CLIENT INFORMATION

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New Government Proposals on Significantly Tighter German Foreign Direct Investment (FDI) Rules in the Wake of the Corona Crisis

The German foreign direct investment regime has historically been regarded as market-liberal. Following a series of earlier changes in 2017 and 2018, with a legislative bill for the amendment of the German Foreign Trade Act (Außenwirtschaftsgesetz) put forward by German government in early April 2020, this conclusion may now be (more) difficult to support. Formally on the background of the EU-Screening Regulation (Regulation EU 2019/452 of March 19, 2019), but clearly also under the influence of the current Corona crisis, the proposed new rules would substantially tighten several core provisions of German foreign investment control.

It is to be expected, that on top of these revisions to the Foreign Trade Act, already announced plans to also revise the accompanying Foreign Trade Ordinance (Außenwirtschaftsverordnung), which contains several key implementation rules, will further significantly expand the scope of government review, as the list of critical infrastructure businesses (and the respective review and prohibition rights) will be greatly expanded to include, in particular, critical technology such as cybersecurity, nanotechnology, artificial intelligence and similar areas. The forthcoming amendments to the Foreign Trade Ordinance have not been made public so far. They will also determine important procedural aspects and impact the timelines for review. Once available, we will update this client information accordingly.

It should be noted that these (tightened) rules may also apply to intragroup restructurings or transactions between foreign parent entities, which do not involve any direct transfer of shares in a German subsidiary and may at first glance thus be considered unproblematic. This is so because the law also covers indirect share acquisitions, and contains far-reaching voting rights attribution rules. Whenever a transaction of a non-EU investor involves a German entity, directly or indirectly, the impact of these rules should thus be thoroughly assessed.

I. In a Nutshell

The proposed revisions to the Foreign Trade Act, in principle, concern four key aspects:

First, in evaluating whether a transaction should be prohibited, the competent Federal Ministry for Economic Affairs and Energy (BMWi) will in future not just consider German public order or security, but (in line with the EU Screening Regulation), take into account concerns in regard to public order or security of other EU Member States or effects on certain EU-wide projects or programs of strategic importance. This will lead to a significantly expanded review process and a lengthening of the respective review periods.

Second, in order to prohibit a transaction, it will no longer be necessary for the BMWi to show an "actual and serious threat to public order or security" as an effect of the

transaction. It will be sufficient to establish that the foreign direct investment is "likely to affect" (*voraussichtliche Beeinträchtigung*) public order or security. This particularly material change not only reduces the element of prognostic certainty necessary for a prohibition, but also the required severity of the effect on public order or security. It is thus to be expected, that goverment in future will have significantly more leverage to prohibit transactions (or to negotiate commitments of investors as a condition for clearance), which might be seen as facilitating industrial policy.

Third, while a notification of acquisitions of enterprises active in critical infrastructures, as defined in more detail in the Foreign Trade Ordinance, already is required pursuant to the 2017 revisions of German FDI rules, a transaction can generally be closed during a pending review under currently applicable law. This will no longer be possible in future, as the proposed 2020 revisions explicitly state that the underlying contract is provisionally void (*schwebend unwirksam*) until clearance is received.

Fourth, the new law will establish strict anti gun-jumping prohibitions, which prevent, in particular, a dissemination of critical information while a transaction has not been cleared. This will likely have significant effects on M&A processes, and in particular the diligence phase of a transaction.

II. Cross-Sectoral FDI Review Scheme

The foreign direct investment regime in Germany is bifurcated into a 'sector-specific' and a 'cross-sectoral' control regime. While the sector-specific regime in principle applies to enterprises producing war weapons and other military use goods (and is not discussed in detail here), the cross-sectoral review applies to businesses of all sectors regardless of the size of the target or acquirer company.

Under the cross-sectoral regime, acquisitions by any investor outside the EU and/or the European Free Trade Association (EFTA) are covered, if relevant voting right thresholds are crossed directly or indirectly, through an attribution of voting rights.

Due to the application of these attribution rules, intragroup restructurings or transactions between foreign parent entities, which do not involve any direct transfer of shares in a German subsidiary and may at first glance thus be considered unproblematic, may also be subject to review. In any case where a German target entity is involved, whether directly or indirectly, the impact of German FDI rules should therefore be assessed early-on, to avoid last minute roadblocks.

For the determination of whether an investor qualifies for the cross-sectoral investment review, its place of incorporation or factual place of management outside the EU/EFTA is decisive.

With regard to applicable voting right thresholds, a distinction is made between the acquisition of entities or businesses active in so-called critical infrastructures and other companies.

In priciple, there is a general threshold of 25% of voting rights covering acquisition of any domestic enterprise irrespective of the business segment it operates in. The review will be triggered at the time the investor 'reaches or surpasses' this threshold of 25% of voting rights.

In contrast, the relevant control threshold is significantly lower if the enterprise in question operates in certain specific business sectors of particular relevance to security

(so called critical infrastructures). If businesses active in these areas are concerned, a direct or indirect acquisition of 10% of voting rights already suffices to trigger the foreign investment review process. At the same time, the law stipulates that in case of acquisitions in these sectors, a threat to public order or security may be considered particularly likely.

Critical infrastructures concerned currently comprise, for example, (i) facilities that belong to the energy, information technology and telecommunication, transport, healthcare, water, food, finance or insurance sector, and are vital to the functioning of the community, (ii) develop or modify certain software for the operation of critical infrastructures, (iii) provide certain cloud computing services or (iv) are active in the media sector and, with particular topicality and broad impact, contribute to forming public opinion via broadcasting, tele media or print media.

While we do not currently foresee a further reduction of the currently applicable 10% threshold, it is to be expected that the list of critical infrastructures in this sense will be significantly expanded to reflect the scope of Article 4 of the EU Screening Regulation – the relevant revisions would be contained in the yet to be published amendment of the Foreign Trade Ordinance.

Pursuant to Article 4 of the EU Screening Regulation, in determining whether an investment is likely to affect public order or security, Member States may in future in particular consider potential effects on critical technologies and dual use items including artificial intelligence, robotics, semi conductors, cybersecurity, aerospace, defence, energy storage, quantum and nuclear technologies as well as nanotechnologies and biotechnologies or the supply of critical inputs including energy or raw materials as well as food security. We expect that the forthcoming revisions to the Foreign Trade Ordinance will make use of these categories and establish a number of additional industries which are considered critical infra structures and which therefore become subject to the (lower) review threshold of 10% of voting rights.

III. Substantive Review Standard

Under the currently applicable law, the BMWi assesses whether an investment may impose a risk to public order or security in Germany which is "actually threatening" and sufficiently important so that it may affect fundamental public interests. The term public order or security refers to Article 36, 52 (1) and 65 (1) of the TFEU and has to be interpreted pursuant to EU law.

Under these provisions, grounds of public order and security may justify restrictions of the free movement of goods, capital and payments and the freedom of establishment. Historically, the European Court of Justice has applied these criteria very restrictively and ruled that abstract concerns about investments in undertakings in strategic sectors do not constitute a valid justification based on public order or security.

Under the planned 2020 revisions to the Foreign Trade Act, this conservative approach would likely change quite dramatically. Pursuant to Article 4 of the EU Screening Regulation, a Member State, in determining whether public order or security are affected, may take into account whether the foreign investor is directly or indirectly controlled by government including state bodies or armed forces of a third country, has already been involved in activities affecting security or public order in a Member State or whether there is a serious risk that the foreign investor engages in illegal or criminal activities. The wording of the EU Screening Regulation in context with the political discussion of the recent

past clearly indicates that authorities may apply a broader understanding of public order and security in future and the BMWi has considerable discretion in determining whether public order or security are at risk.

Specifically, the now announced planned revisions to the Foreign Trade Act would bring about two main changes:

1. Consideration of other EU Member States and EU-wide Projects

Pursuant to the EU Screening Resolution, although individual Member States retain their authority to screen foreign investments, numerous procedures and criteria will become applicable in October 2020 for cooperation among Member States and with the European Commission. An EU-wide framework will be established that grants competence to the European Commission to intervene with an official opinion on the grounds of public order or security and a forum for Member States will be provided to weigh in and potentially affect the course of foreign investment activities across the European Union.

Pursuant to the EU Screening Regulation, Member States will be required to notify the European Commission and all other Member States of an ongoing foreign investment screening and provide certain information on the transaction. Upon such notification, other Member States may provide comments to the Member State conducting the screening, where they consider that the foreign investment undergoing the screening is likely to affect their public order or security.

Equally, the European Commission may issue an opinion where it considers that the foreign investment undergoing the screening is likely to affect public order or security in more than one Member State or certain EU-wide projects or programs such as trans-European energy or traffic networks (TEN-E or TEN-T).

Although the European Commission's power to issue opinions is discretionary, if at least one third of Member States consider the foreign investment likely to affect their public order or security, the European Commission must set out its views on the transaction and while the opinion does technically not have binding force, Member States are required to take account of it and provide an explanation if the opinion is not followed.

Factually, therefore, the views of the European Commission and of other Member States will have significant relevance and investors will not only need to analyze potential impact in Germany, but also consider impact beyond the borders of the actual transaction based on the very broad concept of public order and security.

The precise impact of this process on timelines of the German foreign investment review is currently unclear, as the implementing rules in the Foreign Trade Ordinance have not yet been published. However, significant delays are to be expected. Under the EU Screening Regulation., upon a notification of an ongoing screening and provision of the required information, the other Member States have 35 calendar days to provide comments and the European Commission should issue its opinion within that 35 day time frame as well (but is allowed an additional five days if Member States provide comments). If the information provided by the Member State conducting the screening is deemed insufficient, the European Commission and other Members States may also request to be provided with further information within 15 calendar days of the initial notification, and thereupon have 20 calendar days to provide comments and/or an opinion.

Looking at German law and the proposed revisions to the German Foreign Trade Act, in evaluating whether a transaction should be prohibited, the BMWi will in future not just consider German public order or security, but (in line with the EU Screening Regulation), take into account concerns in regard to public order or security of other EU member states or effects on certain EU-wide projects. This will clearly make the required analysis more complex, costly and time consuming, and, together with the further changes highlighted in this note, lead to a more prominent role of FDI controls in the overall transaction process.

2. "Likely to Affect" Standard of Review

Maybe the most relevant change of the planned 2020 revisions is the changed substantive review standard. Should the proposal of the government be adopted, it will no longer be necessary for the BMWi to show an "actual and serious threat" to public order or security as an effect of the transaction, but sufficient to establish that the foreign direct investment is "likely to affect" (*voraussichtliche Beeinträchtigung*) public order or security.

The affects are twofold:

First, the degree of prognostics certainty of the BMWi's decision is reduced, as a potential future effect on public order or security is sufficient, rather than an actual impact. Unfortunately, it remains unclear what degree of certainty will be required and we fear that the law will enable a broad exercise of discretion in this regard.

Second, the necessary substantive impact is reduced from a threat to a status of "being affected", which clearly is a less stringent requirement than a threat and also opens broad discretion to the BMWi.

It remains to be seen how courts will interpret these open-ended definitions but it is already clear that the new standard due to its vagueness will reduce deal certainty for any transaction subject to FDI review.

IV. Notification Requirement, Certificate of Non-Objection and *ex officio* Review

Where the acquisition of a business active in critical infrastructures (as described above) is concerned, current law requires a mandatory notification of the BMWi by the acquirer.

The notification obligation is triggered by the conclusion of the contract obliging the parties to transact (regularly: the sale contract), not just at the time of transfer *in rem*/closing. Upon such notification, the BMWi under the current rules will decide (within 3 months) whether to commence an in-depth review procedure. In case the BMWi decides to initiate an in-depth investigation, the direct acquirer is required to submit documentation as determined by the BMWi by way of a general instruction. The BMWi may request all entities directly or indirectly involved in the acquisition to submit additional documentation as needed for carrying out the investigation.

For the in-depth investigation, currently a deadline of four months after the receipt of complete documents applies. This means that if the BMWi requests additional information upon having being notified, the review period will not commence until complete documentation has been submitted, so that as a matter of fact currently no final deadline exists for the review. It remains to been seen whether the government will take up this point and provide for a long stop

date for the review in the forthcoming revisions to the Foreign Trade Ordinance, as the open ended review period has been a source of much criticism. We are skeptical in this regard and would rather expect review periods to be expanded due to the need to involve the EU Commission and other Member States, as explained above.

As a result of an in-depth review, the BMWi may prohibit the direct acquirer from making the acquisition, or, in the alternative, it may issue instructions in order to safeguard the public order and security. If it intends to issue such prohibitions or instructions, it must obtain the approval of the German Federal Government.

In addition, the BMWi may negotiate and enter into public law contractual agreements with the acquirer which are aimed at guaranteeing public order and security. Any deadline for the issuance of prohibitions or instructions is suspended for the time period of negotiations.

Outside the acquisition of critical infrastructures, there is no obligation to notify. However, to avoid uncertainty with regard to a potential *ex officio* review, an investor may apply for a so-called certificate of non-objection.

To the extent the investor is not obliged to notify the acquisition of voting rights (i.e. where no acquisition of a business in critical infrastructures is concerned) and/or does not apply for a certificate of non-objection voluntarily, the authorities may review transactions *ex officio*.

V. New Anti Gun-Jumping Rules

So far, the review procedure (both in case of the acquisition of critical infrastructure businesses as well as outside of such critical infrastructure acquisitions) had no suspensory effect (so it is currently possible to consummate a transaction, while in case of an adverse decision by the BMWi, it will have to be unwound).

For critical infrastructure acquisitions, this will be changed under the planned 2020 revisions to the Foreign Trade Act.

1. Closing Suspended

In future, in FDI cases where a notification of the BMWi is required (i.e. in all cases of acquisitions of critical infrastructure businesses), the contract concluded between the seller and the acquirer remains provisionally void until clearance has been granted (or is deemed having been granted due to the expiry of the relevant review periods). This means that contrary to the current situation a transaction cannot be closed while the review is pending. In particular, the acquirer is prohibited from exercising any voting rights directly or indirectly, may not conclude voting agreements or give voting instructions. The acquirer may neither receive any dividend payments or equivalent economic rights prior to clearance. While this is an additional restriction, given that under currently applicable law consummated transactions would have to be unwound if clearance is not granted, it may be less relevant in practice than the further restrictions on information sharing also imposed by the proposed 2020 revisions.

2. Information Sharing Restrictions

Under these newly proposed rules, it is also impermissible to make available to an acquirer, prior to FDI clearance, enterprise specific information of the company as far as this relates to business areas or business objects which are relevant for the classification of the enterprise as being a critical infrastructure or which are otherwise specifically to be considered in the context of the review due to their impact on public order or security. In addition, the acquirer

may neither receive company specific information that the BMWi has designated as being relevant upon having being notified of the proposed acquisition.

Any voluntary breach of these restrictions will be subject to criminal liability with up to five years of imprisonment. In case of negligent behaviour, an administrative fine will apply.

While the legislative materials state that these information sharing restrictions shall only cover information the disclosure of which shall be prevented due to the particular impact of a premature disclosure on public order or security and a related critical infrastructure, it will be very difficult in practice to segregate critical information in this sense from information which can be disclosed (e.g. commercial, legal or accounting information or other company information which is irrelevant for purposes of the FDI review).

A key aspect of an acquirer´s due diligence is the operational and commercial review of the target entity and the validation of its business model. This will in all likelihood require the disclosure of sensitive business data (including data that may be relevant for FDI review purposes) to an acquirer in order to evaluate the feasibility of a transaction prior to signing, and thus prior to a formal notification of the transaction to BMWi. It remains unclear under the proposed government bill how such a pre-signing due diligence could be facilitated in light of the broad prohibition of information sharing upon notification of the transaction. One solution to consider could be the disclosure of such information to clean teams, an approach that is familiar under antitrust restrictions, so that the acquirer and economic beneficiary would not directly be provided with critical information, but (only) relevant advisors could assess the viability of the transaction. In practice, any such approach and the classification of relevant data will likely have to be aligned with BMWi beforehand, to avoid application of sanctions.

VI. Conclusion

Once adopted, the planned revisions to the Foreign Trade Act and the expected further revisions to the Foreign Trade Ordinance will have a significant impact on the scope and depth of review, the likelihood that the German government will be able to block transactions, the ability of parties to close a transaction in light of a pending review and, last but not least, the duration of relevant proceedings.

The proposed revisions will thus heavily impact M&A transactions and respective timelines where non-EU investors are involved. They should be closely monitored and considered very early in the process by any non-EU investor.

This client information contains merely a non-binding overview of the subject matter it addresses. It is no substitute for legal advice. To discuss this client information and obtain any legal advice, please contact:

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