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Extended scope of investment screening creates further obstacles for M&A transactions

1. Fourth amendment within three years

German investment control law has been tightened again. More and more transactions can be reviewed by the German Federal Ministry for Economic Affairs and Energy ("**FMEA**"). For the fourth time in three years, the legal bases of investment control in Germany, the Foreign Trade and Payments Act ("**AWG**") and the Foreign Trade and Payments Ordinance ("**AWV**"), have been thoroughly amended.

In an increasing number of cases, transaction advisors must therefore plan for approval procedures before the FMEA in addition to approval procedures before, for example, antitrust authorities. In the past three years alone, the number of transactions reviewed by the FMEA has doubled. This trend is likely to continue. In addition, the FMEA will in the future have to decide on approximately 130 additional cases annually, which are reported by other EU Member States.

For German investment control, the recent reforms of the AWV and AWG essentially brought the following changes:

- The FMEA will also examine whether an acquisition is likely to affect the public order or security of an EU or EEA member state or projects and programmes of Union interest.
- The standard for the prohibition of an acquisition was lowered.
- A prohibition to implement a reportable transaction is introduced and a violation thereof can amount to either a criminal offence or a misdemeanour.

In the following, we first summarise the basics of German investment control law (2.) and then outline the most important changes to the AWV and the AWG in detail (3.). Finally, we show some of the consequences for investors or advisors and refer to upcoming further changes of the AWV (4.).

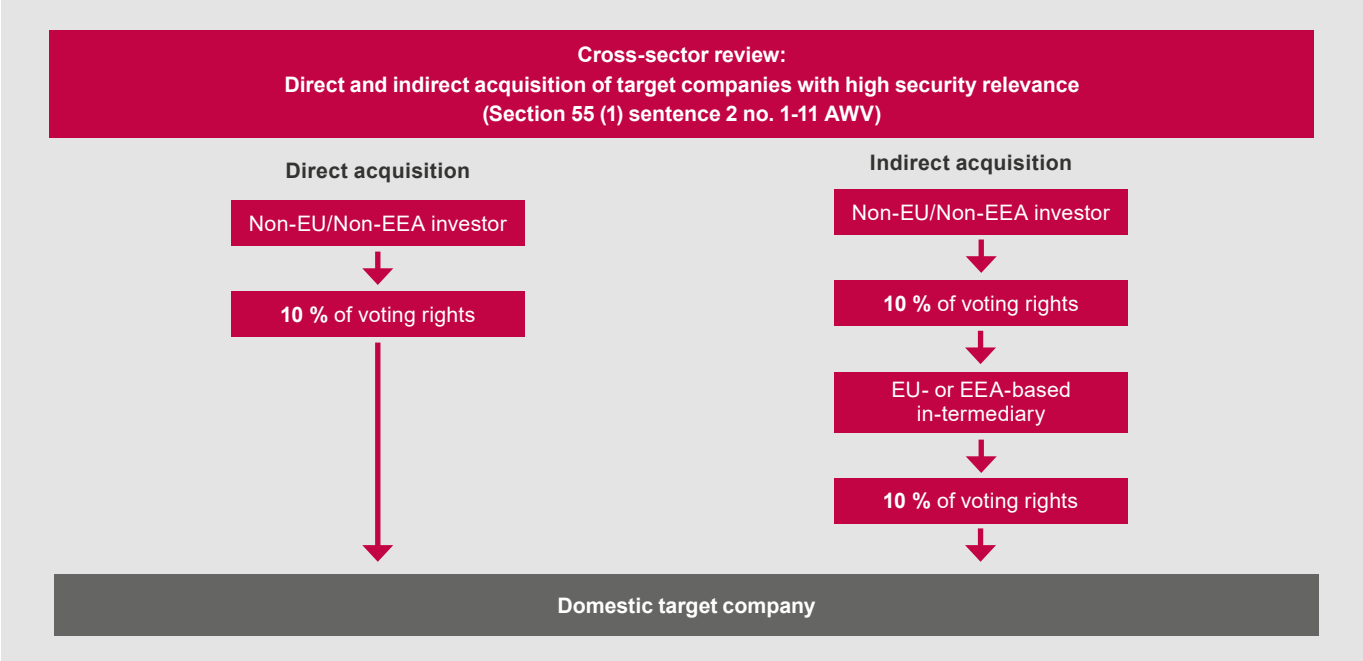
2. Basics of German investment control law

The investment control in Germany knows in particular the so-called cross-sector review procedure (Sections 55 - 59 AWV) and the so-called sector-specific review procedure (Sections 60-62 AWV). The **sector-specific** review procedure covers obvious and particularly sensitive economic sectors, i.e. in particular manufacturers of military equipment or of products with IT security functions used for processing government-classified information (Section 60 (1) AWV). Of greater importance for most companies is the cross-sectoral investigation procedure. It applies to all companies to be acquired, regardless of the sector in which they are active:

The **cross-sectoral** investment review gives the FMEA the right to control in all economic sectors (i.e. cross-sectoral) whether the acquisition of a German company or of voting rights in such a company by a non-EU party is likely to affect public order or security. A "non-EU party" is any natural or legal person or partnership, branch or permanent establishment not resident in the EU or the EEA. Depending on whether the target company is active in certain sectors, the threshold for the FMEA's review competence is already 10% or only 25% of the voting rights in this company or one of its shareholders:

2.1. Industries with high security relevance: Acquisition of 10% of voting rights triggers obligation to notify

According to the AWV, if the target company is active in the business areas listed in Section 55 (1) sentence 2 no. 1-11 AWV, there is an increased probability that public order or security are likely to be affected. In this case, the (direct) acquirer of already **10%** or more of the **voting rights** in such companies is **obliged to notify** the FMEA of the acquisition and thus enable it to review said acquisition (Section 55 (4) sentence 1 AWV). An acquisition is subject to control not only if the direct acquirer is a non-EU party, but also if the indirect acquirer is a non-EU party. It is qualified as an indirect acquisition by a non-EU party if a non-EU party holds 10% of the voting rights in an EU- or EEA-based intermediary, which in turn directly acquires 10% of the voting rights in a domestic company from one of the business areas with high security relevance laid down in Section 55 (1) sentence 2 no. 1-11 AWV (Section 56 (3) AWV):



The business areas listed in Section 55 (1) sentence 2 no. 1-11 AWV are of particular relevance to security, supply and health and therefore play a key role for society and the state. Examples are operators of a so-called "critical infrastructure" as defined by the law on the Federal Office for Information Security and the associated Ordinance on the Definition of Critical Infrastructures; but also companies from the medical, pharmaceutical and healthcare sector were classified as particularly security-relevant areas by the last (and in total 15th) amendment to the AWV due to the Corona pandemic (the Lutherblog reported here and here). The FMEA must then decide within two months whether to open a formal review procedure. If it does not open a review procedure, a so-called certificate of non-objection is deemed to have been issued in accordance with Section 58 (2) AWV, and the acquisition may then be implemented. The purchaser of a company with high security relevance can obtain such a certificate of non-objection also upon request. With such a request, the acquirer would fulfil his obligation to notify at the same time. If the FMEA opens the review procedure in response to such a request or a notification, it has four months to prohibit the acquisition or to clear it with or without conditions, whereby it may unilaterally extend this period by up to three months. The FMEA can prohibit the acquisition or impose conditions on its implementation as far as it "is likely to affect" the public order or security of the Federal Republic of Germany, another EU or EEA member state or certain projects or programmes of Union interest. Otherwise, the FMEA must clear the acquisition. If more than five years have passed since the conclusion of the purchase agreement, a review is no longer possible, even if the FMEA had no knowledge of the acquisition or if the acquisition was reportable.

2.2. Other industries: No obligation to notify, but review possible in case of acquisition of 25% of the voting rights

If the target company is active in business areas other than those listed in Section 55 (1) sentence 2 no. 1-11 AWV, the FMEA may review the acquisition pursuant to Section 55 (1) sentence 1 AWV, if **25%** or more **voting rights** in a German company are acquired. However, in these cases, there is **no obligation to report** the acquisition to the FMEA. The FMEA can conduct a review ex officio if it has become aware of the acquisition through a request by the acquirer for certificate of non-objection or otherwise. The review procedure and the substantive standard for the prohibition (the acquisition "is likely to affect public order or security") are the same as for the review of acquisitions of target companies with high security relevance (see 2.1.).

3. Recent amendments of the AWG and the AWV

The main amendments to the AWV and the AWG, which came into force on 29 October and 10 July 2020 respectively, were the following:

- Protection of public order or security of an EU or EEA member state or certain projects or programmes of European Union interest

The latest amendment to the investment control law intended to adapt it to the EU foreign direct investment screening ("**FDI**") regulation, which is applicable in Germany from 11 October 2020. This regulation provides for a mechanism for cooperation among the EU and EEA member states in investment control. Therefore, the FMEA must henceforth also review whether an acquisition is **likely to affect the public order or security of an EU or EEA member state** or certain projects or programmes of EU interest. Likewise, other EU and EEA member states must report to the FMEA any acquisition of a company that is likely to affect the public order or security of the Federal Republic of Germany.

- Lowering the standard for prohibiting an acquisition

In addition, the German legislator **lowered the standard for a prohibition** decision from an "actual and serious threat" to public order or security to being "likely to affect" such order or security, which extends the FMEA's review powers. The EU FDI screening regulation provides criteria for the interpretation of this term and specifies the scale, requirements and content of such a likely effect. According to the case law of the European Court of Justice, the concept of public order or security must be interpreted dynamically and adapted to developments over time. In accordance with Section 55 (1b) AWV, reasons relating to the person of the acquirer in particular can be taken into account when examining whether an acquisition is "likely to affect" public order or security (e.g. investments by state-controlled companies).

- A prohibition to implement reportable transactions is introduced and a violation thereof can amount to a criminal offence or a misdemeanour

A further central change is the prohibition to implement an acquisition until the FMEA clears the acquisition, issues a certificate of non-objection or such a decision is deemed to be

taken when the review deadline expires (all decisions "**prohibition of implementation**"). So far, such a prohibition of implementation applied only to acquisitions of military equipment and similar business areas subject to the sector-specific review procedure (see 2.1.). So far, a violation of that prohibition did not amount to a criminal offence or to a misdemeanour. Now, a prohibition of implementation also applies to **any acquisition that triggers an obligation to notify**. Violations of this prohibition are – in contrast to the corresponding prohibition under merger control law, for instance – not only subject to a fine but can also amount to a criminal offence, as far as the implementation actions laid down in Section 15 (4) AWG are concerned. These actions are (i) enabling the acquirer to exercise voting rights, (ii.) granting the acquirer certain rights in connection with the acquisition, i.e. rights to payment of dividends or of an economic equivalent and (iii.) the provision or disclosure of information about the target company, insofar as they relate to business units or business objects which trigger an obligation to notify. Intentionally carrying out those actions while the acquisition is to be notified can be punished with **imprisonment of up to five years or a fine**, negligent infringements with a fine. In addition, the effectiveness of legal transactions is further limited under civil law, if these transactions relate to reportable acquisitions of a domestic company. Already before the recent amendments of the German investment control law, any obligation to acquire a domestic company or shares thereof which fell within the scope of investment control was subject to the condition subsequent that the FMEA prohibits the decision (Section 15 (2) AWG).

Now also the implementation of such an acquisition by **transfer of ownership** is **ineffective** under civil law until the clearance decision by the FMEA (or due to a lapse of time), if the acquisition is a notifiable acquisition with high security relevance according to Section 55 (1) sentence 2 no. 1-11 AWV (Section 15 (3) AWG). This ineffectiveness is to prevent the parties involved in the acquisition from creating a fait accompli before or during the review and from undermining the objectives of the review procedure.

4. Consequences for the consulting practice and outlook

The recent tightening further increases the already high practical relevance of the German investment control law. In all M&A transactions, purchasers must evaluate whether they have to go through the review procedure before the FMEA - just as they are used to take into account approval requirements under merger control law. It is advisable to obtain the information required for a report to the FMEA pursuant to Section 55 (4) sentence 1 AWV or for an application for a clearance certificate pursuant to Section 58 AWV as early as possible. Only in this way can transaction security be achieved at a sufficiently early stage. The lowering of the prohibition standard to "likely affect[ing] public order or security" gives the FMEA even more power to assess whether such an effect is present and to prohibit the acquisition. However, this increased risk of a prohibition decision can be partially mitigated by offering the FMEA appropriate commitments in order to address investment control concerns and to achieve a clearance subject to conditions. Such conditional clearance is not unusual in merger control. In this respect, too, investment control law advice can benefit from experience gained in merger control consultancy practice.

That investment control will remain in the focus of the German legislator is shown by the announcement of the FMEA to reform the AWV again. This upcoming reform intends to identify further critical technologies which are of particular (security) relevance and therefore should be reviewable and reportable already in case of an acquisition of 10% of the voting rights of a German target company. These technologies include, according to the EU FDI screening regulation, in particular the areas of **artificial intelligence, robotics, semiconductors, bio- and quantum technology**.

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