FLAIR'S CANADIAN STATUS CONFIRMED IN IMPORTANT RULING

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Following a preliminary status determination by the Canadian Transportation Agency ("**Agency**") on March 3, 2022, the decision issued by the Agency on June 1, 2022 confirmed that Flair Airlines Ltd. ("**Flair**") was able to 'show cause' that it is indeed a Canadian-controlled carrier. The case is notable for its discussion of the factors that the Agency considers when assessing whether non-Canadians exercise "control in fact" over carriers.

- The Agency was willing to overlook the fact that Flair was for a time not "Canadian" and to allow it to come into compliance with the Canadian status rules. This creates an interesting dynamic for entry in the industry. Carriers might have some time to rely on foreign financing, leadership and aircraft to build scale before having to alter their ownership and management structures to align with the Canadian status rules under the *Canada Transportation Act* ("**CT Act**").
- The Agency confirmed that non-Canadian investors do not need to actually exercise control for there to be a concern over Canadian status. The "ability" to direct the strategic decision-making or day-to-day operations of the enterprise is what is relevant.
- Other branches of government may look to the guidance from the Agency on how to determine Canadian control for their regulatory regimes. For example, under the *Investment Canada Act*, acquisitions by non-Canadians of between one-third and one-half of the voting shares of a corporation result in a presumptive change of control, which can be rebutted where the investor does not exercise control in fact over the Canadian business. A control in fact analysis also becomes important for assessing whether an investor or Canadian business is controlled by a foreign state or government. The Canadian Radio-Television and Telecommunications Commission ("**CRTC**") also assesses whether non-Canadians exercise control in fact in its status determinations for licensed broadcasting and telecommunications entities.[1]

In the remainder of this article, we provide the background to the decision, describe the factors the Agency considered when making its Canadian status determination and present our views on the policy implications of the decision going forward.

Background to the Decision

Founded in 2005 with its initial operations based in Kelowna, British Columbia, during its early years, Flair was focused primarily on air cargo services. However, in 2018, Flair moved its headquarters to Edmonton, Alberta, and in conjunction with an investment by 777 Partners LLC ("777"), Flair announced plans to acquire additional aircraft and develop into an ultra low-cost carrier offering scheduled passenger services in Canada. In January 2021, Flair announced plans to increase its fleet size to 50 aircraft within five years and placed an order for 13 Boeing 737 MAX 8 aircraft hoping to expand its scheduled service to more destinations in Canada, the US and the Caribbean.

Following an initial hearing, on March 3, 2022, the Agency issued a preliminary decision that Flair might not be "Canadian" as defined by subsection 55(1) of the CT Act. The Agency was concerned that 777 might have control in fact over Flair. If sustained, that conclusion could have resulted in the suspension or cancellation of Flair's domestic and international operating licenses. Flair was afforded the opportunity to escape that fate through a 'show cause' procedure to convince the Agency that the preliminary determination was incorrect. Flair succeeded in doing just that.

When Parliament enacted the *Transportation Modernization Act* in 2018, we wrote that despite a relaxation of foreign ownership limits for Canadian air carriers, "facts matter" and that "control in fact" was still the rule. The Agency's decision issued on June 1, 2022 following the 'show cause' procedure underscores that conclusion (the "**Flair Decision**").

Following a detailed review of the facts, including a number of significant changes implemented by Flair in response to the Agency's preliminary determination, the Agency concluded that Flair is "Canadian" today, both in fact and in law. The Flair Decision provides useful insight into the application of the Canadian control provisions of the CT Act and regarding the Agency's approach to assessing of the subjective aspects of the control in fact requirement.

The Definition of "Canadian"

The CT Act imposes a three-part test that must be satisfied for an air carrier to be considered "Canadian". The first part of the test is straight forward, requiring that the carrier must be owned by a Canadian incorporated entity. The second part of the test, often referred to as the "*de jure*" test, relates to the ownership of voting shares in that entity. Canadians must own at least 51% of the voting shares and a single non-Canadian shareholder cannot own more than 25% of the voting shares.

Unlike the first two objective parts of the test, the third part of the test requires a largely subjective assessment of whether Canadians actually exercise control in fact, which was the focus of the Agency's concern regarding Flair and the 'show cause' proceeding. The Agency refers to guidelines setting out a wide ranging, but non-exhaustive, list of the factors it will consider in assessing whether control in fact resides with Canadians. The

Agency has long recognized that foreign investors can influence business decisions in various ways in addition than through their shareholdings, such as through financing arrangements, supplier relationships, and the appointment of senior officers.

Preliminary Determination

In its preliminary determination, the Agency noted that Flair was not only dependent upon 777 for its financing and leasing of aircraft but that 777:

i. had assumed the majority of the investment risk and was entitled to the majority of the benefits in respect of Flair's operations;
ii. controlled Flair's board of directors;
iii. held rights that exceeded those granted to the other shareholders;
iv. played an active role in the management of Flair's business; and
v. could select who it would bring in as a new shareholder.

The Agency also noted that 777 had demonstrated both the ability and apparent willingness to exert control over Flair.

Assessment of Control in Fact

The Agency considered four sets of factors in assessing control in fact:

i. corporate governance;
ii. shareholder rights;
iii. risks and rewards; and
iv. business affairs and activities.

The preliminary determination identified concerns with each of these categories. The Agency weighed all factors together to make what is ultimately a subjective determination.

In the Agency's judgment, if Canadians are to have control in fact, (i) Canadian shareholders must have the right to appoint no less than half of the directors of the board, and (ii) no less than half of the directors, whether appointed by Canadian shareholders or otherwise, must be Canadian citizens or permanent residents. The same rule applies when setting the quorum requirements. In the case of tie-breaking votes, a Canadian appointed by Canadian shareholders must cast the deciding vote. In its preliminary determination, the Agency found that Flair did not meet these requirements.

The Agency also noted that 777 had certain veto rights and that the terms of a promissory note held by 777 included certain rights that could give it the power to control corporate decisions and a mechanism by which

to manage operations.

The Agency also concluded that because of the terms of the promissory note held by 777 and its large equity interest, 777 effectively assumed the majority of investment risk and was entitled to the majority of the benefits, which is typically indicative of control in fact.

Flair's 'Show Cause' Response

Flair took several steps to address the concerns outlined by the Agency in its preliminary determination. Flair amended its Unanimous Shareholders' Agreement ("**USA**") to align with the board composition and quorum requirements. The amendments also meant that 777 no longer had the ability to control Flair through the appointment of officers. Flair also amended the USA to remove 777's veto rights and the terms of the promissory note to mitigate the Agency's concern that the promissory note could provide a mechanism, directly or indirectly, to give 777 the ability to influence corporate decisions and a mechanism to manage operations.

In its submissions, Flair addressed the Agency's general presumption that, because 777 assumed the majority of the risks and was entitled to the majority of benefits related to Flair's operations, 777 must have the ability to exercise control in fact. Flair argued that these two factors were not determinative of control and that the Agency's approach historically was to also consider whether the non-Canadian has the motivation, inclination and intention, to exercise control in fact over the Canadian carrier. Flair noted that 777 is not a foreign air carrier and aviation is not its sole business and argued, accordingly, that it had no motivation, inclination or intention to control Flair.

The Flair Decision

Through the 'show cause' proceeding, the Agency reviewed the changes made by Flair and assessed the impact in each of the four categories listed above.

In the end, the Agency concluded that the amendments to the USA, to the promissory note, and to the overall corporate governance structure were sufficient to significantly reduce or remove the means through which 777 could exercise control in fact. The Agency concluded that, with these changes, Canadians were now in a position to control Flair, and that 777's rights were consistent with the rights held by Canadian shareholders who have a similar economic interest to 777. More specifically, with the amendments to the USA and the change to the composition of the board, the Agency determined that Flair had adequately addressed its concerns regarding 777's power to control the board, and thereby to manage the affairs of the company either directly or through the appointment of officers. With the removal of veto rights, Flair now has the freedom to make aircraft acquisition decisions from suppliers of its choosing. Flair also demonstrated that it could lease

new aircraft without having to rely on a guarantee from 777.

Flair did not resolve all the concerns raised by the Agency in its preliminary determination. The Agency noted that, even though Flair had communicated its intent to diversify its funding sources, Flair continued to be financially dependent on 777 for ongoing funding of Flair's operations, including the leasing of its aircraft. However, the Agency noted that Flair had demonstrated that it was able to generate sufficient positive cash flow from operations, which alleviated concerns regarding Flair's continued dependence on 777 for new financing. Amendments to the terms of the promissory note had materially restricted 777's ability to exert control through debt ownership.

Based on its assessment of the full range of relevant factors affecting control, the Agency concluded that control in fact resided with Canadians.

Commentary

The Flair Decision raises a number of commercial and legal issues for both carriers and other non-Canadian investors subject to control in fact regimes.

Control in fact is a status that can change. The Agency was willing to overlook the fact that Flair was for a time not "Canadian" and to allow it to come into compliance with the Canadian status rules. This creates an interesting dynamic for entry in the industry. Carriers might have some time to rely on foreign financing, leadership and aircraft to build scale before having to adjust their ownership and management structures to align with the Canadian status rules. The Flair case may be a product of the times as the Canadian aviation and travel industry was just starting to recover after two years of government imposed lockdowns and other travel restrictions. The Agency may take a different view in terms of both substance and timing should a carrier's Canadian status come into question in the future.

While the Agency's decision considers a variety of factors when it assesses control in fact, some of the factors are more determinative in the analysis. The Agency principally focused on board composition, particularly the requirement that the Canadian shareholders have the right to appoint more than 50% of the directors, as an essential pre-condition to Canadian status. The Agency focused less on the risk posed by holding debt in the business, similar to the outcome in the Globalive matter when the federal Cabinet overturned the CRTC's decision and concluded that Globalive had Canadian status despite Globalive's non-Canadian shareholder, Orascom, holding the vast majority of the company's debt.

If Flair, or other carriers, should face challenges raising capital or funding their operations, the government may once again consider whether Canadian status ought to be a requirement for new entrants in the aviation industry. Indeed, since 2012, non-Canadians have been permitted to acquire or establish new

telecommunications carriers provided their total Canadian market share is under 10%. The change to the *Telecommunications Act* followed broad based consultations in 2006 and 2008 including a thorough review of foreign ownership in regulated industries. It is possible that through similar consultations to Canada's competition framework laws which are about to be underway shortly, we may see a further relaxation of foreign investment restrictions in the aviation sector.

If you have any questions about this decision or would like to discuss any questions raised by this article, please do not hesitate to reach out to us, a member of our Competition or Aviation groups, or to your usual McMillan contact.

[1] Under the *Telecommunications Act*, subsection 16(1) sets out specific thresholds for ownership of voting shares of telecommunications carriers by Canadians and requires that Canadians must exercise control in fact. Section 3 of the *Broadcasting Act* also provides that the Canadian broadcasting system must be owned and controlled by Canadians.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.