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FDI IN GERMANY: PROPOSED LEGISLATIVE CHANGES BROADEN SCOPE OF GERMAN FOREIGN INVESTMENT CONTROL YET AGAIN

Over the course of less than a year, the German rules on foreign investment control underwent a series of far-reaching changes, which fundamentally altered the role of FDI review for M&A transactions in Germany and led to a record number of deals notified to the Federal Ministry of Economics and Energy ("BMWi") in 2020.

The 17th amendment to the Foreign Trade Ordinance, a draft of which was published for consultation at the end of January (the "Draft Bill")), marks the final step in the current legislative overhaul. In addition to the implementation of the EU Screening Regulation (Regulation EU 2019/452 of March 19, 2019) and the addition of various medical and PPE-related businesses to the critical infrastructure businesses in response to the COVID-19 pandemic (see here), the expansion of foreign investment control goes back to a belief increasingly held in Berlin - and other EU capitals - that national governments need to take a more proactive role in implementing domestic industrial policy objectives.

I. Key Changes Proposed

The year 2020 already saw three important revisions to the Foreign Trade Act (*Außenwirtschaftsgesetz*) ("AWG") and the Foreign Trade Ordinance (*Außenwirtschaftsverordnung*) ("AWV"). The Draft Bill will significantly expand the scope of the mandatory notification requirements and government review. The most important changes are:

- An expansion of the list of critical infrastructure and technology businesses subject to cross-sectoral review (and of the respective review and prohibition rights);
- an extension of the sector-specific review to all weapons and military items on part I section A of the export control list;
- an extension of the rules on the attribution of shareholdings for the purposes of determining the relevant thresholds;
- a provision making subsequent acquisitions of voting rights after a threshold has been crossed subject to a renewed clearance; and
- the introduction of the possibility for the BMWi to prohibit transactions where factual influence vests with an investor (*e.g.*, through board seats or information rights) but not necessarily involving the acquisition of voting shares.

II. Individual Proposals

1. Cross-Sectoral Review

Under the cross-sectoral review, acquisitions by any non-EU/Non-EFTA investor are covered, if the relevant voting right thresholds of 25% (or 10% in the case of critical infrastructure and technology businesses) are met. The latter require a mandatory notification to the BMWi and are subject to certain anti-gun-jumping obligations until clearance is granted or the relevant review period expires.

The core part of the Draft Bill is the extension of the list of critical infrastructure and technology businesses. The draft legislation contains 15 additional types of these sensitive businesses, 14 of which go back to the implementation of almost all of the sectors mentioned in Article 4(1)(b) of the EU Screening Regulation. Should the Draft Bill enter into force, the AWV will make a total of 27 types of critical infrastructure and technology businesses subject to cross-sectoral review. New areas cover, in particular, certain activities in:

- artificial intelligence;
- autonomous motor vehicles or unmanned aerial vehicles;
- industrial robots;
- semiconductors;
- cybersecurity;
- air transport under an EU operating license;
- dual-use items in the nuclear, aviation and space industry;
- quantum mechanics;
- additive manufacturing processes (i.e., 3-D printing);
- products for the operation of wireless or wireline data networks;
- smart-meter gateways and related security modules;
- security-sensitive positions at vital facilities pursuant to the Security Clearance Act;
- critical raw materials;
- goods falling under classified patents; and
- large-scale agricultural activities with fundamental importance for food security.

The government's approach to provide specific definitions for the individual critical infrastructure and technology businesses and, thus, increase legal certainty, deserves praise. Other EU member states stopped short of providing addition language and simply introduced the rather generic terminology used in the EU Screening Regulation into their FDI rules.

Nevertheless, the addition of the new sectors will result in a substantial increase of cases in which a FDI filing may be required. The assessment of whether a filing is mandatory will have to be made in a vast number of M&A transactions involving the acquisition by a non-EU/non-EFTA investor of at least 10% of the voting rights in a German entity. In the absence of additional guidance of the BMWi, in many of those cases, a filing requirement will be difficult to rule out with certainty. As a consequence, it may be prudent to combine a (cautionary) notification to the BMWi with an auxiliary application for a certificate of non-objection.

The German government estimates that the increase from six to 27 types of critical infrastructure and technology businesses will result in approx. 150 additional notifiable transactions per year. In reality, this number is likely to be even higher – in 2020 alone, the BMWi dealt with more than 300 notifications. Against this background, non-EU/non-EFTA investors will be well advised to factor in additional resources and time for future M&A processes involving German targets.

2. Sector-Specific Review

The revised AWV will also subject a much broader set of weapons and military items to sector-specific review. Pursuant to the Draft Bill, non-German investors will have to notify acquisitions of at least 10% voting rights also in companies

- manufacturing or developing weapons or military items requiring an export license under part I section A of the German export control list;

- manufacturing, modifying, developing or possessing defense technology products protected by classified patents; or
- qualifying as defense-critical facilities under the Security Clearance Act.

The German government expects the number of sector-specific reviews to increase by approx. one third to 30 annually. Again, this seems to be a rather conservative estimate. It would not be surprising to see the number of sector-specific filings go well beyond that figure.

3. Attribution of Shareholdings

a. Acting in concert

Currently, voting rights held by different investors need to be aggregated where (pooling) agreements concerning the joint exercise of the voting rights exist. Pursuant to the Draft Bill, individual investors may already be considered as acting together where other circumstances of the acquisition lead to the conclusion that voting rights will be exercised jointly. Thus, situations of factual acting in concern may well trigger a filing requirement – be it under the cross-sectoral or the sector-specific regime.

b. Additional Acquisitions above Thresholds

The Draft Bill introduces an explicit provision clarifying that any additional acquisition of voting rights - however small - above the relevant thresholds triggers a new filing and clearance requirement. This corresponds to the BMWi's current (while questionable) practice. The legislative clarification was deemed necessary since there are criminal sanctions for infringements of the obligations resulting from the filing requirement, in particular the stand-still obligation and certain restrictions in information sharing. It is regrettable that the legislative overhaul was not used to exclude or limit the notifiability of follow-on acquisitions above the relevant thresholds by at least introducing safe harbors, *e.g.*, in reference to the original threshold. The current practice is problematic, in particular when it comes to listed companies or slight fluctuations of shares in the context of capital increases. The BMWi is aware of the practical difficulties and is considering solutions to address them.

4. Extension of *ex officio* review

The Draft Bill formally extends the BMWi's jurisdiction beyond the acquisition of voting rights insofar as the BMWi can start an *ex officio* review (or a review upon a voluntary notification) into atypical acquisitions of control and prohibit respective transactions. This applies to both cross-sectoral as well as the sector-specific review and the corresponding thresholds. Atypical acquisitions of control may result from contractual agreements providing strategic influence, for instance in form of board seats, veto or information rights. Thus, the Draft Bill significantly widens the scope of review available to the BMWi to a broad set of cases where merely factual influence is exerted. Due to the vagueness of the applicable criteria, this will be very challenging to determine in practice. At least, and presumably reflecting the difficulty to precisely define the underlying criteria, such cases of atypical acquisition of control do not trigger a formal notification requirement (and, as a result, are not subject to the abovementioned stand-still obligations that apply to notifiable transactions).

The proposed rules codify and extend the already far-reaching rules on voting rights attribution rules, indirect share acquisitions and atypical acquisitions of control. Whenever a transaction of a foreign investment, directly or indirectly, involves a German entity, the impact of the revised FDI rules needs to be timely and thoroughly assessed.

III. Conclusions

The proposals in the Draft Bill will heavily impact M&A transactions involving non-EU/non-EFTA

or foreign investors. They are currently under consultation and are expected to enter into force during the second quarter of 2021.

While the introduction of concise definitions of the critical infrastructure and technology businesses inspired by the EU Screening Regulation has to be welcomed, the Draft Bill introduces additional vagueness to several key areas of foreign investment control and is a missed opportunity to introduce safe harbor rules for follow-on acquisitions or to clarify the exact scope of the gun-jumping rules. Specifically the restrictions on information sharing raise significant practical difficulties when it comes, *e.g.*, to the question to what the exact boundaries for a due diligence process are.

Investors that applauded the increase of the German merger control thresholds in January (see here) and the resulting ease of the regulatory burden and time constraints may wonder if those benefits will not be outweighed by the proliferated FDI review process.

Overall, it remains to be seen, whether the overhaul of the FDI rules will have a chilling effect on foreign investments in Germany. It would be an unfortunate effect if the ramping up of the foreign investment control would effectively make access for German companies, particularly start-ups, to foreign capital more difficult.

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