# France criticized for new foreign investment rules

Winston Maxwell examines the European Commission's objections to France's new foreign investment decree

In the 1980s, most acquisitions of a French company by a non-French entity had to be notified in advance to the French Ministry of Economy, which had the right to adjourn the investment in certain circumstances. These restrictions gradually disappeared in the 1990s, first for investments by EU companies, then for all foreign investments. Most foreign investments now require only a post-closing declaration for statistical purposes.

Despite this liberalization, France retained the right to veto foreign investments that could threaten public order, public security or public health. In 1995 the French used this provision to block an investment by a UK affiliate of the Church of Scientology on the ground that the Church of Scientology was then under a criminal investigation and that the proposed investment would endanger public order and security. The French branch of the Church of Scientology challenged the decree upon which the government's decision was based, arguing that the decree violated Article 56 of the EC Treaty, which guarantees free movement of capital. The French Supreme Administrative Court referred the question to the European Court of Justice, which found in favour of the Church of Scientology, holding that the French provision was too vague to be valid under the EC Treaty (ECJ case C-54/99, March 14 2000 - Eglise de Scientologie). The French law and decree stated at the time that an authorization was needed for any foreign investment that represented a threat to public order, public security or public health, but neither the law nor the decree gave investors any further guidance as to what specific circumstances would constitute such a threat. The Court held that the French decree violated the principle of legal certainty because individuals were unable to determine in advance, based on the wording of the decree, whether a given investment would require an authorization.

As a result of the European Court of Justice (ECJ) decision, the French legislature took steps to amend the country's foreign investment rules. It first removed public health from the list of threats that could justify ministerial action, because public health is not one of the exceptions mentioned in Article 58 of the EC Treaty. It then added national defence to the list of relevant interests that could cause a foreign investment to fall within the authorization procedure, and provided that a government decree would define exactly what kinds of activities the authorization regime would cover. This new decree, with its detailed list of sensitive sectors, was intended to address the ECJ's requirement that French law must give enough guidance to investors to enable them to determine in advance whether a given investment is covered by the authorization regime. The government took more than a year to develop the new decree, which was published on December 31 2005 (Decree no 2005-1739). Several weeks after the decree's publication, the European Commission expressed concerns about the decree's legality in light of EC Treaty rules.

> **The new decree distinguishes between three different kinds of investments, and attributes a different list of sensitive sectors to each kind**

### Content of the new French decree

The new decree was required by a December 2004 amendment to Article L151-3 of the French Monetary and Finance Code. It distinguishes between three different kinds of investments, and attributes a different list of sensitive sectors to each kind. The three kinds of investments are as follows:

- investments by non-EU entities, whether structured as the acquisition of control, of all or part of a branch of activity, or of more than one-third of the share capital of a French company (to determine whether an entity is an EU or non-EU entity, French authorities would look to the nationality of the ultimate controlling shareholder);
- investments by EU entities if structured as the acquisition of part or all of a branch of activity; and
- investments by EU entities if structured as the acquisition of control of a French company.

Each form of investment has its own list of sensitive sectors. The list for non-EU investments comprises: (i) gaming, (ii) private security businesses; (iii) life science research or production when linked to vaccines or antidotes destined to counter terrorist activities; (iv) activities linked to communication interception equipment; (v) certified laboratories for testing computer security; (vi) computer security when used to protect infrastructure; (vii) certain dual-use technologies; (viii) encryption; (ix) businesses that possess classified defence secrets pursuant to government contracts; (x) research, production or supply of arms or munitions; and (xi) companies that have contracts with the Ministry of Defence to develop or supply any of the items mentioned in (vii) through (x). Any investment by a non-EU investor in a French business active in one of these areas will require authorization by the Ministry of Economy.

The list for EU investments differs depending on whether the acquisition is structured as the purchase of all or part of a branch of activity or the acquisition of control over a French company. The list of sectors for an EU investment in a branch of activity contains the same 11 sectors as those defined for non-EU investments, but the scope of certain sectors is narrowed. For example, instead of mentioning gaming, the list that applies to EU investments refers to regulated casinos, which has a precise meaning under French law. Instead of mentioning pathogens, the list applicable to EU investments mentions pathogens defined in paragraphs 1C351 and 1C352a.2 of Annex I to EU Regulation 1334/2000. Nevertheless, in most respects the list that applies to EU investments in a branch of activity is similar to the list applicable to non-EU investments.

The list applicable to EU investments that acquire control of a French company is shorter. It contains only four sectors: (i) encryption; (ii) companies holding classified defence secrets; (iii) companies involved in arms research, production or sale; and (iv) companies having contracts with the Ministry of Defence to develop or supply any of the foregoing or certain dual-use technologies. This difference in treatment between the two kinds of EU investments raises several questions. First, the concept of acquiring all or part of a branch of activity versus acquiring control of a French company is difficult to grasp, particularly in share transactions. The decree does not define what a branch of activity is, and if one refers to relevant French tax rules defining a complete branch of activity, both asset and share transactions can be covered. A share acquisition might therefore be considered both as an acquisition of control and as an acquisition of a branch of activity, in which case the EU investor would be uncertain as to whether the long list or the short list applies. The difference could be significant because key businesses, including vaccine research for avian flu, for example, are not covered in the shorter EU list, but are covered in the longer EU list. The second problem relates to the justification as to why a less stringent list should apply to EU investments structured as the acquisition of control, as opposed to the acquisition of a branch of activity. The decree does not explain why the acquisition of a branch of activity would raise more pervasive security risks than the acquisition of control. This problem is examined in more detail below, in connection with the Commission's objections to the decree.

> **The difference in treatment between the two kinds of EU investments raises several questions**

As noted above, the concept of branch of activity is ill-defined, which might lead to uncertainty about which list applies to certain EU investments. By contrast, the concept of control is quite clear because the decree refers to Article L233-3 of the French Commercial Code. That article defines control using several criteria, including the ability to determine the outcome of decisions at the company's general shareholders' meeting. French case law has found control to exist in a broad range of situations, including the ownership of a minority stake in a French company when the minority shareholder holds veto rights over certain management decisions (the case law held that where a minority shareholder has a veto right over the adoption of the annual budget, and business policies and objectives, the minority shareholder enjoys joint control over the company). The upshot of this is that even a minority investment in a French joint venture entity could be deemed to create control and require a request for authorization under the new decree.

For investors that are unsure whether they fall under one of the categories described in the decree, the decree has provided for the possibility of requesting a comfort letter from the minister of economy. The minister must issue the letter within two months. This is an important option because of the serious consequences that can result from misinterpreting the new decree. Articles L151-3 and 151-4 of the Monetary and Finance Code provide that, if an investment covered by the decree was made without a proper request for authorization, not only can the government order the transaction to be unwound, but the agreements relating to the investment are null and void. This provision should catch the attention of banks financing the transaction, and encourage parties to seek a comfort letter when there is the slightest doubt as to whether the decree applies.

The decree allows the minister of economy to impose conditions on any foreign investment falling under the decree to ensure, among other things, that relevant production capacity and/or R&D activities remain on French soil. Where the business raising the national security or defence issue is only a small part of the acquired company as a whole, the minister can require divestiture of the sensitive part of the business. This provision in the decree is intended to facilitate the negotiation of security conditions between French authorities and the potential investor, so that the French authorities can avoid issuing an outright veto and instead can propose more narrow remedies. These negotiations already took place under the old decree, but their legal status was questionable because the law previously contained no reference to possible conditions in the minister's authorization. The negotiations will typically involve the Ministry of the Interior and the Ministry of Defence, with the Ministry of Economy acting as the investor's single point of contact.

The minister of economy's decisions are subject to appeal to the French Supreme Administrative Court. Appeals can be lodged by the foreign investor whose request for authorization has been denied, or even by frustrated rival bidders who are unhappy that authorization was given. Frustrated rival bidders have to prove that they were adversely affected by the government's decision to authorize the acquisition, and that the government manifestly erred in authorizing the transaction in light of the security risks involved. The likelihood of such an appeal prevailing is expected to be low.

### The Commission's objections to the decree

A few weeks after the publication of the new decree, the French newspaper *La Tribune* published a copy of a letter written by the Commission to the French government raising concerns about the new decree. The Commission's main questions related to the fact that the authorization requirements for EU investments do not appear indispensable and proportionate to attaining the security objectives that France seeks to protect. The Commission also questioned whether the decree creates a discriminatory effect with respect to foreign (EU-origin) investments compared to French investments. These objections should be viewed in relation to the applicable EU law on national measures restricting free movement of capital.

Free flow of capital is a right under Article 56 of the EC Treaty, but the right is subject to limited exceptions. Those exceptions are listed in Article 58 of the EC Treaty (measures to protect public order and public security), and in Article 296 of the EC Treaty (measures to protect interests of national defence). Any restriction on the free movement of capital must satisfy several tests. The national interest that the measure seeks to protect must be one that falls within the scope of the public order, public security or national defence exceptions. The scope of these exceptions must be

## The revised law

Paragraphs I and II of Article L151-3 of the French Monetary and Finance Code now read as follows:

"I. Are subject to the Minister of the Economy's prior authorization, foreign investments made in an activity in France, which even if occasionally, affects the exercise of public authority or belongs to one of the following groups:

a) activities which are likely to threaten public order, public safety or national defence; or

b) activities of research, production or trading of arms munitions, or explosive powders.

A Council of State decree defines the nature of the activities mentioned hereinabove.

II. If needed, the authorization given can be accompanied with conditions aimed at providing that the planned investment will not cause harm to the national interests mentioned in paragraph I.

The decree mentioned in paragraph I defines the nature of the conditions which can accompany the authorization."

interpreted narrowly. The measure must respond to a genuine and sufficiently serious threat to the relevant national interest. The measure must be proportionate and indispensable to the threat. In other words, the measure is permissible only if the relevant objectives cannot be attained by other less restrictive measures. The measure must not result in discriminatory effects with respect to goods, persons or capital moving to or from other countries. The measure must not violate the principle of legal certainty by leaving individuals unable to determine the extent of rights and obligations. And lastly, anyone affected by such a measure must have access to legal redress.

The Commission does not challenge the fact that France's objectives fall within the public policy, public security and national defence fields. France is within its right to take measures to address the kinds of risks described in the decree (such as national defence, the fight against terrorism and organized crime). But the measures could be addressed by rules that do not single out foreign investments for special treatment and thereby restrict the free movement of capital. For example, the French assert that foreign investment in casinos requires authorization because of the risks linked to money laundering and organized crime. But the Commission points out that those risks exist for French investments as well, and that the appropriate way to deal with the risk is to create stringent licensing conditions for casino operators. The French also argue that, if a foreign investor were to take control of certain strategic activities such as research and development in vaccines against bio-terror agents, the foreign investor might delocalize the activity outside France, thereby depriving France of important strategic assets in its fight against terrorism. The Commission points out, however, that French investors could delocalize too, and that the appropriate remedy would be to enact a law that permits the government to prohibit delocalization of certain strategic activities.

Citing the ECJ's *Conegate* decision, the advocate-general in the Church of Scientology case usefully summarised the discriminatory effect rule for measures restricting foreign investment:

*"It is obvious that a preventive measure establishing an authorization procedure for investments from abroad intended to finance high-risk sectors and activities must be accompanied by national measures relating to domestic investments with similar content."*

On this front, the French decree seems inadequate because it singles out foreign investors for special treatment without necessarily applying the same rules to French investors.

### Possible modifications to the decree

The decree's rules applicable to EU-origin investments create a curious split between investments that constitute taking control of a company versus acquiring a branch of activity. In a share transaction, identifying the difference between these two concepts might not always be easy. The rules that apply to the acquisition of a branch of activity are much stricter because they apply to 11 sectors as opposed to four, but the decree does not explain why stricter treatment is warranted. One would logically conclude that the drafters of the decree felt that the acquisition of a branch of activity by an EU investor raises greater risks for public security and national defence than does the acquisition of control. But the reason for this difference in risk is not explained. The failure to explain the difference weakens the decree as a whole, making the Commission's comments appear all the more relevant. If an EU-origin investment truly raises serious risks for French public security and national defence, why would those risks differ depending on whether the acquisition is structured as taking control versus purchasing a branch of activity? If the foreign investment itself poses a risk, the legal structure should be irrelevant. One can conclude therefore that the most important risks are those addressed in the shorter list linked to control, and that the longer list might be excessive.

It remains to be seen how the decree will evolve, if at all. One possible outcome is that the decree will be challenged before the French Supreme Administrative Court for non-compliance with the EC Treaty, and that the government will be obliged to modify the decree to adopt a single list for EU investments - probably the shorter list of four items applied to EU control transactions. The rules applicable to non-EU investments will probably remain the same. The European rules on the free movement of capital do not apply to non-EU investments, although when a non-EU investment is made through an EU investment vehicle, disagreement can sometimes arise as to whether the investment should be considered EU or non-EU. So France is free to do what it wants in this area, subject to bilateral investment treaties, which invariably contain an exception for public order, public security and national defence measures. The US - the trading partner most likely to complain about France's new rules - has a rule that allows its president to veto any foreign investment that raises a serious threat to national security. The US rules are much broader than those contained in new French decree, so the US would hardly be in a position to complain.

Another option that the French legislature might wish to pursue in parallel is to develop a harmonized EU list of sectors that can appropriately fall under the national security or national defence exceptions to the free movement of capital. Germany has recently introduced measures to shield certain defence-related industries from foreign takeover where there is a risk for national security, and the most effective way to set rules of this kind would be to do so at the EU level. ■

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