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Foreign Investment Review in Canada: Assessing Risk in the Wake of Nexen

Julie Soloway & Charles Layton[1]

"To be blunt, Canadians have not spent years reducing the ownership of sectors of the economy by our own governments, only to see them bought and controlled by foreign governments instead." – Canadian Prime Minister, Stephen Harper

I. INTRODUCTION

While many countries around the world have established procedures for reviewing transactions with national security implications, few have enacted statutes of general application that apply to all, or the vast majority of, foreign investments within their borders.

Canada represents one of the primary exceptions to this rule.[2] Foreign direct investment has been regulated in Canada since 1973 and the current statute enabling foreign investment review, the Investment Canada Act ("ICA" or the "Act"), has been in force since 1985.

While the Act engendered little controversy during the first 23 years of its existence, several foreign investment reviews since 2008 have garnered an unusual amount of attention, including those in respect of BHP Billiton's proposed acquisition of Potash Corporation and the Chinese National Offshore Oil Corporation's ("CNOOC") acquisition of Canadian oil and gas producer, Nexen Inc. As the recent quote cited above by Canadian Prime Minister Stephen Harper illustrates, particular scrutiny is now being directed at investments made in Canada by foreign state-owned enterprises ("SOEs"). To that end, guidelines governing investments by SOEs in Canada were revised and strengthened in December 2012.

This paper examines recent trends in foreign investment review in Canada and considers the implications of these developments for the future negotiation and apportionment of foreign investment review risk in M&A transactions.

II. RECENT DEVELOPMENTS IN CANADIAN FOREIGN INVESTMENT REVIEW

The allocation of risk in transaction agreements cannot occur without regard to the guidance provided by foreign investment reviews in precedent transactions. The record in this

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[2] Of the developed economies, Australia is the other primary exception. Under the *Foreign Acquisitions and Takeovers Act 1975*, the Foreign Investment Review Board in Australia is responsible for examining proposals by foreign persons to invest in Australia and determining whether such proposals are "contrary to Australia's national interest."

regard would suggest that foreign investment risk has been on the rise in Canada over the past half-decade. While previous governments approved all transactions between 1985 and 2006 as being of "net benefit" to Canada, under Conservative Prime Minister Stephen Harper, the government has become arguably more restrictive in its interpretation of the type of transactions that are of "net benefit" to Canada.[3]

In 2008, Alliant Techsystem's proposed (CDN) $1.33 billion acquisition of MacDonald, Dettwiler and Associates Ltd.'s satellite business was rejected. The decision came as a surprise to many observers, not only because it represented the first time that a transaction failed the "net benefit" test since the Act was enacted in 1985, but also because the purchaser was headquartered in the United States, a country with which Canada has close security and national defense ties. While the Minister of Industry (the "Minister") was at that time precluded by the statute from giving reasons for his decision, according to reports, he was concerned that the sale would lead to a loss of sensitive satellite technology and would negatively impact Canada's surveillance of disputed Arctic territory.[4]

While the government's rejection of the Alliant–MacDonald, Dettwiler and Associates transaction largely went unnoticed, appreciation for foreign investment risk in Canada increased significantly following BHP Billiton's inability to close its proposed (CDN) $39 billion acquisition of Potash Corporation in 2010. While the Minister did not formally reject the proposed transaction in this instance, its provisional decision that the transaction was not likely to be of "net benefit" to Canada was sufficient to scupper the deal.[5] The decision in BHP-Potash demonstrated the government's intent to carefully scrutinize acquisitions of control of Canadian businesses, particularly so-called "Canadian champions" of global industry. The occasion has also been characterized as a reflection of the government's determination to retain a significant degree of domestic ownership over natural resource producers.

Following a series of transactions in which SOEs, primarily from Asian countries, entered into joint ventures or acquired small minority interests in Canadian oil and gas producers,[6] in 2011 Chinese SOEs embarked on the further step of offering to acquire majority control of two

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[3] The government is following Canadian public opinion in this regard. According to one survey, 67 percent of Canadians oppose Chinese companies acquiring Canadian natural resource companies, with similar opposition to acquisitions by firms from India and Russia. Moreover, notwithstanding that U.S. companies have a long history of foreign direct investment in Canada, only 33 percent of survey respondents favored U.S. companies acquiring Canadian resource firms. *See* Shawn McCarthy, *Public Attitudes a Big Hurdle to Foreign Takeovers*, THE GLOBE AND MAIL (November 20, 2012), *available at* http://www.theglobeandmail.com/report-on-business/industry-news/energy-and-resources/public-attitudes-a-big-hurdle-to-foreign-takeovers/article5508387/

[4] *See* Alexandre Deslongchamps & Edmond Lococo, *Alliant Bid for MacDonald Unit Rejected by Canada*, BLOOMBERG (April 10, 2008), *available at* http://www.bloomberg.com/apps/news?sid=areIp.MQUTXc&pid=newsarchive.

[5] *See* Phred Dvorak & Anupreeta Das, *Canada Slaps Down BHP's Potash Bid*, WALL STREET J. (November 3, 2010), *available at* http://online.wsj.com/article/SB10001424052748703506904575592870406638644.html

[6] *See* for example: Sinopec's 2010 acquisition of a 9.03 percent interest in Syncrude from ConocoPhillips for (CDN) $4.65 billion at http://www.ic.gc.ca/eic/site/064.nsf/eng/05684.html and China Investment Corp.'s acquisition of a 45 percent interest in an oil sands project owned by Penn West in 2010 for (CDN) $817 million, *available at* http://www.bloomberg.com/news/2010-05-13/china-investment-to-pay-803-million-for-penn-west-energy-oil-sands-stake.html.

Canadian energy companies: oil sands developer OPTI Canada was acquired by CNOOC for (CDN) $2.1 billion and Daylight Energy Ltd. was acquired by China Petrochemical Corporation ("Sinopec") in a transaction valued at (CDN) $2.2 billion.

The change in approach from acquiring minority interests to acquiring majority control of OPTI and Daylight carried with it significant regulatory implications. While acquisitions of minority interests are not subject to review under the ICA, acquisitions of control are subject to review and therefore must pass scrutiny as being of "net benefit" to Canada. Both transactions were approved by the Minister as being of "net benefit" to Canada; however, the Minister's review of the CNOOC-OPTI transaction was likely simplified due to the fact that OPTI was in bankruptcy at the time of its acquisition.

In July 2012, CNOOC's pursuit of acquisitions led to its (CDN) $15.4 billion offer to acquire Canadian oil and gas producer Nexen Inc. The transaction represented the first proposed acquisition of a major North American energy company by a Chinese SOE since U.S. opposition forced CNOOC to abandon its (USD) $18.5 billion acquisition of Unocal Oil Company in 2005. Accordingly, the transaction was regarded as a litmus test of the Canadian government's willingness to cede control over large domestic oil and gas producers to foreign owners.

From a public relations perspective, complicating the Minister's review of the CNOOC-Nexen transaction was the announcement one month prior that Petroliam Nasional Bhd ("Petronas"), the Malaysian SOE, had reached an agreement to buy Progress Energy Resources Corp. ("Progress Energy") for (CDN) $5.9 billion.[7] While the PETRONAS-Progress Energy transaction on its own would have been unlikely to generate a significant profile, in tandem with CNOOC's proposed acquisition of Nexen, it was perhaps inevitable that pressure would mount on the Minister to respond to concerns regarding the "hollowing out" of Canada's energy patch.

Although the acquisitions of both Nexen and Progress Energy were ultimately approved by the Minister, the affirmative "net benefit" determinations were far from pre-ordained. Under the ICA, the Minister has 45 days to issue a decision, but can extend the review period at his or her sole discretion by an additional 30 days. Any extensions beyond day 75 are subject to the consent of both the Minister and the investor. In the Petronas-Progress Energy transaction, the 75-day review period under the ICA expired, after which both parties consented to an extension until October 19, 2012 to reach an agreement on the proposed undertakings. It has been reported that on October 19, the government asked for a further extension. When Petronas withheld its consent for any further extension, the government was forced to issue its "net benefit" decision.[8] Only a few minutes before midnight on October 19, the Minister announced that he was not satisfied that the Petronas transaction was likely to be of "net benefit" to Canada.

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[7] Jim Polson, *Petronas Agrees to Buy Canada's Progress Energy*, BLOOMBERG (June 28, 2012), *available at* http://www.bloomberg.com/news/2012-06-28/petronas-agrees-to-buy-canada-s-progress-energy-for-4-7-billion.html.

[8] Boyd Erman, Carrie Tait, & Shawn McCarthy, *How Malaysia's oil-patch 'came unglued' after Ottawa pressed to extend talks*, THE GLOBE AND MAIL (October 20, 2012) *available at* http://www.globeinvestor.com/servlet/WireFeedRedirect?cf=GlobeInvestor/config&vg=BigAdVariableGenerator&date=20121020&archive=rtgam&slug=escenic_4626206

Under the ICA, once an "interim" decision is issued, the investor has a further 30-day period during which it can make further representations or provide revised undertakings to the Minister to establish that the transaction is, in fact, likely to be of "net benefit" to Canada. Rather than abandon the transaction, as BHP Billiton elected to do in the case of Potash Corp., Petronas strengthened its undertakings and ultimately received approval from the Minister.[9] After considerable speculation about the government's intentions, CNOOC's bid for Nexen was likewise approved by the Minister.

III. REVISED GUIDELINES APPLICABLE TO STATE-OWNED ENTERPRISES

On the same day on which the approvals for Nexen and Progress were announced, the government issued revised guidelines for SOEs that raised hurdles to further SOE investments in Canada. First, the definition of an SOE was broadened to capture investors that are not only owned by a foreign government, but also entities that are "influenced directly or indirectly" by a foreign government.

Second, in response to "inherent concerns regarding foreign state influence, transparency and non-commercial activities," the guidelines clarify that governance and commercial orientation are taken into account by the Minister when reviewing investments by SOEs. In particular, the SOE investor will need to demonstrate that:

- The investment is commercially oriented and adheres to free market principles;
- The Canadian business will be operated in a manner that is free from foreign political influence;
- Canadian laws will be adhered to;
- Standards and practices will be implemented to promote sound corporate governance and transparency; and
- Positive contributions will be made to the productivity and industrial efficiency of the Canadian business.

The government also signaled that foreign state control of the oil sands had "reached a point at which further such foreign state control would not be of net benefit to Canada." Accordingly, future acquisitions of control of Canadian oil sands businesses by foreign SOEs would be determined to be of "net benefit" to Canada only in an "exceptional circumstance."[10]

The government's rationale for strengthening the guidelines is clearly revealed in the following statement by Canada's Prime Minister Stephen Harper:

> Canadians expect that we shall approve foreign transactions that are of net benefit to Canada. But, all investments are not equal. In particular, as we have indicated for many years, purchases of Canadian assets by foreign governments through

[9] In order to obtain "net benefit" approval, investors typically enter into formal undertakings with the Minister making commitments with respect to Canadian employment levels, the amount that will be invested in the Canadian business, corporate governance, health and safety, and the promotion of well-being in Canadian communities.

[10] Statement by the Prime Minister of Canada on foreign investment, December 7, 2012, a*vailable at* http://www.pm.gc.ca/eng/media.asp?id=5195

> state-owned enterprises are not the same as other transactions. The larger purposes of state-owned enterprises may go well beyond the commercial objectives of privately owned companies. That raises the question of when, and to what degree, foreign state control of Canadian business can be of net benefit to Canada. To be blunt, Canadians have not spent years reducing the ownership of sectors of the economy by our own governments, only to see them bought and controlled by foreign governments instead.[11]

The revised Guidelines on SOEs reflect that, to the Canadian government, not all foreign investment is created equal. The additional safeguards imposed on investments by entities that may not be commercially oriented, or which may be influenced by foreign governments, demonstrates the extent to which foreign investment review risk is particularly acute in the case of foreign investments by SOEs.

While both transactions were ultimately determined to be of "net benefit" to Canada, the fallout from Petronas' acquisition of Progress Energy and CNOOC's acquisition of Nexen has led to a heightened appreciation of the risks related to foreign investment review in Canada. Due to the toughened SOE guidelines that accompanied these two decisions, risk also has also been demonstrably increased for SOE investors.

IV. IMPLICATIONS FOR THE ALLOCATION OF INVESTMENT REVIEW RISK IN FUTURE TRANSACTIONS

We expect that when parties are negotiating transaction agreements in the future, an increasing number of targets will demand that a greater proportion of foreign investment review risk be allocated to the purchaser. This allocation could result in more purchasers undertaking to use their "best efforts" to obtain regulatory approval, as opposed to merely "reasonable commercial efforts," and/or purchasers being required by agreement to offer all undertakings necessary in order to obtain ICA approval (short of undertakings that would be commercially unreasonable). It could also result in more frequent adoption of reverse break fees to compensate the target in the event that the purchaser is unable to consummate the transaction on account of the foreign investment review process.

While covenants requiring the purchaser to use "best efforts" to obtain ICA approval may become more common, we anticipate that "hell or high water" covenants requiring the purchaser to do everything in its power to obtain ICA approval will continue to be used only sparingly in transaction agreements. Given that there is effectively no limit on the undertakings that can be offered to the Minister to demonstrate that a transaction is of "net benefit" to Canada, purchasers will likely continue to be extremely reticent to make any such open-ended commitments. Furthermore, while purchasers may agree to "best efforts" covenants in certain circumstances, they will likely seek to limit their obligations to avoid a scenario in which they are required to provide undertakings that are not commercially reasonable or that would impose upon the purchaser a substantial negative financial burden.

It remains to be seen whether the SOE Guidelines released in conjunction with the government's decisions in Nexen and Progress Energy will impact upon foreign investment flows into Canada. As a result of the additional hurdles put in place by the SOE Guidelines, SOE

[11] *Id.*

investors may be dissuaded from attempting acquisitions that require review under the ICA. As discussed above, acquisitions of control of Canadian businesses made by investors from WTO countries are subject to review if the assets being acquired are valued at (CDN) $342 million or more. Although it is not yet clear how much of a dampening effect the new SOE guidelines will have, SOEs may increasingly: (1) target companies with assets that fall below the $342 million threshold and/or (2) assume non-controlling interests in joint ventures ("JVs") with Canadian companies rather than acquire control of Canadian companies outright.[12]

The heightened scrutiny placed on SOE investors may affect the competitive dynamic among SOE and non-SOE investors vying for Canadian assets. Where there is a competitive bidding scenario, or where two or more purchasers are pursuing a Canadian target, an SOE, all other things being equal, will need to provide additional comfort to the target through its representations and covenants in order to mitigate the higher degree of foreign investment risk that accompanies the SOE bid vis-à-vis the non-SOE acquirer.

Conversely, the additional hurdles imposed on SOEs will render non-SOE investors relatively more attractive from the vantage point of Canadian target companies. Given the added complexity under the ICA where the purchaser is controlled by an SOE, it may be easier for non-SOE investors to reach agreements with Canadian target companies in which both parties are reasonably confident that the transaction will proceed and in which both parties are satisfied with the apportionment of foreign investment review risk.

Finally, vendors may require additional representations from non-SOE investors confirming that they are not, in fact, owned or influenced by a foreign government. For example, non-SOE purchasers may be called upon to warrant that no foreign state owns a significant minority interest in the purchaser, and/or that no foreign state has the power to nominate members of the purchaser's board or otherwise direct the strategic or operational decision-making of the investor. Such representations would be intended to avoid any unpleasant surprises in which a transaction's risk profile is materially altered on account of an undisclosed nexus between a foreign state and the investor.

[12] One of the first transactions involving an SOE investor following the release of the revised SOE Guidelines was Encana's joint venture with PetroChina announced on December 13, 2012. Under the terms of the JV, PetroChina will gain a 49.9 percent interest in Encana's 445,000 acres in the Duvernay gas field in Alberta for total consideration of (CDN) $2.2 billion. Since PetroChina will not acquire majority control over the JV, the transaction is likely not subject to review under the ICA. *See* Shawn McCarthy, *PetroChina, Encana strike natural gas pact*, GLOBE AND MAIL (December 13, 2012) *available at* http://www.theglobeandmail.com/report-on-business/industry-news/energy-and-resources/petrochina-encana-strike-natural-gas-pact/article6313195/.