



New German foreign investment controls unlikely to have any material effect on cross-border transactions

The German parliament has passed legislation that enables the German government to block acquisitions of stakes in German businesses under certain circumstances. This briefing explains the changes and their possible implications for potential Chinese investors.

On 13 February 2009, the lower house of the German parliament passed much-anticipated amendments to the Foreign Trade Act (FTA), which effectively enable the government to block any acquisitions of stakes in German businesses if:

- the purchaser is a non-EU person or 25 per cent or more of the voting rights in the purchaser are owned by a non-EU person;
- following the transaction, the purchaser directly or indirectly holds 25 per cent or more of the target company's voting rights; and
- the transaction threatens the public order or safety of the German state.

The last requirement is to be construed narrowly and in accordance with EU law. It is therefore in practice rather unlikely that the German government will ever use the new law to prohibit any transaction, except in cases where critical and unique infrastructure assets were to be sold (eg the sole national railway operator). Nonetheless, the new legislation will have an effect on structuring acquisitions in Germany by foreign investors from outside the EU and Chinese investors as well as the Chinese media have voiced concerns about the fairness and even-handedness of the new rules since they were first publicly discussed about two years ago.

Non-EU control

The FTA amendment allows the German Ministry of Economics and Technology (MET) to review any direct or indirect acquisitions of businesses based in Germany, or

of participations of 25 per cent or more in such German businesses, by non-EU persons or by entities in which a non-EU person or company holds 25 per cent or more of the voting rights. For the purposes of the FTA, EU persons include persons and companies from the European Free Trade Association (EFTA) states – ie Switzerland, Norway, Liechtenstein and Iceland – even though these countries are not member states of the EU.

The government's right to review is triggered only if the purchaser is a non-EU person, or if *one* non-EU person controls 25 per cent or more of the voting rights in the purchaser individually, but not if there are several non-EU shareholders with a combined shareholding of 25 per cent or above, as long as each of them individually remains below 25 per cent. However, any voting rights held indirectly through other entities in which the relevant non-EU person holds 25 per cent or more of the voting rights are attributed to that person (as well as voting trusts).

In addition, if the direct acquisition vehicle is an EU entity (ie a company incorporated and with its principal place of business in an EU or EFTA member state), the right to review is triggered only if the acquisition vehicle has been established with a view to circumventing the review process through an 'artificial structure'. If, on the other hand, the acquisition vehicle has sufficient EU substance, namely its own business activities, employees and/or assets, then no review right will be triggered even if a non-EU person holds 25 per cent or more of the voting rights in the EU company.

The following examples may illustrate these mechanics.

- The purchaser is a Luxembourg company with five Chinese (or other non-EU) shareholders, each holding 20 per cent of the voting rights. The shareholders are not otherwise related to each other – ie there are no cross-shareholdings between them or their shareholders. No review is triggered.
- Assume two of the Chinese shareholders in the above example are themselves controlled by the same Chinese state-owned enterprise (SOE), which holds 25 per cent or more in each of them. A review is triggered because the SOE indirectly controls 40 per cent of the voting rights in the purchaser, *unless* the Luxembourg company has sufficient substance in Luxembourg or elsewhere in the EU.
- The Luxembourg acquisition vehicle is 80 per cent controlled by a German shareholder and 20 per cent by a Chinese shareholder – no review is triggered. However, if the Chinese shareholder owned 25 per cent, a review would be triggered (again, unless the substance requirement was satisfied).
- Assume, in the previous example, that the Luxembourg vehicle does not have sufficient EU substance and the German shareholder in the acquisition vehicle transfers an additional 5 per cent shareholding to the Chinese shareholder after the acquisition of the German target, such that the Chinese shareholder now holds 75 per cent. Presumably, a review would now be triggered, because the transfer constitutes the indirect acquisition of a participation in the target.

The above examples illustrate the importance of the substance requirement in determining whether a review is triggered. This requirement has been added rather late in the legislative process to comply with the jurisprudence of the European Court of Justice (ECJ), which allows for the discrimination against EU persons or entities in other member states only in very limited circumstances, whether or not such EU entities are ultimately controlled by non-EU shareholders. The legislative materials make it quite clear that therefore only artificial structures designed to circumvent the foreign investment review process may be challenged. For example, if a Chinese investor has an existing operating subsidiary in an EU or EFTA country and carries out the acquisition of the German target through that

subsidiary, this clearly could not be viewed as a deliberate circumvention, even if the Chinese investor decided to use the existing EU subsidiary, rather than make the acquisition directly, to facilitate the process.

There may also be other motives for choosing EU acquisition vehicles – namely tax reasons. For example, Chinese investors may prefer to carry out investments in Germany through a Luxembourg subsidiary to benefit from the exemption from dividend taxation provided for under the China-Luxembourg double taxation treaty. However, this acquisition structure would also require a certain minimum substance of the Luxembourg company, such as officers and employees based in Luxembourg, to withstand scrutiny from the German fiscal authorities. These substance requirements will be similar to the ones required under the FTA, because both substance tests are ultimately based on the aforementioned EU law and ECJ precedents.

Review process

If the MET's right of review is triggered by an acquisition, the entire sale-and-purchase remains subject to the condition subsequent of the MET's prohibiting the transaction within the statutory review period. This period is calculated as follows: the MET may decide to enter into a formal review within three months from the conclusion of a sale-and-purchase agreement or the announcement of a public takeover offer. If the MET enters into a formal review, the purchaser has to provide the MET with all pertinent information about the purchaser's shareholder structure, the contemplated transaction and its strategic intentions. The MET then has two months from the date of receipt of the complete information to prohibit the transaction on the grounds of public order or safety.

The purchaser may, however, shorten the review period by proactively notifying the MET of the transaction and providing an outline describing the planned acquisition, the purchaser and its business. In this case, the MET has only one month from the date of receipt to enter into a formal review of the transaction, which is otherwise deemed cleared. (It should be noted, however, that there is no requirement for the parties to a sale-and-purchase to notify the transaction.)

It is therefore to be expected that most parties to mergers and acquisitions transactions involving a non-EU buyer will simply notify the MET of the transaction and the sale-and-purchase agreement will provide for an additional condition precedent, namely that no formal review proceedings are opened within the one-month period. This is a practicable solution because both the review period and the information to be submitted are compatible with the EU merger control process. EU merger clearance takes at least 25 business days in phase I – ie slightly longer than one month. This means that the notification does not delay the closing of the transaction, but provides the parties with the benefit of absolute legal certainty. How the MET intends to cope with the expected wave of notifications may be a different question.

Very limited grounds for prohibition

The only ground on which the MET may prohibit a transaction is ‘a threat to the public order or safety of the Federal Republic of Germany’. At first sight, this may read like a very vague and potentially broad clause, but EU legal precedent will in fact require an extremely narrow interpretation.

The reason this criterion was chosen is that these are the only grounds upon which an EU member state may, under article 58 of the EC Treaty, restrict the free movement of capital within the EU. Consequently, what does and does not constitute a threat to public order and safety will need to be determined by the German authorities and courts in accordance with ECJ precedent, which has upheld restrictions on the free movement of capital by member states only in very few cases and in extremely limited circumstances. The only case in which the ECJ upheld a prohibition against foreign investment concerned a Belgian law preventing the acquisition of the (entire) national grid by foreign investors. Other cases have been consistently turned down, most recently Spanish legislation seeking to protect a Spanish utility against a takeover by a German competitor. (It is of course recognised that special rules govern military and dual-use equipment as well as participations in ‘flag carrier’ airlines.)

In our opinion, it would therefore be impermissible under EU law for the German government to prohibit, for example, an investment by non-EU parties into German ports (as long as it does not concern all major seaports) or one of several energy companies.

Legal consequences of prohibition

In the unlikely event of a prohibition, the legal consequence is the invalidity of the underlying sale-and-purchase agreement under German civil law. If the shares have already been transferred to the purchaser, the MET can limit or restrain completely the voting rights of the foreign investor in the German target or appoint a trustee to unwind the transaction (presumably by requiring the transfer of the shares to the trustee or its designee). It is unclear how the limitation of voting rights is supposed to work if the voting rights are held by an EU (but non-German) acquisition vehicle, because the German authorities would not have jurisdiction to limit the exercise of voting rights in eg a Luxembourg company. Also, if a foreign investor takes control of or increases its stake in a non-German EU vehicle (in our example, the Luxembourg company) to 25 per cent or above *post-acquisition* of a German business by the Luxembourg entity, thereby indirectly acquiring control of that German participation, it would appear unusual, and hardly defensible under EU law, for the German government to order the Luxembourg company to cease exercising its voting rights or even transfer the shares to a trustee, considering that the Luxembourg company can hardly be held responsible for movements in its shareholder base.

Conclusions for potential Chinese investors

This raises the question why the German government would bother to go to so much trouble and public discussion only to pass (and even more trouble to administer and enforce) an unwieldy piece of legislation whose practical applicability will always be confined to extreme and rather remote cases. The likely answer is that the government’s primary goal is not actually to prohibit any transaction, but to have ‘a seat at the table’

in discussions involving *potentially* critical deals. The German government wants to have a formal basis to get involved in transactions it may not like (beyond the formal scope of the law) to be able to impose conditions (such as job and site guarantees) that may make the deal more 'palatable' for domestic public opinion.

Considering that any major transaction by a Chinese buyer will always be likely to attract some degree of public attention, it is critical, therefore, to prepare carefully outbound investment into Germany by building trust not only with the vendor and target but also with other stakeholders. Certain foreign private equity houses, for example, have built a track record of courting employee representatives as well as local and national authorities when entering the German market, a strategy that in many cases has proved highly successful.

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