

The Treatment of State-Owned Enterprises Under Canada's Investment Review Regime

SHAWN NEYLAN,
STIKEMAN ELLIOTT LLP

APRIL 2008

The Treatment of State-Owned Enterprises Under Canada's Investment Review Regime

SHAWN NEYLAN,
STIKEMAN ELLIOTT LLP

Presented at Inter-Pacific Bar Association April 27 – 30, 2008, 18th Annual Conference in Los Angeles: Many Borders. One World. Panel: Go West, Good Investor, Go West...to the West Coast

INTRODUCTION

This paper provides an overview of Canada's *Investment Canada Act* and discusses one of the most significant current issues under that legislation: acquisitions of Canadian businesses by foreign state owned or controlled entities ("SOEs"). Acquisitions by SOEs are attracting considerable attention in Canada, and around the world. Canada's federal government has recently issued guidelines concerning the review of acquisitions by SOEs. While there is no express mention in the guidelines of China or the Middle East, there is little doubt that much of the concern is with respect to investors from these areas.

Deng Xiaoping famously said "to be rich is glorious". This is widely viewed as a key milestone in China's evolution to a capitalist market system, with resulting dramatic economic growth. China is viewed today as perhaps the most significant bastion of state-owned enterprises that hold vast amounts of capital that is available to be invested. Non-democratic Middle Eastern countries also hold significant amounts of investable capital, but their current lack of significant consumption of raw materials (in contrast to China) probably reduces the potential for concern about strategic pre-emption of resources.

Real or imagined interest by Chinese and other foreign SOEs in acquiring Canadian businesses has prompted a flurry of media and political activity including specific proposals for special treatment of such acquisitions. One of the key concerns is that some SOEs may not act as "normal" western-owned capitalist enterprises. In particular there is a vague but real worry that SOEs may act in unusual ways to further the interests of foreign states in ways that may be detrimental to Canada.

This paper will not discuss other Canadian regulatory processes including the *Competition Act* merger control regime that provides for pre-notification of mergers where certain financial thresholds are exceeded as well as *ex ante* or *ex post* merger challenges if a transaction will result in a likely substantial lessening or prevention of competition.¹

¹ A summary of Canada's merger review laws can be obtained from the author.

OVERVIEW OF THE INVESTMENT CANADA ACT

ICA Process

An acquisition of control of a Canadian business by a non-Canadian investor requires either notification² or review under the *Investment Canada Act* (“ICA”).³ In general, a direct acquisition by a WTO investor is subject to review where the book value of the assets being acquired is CDN\$295 Million or more.⁴ This threshold is much lower if the acquisition involves a sensitive sector.⁵ In most cases, the applicable asset value threshold for sensitive sector businesses is CDN \$5 Million,⁶ but this threshold rises to CDN\$50 Million in some cases.⁷ It is usually wise to determine that there is no sensitive sector issue as early as possible.

Indirect acquisitions⁸ by WTO investors⁹ that would otherwise be reviewable may be exempt from review based on Canada’s international trade obligations and domestic implementation legislation. The law on this issue is currently uncertain. The Investment Review Division of Industry Canada (the “IRD”) has publicly stated that all indirect acquisitions by WTO investors that do not involve a sensitive sector business are not reviewable.

Except in certain cases, reviewable transactions may not be completed until the Minister of Industry Canada has issued, or is deemed to have issued, a notice to the purchaser that he is satisfied that the proposed transaction is likely to be of “net benefit to Canada”. In determining whether the “net benefit to Canada” test is met, the Minister will consider factors such as effects on employment, competition, Canadian suppliers, capital expenditures and participation of Canadians in the management of the business. In the case of cultural businesses, the Minister of Heritage has the decision making power, acting on the advice of the Cultural Sector Investment Review Division of Heritage Canada (“CSIR”).

The acquirer makes an application for review. The vendor or corporation being acquired is not a party to the application. There is no filing fee associated with an application for review under the ICA. An application for review requires information such as annual reports of the purchaser and the Canadian business being acquired, the value of the business being acquired, and the location and description of all facilities of the acquired business in Canada as well as the number of employees at each location. The key part of an application is the so-called “plans document” which sets out the purchaser’s intentions with respect to the acquired business and includes an analysis of how the transaction will meet the statutory criteria that the transaction be

² Notification is a simple procedure that requires that notice of the investment be given to the Minister. There is no requirement that the Minister’s approval be obtained as is the case where there is a requirement for an application for review.

³ Control is deemed to have been acquired when more than a majority of an entity’s voting interests are acquired, while (except for investment in a cultural business) control is deemed not to have been acquired where less than one-third of the voting interests of a corporation is acquired. For entities other than corporations, the acquisition of less than a majority of the voting interests is deemed not to be an acquisition of control. A presumption of control being acquired arises where an investor acquires between one-third and one-half of the voting interests of a corporation. The onus then lies with the investor to establish that control has not in fact been acquired.

⁴ The assets that must be included in the asset valuation vary with the type of transaction. In some cases, assets outside of Canada must be counted. Also, the \$295 Million threshold is for 2008.

⁵ The sensitive sectors are financial services, transportation services, uranium production and cultural businesses. Cultural business is defined on the basis of format, not content. Generally speaking it includes (i) the publication, distribution or sale of books, magazines, periodicals or newspapers; (ii) the production, distribution, sale or exhibition of film or video recordings; (iii) the production, distribution, sale or exhibition of audio or video music recordings; (iv) the production, distribution or sale of music in print or machine readable form; and (v) broadcast undertakings. “Transportation services” are defined as meaning the carriage of passengers or goods from one place to another by any means, including carriage by air, rail, water, land and pipeline.

⁶ Acquisitions of cultural businesses with relevant book values under \$5 million can still be subject to an application for review requirement if Cabinet makes an order under s. 15 of the ICA.

⁷ The \$50 Million threshold is applicable where the value of the Canadian assets is less than 50% of the total assets acquired and the transaction is indirect.

⁸ An indirect acquisition occurs where there is an acquisition of control of a corporation incorporated elsewhere than in Canada that controls, directly or indirectly, an entity in Canada carrying on the Canadian business.

⁹ In general terms, WTO investor status is determined based on the domicile of the persons who ultimately own the investor.

of “net benefit to Canada”. The plans document is required to have discussion of certain factors relevant to the impact of the transaction on Canada.¹⁰ In preparing the plans document, it is helpful to have certain information about the acquired business, including, where applicable: capital expenditure plans; marketing, business and strategic plans; details of current research and development facilities and programs; annual budgets; employees; and a description of activities and current projects for each Canadian business.

Once the IRD has received an application for review and has certified it as complete, a 45-day waiting period will begin to run. This review period can be unilaterally extended for an additional 30 days by the IRD if the Minister has not completed his review and may be extended further with the investor’s consent.¹¹

As part of the application for review, the IRD will consult with governments of those provinces in which the acquired business carries on business and will also consult with relevant federal government departments.

The IRD often requires the purchaser to provide legally binding undertakings during the course of the application for review. These undertakings are negotiated with the IRD. Once finalised, the purchaser submits a letter to the IRD attaching the proposed undertakings. The Minister will consider the undertakings when making the “net benefit to Canada” ruling. The Minister will typically require at least a week to review the matter and make a decision.

Undertakings often have a duration of three to five years (although they may be longer) and often include the following types of commitments:

- > maintaining specified employment, capital expenditure and research and development expenditure levels in Canada;
- > maintaining certain head office functions in Canada;
- > maintaining Canadians in senior management positions; and
- > maintaining or increasing community support such as charitable contributions.

In the case of cultural businesses, CSIR may require detailed undertaking with a focus on Canadian culture. In some specific cultural industry cases, established policy is to refuse to approve the transaction.

After the closing of a transaction with respect to which undertakings have been given, the IRD or CSIR will likely conduct a post-closing review to determine if the undertakings have been complied with. Post-closing reviews usually occur approximately 18 months after closing.

In some cases it may be unclear as to whether there is a requirement for an application for review, often as a result of uncertainty as to whether the business is engaged in cultural or transportation activities. Closing such transactions without either having completed an application for review or otherwise having determined the views of the

¹⁰ The following information is required in the Plans Document:

(a) the effect of the proposed investment on the level and nature of the economic activity in Canada, including, without limiting the generality of the foregoing, the effect on employment, on resource processing, on the utilization of parts, components and services produced in Canada and on exports from Canada;

(b) the degree and significance of participation by Canadians in the Canadian business (representation in senior management, on boards);

(c) the effect of the investment on productivity, industrial efficiency, technological development, product innovation and product variety in Canada;

(d) the effect of the investment on competition within any industry or industries in Canada;

(e) the compatibility of the investment with national industry economic and cultural policies, taking into consideration industrial, economic and cultural policy objectives enunciated by the government or legislature of any province likely to be significantly affected by the investments;

(f) the contribution of investment to Canada’s ability to compete in world markets.

¹¹ Where such consent is not provided, the Minister can rule against the transaction.

IRD or CSIR results in some risk of a post-closing application for review requirement. The significance of this risk can only be evaluated on a case-by-case basis.

2007 SOE GUIDELINES

In December, 2007, the Minister of Industry issued “*Guidelines - Investment by state-owned enterprises - Net benefit assessment*” (the SOE Guidelines”) pursuant to authority given to the Minister under the ICA. The SOE Guidelines state that they are made “to inform investors of certain procedures that will be followed in the administration of the review and monitoring provisions of the [ICA] where the investors are state-owned enterprises”. The SOE Guidelines specifically recognize that “increased capital and technology would benefit Canada.”

Key Points of SOE Guidelines

The key points of the SOE Guidelines are as follows:

- > A SOE is considered by the Minister to mean an enterprise that is owned or controlled directly or indirectly by a foreign government;
- > The Minister will apply the existing principles in the ICA when reviewing acquisitions by SOEs;
- > It is the policy of the Government of Canada to ensure that the *governance* of SOEs is considered as part of an application for review including:
 - whether the non-Canadian adheres to Canadian standards of corporate governance (including, for example, commitments to transparency and disclosure, independent members of the board of directors, independent audit committees and equitable treatment of shareholders) and to Canadian laws and practices;
 - the manner and the extent to which the non-Canadian is owned or controlled by a state;
- > It is the policy of the Government of Canada to ensure that the *commercial orientation* of SOEs is considered as part of an application for review;
- > Furthermore, the Minister will assess whether a Canadian business to be acquired by a non-Canadian that is an SOE will continue to have the ability to operate on a commercial basis regarding:
 - where to export;
 - where to process;
 - the participation of Canadians in its operations in Canada and elsewhere;
 - support of on-going innovation, research and development; and;
 - the appropriate level of capital expenditures to maintain the Canadian business in a globally competitive position.
- > SOEs are encouraged to submit specific legally binding undertakings covering aspects of the business including:
 - the appointment of Canadians as independent directors on the board of directors,
 - the employment of Canadians in senior management positions,
 - the incorporation of the business in Canada, and
 - the listing of shares of the acquiring company or the Canadian business being acquired on a Canadian stock exchange.

SOE Guidelines – Implications

In light of the fact that the Canadian government has decided to issue the SOE Guidelines, it is remarkable that, other than references to the governance structure and commercial orientation of the investor and the destination of exports, the SOE Guidelines essentially reiterate existing law and procedure that are applicable to any application for review. It is clear that the Canadian government is not opposed in principle to investment in Canada by SOEs. Rather, the government has mentioned a few specific concerns that it may consider with respect to acquisitions of Canadian businesses by SOEs.

Governance Structure

There are two main aspects to the governance structure factor. First, there is the question of whether the SOE adheres to Canadian standards of corporate governance. While certain examples are given in the SOE Guidelines (e.g. disclosure and an independent board) it is doubtful that the IRD will be focus on variations that do not call into question the likelihood of the SOE acting in a “normal” commercial manner.

The second aspect of the governance structure factor is the manner and the extent to which the SOE is owned or controlled by a state. The key issue is likely to be whether the IRD views the SOE as simply an extension of the state, readily subject to receiving directions to advance state, as opposed to commercial, interests. If the SOE has been partially floated, or is otherwise showing signs of an evolving separation from the control of the state, the IRD may have fewer concerns.

Commercial Orientation

To a large extent the stance of the IRD is likely going to be highly correlated with the degree of comfort with the commercial *bona fides* of the SOE. Intangible perceptions based on the SOE’s home country and the history of the SOE are likely to receive significant weight. Building early and strong relationships with the IRD and other government actors in order to demonstrate commercial *bona fides* is likely to be very important in ensuring the successful completion of the application for review process.

Destination of Exports

While typically the IRD will be very interested in the investment’s potential to increase exports, it is generally agnostic as to the destinations of such exports. The “where to export” factor likely reflects a concern that a Chinese SOE might pre-empt supply for use in China. Given that Canada consumes a minimal amount of its raw material production, it is difficult to see this factor as having much significance in resource company transactions. For example, the difference between a Chinese SOE operating a Canadian mine and a American-owned company operating the same mine does not appear to be likely to produce varying results in Canada: both will want to export the vast majority of production. In both cases, at the time when the mine is acquired, the government will likely seek assurances re secondary production (e.g., concentrates and smelting), regardless of whether the buyer is a SOE. Subject to such assurances, the IRD is unlikely to have any real interest in the destination of exports.

However, it is possible to envisage scenarios where acquisitions by SOEs of technology companies or other companies involved in different potentially sensitive industries could lead to heightened concerns, particularly with respect to national security. In this regard, it is anticipated that further government policy-making or legislation with respect to the national security issue is possible in the not-too-distant future.

GUIDANCE FOR SOEs CONSIDERING CANADIAN ACQUISITIONS

SOEs considering Canadian acquisitions should consider the following points with respect to potential ICA issues:

- > Determine as soon as possible whether the acquisition will be reviewable under the ICA – if no review is required a simple notification will need to be filed;
- > If an ICA application for review is required it is important to consider at an early date whether the factors related to SOE involvement is likely to cause heightened concern at the IRD:
 - Assess governance standards and commercial orientation of the SOE in relation to general Canadian standards. Do not assume that differences will necessarily raise concern, but consider whether there is likely to be a Canadian government concern that a foreign state will direct the actions of the SOE;
 - Consider whether there is likely to be a Canadian government concern re diversion of exports. Assess the potential for an undertaking being offered in relation to the destination of exports;
 - Consider the potential for a national security concern. In particular, determine whether there are technologies or products that have national security applications or implications;
- > Develop detailed plans for the Canadian business at an early date. These will be needed for the ICA application for review;
- > Keep in mind that the business plans are the starting point for the negotiation of undertakings and that it is therefore unwise to include plans that the SOE would be uncomfortable including in undertakings;
- > Spend time early in the process developing draft undertakings that are workable from a business perspective;
- > Be prepared to carefully listen to any government concerns. These can often be addressed without undertakings. It is also possible to work with the IRD to negotiate undertakings that address government concerns but do not unduly constrain the business; and
- > Building early and strong relationships with the IRD and other government agencies is likely to be very important in ensuring successful completion of the application for review process.

CONCLUSION

With careful consideration of the various potential issues that may be raised by the Canadian government and a well developed regulatory strategy, ICA approval of most if not all acquisitions of Canadian businesses by SOEs is likely achievable. While the undertaking negotiation process will require considerable work and possibly significant concessions, an outcome that is workable for the business involved is almost always obtainable.

THE AUTHOR



Shawn C. D. Neylan

5300 Commerce Court West, 199 Bay Street, Toronto, Canada M5L 1B9
Direct: (416) 869-5545 Fax: (416) 947-0866 sneylan@stikeman.com

Suite 1700, Park Place, 666 Burrard Street, Vancouver, Canada V6C 2X8
Direct: (604) 631-1320 Fax: (604) 681-1825 sneylan@stikeman.com

Shawn Neylan is a partner in the Toronto office of Stikeman Elliott. His practice is primarily focused on the review of transactions under the *Competition Act* and the *Investment Canada Act*. Recent notable mandates include having led the regulatory teams for discount brewer Lakeport Brewing Income Fund in its acquisition by Labatt Brewing Limited (where the Commissioner of Competition failed to get an order delaying closing in a landmark Competition Tribunal ruling), CVRD (now Vale) in its groundbreaking acquisition of the Canadian icon Inco Limited, and PaperlinX Canada Limited in its acquisition of the competing paper merchant business of Cascades Resources Division (where remedies were negotiated for limited geographic areas).

MONTRÉAL

1155 René-Lévesque Blvd. West, 40th Floor, Montréal, QC, Canada H3B 3V2
Tel: (514) 397-3000 Fax: (514) 397-3222

TORONTO

5300 Commerce Court West, 199 Bay Street, Toronto, ON, Canada M5L 1B9
Tel: (416) 869-5500 Fax: (416) 947-0866

OTTAWA

Suite 1600, 50 O'Connor Street, Ottawa, ON, Canada K1P 6L2
Tel: (613) 234-4555 Fax: (613) 230-8877

CALGARY

4300 Bankers Hall West, 888 - 3rd Street S.W., Calgary, AB, Canada T2P 5C5
Tel: (403) 266-9000 Fax: (403) 266-9034

VANCOUVER

Suite 1700, Park Place, 666 Burrard Street, Vancouver, BC, Canada V6C 2X8
Tel: (604) 631-1300 Fax: (604) 681-1825

NEW YORK

Tower 56, 14th Floor, 126 East 56th Street, New York, USA 10022
Tel: (212) 371-8855 Fax: (212) 371-7087

LONDON

Dauntsey House, 4B Frederick's Place, London EC2R 8AB England
Tel: 44 20 7367 0150 Fax: 44 20 7367 0160

SYDNEY

Level 12, The Chifley Tower, 2 Chifley Square, Sydney N.S.W. 2000 Australia
Tel: (61-2) 9232 7199 Fax: (61-2) 9232 6908

www.stikeman.com

STIKEMAN ELLIOTT