

## Mergers and Acquisitions Law

December 8, 2012

### Government of Canada Approves CNOOC and Petronas Investments but Signals Tougher Measures for Reviewing Future Investments by Foreign State-owned Enterprises

On Friday, December 07, 2012, the Government of Canada issued its long-awaited decisions under the *Investment Canada Act* (“ICA”) regarding the takeover of Canadian oil and gas giant Nexen Inc., by CNOOC Limited, a state-owned enterprise (“SOE”) of the People’s Republic of China, and of Progress Energy Resources by Petronas International Corporation Ltd., a Malaysian SOE.

While it approved the two transactions that had been before it since the summer, the Government signaled that future acquisitions of control over oil sands businesses by SOEs will be found to be of net benefit to Canada – and approved – only on an exceptional basis.

Concurrently with these approvals, the Government released significant developments and changes to the review process under the ICA, including:

- new, more restrictive guidelines for the review of SOE investments under the “net benefit test”;
- imminent implementation of a previously announced hike to the financial threshold for review of non-SOE investments, from \$330 Million to \$1 Billion over five years; and
- an unspecified extension to the time available to the Government to review transactions that raise national security concerns.

Missing in the flurry of announcements was any improved guidance on the Government’s approach to the application of the net benefit test generally, however. Indeed, the press releases announcing the approvals

of the Nexen and Progress acquisitions are virtually identical and provide little insight into the rationale for approving these highly public and politicized transactions.

#### Background

Under the ICA, a non-Canadian investor seeking to acquire control of a Canadian business over certain financial thresholds is required to demonstrate that its transaction will result in a “net benefit to Canada”. In 2007, Industry Canada released guidelines meant to specifically address the additional factors to be considered under the net benefit test, for acquisitions by SOEs.

The Government’s rejection in 2010 of the proposed acquisition of Potash Corporation of Saskatchewan Inc. by BHP Billiton led to significant uncertainty regarding Canada’s openness to foreign investment, particularly in Canada’s strategic resources sector. It also created an expectation that the Government would provide greater clarification of the net benefit test to address market uncertainty.

#### The Approvals

The Nexen and Progress transactions were approved under the existing SOE guidelines, with little rationale given for how the Government addressed any public interest concerns associated with the transactions beyond information already made public by the acquirers. In each case, a very brief summary was provided regarding “undertakings” made by the acquirer, which reportedly included “commitments in the areas of: governance, including commitments on transparency and disclosure; commercial orientation, including an adherence to Canadian laws and practices as well as free market principles; and employment and capital investments, which demonstrate a long-term commitment to the development of the Canadian economy.”

#### Closing the Door to Future SOE Acquisition of “Oil Sands Businesses”

In the policy statement that it released concurrent with the approval of these two transactions, the Government singled out the Canadian oil sands as being “of global importance and immense value to the future economic prosperity of all Canadians.” Noting the predominance of state-control over energy

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deposits worldwide, the Government highlighted the importance that it perceived in reinforcing the role of innovative private sector businesses in this segment of Canada's resource industry.

The Government also identified certain risks that it perceived could be presented by foreign SOEs, namely:

- their inherent susceptibility to foreign government influence that might be inconsistent with Canada's national industrial and economic objectives; and
- potentially adverse effects on the efficiency, productivity and competitiveness of companies acquired by foreign SOEs.

Accordingly, while it stressed that it welcomes non-controlling minority interests, the Government stated that given the "inherent risks" posed by foreign SOE acquisitions in the oil sands, acquisitions of control over oil sands businesses by SOEs will be found to be of net benefit on an "exceptional basis" only.

## **The New SOE Policy Framework**

Friday's announcements included an expanded and tougher version of the SOE guidelines that appears to be aimed at addressing the risks identified as being inherent in control of Canadian businesses by foreign SOEs. Under the new SOE guidelines:

- an SOE is defined broadly to include "an enterprise that is owned, controlled or influenced, directly or indirectly by a foreign government";
- SOE investors will be expected to address the "inherent characteristics of SOEs", specifically their susceptibility to state influence;
- SOE investors will need to demonstrate a strong commitment to transparent and commercial operations;
- in addition to demonstrating adherence to Canadian standards of corporate governance (such as commitments to transparency and disclosure, independent members of the board of directors, independent audit committees and equitable treatment of shareholders), SOE investors will now need to demonstrate adherence to free market principles; and

- in assessing whether a Canadian business that is proposed to be acquired by a foreign SOE will likely operate on a commercial basis, the Government will have regard to the "impact of the investment on productivity and industrial efficiency in Canada" (this is in addition to the existing criteria such as plans where to export and where to process, participation of Canadians in operations; support of on-going innovation, research and development in Canada, and appropriate level of capital expenditures to maintain the Canadian business' globally competitive position).

These guidelines remain broadly drawn and provide the Minister of Industry with significant flexibility in determining whether a proposed investment is of net benefit to Canada. Ultimately, they reinforce that under the ICA the burden of proof is on foreign investors to demonstrate to the "satisfaction of the Minister" that proposed investments are likely to be of net benefit to Canada. The protracted process to which the Nexen and Progress transactions were subject further reinforces the need for non-Canadian acquirers (and particularly SOEs) of Canadian businesses to view the ICA process as a substantive component of proposed acquisitions that are of any significant size or potential political interest.

## **Implementation of Higher Thresholds for Non-SOE Acquisitions**

In 2009, the Government announced, but did not implement, amendments to the current threshold requiring a net benefit review of proposed acquisitions by investors from WTO countries of businesses with assets worth more than \$330 Million. The Government announced that it will now implement these amendments, with the result that the threshold for WTO investors will rise to \$1 Billion over 5 years. This new threshold will be based on the enterprise value of the business, rather than the book value of its assets.

The new threshold will not apply to proposed acquisitions by SOEs, which will remain subject to the existing threshold, adjusted on an annual basis.

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## **Extensions to National Security Reviews**

The Government also announced that it will provide the Governor in Council (i.e., Federal Cabinet) with greater flexibility for the extension of the process for a national security review, which currently contemplates a review period of up to 135 days.

## **Conclusion**

Friday's announcement comes almost 6 months after the proposed acquisitions of Nexen and Progress first became public. These deals generated unprecedented media attention and public debate on a variety of issues, including the advisability of allowing foreign state control over Canada's natural resources and concerns about how the SOEs will operate the Canadian businesses after acquisition, prompting involvement by the Prime Minister's Office and by provincial governments.

Because the Nexen and Progress transactions were approved under the existing SOE guidelines, uncertainty remains regarding how the new, more restrictive SOE guidelines will be applied in practice. Also disappointing is the lack of greater clarity regarding the Minister of Industry's application of the net benefit test more generally.

Two things appear certain, however:

- the door is virtually closed to further acquisition of Canadian oil sands businesses by foreign SOEs; and
- the increasing politicization of foreign investment makes it essential that potential foreign investors proactively focus on the governmental – at the local, provincial and federal levels – and public relations aspects of an Investment Canada review.

For further information please contact any member of our M&A, Corporate Securities or Competition Law Groups.