Toronto Law Journal

Simple Agreement for Future Equity — Are They Really That Safe?

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If you're involved in the start-up space, you've likely heard the term "safe". A Simple Agreement for Future Equity, more commonly referred to as a SAFE, was introduced by Y Combinator in 2013[2] as a cost-effective, simple and quick method for start-ups to raise capital. While SAFEs have yet to become as popular in Canada as they are south of the border, they are emerging as an alternative to more traditional forms of early-stage financing, such as convertible notes or preferred shares.

The Basics

A SAFE is a convertible security that typically does not have a debt component or an expiration/maturity date (*i.e.*, no obligation to repay). Investors who participate in a SAFE are acquiring an option to convert their investment into the company's shares at a later date when a pre-determined event occurs. This conversion event usually happens when the company completes an equity financing for a negotiated aggregate proceeds amount. To motivate investors to invest in a SAFE, their money will typically be converted at either, or the lesser of either, (a) a discount to the equity financing valuation, or (b) an agreed upon valuation cap. Due to this relatively simple structure and standard form documentation, negotiations between the parties generally focus on what the valuation discount or valuation cap will be, and whether the SAFE will include one or both features. Some modified SAFEs also try to entice investors by paying interest on invested capital, to be paid-in-kind on the equity conversion date (however, this is a relatively rare feature).

What Founders Should Know

One of the biggest draws to SAFEs for founders is the ability to close financing with an investor on an individual basis, rather than coordinating a single closing with multiple investors — often a stressful and costly process. This feature in effect creates a staggered equity raising process which allows founders to better manage how much equity should be offered (so they do not become diluted more than necessary) and ensures that the company does not become overcapitalized. A further benefit is that issuers will spend less on lawyers and save time negotiating given the lack of complex terms in the agreement compared with more traditional financing methods. Finally, given there are no maturity dates or equity financing deadlines,

[1] This article is reproduced with the permission of Fogler, Rubinoff LLP. Roberto is an associate in Fogler, Rubinoff LLP's business law group. If you have a question about SAFEs, please contact Roberto De Pasquale at 416.864.1366 or rdepasquale@foglers.com.

[2] https://www.ycombinator.com/documents/.

founders can focus on growing their business without the overhanging stress that debt or financing deadlines cause.

Despite the positives, there are some drawbacks of which founders should be aware. Often, founders will include a valuation cap in a SAFE and raise funds with the expectation they are diluting their ownership stake based on that valuation. It is important to remember that the valuation cap is not necessarily the valuation at which the capital is being raised. To illustrate, let's say a founder raised $500,000 of seed capital through a SAFE. The SAFE's conversion event is an equity round (commonly referred to as a Series A round) of $1M, and the equity converts at the lesser of either a $10M valuation cap or a 20% discount. If the company is forced to raise $1M at a $6M valuation due to a liquidity crunch or other market factors, the founders will have given up 27% of their company, compared with the 16% they would have anticipated at a $10M valuation.[3]

What Investors Should Know

Investors benefit from SAFEs for many of the same reasons as founders. The simplicity of the nature of the investment and the standard form paperwork reduces negotiation time and allows investors to make decisions quickly, while also reducing pressures to meet deadlines to participate in a formal equity round.

That said, there are also some negatives for investors. First, it is unclear what an investor actually owns when they purchase a SAFE. There are no expiration or maturity dates, so it may take years before a conversion to equity occurs or it may never happen. Second, an investor does not have any shareholder rights until the SAFE is converted to equity. Accordingly, a SAFE holder does not have the power to vote in an election of the board of directors or to participate in dividends. Third, on a dissolution of the company, SAFEs rank junior to outstanding debt and creditor claims (but generally are senior to payments to common shares).

Takeaways

A SAFE is a useful tool for start-ups looking to raise capital without incurring the higher costs and protracted negotiations associated with more traditional methods of financing. Nevertheless, it is important for founders to carefully consider how much equity they are willing to give up, and for investors, to keep in mind that they have no shareholder rights and lack recourse in the event a conversion to equity does not occur.

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[3] $10M Valuation: [SAFE dilution + Series A Dilution] = (500,000 / 8,000,000) + (1,000,000 / 10,000,000) = 16% $6M Valuation: [SAFE dilution + Series A Dilution] = (500,000 / 4,800,000) + (1,000,000 / 8,000,000) = 27%

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The Doctrine of Rectification and Beneficiary Designations

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It is well known that contracts and other written documents can be rectified in certain circumstances to correct obvious errors or other deficiencies. Estate lawyers encounter situations in which testamentary documents, typically Last Wills and Testaments or the Codicils thereto, are rectified. *The Manufacturers Life Insurance Company v. Sorozan Estate*, 2016 ONSC 2914 is a 2016 decision of the Ontario Superior Court of Justice which considers how the principles of rectification may apply to correct life insurance beneficiary designations, or allow for the substitution of such documents where they cannot be located.

In this case, after the deceased's death, there were competing claims against the proceeds of a group policy on the life of the deceased by his surviving spouse and a child from a prior marriage. The deceased's spouse asserted that she was the sole beneficiary of the life insurance policy valued at $80,000.

The primary evidence before the Court was as follows:

- a beneficiary designation form from 1986, naming the deceased's child and the deceased's spouse as equal beneficiaries, which had subsequently been struck through with a vertical slash; and

- a Group Life Insurance Record dated 1996, sent to the deceased and indicating that the beneficiary of the policy was the deceased's common-law spouse.

Justice Dunphy was required to make inferences on the basis of what limited evidence was before the Court to determine that the proper beneficiary of the life insurance policy was the surviving spouse, notwithstanding that the form designating her as beneficiary could not be located:

> [18] I find that it is likely on the balance of probabilities that Mr. Sorozan Sr. signed and delivered to Allstate a designation of beneficiary form after 1986 and prior to August 1, 1996 naming Ms. Partanen as the sole beneficiary of his group life insurance policy benefit but that the form has been misplaced or lost. In my view, this is the only reasonable inference that can be drawn based on the following:
>
> (a) The fact that the 1986 designation of beneficiary form has been manually struck with a vertical slash, apparently on Mr. Partanen's retirement day in 1991, suggests that the document had been superseded and was no longer considered current or valid;

(b) The Record dated August 1, 1996 unequivocally certifies that [the surviving spouse,] Ms. Partanen is the sole beneficiary of the life insurance benefit and the cover letter that accompanied it describes the Record as a "Certificate" that Mr. Sorozan was urged to (and did) keep in his records; and

(c) Ms. Partanen's affidavit evidence supports this inference in that Mr. Sorozan Sr. confirmed to his lawyer at the time he made his will in 2014 that he knew Ms. Partanen to be the beneficiary in circumstances where it would have been very simple for the lawyer to change the beneficiary by will had there been any doubt.

[19] It is simply not reasonable to assume that Allstate made a mistake in sending the 1996 letter attaching the Record to its retired employee. Ms. Boulay's suggestion that Allstate might have confused this with an annuity makes no sense given that the annuity in question was entirely different and contained joint contingent beneficiaries. I conclude that Allstate had in hand at that time a designation of beneficiary form from Mr. Sorozan Sr. (dated after the 1986 form) naming Ms. Partanen as sole beneficiary and that it has since misplaced that form.

[20] Mr. Sorozan Sr.'s handwritten instructions to his lawyer in regards to the will corroborates his general intention to make Ms. Partanen his universal beneficiary and corroborates in part Ms. Partanen's affidavit evidence that Mr. Sorozan Sr. felt that he had sufficiently provided for his son with cash payments over the years. I accept that Mr. Sorozan Sr. would have effected a change of beneficiary by will but for the confirmation the Record provided him with confirmation that this was simply not necessary.

…

[23] Ms. Partanen was in fact the designated beneficiary. The fact that a written document cannot be located does not lead to the conclusion that it has no effect if its existence and content can be inferred from other evidence. The 1996 Record provides that evidence. There is no doubt as to Mr. Sorozan Sr.'s intentions – he had the letter from Allstate from 1996 in his possession at all material times including when he approached his lawyer to give instructions to draft his will. Had the Record *not* conformed to his intentions, there were steps that he could have taken when he met his lawyer.

This decision highlights not only the importance of maintaining clear records as to the intended beneficiary of a life insurance policy, but also the potential importance of the notes of solicitors and other advisors. A doctrine like rectification does not allow a remaking of the contract based on fairness or finding the intentions of the deceased in naming a beneficiary, and its application

is somewhat limited; however, the evidence of independent third parties will often be determinative where rectification is permitted.

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The Godfrey Decision: Competition Class Action Certification Made (Even) Easier

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These appeals raise a fundamental question: are courts at a stage where the balance struck by Parliament of Canada's competition law should be upset by applying new principles of liability for price-fixing cases, resulting in near-automatic certification of class actions? In doing so, are courts going a bridge too far?[2]

Introduction

On September 20th of this year the Supreme Court of Canada released its long anticipated decision in *Pioneer Corporation et al v. Godfrey*, which dealt with a number of important cartel class action questions. It is the first meaningful decision by the Supreme Court in the area in more than 6 years.[3] So much anticipated was the decision that many pending cartel class actions had been halted or paused pending the decision in *Godfrey*. Presumably those paused cases will now commence again and the ruling in *Godfrey* will inform those cases. As foreshadowed in the title of this Brief, by and large that information will not be welcome for defendants.

The Godfrey Issues

Godfrey brought to the Supreme Court a number of key issues which had been the subject of debate within and amongst lower courts over the last number of years. These included the applicable limitation period for actions alleging a breach of the *Competition Act* ("Act"); whether umbrella purchasers (that is, purchasers of the relevant product who buy it not from alleged conspirators, but rather from third parties who did not participate in a conspiracy) have a cause of action; whether the Act excludes parallel or similar common law causes of action, such as civil conspiracy; and, finally, whether it is necessary at the certification stage to be able to show a methodology which can demonstrate injury to each individual proposed class member, or merely injury to "the level" (of purchaser — that is indirect purchasers once, twice,

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[1] This paper is reprinted with the permission of McMillan LLP. The authors were not part of the McMillan LLP team which represented one of the parties in *Godfrey*. For more information on this topic, please contact:

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[2] Côté J., in dissent, in *Godfrey*.

[3] Since *Pro-Sys Consultants Ltd. v. Microsoft Corporation*, [2013] 3 S.C.R. 447.

thrice, etc. removed from the initial purchase). As noted, these questions were all answered to the advantage of plaintiffs and the disadvantage of defendants, with the exception of an important subset of the proof of injury question, discussed below.

Limitation Period Issues

(i) Discoverability

Section 36 of the Act provides for a right of civil recovery for those who are injured as a result of breaches of the criminal provisions of the Act. Section 36(4) provides the following specific statutory limitation period:

> No action may be brought…after two years from (i) a day on which the conduct was engaged in…

The question which the Supreme Court was asked to answer in relation to this provision was whether it means that the limitation period runs from the last day on which the conspirators conspired, or whether the *discoverability* principle applies, such that the cause of action does not accrue for the purposes of the running of the limitation period until the material facts on which it is based have been discovered or ought to have been discovered by the exercise of reasonable diligence. The Court noted that whether or not the discoverability principle applies is a matter of construction of the relevant statute. Where the event triggering a limitation period is an element in a cause of action, discoverability will apply. The Court found that because the limitation period states that it runs two years from "a day on which the conduct [contrary to Part VI] was engaged in" the event triggering the limitation period is an element of the underlying cause of action. Therefore, the limitation period is subject to the discoverability principle.[4]

The majority of the Court was bolstered in its conclusion that this was the appropriate way to approach the matter by considering the overall statutory scheme, noting that price fixing conspiracies are invariably conducted through secrecy and deception, meaning they are by their very nature unknown to potential claimants. Therefore it would have been absurd, in the Court's view, and would render the cause of action granted by section 36 almost meaningless, if the discoverability principle did not apply. The Court also noted that application of discoverability to the limitation period was supported by the objects of the statute, and by the unfairness of allowing wrongdoers to escape liability.

(ii) Fraudulent Concealment

The plaintiff had argued that, even if the discoverability principle did not apply, the limitation period should be extended beyond two years pursuant to the doctrine of fraudulent concealment. Because of its decision on discoverability the Court did not have to consider

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[4] This was the decision of the majority, but not of Madam Justice Côté, in dissent.

fraudulent concealment, but it did. It noted that fraudulent concealment is an equitable doctrine that prevents limitation periods being used as an instrument of injustice. It provides that where a defendant fraudulently conceals the existence of the causes of action the limitation period is suspended until the plaintiff discovers the fraud or ought reasonably to have discovered the fraud. The issue was whether there has to be a 'special relationship' between the two parties concerned for fraudulent concealment to apply. The Court found that was not the case. A special relationship could be one reason for the doctrine of fraudulent concealment to apply but that, in addition, if it was unconscionable for the defendant to rely on an advantage gained by having concealed the existence of a cause of action the equitable doctrine could apply.

Umbrella Purchasers

As noted above, the concept of umbrella purchasers relates to whether or not customers buying the cartelized product from third parties, not participants in the conspiracy, have a cause of action against the conspirators. The claim is based on the theory that, as the Court in *Godfrey* put it, "a rising tide lifts all boats".

This issue had been a debate in a number of courts of appeal. The defendants argued that allowing claims by umbrella purchasers would expose defendants to indeterminate liability. The Supreme Court determined that the question was one of statutory interpretation and, if the alleged injured person can prove injury, section 36 provides that they have a cause of action against those who engaged in the conduct and caused the injury. It noted that while proof might be difficult, if the umbrella purchaser can prove such loss or damage the Act gives them a cause of action. It found that approach to be consistent with the purposes of the Act to discourage anticompetitive conduct and provide a recourse for those who suffer damages as a result. It found that this did not expose defendants to indeterminate liability because the umbrella purchasers would have to show that they suffered injury resulting from the unlawful conduct.

Additional Causes of Action Beyond the *Competition Act*

The defendants in *Godfrey* argued that section 36 of the Act, providing for the right to claim damages following from breach of the criminal provisions of the Act, represented a complete code, ousting other parallel common law causes of action such as civil conspiracy to injure. Again, a number of lower Court rulings had explored this issue with varying outcomes. The Supreme Court has answered that question reasonably clearly. It found that section 36 is not duplicative of the tort of civil conspiracy nor does it represent a comprehensive and exhaustive code regarding anticompetitive conspiratorial conduct.

Loss as a Common Issue

The most complex and lengthy aspect of the majority decision in *Godfrey*, and likely that which will have the most practical impact, is the question of what proof the plaintiff must offer of loss or injury, at the certification stage, in order to have a class action certified.

In order to certify a class action there must be proof of injury, as injury is an element of the cause of action itself. That has led to a debate in the cases over the years as to whether the plaintiff has to offer a methodology to show injury to *all* proposed class members, or only need offer a methodology to show that injury resulted to "the level" of purchaser (that is to the level of direct purchaser, to the level of the immediate indirect purchaser, to the level of the secondary indirect purchaser, etc.) of the cartelized product.

In considering this question, the Supreme Court in *Godfrey* first confirmed its earlier decision in *Vivendi*[5] that success for one class member cannot be failure for another class member.

Courts are not to certify a class action where some members of the proposed plaintiff class will be injured by the success of the action. But then the question is whether the methodology proposed must be able to demonstrate that there was injury to all class members at a particular level of purchase, or simply that the injury reached that level of purchaser, whether or not such methodology can demonstrate injury to any particular purchaser at that level.

The Court found that the issue in *Godfrey* may be moot in that the plaintiffs' expert purported to opine that he could show injury to all class members at various levels of purchase. Leaving that aside, the Court found that it was not necessary to have a methodology which could show that each and every class member suffered a loss; rather, only that the methodology proposed be sufficiently credible to establish that the loss reached the requisite purchaser level. It found that showing that loss reached a particular level of purchaser will significantly advance litigation, and is therefore all that is necessary to certify the action.

One bright spot for defendants is that the Supreme Court criticized the court below for stating "the aggregate damages provisions…allow for an aggregate award even where some class members have suffered no financial loss". The Supreme Court found that this was not so. Rather, the Court found that, where the evidence at trial showed that the damage could be shown to reach the relevant level of purchaser by way of aggregate evidence, but that it was not possible to determine which purchasers at that level had suffered damage and which had not, then ultimately it might be that individual issues trials would be required to determine which of the class members suffered damage and which did not. Aggregate damages could not be awarded to obviate proof of injury.

Conclusion

As noted at the outset, the *Godfrey* case represents a fairly clear victory for plaintiffs seeking to certify price fixing class actions. It reduces the burden on plaintiffs to show a methodology to prove injury as a condition of certification; it extends the potential limitation periods; it expands the class of plaintiffs to those who did not buy from the price-fixers; and it confirms a broader potential set of causes of action.

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[5] *Vivendi Canada Inc.* v. *Dell'Ariello,* [2014] 1 S.C.R. 3.

If there is a silver lining for defendants it falls on the post-certification side of the ledger. The Court noted that, while it is possible to bring an action on behalf of umbrella purchasers, it is likely to be difficult for them to prove damages. As well, and more significantly, it noted that while an action may be certified even if the plaintiff cannot offer a methodology which demonstrates who suffered injury by use of common evidence; nevertheless, if class members seek to actually obtain damages they must prove injury at trial, either with common evidence, if it is available, or by separate trials, if necessary.

There is no doubt that making class actions easier to certify will result in more payments to plaintiffs — simply because the vast majority of class actions settle if certified. But, if cases become easier and easier to certify — as appears to be the case, such that it is now unambiguously easier to certify class actions in Canada than it is in the United States — the result may be that more cases will be taken to trial, where proof of injury may not be possible. At some point Canadian courts may decide that ease of certification has gone too far. As Madam Justice Côté, in dissent, seems to have indicated in the quote which begins this Brief, the balance may be somewhat off kilter in the certification of competition law class actions at the moment. When things are unbalanced they tend to come back into balance over time. In the interim we may see fewer, or more focused certification battles, with some defendants choosing to go directly to trial, where their prospects may be brighter. Time will tell.

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A Notice of Rescission by Any Other Form May Not Serve as the Same

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Pursuant to provincial franchise legislation, including in Ontario the *Arthur Wishart Act (Franchise Disclosure), 2000* (the "*Wishart Act*"), a franchisee is granted the right to rescind its franchise agreement if the franchisor failed to provide a disclosure document or if the disclosure document provided was so deficient that it amounted to no disclosure. The *Wishart Act* states that a franchisee must give notice of its rescission in writing (a "Notice of Rescission"), and prescribes methods of service for documents, but it does not provide a form that the Notice of Rescission must take.

Over the years, there has been litigation on whether court pleadings may constitute a Notice of Rescission, and this issue was further canvassed in the recent decision in *2352392 Ontario Inc. v. MSI*, 2019 ONSC 4055 ("*MSI*").

Background Facts

Although the background facts in MSI are somewhat convoluted, the issue before the Court was whether the issuance by a franchisee's (the "Franchisee") former lawyer (the "Former Counsel") of a third-party claim in a separate action against a franchisor (the "Franchisor") claiming unpaid rescission damages on behalf of the Franchisee, constituted a properly issued Notice of Rescission to the Franchisor. This was the first and only time the Franchisor was informed of the Franchisee's intent to rescind its franchise agreement within the 2-year period afforded under the *Wishart Act*.

In *MSI*, the Franchisee alleged that the claim for rescission damages contained in the third-party claim did not constitute a Notice of Rescission and that the Former Counsel was negligent by not issuing a proper, stand-alone, Notice of Rescission to the Franchisor within the 2-year limitation period. The Former Counsel, in its defence, argued that the third-party claim against the Franchisor was a valid Notice of Rescission, an argument contested by both the Franchisee and the Franchisor.

The Franchisee, with the support of the Franchisor, brought a Rule 21 Motion to determine whether the third-party claim was a valid Notice of Rescission. Nakatsuru J. agreed with the Franchisee and the Franchisor that the third-party claim was not a valid Notice of Rescission.

Legal Analysis

Nakatsuru J. followed the reasoning in *2130489 Ontario Inc. v. Philthy McNasty's (Enterprises) Inc.*,[1] in which the Ontario Court of Appeal held that an originating pleading is distinct from a Notice of Rescission, because the two documents serve different purposes. A Notice of

[1] 2012 ONCA 381.

Rescission notifies the franchisor that the franchisee is rescinding its franchise agreement, and gives the franchisor 60 days to compensate the franchisee for its alleged losses. In contrast, a pleading sets out the franchisee's claim in litigation, including the franchisor's theory of the case and stance on relevant issues.

Nakatsuru J. further stated that an action for rescission damages cannot be commenced prior to either the expiry of the 60 days the franchisor has to compensate the franchisee or the franchisor's refusal to compensate the franchisee. In his opinion, a franchisee's claim for damages is only discovered after the franchisor is in breach of its obligations to compensate the franchisee, which occurs after the franchisor has been given adequate time to comply with its obligations. As such, to issue a claim against a franchisor without first rescinding the franchise agreement through a Notice of Rescission would be a flawed approach.

Nakatsuru J. also endorsed a 2009 decision of the Court in *779975 Ontario Limited* v. *Mmmuffins Canada Corporation* ("*Mmmuffines*"),[2] which considered whether rescission claimed within a pleading could constitute proper Notice of Rescission. In *Mmmuffins*, the franchisee had not delivered a Notice of Rescission prior to commencing litigation by serving a pleading. However, unlike the facts in *MSI*, the pleading in *Mmmuffins* made no reference to the *Wishart Act* or its statutory rescission provisions. Rather, the pleading made reference only to a more generally available claim for equitable rescission and damages.

The Court in *Mmmuffins* held that the failure of the franchisee to expressly claim statutory rescission under the *Wishart Act* meant that the pleading did not constitute a Notice of Rescission. In arriving at that conclusion, the Court offered helpful guidance about the minimum contents that must be included in a Notice of Rescission for it to be valid, stating that:

> the notice must at least be sufficient to bring home to the franchisor that the franchisee is exercising its statutory right of rescission under the [*Wishart Act*] and to inform the franchisor that the clock has begun to run on the 60-day period… The notice does not have to be in specific language, but it must at least make it clear that the franchisee is exercising its statutory right to rescind the franchise agreement and demanding the compensation to which it is entitled.[3]

Practice Matters

Going forward, practitioners acting for franchisees looking to rescind their franchise agreements must:

- Ensure that a franchisee is rescinding its franchise agreement within:

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2 2009 CanLII 28893 (ONSC) [*Mmmuffins*].

3 *Mmmuffins*, above, para. 45.

  - 60 days of receiving a disclosure document, if the disclosure document or statement of material change was not delivered in a timely manner or if the contents of the disclosure document did not meet the requirements; or
  - 2 years of entering into the franchise agreement, if the franchisor never provided a disclosure document or provided a disclosure document that was so deficient that it amounted to no disclosure.

- Issue a formal, stand-alone Notice of Rescission. The Notice of Rescission should include:
  - The specific statutory grounds relied upon for the rescission;
  - The factual basis for exercising rescission; and
  - A breakdown of the rescission amounts claimed, as set out in the various categories in s. 6(6) of the *Wishart Act*. If the quantum of damages is not known at the time, the lawyer should state this fact, provide an estimate of damages, and quantify actual damages and remit them to the franchisor as soon as possible.

- Serve the Notice of Rescission in a manner prescribed by the relevant franchise agreement or under the *Wishart Act*, as the case may be.