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Foreign Investment in the Child Care Sector: Canada's International Trade Obligations

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Introduction and Summary

The following opinion was prepared for the Canadian Union of Public Employees, and assesses the potential impact of Canada's international trade obligations on provincial policy and law as these relate to child care services.

Of particular concern is an apparent plan by an international child care conglomerate to establish a chain of daycare centres in Ontario, Alberta and British Columbia, largely through corporate acquisitions of existing child care businesses. This unprecedented development has prompted calls by various child care coalitions for a moratorium that would prevent such a corporate takeover and consolidation of child care services. In response, Ontario Government officials have questioned whether such a moratorium is possible given Canada's trade obligations.

In light of these developments you have asked us to address three questions:

i) Does foreign investment in the child care sector engage the application of trade rules so as to limit the range of policy and regulatory options available to governments concerning early learning and child care programs?

Short Answer: Yes.

Once foreign investment in the child care sector is permitted, the rights of such investors become vested under the North American Free Trade Agreement (NAFTA), and these include the right to make damage claims where government measures impinge on those investments, as for example is likely to occur if a program of full-day learning for four-

and five-year-olds attending junior and senior kindergarten is implemented. The risk of such a claim is proportional to the extent of foreign investment in the sector.

Moreover, if foreign investors establish a commercial presence in the sector, Canada's claim to the protection afforded by a key NAFTA exception for social services is weakened. This would further expand the potential scope for NAFTA based claims challenging government child care policies, laws, programs and regulations.

ii) Can provincial governments adopt measures to prohibit foreign investment in the child care sector without violating Canada's trade obligations?

Short Answer: Yes.

Canada has declared a general exception for social services under NAFTA services and investment rules. This preserves the right of Canada to limit or ban private and/or foreign investment in the child care sector. Similarly, governments can require a child care center to hire in the local community, provide service to a particular region as a condition of its license, or ensure that parents and members of the local community comprise a majority of the board of directors. Without the social services exemption, each of these measures would offend NAFTA rules.

But the social services exception is qualified and does not protect Canada from certain NAFTA claims once foreign investors have established investments in the sector. Moreover, the protection afforded by this exemption is weakened where services are privatized or delivered on a commercial basis.

iii) Can Canadian governments allocate public funding for child care exclusively to not-for-profit providers without violating NAFTA rules?

Short Answer: Yes.

International trade constraints do not require governments to subsidize for-profit child care service providers, whether owned by domestic or foreign investors. Therefore no trade law impediment exists to the government allocating public funding exclusively to not-for-profit providers. Nevertheless, where such a funding regime undermined the viability of for-profit service providers, it is possible that they could challenge the scheme as effectively expropriating their investments in such services. But this problem can only arise if foreign investors are permitted to establish a significant commercial presence in the child care sector.

In sum:

Canadian governments currently have the authority to prohibit foreign investment in, as well as the privatization of, child care services without running afoul of international trade rules. However, if governments fail to use this authority to prevent the establishment of a significant foreign investor presence in the sector, they will invite the

application of trade rules that limit their future policy and program options. Should this occur, NAFTA investment rules will make it very difficult for governments to reverse course to favour not-for-profit and community based child care, and will also render certain forms of child care regulation vulnerable to challenge before NAFTA tribunals. In light of current uncertainty about the future direction of federal child care policy, the prudent course for provincial governments wishing to preserve their options would be to restrict foreign investment in the child care sector.

Trade Liberalization and Social Services

In an earlier opinion, we assessed plans by the previous federal government to establish a pan-Canadian child care program in light of Canada's international trade obligations. The following conclusions of that assessment are relevant to the present inquiry:

1. In many ways, the trade liberalization objectives of NAFTA and the World Trade Organization (WTO) are fundamentally incompatible with policies that seek to limit market forces in order to achieve societal goals, such as the provision of universal, accessible, high quality and publicly funded child care.
2. Canada has acknowledged this contradiction and taken steps to protect social programs from the full impact of trade rules by negotiating exceptions to these trade regimes. Ultimately, the future viability of Canada's social programs depends upon the integrity and broad application of these safeguards.
3. Because of these exceptions, Canadian governments have retained the right to maintain existing and establish new social programs, like child care. However, the protection afforded by these exceptions is qualified and these safeguards are weakened when child care services are delivered or provided on a commercial basis.
4. Furthermore, as a practical matter, the risk of a trade challenge or foreign investor claim is negligible so long as there is no significant foreign investment in the child care sector. But where foreign investment is permitted, trade agreement based claims can be asserted, and the risk of such challenges grows in direct proportion to the extent of foreign investment permitted.
5. For these reasons the most effective strategy for preserving policy and program flexibility with respect to child care is to minimize or eliminate the delivery of child care services by commercial or for-profit providers. Conversely, allowing commercial child care companies to acquire a significant stake in the sector represents high-risk behavior that significantly increases exposure to trade complaints and foreign investor claims.

As our earlier opinion also indicated, unless Canada takes steps to expand the application of GATS¹ rules to child care, it is NAFTA and the rights of foreign investors entrenched by that treaty that are of primary concern in this regard. Accordingly, this opinion focuses on the rights of private investors under NAFTA investment rules as these apply to child care policy and law.

Globalization Comes to the Child Care Sector

It is our understanding that a rapidly expanding international child care conglomerate is seeking to establish operations in at least three Canadian provinces. While the corporate actors involved have declined to make their plans public, over the past few months child care service providers in Ontario, BC and Alberta have received letters from two individuals representing a “large financial/child care group purchasing child care centres across Ontario”. The letter expresses an interest in purchasing the recipient’s child care centre. The return address is to “Adroit Investments” at a post office box in North Carolina.

Other corporate entities appear to be involved in the acquisition scheme, including a company named 123 Busy Beavers Learning Centres, which was recently registered in Ontario, British Columbia and Alberta. While their relationships are murky, 123 Busy Beavers, Adroit Investments, and another company named 123 Global Holdings (North America), have all been linked to the Australian multinational ABC Learning Centres, the world’s largest child care corporation.

For present purposes, however, the identity and relations among these corporate players is not particularly relevant, save to establish the participation of foreign investors in the scheme. In order to qualify as a foreign investor under NAFTA investment rules, Adroit Investments, 123 Global Holdings, ABC Learning, or their shareholders need only be resident in the United States or Mexico. Moreover, should any or all of these companies acquire investments in child care businesses in Canada, they are entitled to assert the rights accorded foreign investors in NAFTA investment rules, including the right to bring a claim for damages before an international tribunal where it is alleged that some action by a Canadian government, including a provincial or municipal government, interfered with their rights under NAFTA. For this purpose, they need only own shares in a company providing child care services in Canada.

Should this acquisition plan succeed, the result would establish the first large chain of for-profit child care centers in Canada. While a few Canadian child care companies now run more than one facility, these operations are relatively small and limited to particular urban centres. The scale of this present acquisition scheme is entirely unprecedented and could for the first time establish a consolidated corporate presence in a social service sector that is currently dominated by not-for-profit day care centers, many of which are

¹ The General Agreement on Trade in Services to the World Trade Organization. The most onerous GATS rules apply only to service sectors with respect to which Canada has made explicit commitments. It has not done so with respect to education services.

run by community-based organizations. It is not our purpose here to assess the broader implications of such a development, but rather to assess its implications in light of Canada's obligations under NAFTA rules concerning foreign investment in social services.

The Early Childhood Education Policy Context in Canada

The delivery of child care is largely a provincial responsibility, and policies and programs vary considerably across the country. Commitments by the previous federal government to increase child care funding and impart greater policy and program coherence to provincial programs took the form of agreements between the federal and several provincial governments. In return for increased federal funding, the provinces agreed to enhance child care services according to four core principles: quality, universally inclusive, accessible, and developmental (the QUAD principles).

The current federal government has abandoned that initiative and cancelled the federal-provincial agreements that had been negotiated in favour of modest, and taxable, direct transfers to parents of young children. No longer assured of federal funding, provinces abandoned or scaled back commitments to create day care spaces. Recent reports indicate that the federal program has failed to enhance the availability of child care services.

Anticipating the failure of the Conservative government child care policy, the three opposition parties have united behind a private members' bill that would establish—a Canada-wide child care program, expanding on the QUAD principles and restricting federal child care funding to not-for-profit providers. Because this proposed legislation is considered to be a “money bill”, it cannot proceed without Conservative government support, and the government has advised that this support will not be forthcoming.

The result of failed and obdurate federal government policies has both frustrated efforts to establish needed child care spaces, and created a policy vacuum which foreign investors appear poised to take advantage of.

i) Does foreign investment in the child care sector engage the application of trade rules so as to limit the range of policy and regulatory options available to governments concerning early learning and child care programs?

In identifying the potential pitfalls associated with trade rules, two assessments must be made - the first is legal, the other practical. The legal question concerns whether a particular government measure,² such as a requirement that child care centres be public or community-based organizations, conforms to trade rules that generally prohibit government regulations restricting foreign investment in the service sector.

² Measure is a technical term under NAFTA and the WTO. NAFTA Art. 201 defines “measure” to include any law, regulation, procedure, requirement or practice.

The second question concerns the actual likelihood of a trade challenge or foreign investor claim even where some action by government may be inconsistent with free trade rules. The risks here largely depend upon the extent to which the measure affects the vested interests of our trading partners or foreign investors. In an opinion prepared for the Romanow Commission, a senior trade lawyer who represented Canada during the initial free trade negotiations put it this way:

It is easy to invent NAFTA and WTO worst-case scenarios but the actual impact of these agreements must be assessed realistically. An expansion of the public component of the health care system into new areas, with the resulting exclusion of private interests, would result in NAFTA compensation claims or WTO challenges only if the private economic interests adversely affected were significant. If these interests are non-existent or insignificant, the risk of claims or challenges is negligible.³

Conversely, the presence of significant private or foreign investment interests in a particular sector, such as child care, creates an impediment to establishing or expanding public sector and not-for-profit delivery. This is true because NAFTA investment rules allow foreign investors to claim compensation when their businesses are adversely affected by public policy or regulatory initiatives.⁴

As for the lawfulness of measures relating to child care services, the most important provision of NAFTA is the exception for social services that Canada established to exempt certain government measures relating to such services, which provides that:

Canada reserves the right to adopt or maintain any measure with respect to the provision of public law enforcement and correctional services, and the following services to the extent that they are social services established or maintained for a public purpose: income security or insurance, social security or insurance, social welfare, public education, public training, health, and child care. [emphasis added]⁵

The character of this ‘social services’ reservation is such that Canadian governments are entitled not only to maintain existing social service programs and regulations, but to establish new ones. This is true even where such initiatives explicitly restrict the rights of foreign investors or service providers, such as by prohibiting foreign investment in the child care sector.

³ Jon Johnson; *How Will International Trade Agreements Affect Canadian Health Care?* Commission on the Future of Health Care in Canada, Sept. 2002.

⁴ David Schneiderman, *NAFTA’s Takings Rule: American Constitutionalism Comes to Canada*, University of Toronto Law Journal 499 (1996), at pp. 521-523, and *Investment Rules and New Constitutionalism*, 25 Law and Social Inquiry 757 (2000).

⁵ NAFTA Annex II.

However, the reservation for social services has limits. To begin with, the reservation does not apply to all NAFTA investment rules, including most notably the prohibition against expropriation.⁶ This prohibition has been given broad interpretation by a NAFTA tribunal, and has been invoked to warn governments away from plans to establish public services which would adversely impact commercial providers in the sector. This happened most recently in Canada to discourage New Brunswick from establishing a public auto insurance plan for the province. The same argument, or threat of litigation, is likely to greet government plans to establish a comprehensive and publicly funded child care system if foreign investors are allowed to establish a significant presence in the sector.

Present plans by the Government of Ontario to establish a full-day learning program for 4 and 5 years olds attending kindergarten provide a good example. When this plan proceeds it will displace a certain amount of private care now provided to these children. This has the potential to adversely affect private businesses now providing these services, in the same way public auto insurance would diminish the business of private insurance providers. If foreign investors have established significant investments providing such services, NAFTA provides a basis for asserting a claim for damages arising from this lost business.

Another limitation arises from the fact that the reservation for child care and other social services is qualified and applies only to "social services established or maintained for a public purpose". The qualification is problematic because of the US view that:

The reservation in Annex II U-5 (the US equivalent to Canada's) is intended to cover services which are similar to those provided by a government, such as child care or drug treatment programs. If those services are supplied by a private firm, on a profit or not-for-profit basis, Chapter Eleven and Chapter Twelve apply.
[emphasis added]⁷

In other words, according to US trade officials, child care provided on a commercial basis would not be considered a social service. Consequently child care policies and law that sanctioned for-profit services would not have the protection afforded by the NAFTA reservation.

Canadian trade officials have little to say about the US view, suggesting instead that the scope of this reservation "depends largely on how a country's own government, views the situation."⁸ But the suggestion that this reservation is essentially self-defining is entirely

⁶ Under NAFTA, expropriation is defined much more broadly than under Canadian law, and as noted by the BC Supreme Court is so expansive as to include "a legitimate rezoning by a municipality or other zoning authority." *The United Mexican States vs. Metalclad Corporation*, 2001 BCSC 664, reasons for judgement of the Honourable Mr. Justice Tysoe, released May 22, 2001 at para. 99.

⁷ Correspondence from the USTR, Michael Kantor to the Attorney General for the State of Oregon, Mar. 1996

⁸ See views expressed in correspondence between John Weekes, then Canada's NAFTA coordinator, and the Ontario Deputy Minister of Health, reproduced in *Inside NAFTA*, November 29, 1995, cited in Epps and Flood, p 25, n6.

inconsistent with the approach adopted by the NAFTA parties for defining such exceptions, and is very unlikely to persuade an international trade or investment tribunal.⁹

It remains to be seen which view will prevail if a trade panel or arbitral tribunal convenes to decide the matter. However, it is very clear that a child care system that allows little if any role for private or commercial providers is far more likely to fall within the boundaries of this key reservation. This provides a strong rationale for limiting the role of commercial child care providers.

As noted, this conclusion is reinforced when practical realities are taken into account. The absence of significant foreign investment in the child care sector allows Canadian governments to develop a national child care program and policies without having to contend with the threat of foreign investor claims. This advantage would be lost if significant commercial investment is allowed in the sector. This is precisely the predicament that now confronts Canadian governments considering options for expanding the medicare system to include a prescription drug program, given the established interests of the private insurance industry in this sector.¹⁰

Finally on this point, it is unclear where the tipping point will be in determining whether a child care system is private or commercial in character. However, there is no doubt that Canada's claim to the protection afforded by its social services reservation will be weakened if private investors are allowed to establish a substantial commercial presence in the child care sector.

In sum:

NAFTA accords foreign investors certain rights as soon as investments are established in Canadian child care services. Most notable is the right to claim damages where it is alleged that government measures effectively expropriate an investor's investments. Because expropriation is broadly defined, a plan by government to establish a publicly-funded child care system, where funding is restricted to not-for-profit providers, could be considered to breach the NAFTA prohibition against expropriation. The risk of such claims is proportional to the size of the commercial stake foreign investors have in the sector.

Moreover, the presence of commercial child care service providers weakens Canada's claim to the protection afforded by the social services exception it has declared under the trade regime. This risk is also proportional to the presence of private investors in the sector.

If the protection afforded by this reservation is negated, the policy and regulatory options of governments relating to child care would be seriously constrained. This would significantly expand the scope for foreign investor claims to not only challenge any

⁹ See for contrast Article 2102 of NAFTA which reserves to the each of the Parties, the right *to take any actions that it considers necessary for the protection of its essential security interests* [emphasis added].

¹⁰ See Jon Johnson, note 7.

restriction on foreign investment, but also to challenge regulations concerning the governance, service obligations and operation of child care centers where these are alleged to breach the broad constraints on government action set out under NAFTA investment rules.

The obvious and prudent course for governments seeking to avert these risks in light of recent foreign investor interest in the sector is to move quickly to prohibit such foreign acquisitions.

ii) Can provincial governments adopt measures to prohibit foreign investment in the child care sector without violating Canada's trade obligations?

As noted, Canada has declared a general exception for social services under NAFTA services and investment rules. In this regard Article 1108:3 provides:

Articles 1102, 1103, 1106 and 1107 do not apply to any measure that a Party adopts or maintains with respect to sectors, subsectors or activities, as set out in its Schedule to Annex II.

Canada's social services reservation is listed in Annex II, and in the jargon of international trade law is "unbound", meaning that Canadian governments are entitled to maintain, expand or establish new social services. This is true even where such initiatives restrict the rights of foreign investors or service providers, so long as governments respect the limits of the public policy and legal domain carved out by the reservation.

Thus, by virtue of Canada's reservation, governments may prohibit or restrict foreign investment in the child care sector. This would otherwise be prohibited under Articles 1102 (National Treatment) and 1103 (Most Favoured Nation Treatment) for treating foreign investors in a discriminatory fashion.

Similarly, governments are permitted to establish performance requirements, such as a requirement that child care centers hire in the local community, or provide service to a particular region as a condition of its license – both types of regulatory requirement would otherwise be prohibited under Article 1106. They may also stipulate that parents and members of the local community comprise a majority of the board of directors, notwithstanding the prohibition on such measures set out by Article 1107.

However, as noted, Article 1110 which concerns expropriation, is not covered by the Annex II reservation. Therefore once foreign investors are permitted to acquire investments in the child care sector, they are accorded certain NAFTA rights. And as also noted, the protection afforded by the social services exemption is weakened where services are privatized or delivered on a commercial basis.

Put in colloquial terms, in order to preserve their rights under NAFTA, Canadian governments must use them. Thus while governments may restrict foreign investment in the child care sector, failure to do so has two consequences. The first is to constrain future government policy and regulatory options that may be considered as expropriation. The second is to undermine Canada's claim that its social services reservation applies to

commercial providers. This would not only expand the scope for investor claims, but would also mean that once the door is opened to foreign investment in the child care sector, it may be impossible for governments to close it.

iii) Can Canadian governments allocate public funding for child care exclusively to not-for-profit providers without violating NAFTA rules?

NAFTA investment rules generally preserve the prerogatives of governments to allocate public funding as they see fit.

NAFTA Article 1108:7 stipulates that:

Articles 1102, 1103 and 1107 do not apply to:

- (a) procurement by a Party or a state enterprise; or
- (b) subsidies or grants provided by a Party or a state enterprise, including government-supported loans, guarantees and insurance.

This means that governments can allocate public funding to not-for-profit providers, even though the effect is to discriminate against foreign investors. Even so, and as noted, it is possible that such discriminatory treatment could found a claim for expropriation where the public funding regime was such as to significantly reduce a for-profit provider's market share. But again, this problem can only arise if foreign investors are permitted to establish a significant commercial presence in the child care sector.

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