It’s not all about China

Foreign investors face new European regulatory challenges to getting the deal done

Catriona Hatton and Sofia Doudountsaki

Dec 30 2020

This year has seen European governments and institutions move to bolster protection of European companies and critical assets from foreign takeover through increased foreign direct investment (FDI) screening, as well as a proposed new tool which would see acquisitions subsidised by foreign governments subject to prior approval by the European Commission (Commission). While this is partly in response to the economic crisis caused by Covid-19, concerns about how to control foreign investment in EU assets, in particular by state-owned and state-subsidised Chinese companies, have been brewing for several years. In 2017, the governments of France, Italy and Germany summarised their concerns around foreign investment and the absence of a “level playing-field” in a letter to the Commission:

“In the field of investment, when other countries put up hurdles to direct investment by European companies or only allow such investment under certain discriminatory conditions whilst, at the same time, European companies are being acquired as part of other countries’ strategic industrial policies, there is no level playing-field. The playing-field is even less level if such investment is subsidised by state bodies.”[1]

The response is a two-fold legislative approach to M&A and investments by foreign companies: first, to coordinate and strengthen member state screening of FDIs through the recently adopted EU framework for FDI screening; a second instrument is modelled on merger control and, if adopted, would give the Commission far-reaching ex-ante regulatory powers to block or require remedies in investments in EU companies, which are subsidised directly or indirectly by foreign governments.

These developments present a more challenging regulatory landscape for non-EU investors and while concerns have centred around Chinese investment, it is not all about China. For political reasons, investments from China and certain other countries in strategic sectors are more likely to be blocked or subject to remedies under FDI rules, but FDI screening applies to investments across a broad range of sectors by all non-EU companies.[2] For example, US acquisitions of European target companies as well as acquisitions of US target companies active in certain sectors in the EU, are already frequently subject to FDI approvals and remedies in a number of member states and as of January, UK companies will be considered as “foreign investors” in the EU and subject to FDI screening. On its side, the UK recently introduced a Bill to Parliament which would introduce a filing obligation for proposed investments by foreign companies of 15 per cent or more in a company active in the UK in one of 17 specified sectors.[3] Separately, the potential new EU merger-control type instrument to control distortions caused by foreign subsidised acquisitions would draw increased scrutiny of acquisitions by state-owned-entities including from China, Russia and the Middle-East but would have a much broader reach, particularly if its scope extends as proposed, to a very broad swathe of both direct and indirect foreign government subsidies.

Whatever the outcome of the proposed new European Commission powers to vet and veto transactions involving foreign subsidies, new and strengthened member state laws on FDI screening are already impacting transaction timelines and in some cases outcomes. Up-front multijurisdictional analysis of FDI filings are increasingly a feature of many transactions alongside merger control and need to be factored in to deal planning from the early stages. This article takes a look at key features of FDI in the EU, as it impacts M&A as well as the current scope of the proposed EU vetting of foreign-subsidised transactions.

FDI screening in the EU

In the EU, control over FDI is exercised nationally by the member states, with 15 out of 27 member states having an FDI regime in place.[4] In the past five years, EU member states have been increasingly expanding or adopting FDI screening mechanisms in order to safeguard their strategically sensitive industries from acquisitions by non-EU investors. Recently, this has been spurred-on by a combination of two factors – the new EU framework for FDI screening (EU Screening Regulation) which entered into force in October 2020,[5] and the economic crisis caused by the pandemic.

A new EU cooperation framework for FDI screening

The EU Screening Regulation does not create a standalone EU-wide FDI regime. Instead, it sets out a framework for screening by member states of FDIs on grounds of security or public order and establishes a mechanism to facilitate sharing of information between member states and the Commission. Most importantly, it obliges the EU country where the investment takes place to give other EU countries and the Commission the opportunity to comment on proposed and completed investments, and although Commission opinions or comments from other member states are not binding on the competent member state, it is obliged to give them “due consideration”. While this has the potential to lead to a more harmonised approach to FDI screening across the EU, it can also increase the regulatory burden and timeframe for reviews and open the way to tactical lobbying by opponents.

Scope of transactions caught by FDI screening

There has been a general trend in member states over the years to expand the scope of application of FDI rules beyond the defence industry and capture investments in a much broader array of sectors. The EU Screening Regulation reflects and reinforces this trend by setting out a non-exhaustive broad range of sensitive sectors that member states may focus on in reviewing the impact of FDIs on security or public order. These cover investments grouped under a variety of categories including critical infrastructure, technologies, dual-use items, the supply of critical inputs and businesses with access to sensitive information including personal data, and bring multiple sectors within the ambit of FDI, from energy, transport, water, media, health, nanotechnologies, biotechnologies and food, to semiconductors, robotics, artificial intelligence and cybersecurity.

In contrast with merger control rules, many EU national screening regimes do not apply monetary thresholds (revenues of parties or transaction value) in order to determine jurisdiction, or whether a notification requirement exists. In addition, most countries apply FDI screening not only to investments which result in acquisitions of control of a target but also to minority investments which fall short of conferring any type of control. Therefore, FDI screening captures a much broader scope of transaction than merger control.

Member states adopt new regimes or strengthen existing screening mechanisms

In light of the outbreak of the Covid-19 pandemic, and concerned in particular about foreign investment in EU-based companies active in the healthcare sector, the Commission has urged member states to vigorously apply their existing FDI review mechanisms and, in case they have not already done so, to adopt such mechanism.[6] Several countries in the EU have either tightened their foreign investment screening mechanisms or introduced (or are planning to introduce) new screening regimes. For example, Germany has broadened the scope of health-related businesses which fall under the requirement of prior notification and approval of acquisitions of 10 per cent or more of the voting rights in a domestic target company. It also adopted new legislation to tighten its screening regime including introduction of a standstill provision for investments subject to review. In France, the review threshold for foreign investments has been temporarily lowered this year from acquisitions of 25 per cent to acquisitions of 10 per cent or more of the voting rights in listed French companies, and France added biotechnology to the list of sensitive sectors subject to FDI screening. Meanwhile, Spain has adopted a raft of measures applying FDI screening to acquisitions of 10 per cent or more in the share capital of a Spanish company and requiring prior authorisation for investments in a range of sensitive sectors with an expanded scope of application to investments by entities which are directly or indirectly controlled by a foreign government. In addition to the 15 national FDI regimes already in place in the EU, at least four other member states are set to introduce FDI screening in the near future.[7]

Enforcement and remedies

In terms of EU enforcement, Germany and France have been leading the efforts. In August 2018, the German government issued its first formal prohibition of a foreign investment in Germany, blocking private Chinese company Yantai Taihai from acquiring the German company, Leifeld Metal Spinning AG. The German authorities considered the transaction a potential threat to public order and national security, since Leifeld produces metal parts that are also used in the nuclear industry.[8] In April this year, the French government announced its intention to veto the proposed acquisition by US company *Teledyne* of French-based *Photonis*, a leading French manufacturer of military night vision devices. However, in October 2020, it was reported that Teledyne was still in the race to acquire Photonis for a discounted price that would reflect the remedies unofficially imposed by the French government in order to alleviate its concerns about the effects of the acquisition on national security. These remedies reportedly include: the acquisition by Bpifrance (a French investment bank and joint venture between French public entities) of a minority shareholding of 10 per cent in Photonis with veto rights on the operations of Photonis in France and the Netherlands; and the prohibition of any communication to the US of information on the equipment delivered by Photonis to the French forces.[9] At the time of the writing of this article the negotiations are still ongoing.

In 2019, the UK Government intervened on grounds of public interest in two high profile transactions, the acquisition of Inmarsat by a private equity consortium and the acquisition of aerospace company Cobham, by private equity investor, Advent. In both deals, commitments were offered in what seems to be an attempt to head off greater Government intervention, including commitments to maintain physical headquarters in the UK and in relation to Cobham, commitments on R&D spend.[10]

However, while these types of headline prohibitions or remedies cases are rare, they do not reflect the true scope of impact of FDI screening. Many transactions withdrawn in light of government objections, or subject to remedies, fall below the radar and are not the subject of public decisions or reporting.

Commission proposal on leveling the playing field – acquisitions by state-subsidised foreign companies

In June 2020, the Commission adopted a White Paper proposing novel review mechanisms to address the distortive effects caused by foreign subsidies in the EU internal market.[11] The White Paper sets out proposals for legal instruments to address the perceived regulatory gap in relation to foreign subsidies with an impact on: (a) economic operators generally active in the EU; (b) acquisitions of EU undertakings; (c) public procurement procedures; and (d) the allocation of EU funding. As regards M&A, the White Paper considers the introduction of a special instrument allowing for the ex-ante review of acquisitions and investments in companies established in the EU, where the investor benefits from foreign subsidies. This new legal instrument is specifically intended to address distortions caused by foreign subsidies facilitating the acquisition of EU companies, by ensuring that no unfair benefit is conferred on recipients, either directly by linking a subsidy to a given acquisition, or indirectly by de facto increasing the financial strength of the acquirer.

Scope of transactions subject to foreign subsidy review

Transactions that fall under the scope of review would be determined based on either turnover thresholds (similar to those used in merger control), and/or transaction value thresholds, or other qualitative criteria which would facilitate review of acquisitions of smaller nascent competitors. In contrast to EU merger control, non-controlling minority shareholdings which give the investor "material influence" over the target would also fall under the scope of application of this instrument.

Procedure and substantive assessment

In terms of procedure and substantive assessment, acquirers would need to file an information notice with the Commission if they have received a "financial contribution" from any foreign authority in the past three years or expect such a contribution in the coming year. Closing of the transaction would have to be suspended for a certain period of time following notification. The Commission would review the transaction to determine if it is facilitated by a foreign subsidy and, if so, whether the subsidy results in distortive effects in the EU's internal market. In the case of targeted subsidies that directly facilitate the acquisition, there would be a presumption of distortion of competition, while a case-by-case analysis would be required for de facto facilitation, namely where subsidies reinforce the financial strength of the acquirer. If the subsidy is found to have a distortive effect, the Commission will apply an "EU Interest Test" in deciding whether to allow the investment with or without remedies, or to prohibit the transaction. The EU Interest Test involves balancing the established distortion against any positive impact of the foreign subsidy in the EU, for example on jobs, environmental protection or security. As regards remedies, these could be either structural, including divestment of assets, or behavioural, including prohibition of certain conduct linked to the foreign subsidy.

Conclusions

Recent developments in FDI screening in Europe have increased the regulatory burden on foreign investors in companies active in a broad range of sectors in the EU. This trend is set to continue with new FDI regimes being introduced by several EU member states. In planning transactions, companies need to consider at an early stage the potential implications of any FDI screening on timing, drafting of deal documents, including conditions precedent, and hell or high-water provisions, and ultimately implications to the outcome. Early definition of a strategy to secure approvals, or allow work-arounds such as carve-outs, will help avert unexpected obstacles and delays. Where transactions are likely to raise concerns, early engagement with authorities may allow parties to identify suitable remedies which can secure approval and head off lengthy investigations.

The proposals in the White Paper on foreign subsidies would further increase the regulatory burden for foreign investors, introducing a completely new level of regulation, unrelated to merger control which assesses the impact of a deal on competition in the EU, or FDI screening which is focused on the impact of a deal on national security and public order. The new instrument would give broad powers to the Commission to assess all types of distortions in the EU’s internal market which could result from an acquisition which is subsidised by a foreign authority. The President of the European Commission recently identified upcoming legislative proposals based on the White Paper as a priority for the Commission, with binding legislation expected in 2021.[12] While much more work is needed on the detail of this new legislation, it is clear that if implemented, it will impact in particular investments by Chinese state-owned companies as well as private Chinese companies with links to government. However, again, this is not all about China or only about investments by state-owned companies. Given the scope of the subsidies which could be considered as facilitating an investment, many investments by foreign companies could be subject to review.

Catriona Hatton *is a partner – and* ***Sofia Doudountsaki*** *is an associate – at Baker Botts in Brussels (www.bakerbotts.com).*

ENDNOTES

1. https://images.politico.eu/wp-content/uploads/2017/08/170728_Investment-screening_non-paper.pdf.

2. Some member state regimes also capture investments made by EU companies, where they are part-owned by a non-EU entity, or where they involve investments in particularly sensitive sectors, such as arms-manufacturing.

3. https://commonslibrary.parliament.uk/research-briefings/cbp-8784/.

4. https://trade.ec.europa.eu/doclib/docs/2019/june/tradoc_157946.pdf.

5. Regulation (EU) 2019/452 of the European Parliament and of the Council of 19 March 2019 establishing a framework for the screening of foreign direct investments into the Union.

6. Communication from the Commission Guidance to the member states concerning foreign direct investment and free movement of capital from third countries, and the protection of Europe’s strategic assets, ahead of the application of Regulation (EU) 2019/452 (FDI Screening Regulation) 2020/C 99 I/01.

7. Ireland, Sweden, Czech Republic, Slovakia.

8. https://www.bloomberg.com/news/articles/2018-08-01/germany-said-to-block-company-purchase-by-chinese-for-first-time.

9. https://www.challenges.fr/entreprise/defense/incroyable-l-americain-teledyne-repart-a-l-assaut-de-la-pepite-francaisephotonis_734462, https://www.lesechos.fr/industrie-services/air-defense/defense-lamericain-teledyne-va-racheter-photonis-a-prix-solde-1259299.

10. https://www.gov.uk/cma-cases/connect-bidco-inmarsat-merger-inquiry; https://www.gov.uk/cma-cases/advent-international-cobham-merger-inquiry.

11. https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1070.

12. https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/652053/EPRS_BRI(2020)652053_EN.pdf.