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Foreign Investment Review in Canada: Be Careful What You Wish For

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In February, 2011, a Canadian Parliamentary committee began reviewing the Investment Canada Act (ICA) with a view to recommending measures to increase the transparency and effectiveness of the statute. The review was terminated by the federal election called in late-March, but may well recommence in the next Parliament. This article examines recent events leading to the statutory review as well as the various decision-making models under consideration and asks: "Will reforms be of 'net benefit' to Canada?"

The ICA applies to the acquisition of control of existing Canadian businesses and to the commencement of new Canadian businesses by non-Canadians. In the case of most such transactions, the foreign purchaser or investor is merely required to file a short notification within 30 days following completion of the transaction, and there is no discretion on the part of the Canadian government to block the deal from closing or to re-visit it after the fact to impose conditions. Acquisitions of control of large Canadian businesses, however, by persons controlled in WTO-member states (and smaller acquisitions if the business has a "cultural" aspect or neither party is controlled in a WTO-member state) generally require the approval of the minister of industry on the grounds that he or she is satisfied that the transaction is likely to be of "net benefit" to Canada, according to a prescribed set of criteria.

The Standing Committee on Industry,

Science, and Technology of the House of Commons (the Industry Committee) commenced a review of the ICA in February, 2011, considering the pros and cons of proposals for increased transparency and predictability of the ICA review process. Proposals under consideration range from public hearings for all reviewable transactions, to publication of the undertakings upon which ministerial approval is conditioned, to amendments to the "net benefit" test, to the publication of case summaries and guidelines to help investors gain insight into what is currently perceived by some to be a "black box" of bureaucratic and ministerial discretion.

For much of its history, the ICA had been seen as a bit of a rubber stamp—a nuisance for foreign investors who wished to acquire control of Canadian businesses, but at the end of the day, not a serious obstacle to doing so nor a serious impediment to conducting business post-closing.

The ICA has slowly been growing teeth however, as globalization has seen the acquisition in recent years of several iconic Canadian companies by foreign investors (including, for example, Inco, Falconbridge, Alcan, and Stelco), and the serious recession of 2008/2009 inevitably led to the rise of protectionist and nationalist sentiments in many countries, including Canada. The increased role of sovereign wealth funds and other state-owned investors has given rise to concerns over political interference in Canada's economy and

resulted in the issuance of special rules for review of investments by state-owned enterprises (SOEs) under the ICA. The need for a national security screen post-9/11 also led in 2009 to entirely new powers granted to the federal cabinet, to review a broad range of investments in Canada for potential national security risks.

The decision by the minister of industry on November 3, 2010, to block the hostile bid by BHP Billiton Ltd. (BHP) for Potash Corporation of Saskatchewan, Inc. (PotashCorp), amid unprecedented public and media attention, ultimately led to the review of the statute that is currently underway. Federal opposition parties, while applauding the decision, decried the confidential nature of the discussions, and complained that the test and the manner in which it is applied are vague and unspecified, therefore defying accountability on the part of the minister and his staff. The minister's rejection of the BHP bid for PotashCorp also led to speculation as to whether Canada is still open to foreign investment, or whether politics (and the uncertainties associated with it) are now to play a more prominent role.

The bid for PotashCorp was just the second time that a proposed foreign acquisition has been turned down by the Canadian government (other than when a "cultural business" was involved). The first such rejection involved Alliant Techsystems Inc.'s bid for the information systems division of MacDonald

Dettwiler and Associates Ltd. which, in light of the military use of some of the technology involved, seems to have been understood by the investment community as having been based on national security grounds. The friendly “merger of equals” which was recently proposed between the Toronto Stock Exchange and the London Stock Exchange will, in some sense, be more important for Canada’s reputation as a relatively free-market jurisdiction as investors ask: “Was BHP/PotashCorp an anomaly or is it part of a trend?”

Recent cases and the current calls for reform should be viewed in the context of two conflicting trends. On the one hand, there has been a trend toward a higher public profile for the ICA, and the chief lesson investors can learn from the failed BHP bid is that they and their advisors ignore local politics at their peril. On the other hand, there has been a longer-term trend toward deregulation of the Canadian economy, resulting in higher thresholds for review and the removal of Canadian control restrictions in a number of industries. The circumstances of PotashCorp and of the BHP bid were unique, and are not likely to recur very often. More significant for the future of foreign investment in Canada will be the outcome of calls for reform.

All but the most drastic reforms are unlikely to significantly affect the vast majority of reviewable transactions. Convincing the minister of industry that a proposed investment is likely to be of “net benefit” to Canada will still be fairly easy in the vast majority of cases. Canada needs and welcomes foreign investment and, as significant investors abroad, Canadians need reciprocal access to foreign markets. Canada is and will remain a small, open economy, and more or less unfettered access to global capital markets is critical for continued growth. It is therefore only very high-profile transactions that would—or should—be affected by reform of the ICA review process.

A blue-ribbon panel appointed to study Canada’s regulatory regime with a view to increasing Canadian competitiveness (the Competition Policy Review Panel led by Red Wilson issued its report, *Compete to*

Win, in 2008) recommended drastically increasing thresholds for the size of review of foreign acquisitions (from the current \$312 million based on the book value of assets, to \$600 million and eventually \$1 billion based on the enterprise value of the Canadian business). It also recommended changing the onus from the investor having to prove “net benefit” to the minister having to prove “net harm,” and removing foreign investment restrictions on sectors such as telecommunications and airlines. As noted, these changes are part of a long-term trend in Canada toward deregulation generally, and the encouragement of the free flow of capital internationally.

The proposals being considered by the Industry Committee would, if implemented, result in the Canadian government being held more publicly accountable for its administration of the ICA and for ensuring that foreign acquisitions indeed are of “net benefit” (or at least not of “net harm”) to Canada. Whether increased transparency is good or bad for Canada, however, will depend on how it is achieved. To understand the pros and cons of current reform proposals, one must understand the nature of the current “net benefit” test, as well as the institutional decision-making models under consideration. Finally, an examination of recent trends under the act assists in understanding the relative benefits of the reform proposals.

How ICA Reviews are Currently Conducted

The purpose of the ICA is to “encourage investment in Canada by Canadians and non-Canadians that contributes to economic growth and employment opportunities and to provide for the review of significant investments in Canada by non-Canadians in order to ensure such benefit to Canada.” These goals are sought to be achieved by reviewing the acquisition of large Canadian businesses with reference to a list of largely economic criteria, to ensure that, on balance, such acquisitions are likely to be of “net benefit” to Canada.

The factors required to be considered by the minister are:

- the effect of the investment on the level and nature of economic activity in

Canada (employment; resource processing; utilization of Canadian parts, components, and services; exports; capital expenditure, *etc.*);

- the degree and significance of participation by Canadians in the Canadian business;
- the effect of the investment on productivity, industrial efficiency, technological development, product innovation, and product variety in Canada;
- the effect of the investment on competition within any industry in Canada;
- the compatibility of the investment with national industrial, economic, and cultural policies, taking into account policies enunciated by the federal government or by provinces likely to be directly affected; and
- the contribution of the investment to Canada’s ability to compete on world markets.

The minister of industry (and/or of Heritage Canada in the case of “cultural” businesses) is responsible for making the decision which, given the disparate factors involved, can be highly subjective. The “net benefit” test is similar to the “public interest” test as applied by Canadian sectoral regulators to review of mergers in industries such as broadcasting and energy. The list of factors required to be taken into account under the ICA does serve to define the nature of the inquiry (other than the compatibility with cultural policies, they all relate to the short- or long-term economic impact of the foreign acquisition), just as the list of objectives of the Broadcasting Act or of the Competition Act shapes decisions under those statutes. That said, several of the factors listed in the ICA do not provide objective standards against which proposed investments can be measured, and leave the minister with a great deal of discretion.

One question the Industry Committee needs to ask is whether objective standards, and reigning in the minister’s discretion, are in fact desirable? With certainty comes rigidity. Arguably, given the significant range of facts and circumstances applicable to investment in a sophisticated economy such as Canada’s, flexibil-

ity is required if meritorious investment is not to be arbitrarily blocked. For example, many mergers and acquisitions, whether by domestic or foreign nationals, result in a change in management and a house-cleaning of sorts. Particularly if the Canadian business has not been faring well, such a house-cleaning, while resulting in the short term in decreased employment, may well be required for the long-term good of the company and therefore will benefit the long-term level and nature of economic activity in Canada. Leaving the minister the flexibility to determine that certain negative effects can be outweighed by positives in other areas (decreased employment might be offset for example by an increased ability to compete) may well result in the rejection of fewer investments than would a more rigid set of criteria—and may well be better for Canada.

Another feature of the current system which maximizes flexibility is the identity of the decision-maker. Currently, the ICA operates under political leadership, with the minister personally responsible for the decision, based on his or her own weighing of the various factors.

Alternatives will entail, in varying degrees, more of a “law enforcement” approach, such as that used for the review of mergers under the Competition Act. An independent agency investigates and, for practical purposes, decides the fate of most mergers (very few contested mergers are litigated in Canada—they are largely settled or withdrawn). The test for mergers, “substantial lessening or prevention of competition” is, although couched in economic terms, nonetheless justiciable. Particularly with the publication of guidelines and case summaries, a fair degree of predictability has evolved in the application of that standard to particular facts. Even within the Competition Bureau, procedures have been developed which ensure that parties are presented with the case against them and given an opportunity to respond, and have the right to “appeal” internally to the commissioner of competition if they are at odds with bureau officials. Clearly, the Competition Act merger review process was designed with accountability and predictability in

mind. The question is, do we want that, or something similar, for reviews of foreign investment under the ICA?

Arguably, any attempt to quantify the “net benefit” test and to make it independent of politics and politicians would result in the rejection of a far greater number of investments than just two in 25 years. The more rigid the test, the more likely that the long-term benefits of the free flow of investment itself would be forgotten or underweighted when compared to any short-term pains caused by a foreign acquisition.

One might be able to overcome the rigidity to some extent by reversing the burden of proof. Rather than having investors convince the minister of likely “net benefit,” as is currently the case, the act could require the minister to act only if he thinks the investment is likely to result in “net harm” (as noted, this reform was suggested in the Wilson Report *Compete to Win*, but has not yet been taken up by the government). One might even go further, and (taking into account the inherent benefit of the free flow of capital) state that investments are to be approved unless the decision-maker is of the opinion that they will cause “significant net harm” to Canada, based on the enumerated criteria in the act.

Public hearings, of course, would enable not just directly-affected parties, but the press and all stakeholders to follow the details of cases. While greatly enhancing public insight into the administration of the act and investors’ plans in individual cases, and therefore increasing accountability, public hearings might impede the ability of the minister (or an independent decision-maker) to make compromises in order to let investments proceed. In addition, investors may shy away from making reviewable investments if public opinion would be stirred up by such proceedings. If hearings were combined with reversing the burden of proof by moving to a “no net harm” test, the ultimate outcome in terms of the impact on decisions would be difficult to determine. What is certain is that public hearings would significantly increase costs to investors of being reviewed, as well as lengthen the time

required for such reviews, and in all likelihood increase the uncertainty associated with reviews.

All of these reform proposals, moreover, must be examined in light of the changes in investment flows which themselves have already given rise to some of the increased public profile of the act described earlier. Whether in these changing times Canada would be better off with more of a “law enforcement” approach to foreign investment review, or with the current flexible, political but largely discretionary model, or some combination thereof, is presumably what the Industry Committee will address.

The Changing Face of Foreign Investment

One trend noted above has been the apparent drift in recent years toward more stringent enforcement of the act. More—and more detailed—undertakings are being required of foreign investors in ICA reviews. The U.S. Steel acquisition of Stelco, for example, was conditioned on over 30 separate undertakings by U.S. Steel in regard to its future conduct of the Canadian steelmaker. The reasons for this “undertaking creep” are not entirely clear, but may relate in part to the need for Industry Canada officials to measure their own work product. There is more to it than that, however, as at the political level, Canada has had several years of successive minority governments, which can be voted out of office at any time. Such governments are sometimes of necessity more sensitive to criticism than are majority governments who need not face the polls for several years. Undertakings, being binding, show that the government is serious about ensuring foreign investment is beneficial, and thus help protect Ministers from nationalist criticism, even while permitting foreign investment to proceed relatively unfettered.

With respect to enforcement actions themselves, although there has been a lot of publicity concerning the government’s court case against U.S. Steel for breach of several of those commitments (U.S. Steel shut down its Canadian plants in the aftermath of the 2008/2009 recession in

favor of production at US. plants, thereby allegedly breaching its undertakings concerning Canadian production and employment), this is, after all, the first time in over 20 years that the government has sought to punish an investor for breach of its undertakings. Many other investors over the years, facing events beyond their control, have been able to demonstrate their good faith in doing their best to comply with the spirit, if not the letter of their commitments. Seen in this light, it is remarkable that there has only been the one court case to enforce undertakings under the act.

The reform proposals must also be seen in the light of the successive waves of mergers which have accompanied globalization of many industries. Industries which were clearly national or continental in scope when the act was passed in the mid-1980s have since become continental or global. Along with the increased geographic scope of markets comes international consolidation, and along with such consolidation comes cross-border investment. Particularly with high commodities prices spurring investment in natural resource extraction, the pace of foreign investment in Canada has never been higher. Enforcement actions of some sort were inevitable. The fact they were deemed necessary at all does not, however, support the notion that the statute is not tough enough.

Reformers must also be mindful of the reciprocal nature of cross-border investment. Outgoing Canadian investment abroad has increased even more than incoming investment, with total foreign investments in Canada recently falling behind the stock owned by Canadians abroad. Arguably, the free flow of capital out of Canada is even more important than the free flow of capital into Canada. Impediments to cross-border investment flows clearly should be very carefully considered.

Another factor which affects the need for a flexible approach to decision-making under the ICA is the rise of sovereign wealth funds and other state-owned enterprises (SOEs) in the international invest-

ment community. Greater participation by entities owned by foreign governments, as opposed to private business concerns, raises a potential concern about political interference in the Canadian economy. As Dubai sought to invest in American ports, and China sought to acquire a Canadian natural resources company (Noranda) a few years ago, it became apparent that an articulated, coherent strategy toward investment by SOEs was required.

The federal government therefore issued guidelines for the review of investments by SOEs under the “net benefit” test. The guidelines state that as part of the net benefit test, SOE investors will be scrutinized to ensure that the investor adheres to Canadian standards of transparency and governance, and that the Canadian business maintains the ability to make economic decisions, such as the location of processing of raw materials, on a commercial basis. A basic premise of a capital market economy is that the greatest good will be achieved overall if each investor acts in its own economic best interests. If a government that is not answerable to shareholders but to voters in other countries (or, in some cases, only to itself), is instead controlling the Canadian business, a benign approach to foreign investment may not be warranted. The SOE guidelines, accordingly, ensure that investment in Canada by SOEs is screened on the same basis as other investors, and that xenophobic reactions against some governments are not part of the equation.

Similarly, the enactment of the national security review provisions in 2009 can be seen as a necessary response by Canada to rising threats from global terrorism and uncertain political and economic times. Under these provisions, the federal cabinet is permitted to review a foreign investment (of just about any kind—it need not amount to an acquisition of control) if it fears the investment may be injurious to Canada’s national security. Despite the lack of a definition of “national security,” given that a review cannot be held other than at the request of the federal cabinet, and that a review must be ordered within 45 days after the minister of industry is

first notified of the transaction, there are not likely to be many national security reviews. The fact that the sell-off of Nortel proceeded without a national security review, despite very vocal public demands to do so by some Canadian bidders, is testimony to the non-interventionist approach of Canada toward foreign investment and capital markets generally. Again, however, in the face of changing sources of investment and uncertain political and economic times, the Industry Committee needs to consider whether moving away from a model of political discretion toward a more “law enforcement” approach is wise.

Where Do We Go From Here?

It is in the context of these conflicting trends—generally toward a more hands-off approach toward economic regulation on the one hand, with increasing limits for the review of foreign investment and the removal of restrictions on foreign control of key sectors—and on the other hand that of “undertaking creep” and greater public profile of the act amid changing investment flows and diverse sources of funds—that we examine the current proposals for greater accountability, transparency and effectiveness in the ICA review process.

Recent calls for greater accountability in the ICA process could serve to smooth the path for foreign investors by lessening uncertainty surrounding the ICA review process. The publication of guidelines and of after-the-fact case summaries including details of undertakings, for example, would permit the development of a body of non-binding precedent and could be beneficial to the investing community. Investors could see what kinds of undertakings had been required in various circumstances, and the breadth of mechanisms through which “net benefit” has been shown.

Care would need to be taken not to reveal confidential business information, but the need for confidentiality in individual cases has not prevented the publication of very detailed court decisions in other contexts (e.g., Competition Tribunal merger decisions). We see no reason why case

summaries along the lines of the “back-grounders” which the Competition Bureau sometimes publishes in merger cases could not be produced. Over time, they would form a useful body of precedent upon which both Industry Canada and the business community could draw.

Indeed, if guidelines and case summaries are useful for merger review under the Competition Act, where the Competition Bureau’s discretion is ultimately subject to adjudication by the Competition Tribunal, they should prove all the more useful for foreign investment review under the ICA, where the minister alone is responsible and there is effectively (barring extraneous considerations or malfeasance) no avenue of appeal.

When debating the merits of guidelines and case summaries, however, one must also recognize that with increased accountability comes a loss of flexibility on the part of the minister, with a potential cost.

In this context, the Industry Committee should question, if it truly desires increased accountability, does it really

want foreign investors to have to prove “net benefit”? Or should the minister have to prove, as recommended by the Wilson Report *Compete to Win*, that the investment will not be of “net harm” to Canada? Is that not in reality how the test has typically been applied in the past?

Public hearings before an independent adjudicator would make decision makers more accountable, but would considerably lengthen the process, increase the cost for investors, and introduce a much more significant degree of publicity and uncertainty into the process. One possible compromise might be for Industry Canada to develop its processes such that well prior to making a public announcement on a merger, staff would present the case against the investment and request further input from the investors. Just as is currently the case with merger review at the Competition Bureau, the minister might hold him/herself above the fray until the end, thus ensuring a sort of “informal” appeal right. Again, however, such quasi-judicialization of the internal process will come at a cost in terms of time and

flexibility.

In order to get the right institutional and legislative design for review of foreign investment under the Investment Canada Act, the next Industry Committee needs to carefully consider the implications of the various decision-making models under consideration. Recent trends have increased the public profile of the statute, thereby resulting in nationalistic calls for reform. With outflows of investment from Canada now greater than inflows, however, and globalization leading of necessity to increased cross-border investment flows generally, Canada should seriously question whether reforms will be of “net benefit” to Canada.

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