APSC 450
Professional Engineering Practice

Business Relationships and Organizations

(October 2019)

DISCLAIMER

These notes are provided strictly for educational purposes and to supplement lectures. They are intended to provide a basic introduction to business relationships and organization. As such, they should not be used as a basis for making legal decisions that, in any case, should be made with the assistance of legal professionals.

THE UNIVERSITY OF BRITISH COLUMBIA
Faculty of Applied Science

Introduction

An understanding of the forms in which individuals may associate for the purpose of carrying on their professional business is important to the engineer. As an employee, he or she should understand the business organization that he or she is part of. As a private practitioner he or she should be aware of the different forms of association available. A fundamental relationship, perhaps the "atom" of the business organization "molecules", is that of principal-agent.

Principal-Agent Relationship

As a newly-minted engineer, you will quite likely be an employee of a business organization or company. Owners of the business organization or company (*principals*) need not practice engineering directly but may rely on skilled employees (*agents*) such as you. This principal-agent relationship is a business relationship in its own right and is typically established by an express agreement such as an employment contract.[1]

Eventually you may find yourself in the position of employer. Consequently a basic understanding of the principal-agent relationship (or master-servant relationship) and the relevant law of agency will be helpful.

Authority of the Agent

An important aspect of the relationship is the ability of the agent to enter into contracts with third parties. Thus, if a company employs you, you may be given the authority to purchase items from suppliers or to form engineering contracts with clients. The rights and duties under such agreements then become those of the principal. The agent has a duty to the principal not to act with a third party without the express consent of the principal. Thus, you cannot help a supplier secure other sales, or perform engineering services directly for a client without consent of the company you work for.

Obligations of Principal and Agent

The principal has a duty to pay you (the agent) a reasonable fee for the engineering services you render. The principal must also compensate you for any expenses incurred in performing the services. Examples of such expenses might be airfares to job sites, hotels at or near job sites, car rental, use of one's personal vehicle, etc. The employer may also be required to indemnify you (i.e., cover your posterior) in the event of negligence while performing your duties. The issues of liability and negligence will be discussed later.

You, the agent, have a number of obligations to the principal. You must carry out all instructions of the principal, assuming they are lawful. You must also maintain the confidentiality of any information acquired as a result of your employment with the principal. Examples of such information would certainly include engineering reports, company procedures, or compensation packages of company employees. However, one can think of other situations that should be kept

[1] In special cases it may be established by conduct of the agent or principal or by necessity such as in an emergency.

confidential, such as an argument between two co-workers or the fact that the president fell off his bicycle.

More generally, as an agent, you must place the principal's interests above your own. You must always act in the best interests of the employer; for example, by trying to obtain the lowest prices for items purchased from suppliers and the highest possible fees from clients. If you discover any information that may materially affect the principal, you must bring that information to the principal's attention.

Liabilities

Your employment as a professional engineer implies that you have the competence or special skills to perform the tasks required. Where additional specialized skills are needed, some employers may assist you with acquiring or maintaining such competence or special skills.

If you fail to carry out engineering work according to accepted standards, the principal you work for could become liable for any consequent loss. This is (hopefully) less likely to happen in a larger company where there exist many checks and balances to catch deficiencies. In some circumstances, the agent and not the principal may retain liability for a loss due to the agent's actions in a work capacity. For example, if you are a freelance consultant to the principal, the principal is your client and, unless the principal has assumed liability for your work via the consulting contract, you may find yourself with part or full liability for losses incurred by a third party for mistakes or errors in professional judgment. The third party could be, for example, another client of the principal that you are working for, or even a future owner of whatever you worked on, be it a property or a device. Most consulting engineers carry liability insurance to fully or at least partially cover such an eventuality. Liability insurance is discussed in more detail further below.

Termination of the Agreement

In the case of an employee contract, either the principal or the agent may terminate the agreement by giving the other party a specified period of notice after which the agreement will terminate. For example, if you find another job, you must inform your employer of your intention to leave after the specified notice period. Likewise, if the company falls on hard times and cannot meet payroll, they are required to inform you that your services will no longer be required after the notice period. (You will then have experienced a "lay off".) The employer is required to pay you up until the end of the notice period and may be required to give you a severance package. This is discussed in more detail under Employment Law.

"You're fired!" Hopefully no employer ever says this to you. However, in the absence of an agreement to the contrary, an employer has the right to dismiss an employee without notice if the employee has exhibited incompetence, negligence, or has engaged in conduct unbecoming of a professional. This is discussed in more detail in the notes on Employment Law.

If an agreement was established in order to complete a certain task, the agreement terminates when the task is completed. This is a typical arrangement for free-lance consultants, who often provide work to several companies.

Business Organizations

There are four types of business organization possible in Canada: a sole proprietorship, a partnership, incorporation, and cooperatives. These are described below.

Sole Proprietorship

A sole proprietorship is the most basic form of business organization. It consists of an individual professional who directly enters into contracts and is personally liable for the performance of those contracts. While the sole proprietor may do business under a particular business name, all business liabilities remain the sole proprietor's; at law there is no separation between the liabilities of the business and the sole proprietor, they are one and the same.

A sole proprietor may choose to do business under his or her own name, or may give the business a name such as "I am engineer"; however, a sole proprietor cannot add "Inc., Incorporated, Ltd., Limited, Co., or company" after the business name in any business transactions, including advertising. Only registered corporations are permitted to use those tags as part of their business name. Corporations will be discussed in more detail further below.

> ***I AM ENGINEER***
>
> You can register the name "I AM ENGINEER" for your sole proprietorship and conduct business under that name, but the sole proprietorship is not legally separate from you, the owner. Thus, if liabilities or problems in contracts arise, you are personally liable. In the event of a legal claim, you have potentially unlimited liability and all available assets under your name or the registered name are potentially at risk. This includes, for example, cash in I AM ENGINEER's bank account or your personal bank account, your oak desk, your house, your power tools, your Ferrari, and that diamond-studded iPod.

To further the point in the above example, you cannot claim bankruptcy of "I AM ENGINEER" and expect that your assets will be protected; "I AM ENGINEER" is not a recognized legal entity, it is simply an extension of you, personally.[2]

There are two noteworthy disadvantages of a sole proprietorship. One is that potential clients may perceive a sole proprietorship as less legitimate or professional than an incorporated business. Another is the difficulty of valuing the business in the event the business is to be sold since its main value lies with the skill and reputation of its owner. Transfer of ownership can also be problematic since clients may not wish to work with another owner.

Despite these risks and issues, there are several benefits to setting up a sole proprietorship. One is the ease with which it can be established – it is almost as simple as saying "I'm ready to do

[2] You can put assets in your partner's name, but such a partner must be legally recognized as in a marriage or a common law relationship. (This normally requires some form of commitment to that partner.)

engineering" or simply producing what you have designed, written, or developed. Obtaining a business license from your municipality might be required in some cases: e.g. if you are using your basement or garage to build and sell a product. This form of business organization allows development of a business without becoming bogged down in the start-up paperwork normally associated with a more formal type of business. There are also significant tax advantages to engaging in business as a sole proprietor. Although all income derived from work or sales is considered personal income, many types of deductions are available. For example: business losses (Sales-Expenses<0), the cost of the use of your house as an office (typically a percentage of the mortgage payments), the cost of employing people, the colored paper clips, etc., can all be subtracted from your gross income to arrive at a net taxable amount. These tax advantages reflect deliberate government policy and are intended to promote the development of small businesses in the country.[3]

Partnership

A partnership is defined in Canada as "a relationship which subsists between persons carrying on a business in common with a view of profit."[4] The rules and procedures that apply to a partnership are set out in the various partnership acts of the provinces. The text of the *Partnership Act of British Columbia* can be found at the following link:

http://www.bclaws.ca/Recon/document/ID/freeside/00_96348_01#section1

As it is a contractual relationship, a partnership requires the agreement of each member to carry on business together. It must be possible to confirm that agreement. Any event that renders a partner incapable of carrying out business, such as death or bankruptcy, will terminate the partnership. The partnership will also be terminated by a unilateral declaration by one of the partners that he or she no longer wishes to remain a partner.

A formal partnership agreement (i.e. a legal document) is essential to establish the identity of the partners, the name of the firm, the nature of the business, and other terms of the partnership such as how it may be terminated or how it may admit other partners. Almost all provinces require registration of the partnership and of any subsequent changes made to the partnership.

Sometimes, even if a partnership has not been formally registered, it may be inferred if the parties have conducted business as partners. For example, an agreement to share the *profits* of a venture would likely be deemed a partnership while an agreement to share in the *gross revenue* would not be. Note the distinction – if the parties agree to share the profits, then they are "carrying on a business in common with a view of profit" in accordance with the definition of a partnership, while if the parties agree to share the gross revenue, then while there may be a view

[3] Payment of fees to a sole proprietor may be done in cash or near-cash equivalents which allows the possibility for tax evasion by the proprietor or for money laundering by the client. Canada Revenue Agency is well aware of these possibilities and opportunities.
[4] This definition is used in all provincial partnership acts.

of profit, there is not necessarily a business but rather what might be considered an investment opportunity.

A consulting group

Three engineers decide to form a team to write a proposal to do some review work for a lending institution on the design and associated risks of a large engineering project. Each member of the team works out of her house and has her own business expenses. They agree to share the gross fees according to the amount of work each expects to do on the review. Their proposal is successful. The group would have to agree on how joint expenses are made (e.g., printing and binding the report, joint travel expenses) but the amount of profit received by one member of the team will depend mainly on expenses made by that member to perform his portion of the work and not on the expenses or actions of another member. They are acting as a group of sole proprietors, not a partnership.

Partners in a partnership are *jointly liable* (i.e. to the extent of their particular share in the partnership)[5] for all debts and obligations incurred by any member of the partnership while carrying out the business of the partnership.[6] If the assets of the partnership are insufficient to cover a liability, a claim against the partners' personal assets may result. In this sense, the partners are in a similar situation to sole proprietors.

Partners may form what is known as a *Limited Liability Partnership* (LLP) to protect their personal assets. An LLP is part-partnership and part-corporation in that all the partners have a form of limited liability similar to that of the shareholders of a corporation. In an LLP all partners can participate in the management of the business (unlike corporate shareholders, who cannot) without exposing their personal assets to business liabilities (i.e. they have limited liability). In addition to the liability protection available to LLP partners, there may also be some tax advantages over those of a business operating as a corporation.

Another way to limit liability is to form a *Limited Partnership* in which limited partners provide only capital but are not involved in management. Limited partners are not liable for more than the amount of capital they contribute. General partners would manage a Limited Partnership and are fully liable for the debts and obligations of the business. In return for assuming this risk, general partners may be entitled to a greater share of the profits.

Obviously, when forming a partnership, you should pay particular attention to who you choose as a prospective partner, since you could be exposing yourself to considerable risks by joining the partnership.[7] Each partner has considerable influence in how the partnership is operated and

[5] Whereas liability in contract (i.e. for debts and contractual obligations) is *joint*, liability in tort (i.e. for wrongful acts and omissions) is *joint and several*. This means that in a claim against the partnership, an individual partner can be left "holding the bag" for all the other partners if his or her personal assets are greater than the others. The victim of the wrongful act or omission can seek compensation from the partner with the deepest and easiest personal pockets to reach once the direct assets of the partnership are exhausted. The partners can then sue each other to balance things out. (fun, fun, fun)

[6] In principal-agent terms, every partner is an agent of the partnership and of the other partners when carrying out the business of the partnership.

[7] Rule of thumb: Your best friend could be the worst partner.

can legally bind the others without prior approval – all of which can lead to conflict. However, aside from the relative ease and low cost of its formation, a primary advantage of a partnership is the ability to combine assets and skills in forming, running and managing a business.

Incorporation

A corporation is a *legal person* according to law, having rights and duties of its own, separate from those of its owners and shareholders. It can hold and dispose of property, be taxed, and sue or be sued in its corporate name. The main advantage of incorporation is limited liability, that is, the liability of shareholders in the corporation is limited to their capital contribution. In the event of corporate insolvency, creditors or other claimants may seize the company's assets[8] but not those of its shareholders; shareholders lose only the money paid for their shares. Other advantages of incorporation include the ability to raise large amounts of capital through share issuance, perpetual duration (even in the event of a primary shareholder's death or personal bankruptcy), centralized management through a board of directors, and freely transferable ownership.

There are some differences between large corporations and small private companies. For example, to obtain a line of credit in order to operate a small business, the shareholders might be required to provide security or guarantees involving some of their personal assets; which would then be at risk in the event of a claim. In this sense, the liability "protection" of doing business in a corporate form is somewhat defeated; however, lenders do like to protect themselves as best as they can, and for a small business owner this is simply one of the "realities" of doing business.

In Canada, there are both federally incorporated companies as well as provincially incorporated companies. If a company is incorporated as a federal company, it will be governed under the *Canada Business Corporations Act*, (CBCA).[9] If a company is incorporated in a province, it will be governed under the corresponding provincial statute called the *Business Corporations Act.*

The term "corporate veil" refers to the limit on liability of a corporation to the assets owned by that corporation. However, there are situations where the veil can be pierced, so to speak, and the directors of the corporation may be held personally liable. Using the corporation as a means to commit an act that was fraudulent, deceitful, or advanced personal interests, is one (perhaps obvious) way a director (or directors) can attract personal liability.

Of more interest to engineers are cases where managers or directors knew of, or ought to have foreseen, a problem with company activities that could lead to harm to the public or damage to

[8] The assets may be financial or physical in nature. Financial assets might be investments in other companies or contracts for engineering work. Physical assets can range from buildings to the coffee maker in the staff lounge.
[9] Briefly, a CBCA incorporated company can conduct business throughout Canada without re-incorporating in each provincial or territorial jurisdiction in which it wishes to do business (it may still be required to get a business license in a given municipality, however); whereas a provincially or territorially incorporated company must limit its business activities to that jurisdiction, unless it has also incorporated elsewhere.

the environment and failed to address it – an issue of due diligence. In two 1992 Ontario cases, the directors of Bata Industries and Varnicolor Chemical Ltd. were found personally liable for failing to exercise sufficient control of company activities that could or did result in release of toxic chemicals into groundwater systems. (Smythe *et al*, 2007:653-654)

The search term "corporate veil" will lead to many interesting sites.

Cooperatives

A cooperative (co-op) is a business organization owned and operated by a group of individuals for their mutual benefit. The persons making up the group are called members. Co-ops may be incorporated or unincorporated.

Co-ops use the "one member, one vote" principle to elect a board of directors and to make other decisions, usually at an annual general meeting.

Co-ops are common in water and electricity (utility) supply, agriculture production and marketing, banking, credit unions, housing, home care, and other social enterprises.

Choice of the Form of Business Organization

Forming a business association can be a complex legal matter with liability as well as tax implications. Various other factors may affect the choice of a particular form of business organization. Speak to a legal or tax professional and do your homework before entering into any kind of business relationship.

Table 1 summarizes the advantages and disadvantages of sole proprietorships, partnerships, and incorporation.

Table 1
Factors Relevant to Choosing a Form of Business Organization

Factor	Sole Proprietorship	Partnership	Incorporation
Difficulty in establishment	Registration may be required, business license may be required	Agreement and registration	Significant, can be complex
Cost	Low	Medium	High
Maintenance	Low	Medium	High
Ability to generate capital	None beyond the owner's capital and credit	Joint resources of owners in capital and credit	Highest, including share offering
Difficulty in management	Easiest, owner only	Significant	Highest
Liability of owner	Near absolute	Shared, but for wrongful acts or omissions can disproportionately fall to one or more partners	Little or none
Transfer of ownership or responsibility	Sale of assets and reassignment of contracts. Difficult to value.	More complex	Easiest, by sale of shares
Term of operation	Maximum term governed by life of owner	Not beyond death or bankruptcy of any partner	Unlimited
Dissolution	Easy	More complex, can be contentious	Most complex, costly, often contentious

Source: After Willes and Willes, 2004: 250

Liability Insurance

Despite the various ways to limit liability when forming a business organization, liability never really goes away when you are acting as a professional. Engineers may incur liability to their clients and to third parties for their failure to perform their professional obligations with reasonable skill, diligence and competence – an occurrence known as negligence. An engineer practising in a business relationship may need liability insurance to cover claims in the event of negligence.

Engineers contemplating the purchase of liability insurance must consider the following factors:

a) the scope of insurance coverage offered;
b) claims handling and defence capability;
c) other insurance related matters;
d) the insurer: its claim handling experience, financial strength and performance; and
e) costs.

When considering the scope of insurance coverage, an engineer must consider the time period that the policy covers and the types of claims that will be insurable. So, for example, if you are about to start practising some form of engineering that could lead to significant liabilities, ask yourself if the insurance policy that you purchased five years ago is applicable to the work that you are about to undertake.

The type of insurance coverage is also important. Some policies state that they cover services customarily performed by engineers, while other policies may be more restrictive, limiting coverage to the professional services for which the engineer is qualified.

An insurance policy will assist the engineer in three ways. First, it will provide financial protection to the engineer against third parties who claim the engineer has been negligent. Secondly, most insurance policies provide that the insurer will retain and pay a lawyer to defend the engineer in the event of any court proceeding. Thirdly, for certain types of contracts, clients will require certain levels and types of insurance before engineers can even bid on the work.

References

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