is in use. A trademark can be registered under the federal registration system governed by the Trademarks Act and, if so registered, is valid for 15 years but can be renewed indefinitely with continued use.

Registration of a trademark provides additional protection as it is easier to prove infringement of the trademark and does not require proof of any damages as the unauthorized use of a registered trademark is sufficient to establish infringement and protects the trademark across Canada. An unregistered trademark is only protected in the geographic areas associated with the use of the trademark.

Patent law prevents parties, other than the registered patent owner, from using the product or idea that is the subject of the registered patent. In order to have patent protection the patent must be registered under the federal Patent Act and the protection is for a period of 20 years from the date of registration and thereafter can be used by the general public. In order to register a patent, the idea must be new, useful, and not obvious and can be associated with a new or useful improvement of any existing invention. The process to patent a product is very involved and complex and is usually completed with professional assistance of an expert, such as a patent agent that specializes in that area and can guide the application through the entire process.

Copyright law and protection is associated with the right to copy and recognizes the right of the original creator of the work to control its use and reproduction. People are prevented from using the creative work without the permission of the creator or copyright holder. The Copyright Act is federal legislation and copyright protection deals with the exclusive use to any literary, dramatic, musical or artistic work and provides the creator with the exclusive legal right to produce, reproduce, publish or perform the work.

The original work is automatically protected under common law which means that it does not need to be registered but registering it provides evidence of use and can be important for enforcement of any rights associated with the work. Copyright law protects the work for a period of 50 years after the calendar year in which the creator passed away. In order to register a copyright the work must be original and must be written down or recorded in some form and cannot be simply an idea. It is common to use the copyright symbol © on the work to alert others that the work is copyright protected. The use of the symbol is not required and the work is protected whether the symbol is present or not but it can enhance the protection as it acts as a reminder that the work is protected and the symbol is widely recognized. There are exceptions to the use of copyrighted work that will not be discussed herein.

The concepts covered herein are general in nature and are not intended to be legal advice as each circumstance is unique. These concepts deal with a few of the more common issues that may be encountered in the creation and operation of a business. A professional adviser, should always be consulted when dealing with any of the issues included herein to ensure they are properly implemented and reflected in the creation, structure and operation of the business and to avoid potential problems that may require time consuming and expensive resolutions in the future.

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