December 1, 2016

Canada Removes Another Brick in the Wall: Government Consents to Revisit Negative National Security Ruling

Authors: Mark C. Katz, Anita Banicevic and Charles Tingley

In our recent e-communication *Canada Lowers the Wall to Foreign Investment*, we described recent steps taken by the Canadian government to create a more attractive and welcoming climate for foreign investment in Canada: lowering a key review threshold under the *Investment Canada Act* (ICA); committing to issue guidelines to clarify the ICA's national security review process; and permitting increased foreign ownership of Canadian airlines.

In yet another encouraging sign, the Canadian government will now revisit its July 2015 decision requiring a Chinese investor to unwind the acquisition of a Canadian business because of national security concerns. The government agreed to take this step as part of the settlement of court proceedings brought by the investor to challenge the divestiture order.

O-Net's Acquisition of ITF

The Chinese investor, O-Net Communications Holdings Limited (O-Net), had acquired control of ITF Technologies Inc. (ITF) in January 2015. ITF is a Québec-based company that specializes in fibre components and other products used by customers in the defence and security sectors (among others). The former parent company of ITF (3S Photonics S.A.S.) had entered into bankruptcy proceedings and its assets, including ITF, were sold off by public auction. That auction process led O-Net, which is publicly traded on the Hong Kong Stock Exchange, to acquire control of ITF. According to public records, it appears that the transaction was below the applicable thresholds for pre-closing review under the ICA and that O-Net filed the requisite notification post-closing in February 2015.

Divestiture Order and Application for Judicial Review

On July 9, 2015, the former Conservative government invoked its authority under the ICA's national security review provisions and ordered O-Net to divest control of ITF (the Order). O-Net subsequently filed an application for judicial review in the Federal Court of Canada in August 2015, seeking to challenge the Order. This marked the first time that an investor had challenged the government's decision to prohibit a transaction on national security grounds.

To support its application, O-Net argued (among other things) that the Order should be struck down because (i) ITF was already controlled by non-Canadians prior to the sale; (ii) O-Net had increased ITF's revenues and grown the number of employees since closing; (iii) no investors from Canada or North America had expressed an interest in acquiring ITF; (iv) the transaction did not give O-Net unique access to technologies or products that it could not obtain otherwise; and (v) the Order was made without providing O-Net with any details or insight as to the nature of the government's national security concerns.

After what apparently were lengthy settlement discussions, the government agreed to the issuance of a consent order on November 9, 2016 that (i) rescinds the Order and (ii) requires the government to reconsider its decision to compel O-Net to divest ITF.

Implications

One of the consistent complaints about the ICA's national security review process is that it lacks transparency - for investors and the public alike. When the Conservative government's decision to force O-Net to divest ITF first became public, these criticisms were confirmed. First, the decision was brought to light only when O-Net commenced its application for judicial review in August 2015; the government had not publicly disclosed anything at the time the Order was initially issued in July 2015. Moreover, according to the application's allegations, the government had apparently not even disclosed the nature of its concerns to O-Net before issuing the Order.

It remains to be seen whether or not the government will reaffirm its divestiture order following the reconsideration of O-Net's acquisition of ITF. Still, the Liberal government's decision to revisit the O-Net Order, in conjunction with its promise to issue new national security review guidelines, signals that something is finally being done to inject greater transparency into the ICA's national security review process. Although these developments do not mean that legitimate concerns will now be ignored by the government, they do give non-Canadian investors new hope that such concerns will be addressed in a more constructive and fair manner in the future.

The O-Net case also raises an interesting point about process. Another complaint about the ICA's national security regime is that it lacks a formal mechanism for investors to apply for national security clearance before they proceed with a transaction. Indeed, in the O-Net case, the government's national security review took place only after the transaction had closed. The upcoming national security review guidelines may address this problem as well. But even if they don't, non-Canadian investors should be aware that, for most transactions at least, there are ways to engage the government on national security issues before closing - even in the absence of a formal application process. Investors considering acquisitions that potentially raise national security issues should ensure that they obtain professional advice about such options.

If you have any questions regarding the foregoing, please contact George N. Addy (416.863.5588), John Bodrug (416.863.5576), Mark C. Katz (416.863.5578), Anita Banicevic (416.863.5523) or Charles Tingley (416.367.6963) in our Toronto office.

Davies Ward Phillips & Vineberg LLP is an integrated firm of approximately 240 lawyers with offices in Toronto, Montréal and New York. The firm focuses on business law and is consistently at the heart of the largest and most complex commercial and financial matters on behalf of its clients, regardless of borders.