Key Considerations in Minority Investments in Canadian Private Companies: Part 1

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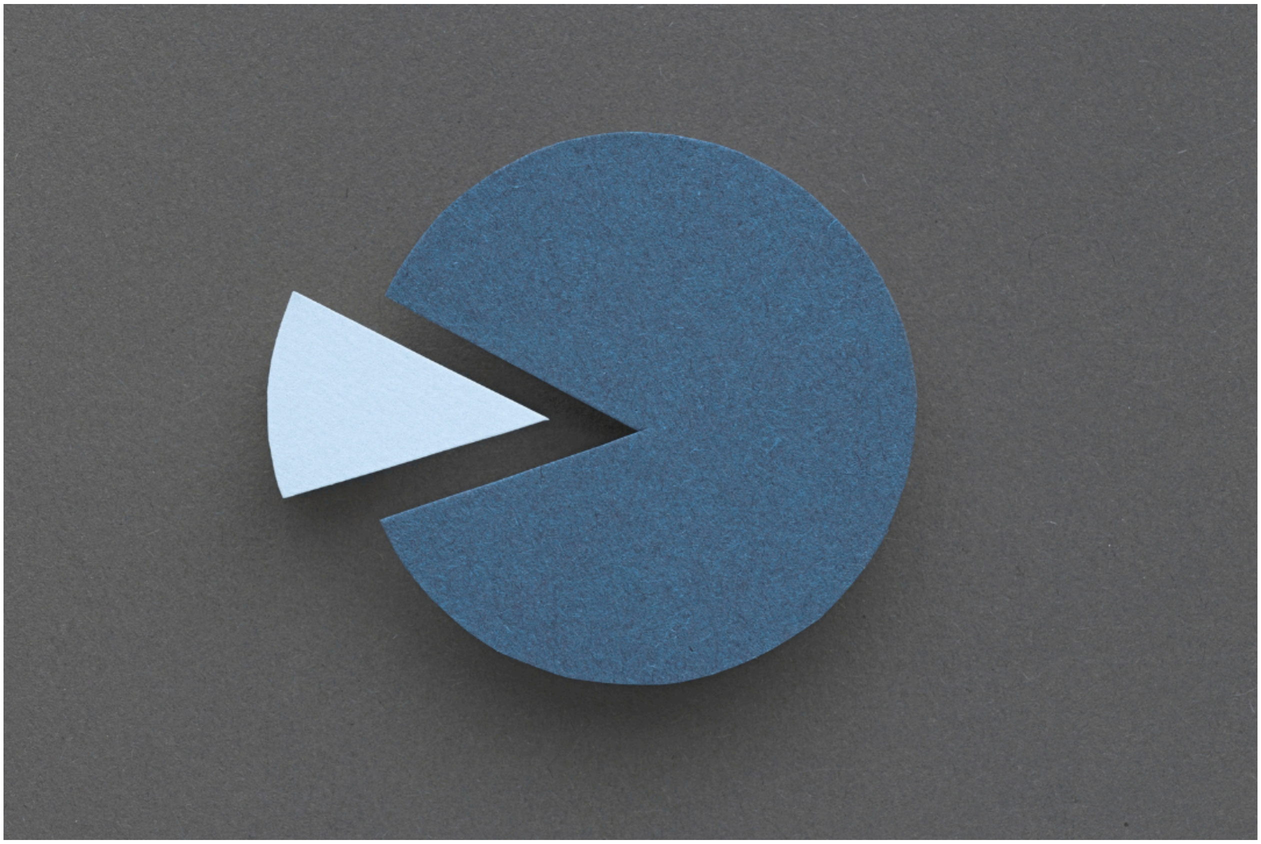

This is the first in a series on the key issues to consider when making or accepting a minority investment.

Front and Centre: Tax Structuring Considerations and CCPC Status

Tax structuring is typically the starting point – for the company, the founders, and the investor, particularly in cross-border transactions. Non-Canadian investors should get tax advice both in Canada and in their home jurisdiction.

A key question will be whether the investor should be subscribing for new shares, or acquiring shares from an existing shareholder.

Among other considerations:

- The company will often want to ensure that it remains a "Canadian-controlled private corporation", or "CCPC", which can have significant implications for the corporation's tax treatment and available incentives. Because governance rights can affect CCPC status, tax analysis should start early and continue as the transaction takes shape.
- Founders must consider how their equity is sold, including whether shares are to be transferred to the investor or newly issued by the company.
- Tax consequences to founders will vary depending on the structure, including access to the lifetime capital gains exemption and the treatment of any earn-out. For further considerations about earn-outs in M&A transactions, see our blog.
- The investor will focus on matters such as which entity should purchase the shares (including whether to use a newly formed acquisition vehicle), how and by which entity the purchase price should be funded, and which tax-related representations will be required from the company and founders in order to carry out the purchase as planned.

Other Regulatory Considerations

Businesses in certain regulated industries, or engaged in sensitive sectors such as defence, may be subject to additional restrictions on foreign ownership. Industry-specific approvals, licensing regimes or sectoral regulations (for example in telecommunications, banking or transportation) may also need to be addressed early in the transaction process.

Founder-Level Structuring Considerations

Tax structuring discussions will often extend to founders' personal and estate planning. Common issues that founders will want to consider with their tax advisors include:

- Whether the founders should hold their shares directly, or in a trust or holding company;
- Whether life and/or disability insurance should be maintained on the founders by the company, and the proceeds used to repurchase their shares (or if the shares should be able to be retained by the founders or in their estates);
- Whether any specialized share structures should be implemented ahead of closing to preserve value or control within certain share classes; and
- Whether any reorganizations or other steps (such as continuances, amalgamations or share restructurings) are required ahead of closing.

The Investment Canada Act

Along with tax advice, one of the earliest considerations in a minority investment deal is whether to submit a pre-closing notification under the Investment Canada Act (ICA).

The ICA requires a notification when a non-Canadian takes a controlling interest in a business carried on in Canada, as well as when a non-Canadian establishes a new Canadian business. Government approval is required for high-value acquisitions of control, with “cultural businesses”, such as those engaged in publishing or broadcasting, subject to stricter review thresholds.

However, the ICA also captures minority investments. Where national security concerns arise (including from a minority investment), the government may block the investment, impose conditions or require divestiture – even after closing. There is no definition of “national security” in the ICA, and the government may take a variety of factors into account.

To help manage that risk, minority investors can make a voluntary pre-closing filing to determine if their proposed investment would be subject to a national security review, triggering a 45-day review period for the government. If no voluntary notification is filed, the government has up to five years after the implementation of the investment to make an order for a national security review.

Although it requires advance planning, a pre-closing filing can help the parties ensure that the investment is viable from a regulatory standpoint before extensive time and resources are dedicated to documenting and closing the transaction.

Investors with their eye on a target in the Canadian critical minerals sector, defence, sensitive technology, and certain other protected industries, should carefully consider submitting a pre-closing filing, as businesses in these sectors are likely to be subject to greater government scrutiny.

The Canadian government has also stated that any investments by an entity owned or influenced by a foreign state into Canada’s critical minerals sector, and any determination that a foreign investor has ties to Russia, will support a finding that the investment could be injurious to national security.

Further to some recent amendments to the ICA, the government is also more likely to take a closer look at investments which could be harmful to the Canadian economy or predatory to Canadian businesses.

For more information about the ICA and related considerations, see our Corporate M&A section for Canada of the annual Global Practice Guide published by Chambers and Partners.

Employment and IP Advice

Minority investment discussions will typically extend to leadership, compensation and governance arrangements.

This is a good time to check in with your employment and intellectual property lawyers. Founders without written employment agreements in place may wish to consider documenting their current working relationships, and those of any other key employees.

It may also be worth confirming that the company has received appropriate written assignments of intellectual property from employees who have made meaningful contributions to the company's branding, know-how, and trade secrets, and that any registered intellectual property is in good standing.

While often viewed as housekeeping, this documentation is critical, both for governance and for investor diligence. Getting an early start is key, as time must be allotted for workers and other counterparties to obtain independent legal advice on any agreements they are asked to sign.

Polishing the Minute Book and Verifying Your Shareholder Base

It is best to have the corporation's minute book up to date and ready for inspection before investor diligence begins. This includes ensuring that annual returns have been filed, annual resolutions have been prepared and signed, approval of material agreements and transactions has been appropriately documented, and corporate registers are complete and current. Rectification resolutions can help confirm the corporation's outstanding share capital and its current directors and officers.

The company should also ensure that any business names (sometimes referred to as trade names) are properly registered. A review of the corporation's public profile can help verify that it accurately reflects its current directors, officers, registered office and business names.

For more information on maintaining a corporate minute book, see our blog.

Of key importance in this stage is ensuring that the corporation has a complete and accurate picture of all existing shareholders and their holdings. Not only will it be essential to the investor to know who their future business partners are and verify the number of shares that correspond to their proportionate holdings, but time must be allotted in course of the transaction for all shareholders to obtain legal advice on any definitive documents they'll need to sign. See our blog about Forgotten Shareholders for further considerations.

Having multiple existing shareholders will raise questions of how risk is to be allotted. Shareholders who have not historically played an active role in the business may ask for less exposure under the representations and indemnity provisions of the definitive agreements than those who have. Contribution agreements, in which multiple existing shareholders agree on how to divide up indemnification liability, are a common feature of minority investment transactions.

Representation and Warranty Insurance

Where risk cannot be fully allocated among the parties, insurance may offer a partial solution. Representation and warranty insurance (often referred to as R&W insurance) can be an effective tool for allocating transaction. A specialized M&A insurance product, it shifts the financial consequences of breaches of representations from the deal parties to the insurer.

This can be particularly valuable where the existing shareholders cannot agree on risk allocation among themselves or, as is often the case in minority investments, where the parties expect to maintain an ongoing relationship after closing that a liability claim could disrupt.

However, R&W insurance comes with a price tag. Premiums and related transaction expenses can be significant and will ultimately reduce the proceeds available from the deal, whether borne directly by the existing shareholders or shared with the investor (for example, through a reduced purchase price).

Key Takeaways

- Tax considerations, including CCPC status, should be addressed early and revisited as the deal evolves.
- Founder-level planning, including ownership and estate structuring, often runs in parallel with transaction negotiations.

- Consider which employment and intellectual property arrangements should be documented before or in connection with closing.
- Even without control, cross-border investments may attract scrutiny under the Investment Canada Act. Consider a pre-closing filing where the target company operates in a scrutinized sector.
- Diligence readiness matters: maintaining an up-to-date minute book and accurate records can prevent delays and reduce execution risk.
- A clear understanding of the company's shareholder base is essential for structuring the transaction and allocating risk among stakeholders.
- Where multiple sellers are involved, contribution arrangements or similar mechanisms may be helpful in allocating indemnification risk.
- Representation and warranty insurance can bridge gaps in risk allocation, but carries a cost that can affect deal economics.