VIDEO GAMES AS CANADIAN CULTURE: NAVIGATING THE *INVESTMENT CANADA ACT* IN INTERACTIVE ENTERTAINMENT ACQUISITIONS

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Canada has been an attractive investment destination for foreign investors in recent years, particularly as the Internet has opened up the digital market throughout North America and the value of the Canadian dollar has declined against foreign currencies, especially the US dollar. While there are the usual antitrust concerns potentially raised by any merger or acquisition transaction, all investments in Canada that could result in foreign acquisition of control are also governed by screening and review mechanisms under the *Investment Canada Act* (Canada) (the "***Act***"). It is critical to keep the Act in mind for acquisition of businesses in the interactive entertainment or video games industry — not only for the usual reasons in any inbound investment, but also because they are considered to be cultural businesses worthy of additional scrutiny under the *Act*.

Brief Overview of the *Investment Canada Act*

Under the *Act*, there are two tracks by which inbound investments into Canada are analysed: the "notification" and "review" tracks. The notification track requires filing a notice of the transaction with an agency of the Canadian government in required form (including information about the foreign investor, the Canadian business, and the vendor) at any time before or within 30 days of closing. The review track requires the pre-closing submission of essentially the same information as is required in a notification *plus* a great deal more information about the investor itself, as well as its plans for the Canadian business. More critically, investments on the review track are reviewed by the government to determine whether the proposed transaction is of "net benefit to Canada" — if not, the transaction cannot close (or, if it has closed, may be unwound). Usually, the government will require that the investor make good on its assurances that the proposed transaction is of "net benefit to Canada" by requiring that the investor provide binding "undertakings" or commitments to run the acquired business in a particular manner, often relating to the role of Canadians on corporate boards and in senior management roles, minimum employment levels, minimum output commitments, commitments to Canadian input sourcing, and similar factors.

As the review track is typically only required when a proposed transaction exceeds certain very high financial

thresholds, the notification mechanism is by far the most common and used for most smaller investments; however, other factors may influence the applicability of the review track including whether the investor is controlled by a resident of a World Trade Organization member state and whether the investor is a private or state-owned enterprise.

Video Games as Culture

Under the Act, a "cultural business" includes a business that "[...] (b) produces, distributes, sells or exhibits film or video recordings; (c) produces, distributes, sells or exhibits audio or video music recordings; [or] (d) publishes, distributes or sells music in print or machine readable form; [...]". The government's interpretation of the Act considers video games businesses to be "cultural businesses" since they involve one or more elements of film, video, audio, and music — all cultural businesses themselves.

In order to protect Canadian culture, the Act provides for two potential governmental review points in the acquisition of a cultural business such as an interactive entertainment business. First, there are substantially lower thresholds to trigger the review track: for example, the direct acquisition of control of a Canadian business with a mere CDN$5 million in book value can trigger a mandatory pre-closing review, as can the indirect acquisition of control (i.e., the acquisition of a corporation outside Canada operating a Canadian subsidiary) with a CDN$50 million book value. Second, even if those thresholds are not met, the government can demand an application for review from the investor by notifying the investor within 21 days of the investor's notification of the transaction.

Application to Video Games Transactions

Consider the case of a video game developer being acquired by a non-Canadian investor such as a US company. As with any other foreign acquisition of control of a Canadian business, the transaction will be at minimum notifiable under the Act's notification track. However, even a very small transaction in the video games space is more exposed than others to the review track, because the Canadian business is seen as being engaged in a "cultural business" and the thresholds are that much lower. Thus, for a transaction close to the CDN$5 million book value level, earn-outs or currency conversions can make the difference between a transaction merely triggering a notification and it being subject to mandatory pre-closing review and evaluation on the "net benefit to Canada" test. This should be part of the standard analysis of the Act's application to any transaction.

However, in the special case of a cultural business, the inquiry does not end there, because even if the transaction is below the thresholds that would require the review track, the government still could, within 21 days of the investor's required notification, demand an application for review. If the investor were to notify on a post-closing basis, and the government did exercise its right to demand review, this could create a risk that the

transaction may ultimately need to be unwound (or that the investor may need to subject itself to undertakings).

Thus, even on the notification track, the determination of whether to file the notification pre-closing or post-closing depends on the parties' risk appetite and their estimation of whether or not the government will ask for a post-closing review. While this flexibility for filing the notification affords parties some room to manoeuvre, it does raise questions regarding optimal timing and allocating the risk of a potential review in the acquisition agreement.

If the notification is filed near the beginning of the deal process and the 21-day period for government demand for an application for review expires before closing, then, even if the government asks for a review, the parties would know before closing and can address it (assuming their transaction documents and closing procedures allow for this). If the notification is filed after closing and the government demands an application for review, the latitude to address any government concerns is materially restricted as the deal is closed (and, unless addressed in the transaction documents, the risk for this would fall entirely on the investor). While earlier notification as part of a closing process is the more conservative approach, since it permits the parties to determine definitively whether an application for review will be required, there sometimes could be a benefit to filing the required notification after closing so that, for practical purposes, the transaction is a "fait accompli".

For this reason, it is important for investors in Canadian interactive entertainment businesses to consider carefully the application of the *Act* to the transaction (i.e., whether or not it is on the notification track or the mandatory review track case), the appropriate timing of the notification under the *Act*, and any mechanism to build into the acquisition agreement to deal with a potential review. Either way, it is also important for the investor to ensure it is prepared to deliver a well-reasoned and well-supported case to the government that the transaction is, in fact, of net benefit to Canada.

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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.