GOVERNMENT ANNOUNCES CHANGES IN FOREIGN OWNERSHIP RULES FOR CANADIAN AIRLINES – 'CHANGE IN FACT'?

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The Canadian federal government's Minister of Transport, Marc Garneau, announced on November 3, 2016 that the government of Canada plans to raise the cap on foreign ownership of Canadian airlines from 25% to 49%. The government appears to be responding to calls from industry and the recommendations in a report from the former Minister of Transport, David Emerson, to encourage more foreign investment in Canadian airlines to foster increased competition. Minister Garneau also announced that, pending the implementation of amendments to *Canadian Transportation Act* ("**CTA**"), exemptions from the current 25% ceiling would be granted and that exemptions have been granted for two discount airlines, Canada Jetlines and Enerjet. This appears to be a useful step to bring Canada in line with the foreign ownership model for airlines in other G7 countries but, as always, "the devil is in the details".

The CTA requires in a two-step process that the operators of domestic air services in Canada must be "Canadian". First, section 57 requires that no person may operate an air service unless that person holds a licence issued under the CTA. Second, section 61(a)(i) requires that an applicant for a license must establish "to the satisfaction of the Agency", being the Canadian Transportation Agency, that the applicant is "Canadian".

Section 55(1) of the CTA defines the term "Canadian" to mean a Canadian citizen or a permanent resident or other entity that is incorporated or formed under the laws of Canada or a province, that is controlled in fact by Canadians and of which at least 75% of the "voting interests" are owned and controlled by Canadians. Presumably, the Minister's announcement refers to this threshold such that the proposed change will reduce the percentage of voting interests that Canadians must hold to 51%. However, the Minister's announcement does not deal with the far more challenging requirement of section 55(1) that the corporation must be "controlled in fact" by Canadians.

Although the concept of 'control in fact' is not defined in the CTA, the Canadian Transportation Agency has published a detailed guideline setting out the factors it will consider in assessing whether a Canadian airline is controlled in fact by Canadians. It is clear from those factors that the percentage ownership of voting shares is only one of many factors that will allow the Agency to conclude whether or not an airline is not controlled in fact by Canadians. Arguably, the increase in the percentage of voting interests held by a non-Canadian

investor will only make it more difficult to satisfy the control in fact test. The reality is that the Agency has made it clear, even in circumstances in which non-Canadians hold 25% or less of the voting interests, that fact is far from conclusive that the Canadians who hold 75% or more of the voting interests actually control the corporation.

The National Transportation Agency (as it then was) set out the test for control in fact in its 1993 decision related to a proposed investment by American Airlines in Canadian Airlines as follows:

"There is no one standard definition of control in fact but generally, it can be viewed as the ongoing power or ability, whether exercised or not, to determine or decide the strategic decision-making activities of an enterprise. It also can be viewed as the ability to manage and run the day-to-day operations of an enterprise. Minority shareholders and their designated directors normally have the ability to influence a company as do others such as bankers and employees. The influence, which can be exercised either positively or negatively by way of veto rights, needs to be dominant or determining, however, for it to translate into control in fact." [*emphasis added*]

The non-exhaustive list of factors to be considered by the Agency in assessing whether there is control in fact by Canadians includes the following:

- Risks and Benefits - Who hold the majoring of the business financial risks and who is entitled to receive the majority of its benefits?
- Concentration of Voting Interests - If a non-Canadian or a group of non-Canadians, individually or together, holds a concentration of the voting interests, it could be indicative of Canadians not being able to exercise control in fact.
- Board of Directors - Canadian shareholders must have the right to appoint the majority of the Board of Directors. In addition, the majority of the Board members must be Canadian.
- Officers - Control implications could arise if officers have a relationship with non-Canadian shareholders that provides a vehicle through which the non-Canadian shareholders can exert their influence over the operations of the air carrier.
- Shareholder and Board Meetings – The corporation's quorum provisions must require that a majority of the shareholders or directors at a shareholders or Board meetings must be Canadian and that a majority of the members at a Board meeting have been appointed by Canadian shareholders.
- Veto Rights - Generally, there are no Canadian ownership implications associated with non-Canadian shareholders and their designated directors having veto rights to protect minority shareholders' investment but veto rights which are comprehensive and broad could indicate that control resides with non-Canadians

There are numerous other factors that will be considered by the Agency including: security rights, the terms of any options and warrants, the existence of rights of first refusal and pre-emptive rights, debt arrangements or guarantees between the corporation and its shareholders, any leases of assets by a shareholder to the corporation, the relative financial strength of the investor, any management agreements or operational or service agreements between the shareholder and the corporation. The essence of the test is whether non-Canadians have the ability, whether exercised or not, to influence the management or control of the corporation.

Applying its assessment of these factors, the Agency can and has found that control in fact does not reside with Canadians even when voting interests held by non-Canadians are limited to 25%. McMillan LLP acted recently as counsel for a Chinese investor seeking approval of its proposed acquisition of a 25% voting interest, and a total economic interest of 49%, in Harbour Air Seaplanes. The application was filed and processed on a confidential basis. However, we can report that the Agency ultimately approved the investment, but only following a careful examination of the factors potentially affecting control to assess whether control in fact remained with Canadians and to ensure that there was no prospect that any of those factors might allow control to be influenced by the foreign investor.

Accordingly, it is difficult to see how the proposed increase in the threshold for voting interest to 49% will have the desired effect of facilitating an increase in investment by foreigners in Canadian airlines. Given the broad range of factors that the Agency will consider in assessing whether control in fact resides with Canadians as required by the CTA, allowing non-Canadians to hold 49% of the voting interests is not helpful. In fact, the challenge for a Canadian airline to demonstrate 'control in fact' by Canadians will be even more daunting if 49% of its voting interests are held by foreigners. The hard question now is how the government will deal with the real issue of 'control in fact'.

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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.