ADG Insights

Foreign investment control in the European Union and its Member States

July 2019

In recent years, several European Union (EU) Member States, as well as the EU itself, have reconsidered their approaches to foreign direct investment (FDI). An increasing number of European jurisdictions have introduced rules restricting FDI or have strengthened existing rules.

To date, 14 of the 28 Member States have adopted mechanisms to scrutinize FDI, ranging from screening procedures to partial or total prohibition of FDI in specific sectors. Among these countries are Europe's largest economies Germany, the United Kingdom, and France,[1] all of which recently tightened their FDI screening regimes. Even European countries that are traditionally recognized as the most open economies, such as the Netherlands and Switzerland, are in the course of or considering or adopting FDI regulations.[2] Furthermore, the EU itself has recently introduced FDI screening regulations for the first time, adopting a "framework for the screening of foreign direct investments into the Union".[3]

Albeit diverse in their nature and procedures, all of these mechanisms aim to address challenges raised by FDI into sectors deemed sensitive or strategic to national economies or national security. This particularly concerns companies active in the aerospace, defense, and government services (ADG) industry. National governments have traditionally kept a close watch on the ADG industry and the current trend is toward even tighter regulation. In the United Kingdom, for example, new provisions amending the Enterprise Act 2002 expressly expand the regulations to cover smaller businesses active in the military and dual-use sectors, and the advanced technology sector.[4] ADG companies should therefore pay close attention to the regulations in force when conducting cross-border transactions and assess their potential impact on the due diligence process and the timing of transactions. As the regulatory frameworks are subject to constant change, it is crucial to stay on top of those developments.

This article aims to provide (1) an introduction to foreign investment control; (2) an overview of the legal framework for FDI screening on EU level; and (3) a summary of recent developments in the area, an outlook on what to expect in the future, and recommendations for the mergers and acquisitions (M&A) process.

1. Background, applicability, and M&A implications of foreign investment control

a) Background and rationale for FDI screenings

The surge in takeovers of EU-based companies manufacturing key technologies and of strategic infrastructure assets by non-EU investors has raised concerns about the potential impact of these transactions on national security or public order. While globalization is leading to an increasing number of cross-border transactions, one of the main factors drawing regulators' attention is the involvement of more and more state-owned funds, enterprises, conglomerates, and private firms with close government links in such transactions.

Two political camps are facing each other in the dispute over the right regulatory response. While the free market-oriented side rejects or seeks to limit scrutinizing mechanisms as protectionist, the more interventionist camp welcomes such regulation. The latter camp is mainly driven by a fear that investments by state-affiliated investors are not market-based, but strategic efforts to facilitate, among other things, "know-how theft" with the goal of surpassing more advanced economies. The debate has considerably intensified since the beginning of the world

1. Other Member States with FDI screening mechanisms are Austria, Denmark, Italy, Latvia, Lithuania, Hungary, Poland, Portugal, Romania, Spain, and Finland. The list can be retrieved on the European Commission's website under http://trade.ec.europa.eu/doclib/docs/2019/june/tradoc_157946.pdf. Our previous coverage of the list's publication is available under https://www.hoganlovells.com/en/blogs/focus-on-regulation/foreign-investment-control-on-the-rise-new-list-of-eu-member-states-fdi-screening-mechanisms.

2. The Swiss Federal Council has only recently blocked a motion to introduce foreign investment control. Documentation is available on the Federal Council's website under https://www.parlament.ch/de/ratsbetrieb/suche-curia-vista/geschaeft?AffairId=20183021 (only in German, French, and Italian). Meanwhile, the Dutch government is currently preparing certain regulations providing for FDI screenings for national security reasons to be introduced in the future. Assessments are made on a sector by sector basis, while legislation for the telecommunications sector is already underway.

3. See further to this below under (2).

4. New provisions, which came into force on 11 June 2018, introduced lower merger control thresholds for transactions in certain sectors. The target turnover threshold was reduced to as little as £ 1 million from previously £ 70 million). These revised thresholds are designed to provide the UK government with increased scope to scrutinize FDI and transactions that raise national security concerns. For further information, see our previous coverage regarding the topic here: https://www.hoganlovells.com/en/publications/new-uk-foreign-investment-screening-rules-come-into-force.

economic crisis in 2008. In Western economies such as those in Europe, and even more in the United States, weight is shifting more and more to interventionist trade and market policies.[5] In contrast, emerging economies have historically been to a large extent closed to FDI and are now attempting to open their domestic markets to it.[6]

b) Relevance for the ADG industry

Of the sectors under regulatory scrutiny, the sector scrutinized most commonly is (and has traditionally been) military and defense, followed by the "critical infrastructure" sectors. The latter term can be defined as an asset, system, or part thereof which is essential for the maintenance of vital societal functions, health, safety, security, economic, or social well-being of people.[7] While definitions in individual jurisdictions slightly differ, this usually concerns traditional areas of government services such as the energy, water, telecommunications, health care, transport and infrastructure, and certain finance infrastructure sectors. Within the ADG area, airports are one example that could fall into this category.

Importantly, FDI screenings not only extend to situations where fully assembled products or facilities are in question, but are also used to scrutinize investments in companies that make spare parts and in subcontractors. This may under certain circumstances extend to the manufacturing of products as simple as screws if specifically designed for a use relating to other covered products. An example of this is the German Federal Government's decision in 2018 to block the proposed acquisition by a Chinese investor of Leifeld Metal Spinning, a German manufacturer of metal forming machines used in the automotive, aerospace, and nuclear industries, which did not itself produce or assemble vehicles, airplanes, power plants, or parts thereof itself.

5. The recently published "Franco-German Manifesto for a European industrial policy fit for the 21st Century", which followed the Alstom/Siemens prohibition by the European Commission, is a notable example of this. Therein, strong support for the recently adopted European foreign investment screening framework as well as "tough national legislation as France and Germany already have in place" regarding FDI is advocated. The manifesto can be retrieved on the website of the German Federal Ministry for Economic Affairs and Energy under https://www.bmwi.de/Redaktion/DE/Downloads/F/franco-german-manifesto-for-a-european-industrial-policy.pdf?__blob=publicationFile&v=2. Our previous coverage of the matter can be retrieved under https://www.hoganlovells.com/en/blogs/focus-on-regulation/we-are-the-champions-france-and-germany-unite-to-revive-industrial-policy-at-european-level.

6. For example, China has recently introduced a new foreign investment law to promote FDI against the backdrop of increasing trade tensions with the United States. See our coverage regarding the matter here: https://www.hoganlovells.com/en/publications/the-foreign-investment-law-a-new-chapter-opens-for-foreign-direct-investment-in-china.

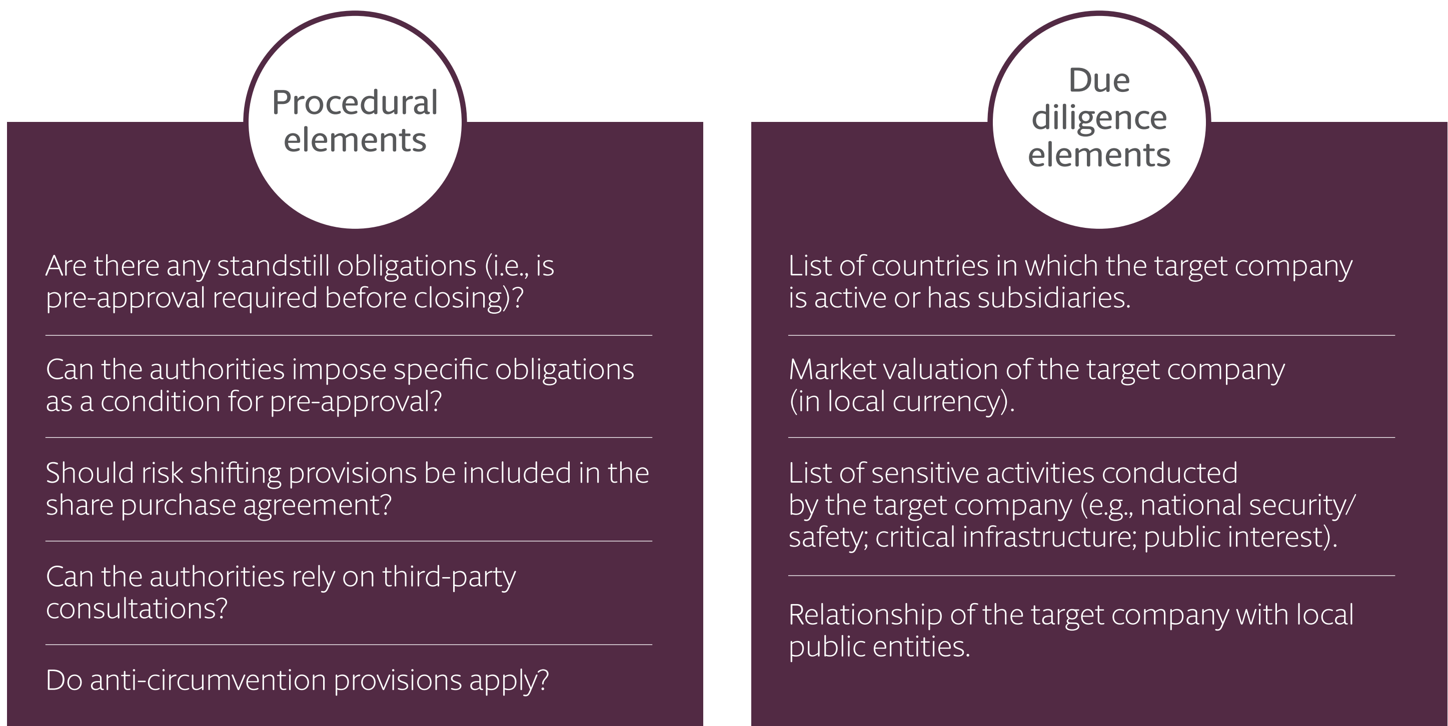
7. The full definition according to Article 2 of Council Directive 2008/114/EC of 8 December 2008 on the identification and designation of European critical infrastructures and the assessment of the need to improve their protection is as follows: "'critical infrastructure' means an asset, system or part thereof located in Member States which is essential for the maintenance of vital societal functions, health, safety, security, economic or social well-being of people, and the disruption or destruction of which would have a significant impact in a Member State as a result of the failure to maintain those functions."

c) M&A implications

Foreign investment control procedures share many commonalities with merger control procedures. In fact, the foreign investment review procedure is in some jurisdictions handled by the competent competition authority as an annex or similarly to merger control procedures. A notable example in Europe is the United Kingdom's Competition and Markets Authority (CMA). Since the Enterprise Act 2002 came into force, the UK government can formally intervene in cases caught by the UK merger control thresholds (and smaller transactions involving government contractors) where specified public interest considerations are engaged.

Furthermore, the regulatory impact of both merger control and foreign investment control on the transaction has to be assessed and the approach and timeline regarding both should be aligned in order to secure a smooth and timely closing of the transaction.

Figure 1: Impact of FDI screenings on M&A transactions



Identifying how an FDI screening could impact the transaction structure is particularly relevant for the M&A process in ADG transactions. While the situation differs in each country, as a general trend four different schemes can be identified. Notification requirements are in place in most jurisdictions for the more critical investments in the fields of security and defense and critical infrastructure. For other areas, voluntary notification regimes exist that enable investors to obtain transaction approval by engaging proactively with the authorities. Finally, many jurisdictions also provide for the option of ex officio investigations into planned or closed transactions.

Figure 2: FDI screening categories

2. Foreign investment control at EU level

The EU has recently chimed in on the prevailing trend of FDI regulation, and on 21 March 2019 published Regulation (EU) 2019/452 (Framework Regulation),[8] establishing, for the first time, a common structure for the screening of FDI into the EU. It came into force on 10 April 2019 and will fully apply from 11 October 2020.

Unlike with the EU merger control regime, in the context of FDI screening the EU does not act as an overarching regulator holding supranational jurisdiction and issuing binding decisions. Member States retain the final say as to whether a specific investment should be permitted or not in their territories. Furthermore, the Framework Regulation does not attempt to harmonize Member State screening mechanisms or to create an EU-wide screening mechanism, nor does it impose an obligation on Member States to have in place a screening mechanism. Rather, it aims to enhance cooperation and increase transparency between Member States and the European Commission.

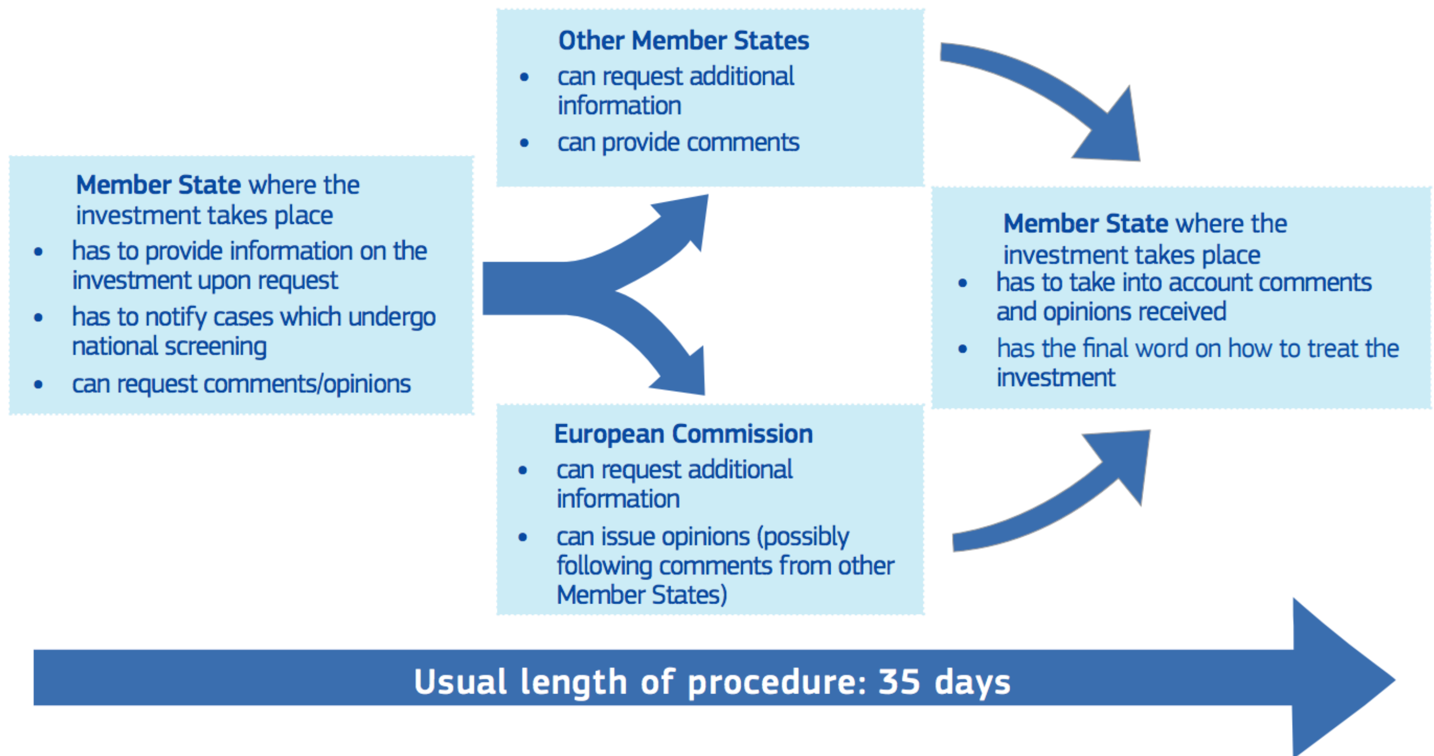
Main features of the framework include the following:[9]

- It introduces certain common principles for national screening mechanisms, such as transparency, non-discrimination, timeframes, confidentiality of information, and possibility for judicial redress.
- It creates a "cooperation mechanism" whereby Member States are required to exchange information (among themselves and with the Commission).
- One of its aims it to allow for enhanced cooperation through the exchange of any relevant information, such as the ownership structure of the foreign investor, the approximate value of the FDI, the products, services, and business operation of the foreign investor and the target company, etc.
- Furthermore, it allows the European Commission to issue non-binding opinions where security or public order might be affected and which have to be considered by the concerned Member State(s).
- Lastly, the framework aims at encouraging international cooperation on screening policies, including sharing experience and best practices as well as information regarding investment trends.

8. 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.

9. A more detailed overview can be derived from our earlier coverage on the Framework Regulation here: https://www.hoganlovells.com/en/blogs/focus-on-regulation/new-eu-framework-for-screening-foreign-direct-investment.

Figure 3: Information exchange procedure pursuant to the Framework Regulation



(Source: European Commission, http://trade.ec.europa.eu/doclib/docs/2019/february/tradoc_157683.pdf)

In order to increase the visibility of FDI screening regimes, on 24 June 2019 the Commission published a list of FDI screening mechanisms notified by Member States, which shows that to date, 14 out of the 28 Member States already have mechanisms scrutinizing FDI in place.[10] As part of the Framework Regulation, Member States with an FDI screening mechanism in place are obliged to notify the Commission of such mechanisms.

3. Looking forward

In the coming years, we expect the number of European jurisdictions increasing scrutiny of foreign investment will grow. Authorities' review competences primarily grow by expanding the scope of applicability of the regulatory framework. Most commonly this happens by extending the review powers to additional sectors and by lowering thresholds – for example, the stake to be acquired in a target, which has recently been set as low as 10 percent for critical infrastructure and security and defense acquisitions in some jurisdictions, such as Germany. Parties to M&A transactions should carefully monitor such developments in their due diligence processes.

1. Europe

On a European level, it can be expected that the new EU Framework Regulation will have a significant impact on M&A transactions. First, and in line with the trend of recent years, it increases the likelihood of more Member States introducing FDI screening tools to level the playing field. Second, for those Member States that already have a screening mechanism, the new rules will likely impact both the timing and the substance of the assessment.

Member States will need to take comments from other Member States and the Commission into account. The additional "usual" timeframe of 35 days for the information exchange procedure regarding FDI screenings is likely to delay the national procedures and decouple the procedure from the shorter first phase merger control reviews in most Member States.

10. See above under footnote 1.

Furthermore, the criteria for concerns to be raised regarding the security or public order of Member States are too broad and not defined, leaving room for legal uncertainty in their applicability.

2. International context – CFIUS and FIRRMA

The current focus on foreign investment control in Europe mirrors developments across the world, including the recent U.S. Committee on Foreign Investment in the United States (CFIUS) reform. In August 2018, the Foreign Investment Risk Review Modernization Act (FIRRMA) was signed into law.[11] Among other things, it considerably expands the scope of "covered transactions" and the factors the CFIUS may consider when assessing security risks. The scope now includes purchases or leases of real estate in close proximity to sensitive U.S. government facilities and non-controlling acquisitions in U.S. businesses whose activities involve critical technologies, critical infrastructure, or sensitive personal data of U.S. citizens. The law extends the timelines for CFIUS investigations, introduces declaration procedures for expedited notifications, and makes declarations mandatory in certain cases such as critical technology. This is a fundamental departure from the voluntary process previously in place.

3. Conclusion

Generally speaking, government intervention under foreign investment rules is already much harder to predict than under the tried and tested merger control regimes. Our experience is that transaction timeframes are also subject to greater uncertainty, since many foreign investment regimes have very unclear and open-ended review timetables.

In addition to the relevant ministry or authority in charge of FDI screenings, specialized agencies tend to play an important role. The need for the coordinating ministry to reconcile with these stakeholders can lead to prolonged screening procedures. Moreover, procedures are (purposefully) often opaque in order to conceal the concerned national security interests. It is often unclear what the substantial issues investigated are and the authority may not share its concerns for confidentiality reasons.

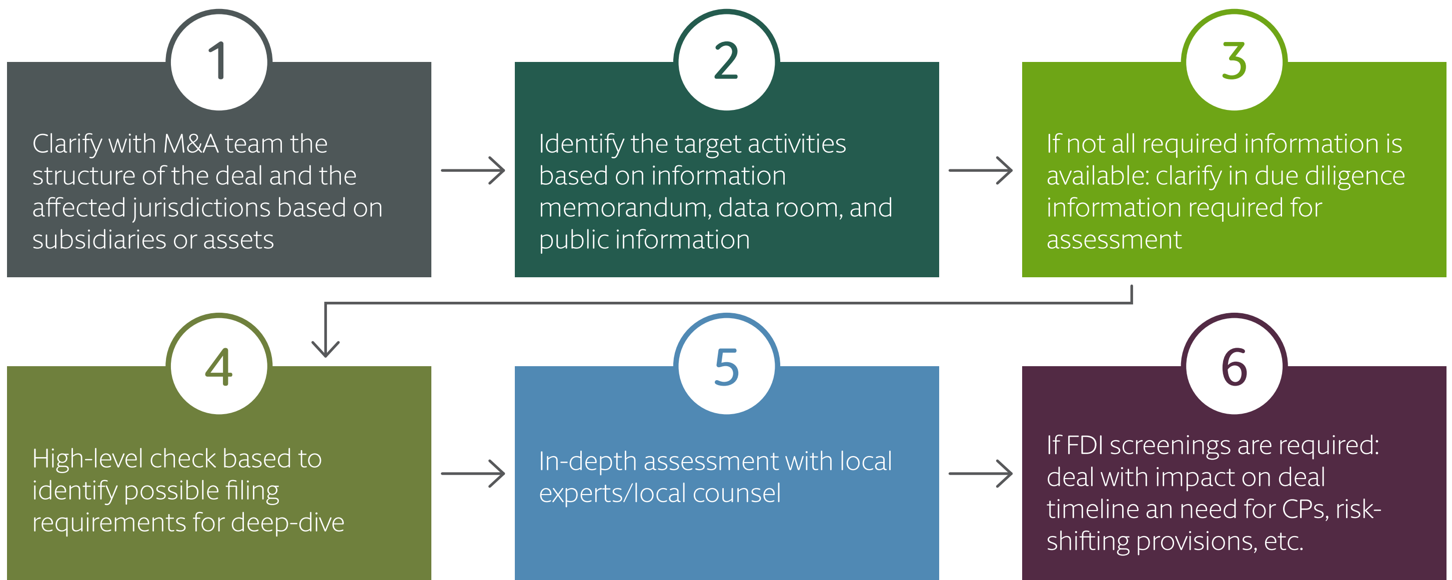
Going forward, ADG companies can expect their cross-border deals to take longer to complete and they will need to consider foreign investment issues upfront to mitigate any potential delays. In addition, the various reforms and proposals will mean potentially increased scrutiny and execution risk for a broader range of deals in a number of jurisdictions. It is vital for deal teams to consider the practical considerations for managing this uncertainty and addressing individual transaction challenges upfront.

For M&A transactions in the ADG sector, we recommend considering the following action items:

1. Identify upfront those jurisdictions where buy- and sell-side M&A activity is most likely (focus jurisdictions).
2. Identify upfront those business units whose products are most likely to trigger governments' interest, e.g., aerospace and defense, energy, automotive.
3. Prepare a standard explanation of (i) your shareholder structure, corporate governance, and specifically shareholder control rights, and (ii) your business activities, particularly in sensitive areas.
4. Be transparent both in government relations and FDI screenings about the above.
5. Prepare for FDI reviews by building a network of subject matter experts internally and externally.

11. See our in-depth client alert of the time here: https://www.hoganlovells.com/~/media/hogan-lovells/pdf/2018/2018_07_30_alert_cfius-legislation-takes-final-form.pdf?la=en.

Figure 4: Recommended process for M&A transactions



Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest*
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta*
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Moscow
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Riyadh*
Rio de Janeiro
Rome
San Francisco
São Paulo
Shanghai
Shanghai FTZ*
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar*
Warsaw
Washington, D.C.
Zagreb*

*Our associated offices
Legal Services Center: Berlin

www.hoganlovells.com

"Hogan Lovells" or the "firm" is an international legal practice that includes Hogan Lovells International LLP, Hogan Lovells US LLP and their affiliated businesses.

The word "partner" is used to describe a partner or member of Hogan Lovells International LLP, Hogan Lovells US LLP or any of their affiliated entities or any employee or consultant with equivalent standing. Certain individuals, who are designated as partners, but who are not members of Hogan Lovells International LLP, do not hold qualifications equivalent to members.

For more information about Hogan Lovells, the partners and their qualifications, see www. hoganlovells.com.

Where case studies are included, results achieved do not guarantee similar outcomes for other clients. Attorney advertising. Images of people may feature current or former lawyers and employees at Hogan Lovells or models not connected with the firm.

© Hogan Lovells 2019. All rights reserved. 05018