April 14, 2020

Germany to Adopt Increased Level of Scrutiny for Foreign Investments

Key Highlights:

- **Higher Intervention Risk Due to Lower Standard of Review**
- **New Gun-Jumping Prohibitions for Reportable Transactions**
- **Scope of Assessment Extended to Interests of Other EU Member States**
- **Implementation of Mechanism for EU-Wide Collaboration**
- **Further Amendments Expected to Cover Additional Sectors**

INTRODUCTION

On April 8, 2020, the German Government approved a draft law from the Federal Ministry of Economics and Energy (*Bundesministerium für Wirtschaft und Energie*) ("**Ministry**") to amend the Foreign Trade and Payments Act (*Außenwirtschaftsgesetz*).[1] The changes essentially implement the EU Screening Regulation[2], which came into force in 2019 and for the first time stipulates requirements for investment control at the European level.

The legislative proposal, which was initiated with its key terms in January, is being picked up during an ongoing discussion on increased requirements for foreign investment control in Europe in relation to the COVID-19 pandemic.[3] On March 25, 2020, the EU Commission issued a guidance paper to all 27 EU Member States on investments by non-EU entities in strategic industries.[4] In this paper, the Commission calls upon all Member States to make full use of their screening mechanisms in the current situation to take fully into account the risks to critical health infrastructures, supply of critical inputs, and other critical sectors, and encourages all Member States to prevent a sell-off of strategic assets, in particular those that are undervalued by the market.

I. LEGAL FRAMEWORK OF GERMAN INVESTMENT SCREENING

In Germany, foreign investment control, i.e. the review of direct or indirect inbound investments, is governed by the Foreign Trade and Payments Act (*Außenwirtschaftsgesetz*) and the implementing Foreign Trade and Payments Ordinance (*Außenwirtschaftsverordnung*). The legal framework comprises one regime governing acquisitions by non-German investors in sectors of special security concern, in particular related to military, defense and security of government information technology (*sector-specific review*). Another set of rules applies to all other investments by non-EU investors (*cross-sectoral review*) with a focus on the acquisitions of assets that are defined as *critical infrastructures* as well as certain related software, specific technology and widely broadcasting media companies. *Critical infrastructures* comprise assets and services in the energy, water supply, finance and insurance, transportation, traffic, information technology and communication sectors, but also include the health sector and food supply. The relevant assets and services, including quantitative minimum size thresholds, are specified in a separate regulation.[5]

Transactions subject to *sector-specific review* or in *critical infrastructures* and related software, specific technology and widely broadcasting media companies must be notified to the Ministry by the parties. In these cases, a threshold of 10% of the target's voting rights applies. In all other cases, notifications to the Ministry are voluntary, and the Ministry can initiate an examination when it becomes aware of a transaction concerning at least 25% of the voting rights in the target.

In case of a transaction subject to *cross-sectoral review*, regardless of whether there is a notification requirement, the acquirer has the option to submit a voluntarily filing accompanied by an application for a clearance certificate (*Unbedenklichkeitsbescheinigung*). In such certificate, the Ministry confirms that the planned acquisition does not raise any concerns related to public order or security.

II. KEY FEATURES OF THE NEW LEGISLATIVE DRAFT

1. HIGHER INTERVENTION RISK DUE TO LOWER STANDARD OF REVIEW

The focus of the new law lies on the adjustment of the screening standard in the area of *cross-sectoral review*.[6] Currently, only those investments can be prohibited, or approved subject to conditions or undertakings by the acquirer, that result in a threat of national public order or security (*öffentliche Ordnung oder Sicherheit*). Intervention measures require an "actual and sufficiently severe threat that affects a fundamental interest of society". Such threat can be established based on the grounds of public policy, public security, financial stability and public health. In the future, pursuant to the new regulations, it will be sufficient that the investment is "likely to affect" (*voraussichtlich beeinträchtigen*) public order or security. This new standard stresses the forward-looking approach of the assessment and makes clear that in terms of severity a (substantially) lower degree of risk is required.

Because of these changes, the German Government anticipates an increasing number of assessment cases and additional cases that will require a more complex in-depth review. In many M&A transactions, this will result in a greater degree of uncertainty and higher risk of regulatory intervention. It is likely that the option of applying for a clearance certificate (*Unbedenklichkeitsbescheinigung*) will gain even more significance in the future based on the new screening standard. However, even in transactions in which the acquirer applied for a clearance certificate, the timing of obtaining the approval has not always been predictable. Unlike in other jurisdictions, the deadline for obtaining the approval is not triggered by the date of the submission of the notification but by the time at which the Ministry considers the filing complete. Accordingly, approaching the Ministry at an early stage and transparent communication is critical, and will be even more critical under the new regime.

2. NEW GUN-JUMPING PROHIBITIONS FOR REPORTABLE TRANSACTIONS

The current framework applicable in case of a *cross-sectoral review* does not provide for a general legal prohibition to complete a transaction prior to obtaining the approval by the Ministry. The parties (only) run the commercial risk that if a review by the Ministry results in a prohibition of an acquisition, such acquisition must be unwound or other remedies are imposed on the parties ex-post. Accordingly, and contrary to other regulatory approvals, in particular in the area of antitrust/merger control, the current regime does not prohibit to take any action that has the *de facto* effect of (partially) implementing the transaction prior to completion (known as “gun-jumping”).

In the future, the legal validity of the contract (*e.g.*, share purchase agreement) and any implementation measure will be pending subject to the Ministry’s approval. As of today, this restriction is only applicable in cases of *sector-specific review* (military, defense and government IT). The new law will extend this restriction to investments in *critical infrastructures* and related software, specific technology and widely broadcasting media companies, *i.e.* it will apply to all transactions that must be notified to the Ministry (see above I.).

In addition, the new law will prohibit any *de facto* implementation of such transactions prior to approval by (i) enabling the exercise of voting rights, (ii) granting profit claims or economic equivalents or (iii) sharing sensitive information. The Government thereby aims at preventing a situation where the parties already create a *fait accompli* during an ongoing examination, in particular that an acquirer already acts as owner and gains access to technology or information prior to approval. Violations of the gun-jumping prohibitions will constitute a criminal offense and can be punished with fines or imprisonment.

This conceptual shift of the regime considerably increases transaction risk outside the area of *sector-specific review* (military, defense and government IT). In particular, it is not always easily possible for the parties to determine whether an investment involves a *critical infrastructure* and thus whether the gun-jumping prohibitions will apply or not. This is in particular true for public M&A transactions or other public market purchases where the acquirer has no access to the target’s management and has therefore no

ability to verify by way of due diligence whether the target qualifies as a *critical infrastructure* business or is subject to *sector-specific review*. The criteria and classifications of the regulation defining *critical infrastructures*[7] are sometimes ambiguous, and often questions arise in the individual case, *e.g.*, on the calculation of the applicable minimum size thresholds. The new gun-jumping prohibitions will therefore likely influence a large number of transactions. Ensuring compliance will affect transaction timelines and require additional efforts by both sellers and buyers.

3. ASSESSMENT OF INTERESTS OF OTHER EU MEMBER STATES AND EU-WIDE COLLABORATION

Until now, the national review of inbound investments by investors from countries outside the EU only addressed the domestic public order or security of Germany. The new law provides for a broadened assessment scope of the Ministry that extends to the public order or security *of another EU Member State* or with respect to specific *projects or programs of the EU*. This means that, in the future, the Ministry will take into account in its assessment relevant interests of other EU Member States or the EU as a whole.

Linked to this substantive extension of the review is a newly introduced EU-wide procedural collaboration to facilitate the assessment whether relevant foreign/EU interests are affected. Based on the new law, the Ministry will be appointed as the German contact point for such collaboration. The Ministry will handle incoming requests from the EU Commission or other member states and notify the EU Commission or foreign EU authorities on its own investigations. National authorities must give due consideration to input received from the EU Commission or their EU counterparts. This additional level of coordination will increase the complexity of assessments and likely result in longer investigation periods.

With respect to relevant projects or programs of the EU, the EU Commission in its guidance paper of March 25, 2020[8] points out as an example the EU's research and innovation funding program "Horizon 2020". The EU Commission emphasizes with respect to foreign investment control that particular attention should be paid to all Horizon 2020 projects related to the health sector, including future projects in response to the COVID-19 outbreak.

III. EXPECTED EXTENSION OF NOTIFICATION REQUIREMENT AND GUN-JUMPING RULES TO ADDITIONAL SECTORS

The German Government has already stated that it views the new rules as a first step of a two-step process to further tighten the German investment control regime and adjust it to the EU requirements. In a second step, it will review the Foreign Trade and Payments Ordinance (*Außenwirtschaftsverordnung*) with a focus on adding more specific definitions of *critical technologies* (such as artificial intelligence, robotics, semiconductors, biotechnology and quantum technology) that will become subject to the same (stricter) rules that already apply to *critical infrastructures*, in particular a reporting obligation of the parties, a 10% review threshold and the new gun-jumping prohibitions.

The German Government introduced the current draft law to the parliamentary legislation process as a matter of particular urgency on April 9, 2020 in order to implement the new restrictions "as soon as possible". It remains to be seen whether additional adjustments will be made in connection with the COVID-19 crisis prior to the new law coming into effect.

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ENDNOTES

[1] Draft Law of the Federal Government of a First Act Amending the Foreign Trade and Payments Act and Other Laws (*Erstes Gesetz zur Änderung des Außenwirtschaftsgesetzes und anderer Gesetze*).

[2] 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.

[3] The Government's statement of reasons for the new law does not contain any reference to the COVID-19 situation.

[4] 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) of March 25, 2020 – C(2020) 1981 final.

[5] Ordinance for the Determination of Critical Infrastructures under the BSI-Act (*Verordnung zur Bestimmung Kritischer Infrastrukturen nach dem BSI-Gesetz*). The BSI is the Federal Office for Information Security (*Bundesamt für Sicherheit in der Informationstechnik*).

[6] In the area of *sector-specific review* (military, defense and government IT) a different standard of review applies: The Ministry assesses whether an investment poses a threat to "material security interests" of Germany. This standard will remain unchanged by the current legislative proposal. The new law specifies that the test is met in particular if national security policy or military security provisions are threatened. In addition, *sector-specific review* will be extended to companies that *use* or *modify* certain military/IT products. Previously, it only applied to companies *producing* or *developing* such goods. In addition, having produced, developed, modified or used relevant goods in the past can be sufficient if relevant knowledge or access to technology is still available in a company.

[7] See footnote 5.

[8] See footnote 4.

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