Kluwer Competition Law Blog

Canadian Control and Foreign Investments in the Canadian Airline Sector

Mark Katz (Davies Ward Phillips & Vineberg LLP, Canada) · Friday, June 10th, 2022

The discussion of foreign investment law in Canada usually centres around the net benefit and national security review provisions of the Investment Canada Act (ICA). However, foreign investors must also be aware of different sector-specific laws in Canada that impose limits on foreign ownership of businesses in those sectors, including whether they exercise "control in fact".

For example, the Canada Transportation Act (CTA) limits the ownership/control that non-Canadians can have in Canadian domestic airlines. Administration of this aspect of the CTA is carried out by the Canadian Transportation Agency (Agency).

Recently, the Agency considered the Canadian qualifications of a discount airline based in Edmonton, Alberta – Flair Airlines (Flair). The Agency concluded initially that Flair likely did not qualify as Canadian because of various arrangements it had entered into with a US-based investor. This preliminary determination placed into jeopardy Flair's ability to continue to operate. However, following further discussions and changes made to the arrangements between Flair and the investor, the Agency issued its final determination that Flair still qualified as Canadian after all.

The Flair case is interesting not only insofar as it is an apt illustration of the CTA rules at work, but because it also has broader relevance for the ICA's foreign investment review processes. In certain circumstances, the ICA also calls for the determination of whether a foreign investor will exercise "control in fact" over a Canadian business. Since the ICA has no express rules of its own in this regard, decisions under the CTA provide helpful reference and precedent.

Foreign Investment Restrictions in the CTA

The CTA provides that to be licensed to operate in Canada, a Canadian domestic airline must:

- (i) be incorporated or formed under the laws of Canada or a province;
- (ii) have at least 51 per cent of its voting interests owned and controlled by Canadians (i.e., the interests cannot simply be registered to Canadians – Canadians must be the beneficial owners); and
- (iii) have no single non-Canadian, or no foreign air carriers (either individually or in affiliation), owning or controlling, directly or indirectly, more than 25 per cent of the voting interests in the airline.

In addition, even if the foregoing criteria are met, the airline cannot be "controlled in fact" by non-Canadians. Although this term is not defined in the CTA, the Agency considers control in fact to be the power, whether exercised or not, to influence the strategic decision-making activities of an enterprise and to manage and run its day-to-day operations. The influence needs to be dominant or determining to be considered, "control in fact".

Determining who has "control in fact" is a question of fact itself. The Agency evaluates this on a case-by-case basis, and has published very helpful guide setting out a non-exhaustive list of factors that it will typically consider (the guide is available at https://otc-cta.gc.ca/eng/publication/guide-canadian-ownership-and-control-fact-air-transportation).

These factors include:

Corporate Governance Factors

- Board of Directors (at least 50% of which must be Canadian)
- Officers
- Shareholder and Board of Directors' meetings

Shareholder Rights Factors

- Veto rights
- Security rights, options, and warrants
- Rights of first refusal/Pre-emptive rights
- Power to wind up the company

Risks and Rewards Factors

- Risks and benefits
- Concentration of voting interests

Business Affairs and Activities Factors

- Debt
- Guarantees
- Lease of assets
- Financial strength and business activity
- Management agreements
- Operational or service agreements
- Charterer/air carrier relationship

Those who may have the power to influence a company's decisions "in fact" can include minority owners, designated representatives, financial institutions, employees and others. They may use their influence either positively or negatively. For example, they may demonstrate a *positive* influence by requiring positive approval when a decision needs to be made. Conversely, *negative* influence could be the ability to veto a decision. Either way, the influence needs to be dominant or determining to be considered "control in fact."

The Flair Decision

1. **Flair**

Flair is a discount airline based in Edmonton, Alberta. It is incorporated under the laws of the Province of British Columbia and holds licences under the CTA authorizing domestic, scheduled international, and non-scheduled international air services (large aircraft). Flair currently operates routes connecting many smaller markets in Canada to other North American destinations. It has a fleet of 14 Boeing 737 aircraft, but has publicly discussed an aggressive growth plan that would see it scale up to 50 aircraft by 2025.

Flair commenced operations in 2004 as a charter airline and began offering regularly scheduled service in 2018. In that same year, Miami-based 777 Partners (777) invested in the airline's equity, although the majority of voting shares remained in Canadian hands (58.3 percent), in conformity with CTA rules. Moreover, no single non?Canadian or group of non-Canadian air service providers directly or indirectly owned more than 25 percent of Flair's equity, also in compliance with CTA rules.

In addition to its equity investment, 777 also provided approximately 70 percent of Flair's debt financing, which constitutes the majority of its funding. The balance of the debt financing is held by a number of other non-Canadian lenders.

2. **The Preliminary Determination**

The Agency commenced an investigation in late 2021 into whether Flair complied with the CTA's requirements regarding Canadian ownership. It is not clear what precipitated this investigation.

On March 3, 2022, the Agency issued its preliminary determination (Preliminary Determination), which is available at https://www.otc-cta.gc.ca/eng/content/canadian-transportation-agency-issues-preliminary-determination-whether-flair-canadian . The Agency found that while Flair satisfied the CTA's requirements with respect to incorporation and voting interests, it was concerned that 777 may have been exercising control in fact over Flair and consequently that Flair may not be Canadian, as defined in the CTA.

The Agency based its Preliminary Determination on the following findings regarding 777's influence over Flair:

- (i) 777 had assumed the majority of risks and was entitled to the majority of benefits in respect of Flair's operations;
- (ii) it controlled the Board of Directors with more than half of the seats ;
- (iii) it held rights that exceeded those granted to the other shareholders;
- (iv) it had played an active role in the management of Flair's business, especially since the advent of the Covid-19 crisis;
- (v) it was in a position to select whom it would bring in as a new shareholder; and,
- (vi) Flair was dependent on 777 for its financing and leasing of aircraft.

After considering all of these together, the Agency found on a preliminary basis that 777 may have

dominant or determining influence over Flair and thus may control Flair in fact.

3. **The Final Determination**

The Agency provided Flair with the opportunity to show cause, no later than May 3, 2022, why the Agency's Preliminary Determination was incorrect and, therefore, why the Agency should not cancel Flair's licences.

On May 3, 2022, Flair filed its response to the Agency's Preliminary Determination, including proposed amendments to the unanimous shareholder agreement with 777 (USA) that defined Flair's corporate governance and the assignment of rights among the shareholders, and to the promissory note governing the debt arrangement between Flair and 777 (Promissory Note).

After considering these materials, and on the basis of subsequent discussions and submissions, the Agency issued its final determination (Final Determination) on June 1, 2022, which is available at https://otc-cta.gc.ca/eng/content/important-notice-cta-flair-determination. The Agency decided that the changes implemented since the Preliminary Determination, including to the USA, the Promissory Note and to Flair's overall corporate governance structure, meant that Flair now satisfied all of the CTA's Canadian incorporation, voting interest and "control in fact" requirements.

In particular, the Agency pointed to the following:

- (i) As a result of changes related to Flair's Board provisions, including composition and quorum requirements, Canadian shareholders would now have the right to appoint no less than half of the Board, and no less than half of the members of the Board must be Canadian.
- (ii) Amendments to the USA meant that 777 no longer held unique shareholder rights.
- (iii) Flair had amended the Promissory Note to ensure that debt funding would continue to be available until at least 2026, thereby considerably mitigating 777's ability to exert influence over Flair.
- (iv) Flair had demonstrated to the Agency that it could generate positive cash flow from operations, alleviating concerns it would be dependent on 777 for additional new financing or require a guarantee from 777 in order to lease new aircraft.
- (v) 777 would no longer be entitled to unilaterally veto Flair's aircraft acquisition decisions meaning that Flair would now have the ability to acquire new aircraft from suppliers of its choosing.

In summary, the Agency found that Flair and 777 had restructured their arrangement sufficiently so as to significantly reduce or remove the means through which control in fact could be exercised by 777.

Application to the Investment Canada Act

The Flair case demonstrates the type of detailed analysis that the Agency will conduct in considering the application of the CTA's Canadian ownership requirements to specific fact situations. It also shows that the Agency may be willing to work with parties to resolve questions

around their Canadian ownership status.

The case also has potentially broader application in the sense that questions of “control in fact” are also relevant in other foreign investment contexts, most particularly under the ICA. For example, this issue can be relevant in defining Canadian status under the ICA (the ICA does not apply to Canadians) and also whether an acquisition of control has in fact occurred in certain circumstances (the acquisition of control of a Canadian business is a pre-condition for the application of the ICA’s “net benefit” review process). Given that the ICA does not contain a definition for what constitutes “control in fact”, and also considering that case law under the ICA is basically non-existent, Agency decisions under the CTA can serve as useful guidance under the ICA as well.

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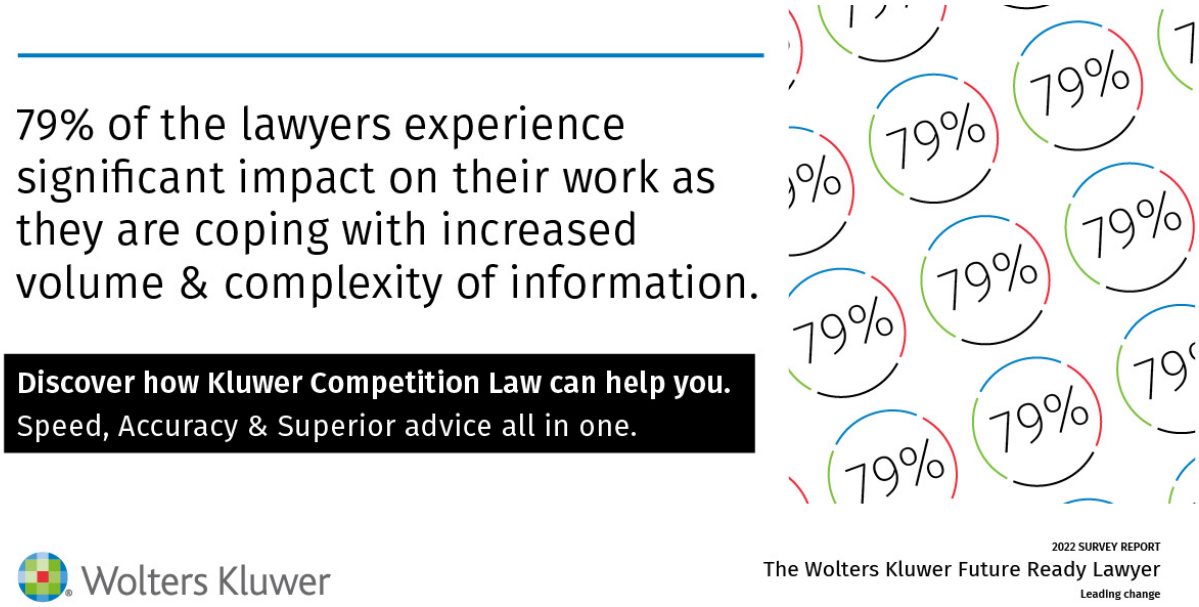

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