

Investing in German Companies as a Foreign Investor

German Foreign Direct Investment Screening Regime
in the time of Covid-19 and beyond



I. Introduction

1. German FDI Screening Regime in M&A Transactions

Whilst foreign direct investments (“**FDI**”) in German companies have been subject to a screening regime for a long time, over the last few years the FDI regime in Germany has constantly become tighter and more M&A transactions are subject to review and the authorities take a closer look at those transactions. In 2018, for the first time in Germany, a transaction targeting a mid-size German metal spinning company was to be blocked under the FDI regime (although the deal was cancelled before this happened). The Covid-19 pandemic has drawn special attention to the FDI instruments that act to safeguard Germany’s medical capabilities; as such, FDI considerations have become an important topic in terms of deal certainty and deal preparation.

Newly introduced “gun-jumping” rules require a thorough assessment to avoid fines and even criminal charges relating to information exchange and closing a deal without the requisite clearance. Since 11 October 2020, the EU FDI Screening Regulation applies, and, on 7 October 2020, the latest amendment to German FDI laws was introduced. Investments from the UK will be treated as FDI upon termination of the transition period for Brexit on 31 December 2020, absent specific arrangements. This white paper gives an overview of the German FDI regime and the key considerations necessary for the smooth navigation of an M&A process.

2. Overview of the German FDI Screening Regime

The German FDI regime differentiates between a (i) sector-specific (**see III.1**) and (ii) cross-sector (**see III.2**) review. Whereas the sector-specific review is applicable to transactions in the area of defense and military goods, the cross-sector review is applicable to all (other) transactions. The cross-sector mechanism differentiates between certain key industries, namely so-called “critical infrastructure”, software relating to critical infrastructure, and certain further listed industries (“**Key Industries**”), and all other industries, and provides for tighter rules in respect of transactions in Key Industries. The German Ministry for Economic Affairs and Energy (*Bundesministerium für Wirtschaft und Energie*; “**German Ministry**”) is the competent authority for the FDI review and coordinates the process with other German and European authorities. The FDI screening regime in Germany is governed by the Foreign Trade and Payments Act

(*Außenwirtschaftsgesetz*; “**FTPA**”) and the Foreign Trade and Payments Ordinance (*Außenwirtschaftsverordnung*; “**FTPO**”) and, from EU level, by Regulation (EU) 2019/452 to establish a Framework for the Screening of Foreign Direct Investment in the Union (“**EU FDI Screening Regulation**”) (**see II.**). These rules require certain steps to be taken pre- and post-signing to ensure a successful closing (**see IV.**).

Investments from the UK will be treated as FDI upon termination of the transition period for Brexit on 31 December 2020, absent specific arrangements.

II. EU Coordination Mechanism for FDI Screening

The purpose of the EU FDI Screening Regulation is *not* to create an overarching European investment control mechanism and *not* to transfer the corresponding decision-making power to the European Commission, as the Committee on Foreign Investment in the United States (“**CFIUS**”) is equipped with in the United States. The ultimate decision remains with the Member State whose FDI regime applies (this can be more than one Member State for the same transaction). It imposes a coordination mechanism on all Member States that have an FDI screening regime, but it does not itself impose a screening mechanism on a Member State. Currently, 16 Member States have national screening regimes for FDI¹. If a Member State has an FDI screening regime, it must ensure that it is transparent, non-discriminatory and complies with the common framework set by the EU FDI Screening Regulation. If a transaction affects more than one Member State, the cooperation mechanism of the EU FDI Screening Regulation shall ensure the involvement of the European Commission and of the relevant Member States.

The ultimate decision remains with the Member State whose FDI regime applies.



¹Austria, Denmark, Finland, France, Germany, Hungary, Italy, Latvia, Lithuania, the Netherlands, Poland, Portugal, Romania, Slovenia, Spain and the United Kingdom.

III. Details of the German FDI Screening Mechanism

1. Sector-specific Review for Defense and Military Goods

RELEVANT SECTORS

Similar to CFIUS which was introduced by an amendment to the Defense Production Act in 1988, the German FDI regime was created in order to have an instrument to monitor foreign direct investments into certain national defense companies. The highest level of scrutiny, which confers extensive powers on the German Ministry, applies to this sector-specific review which is applicable if the target is active in defense technology or security-sensitive areas (e.g. military products). These particularly security-sensitive areas are comprehensively listed and include manufacturers or developers of military weapons and other key military technologies, of specially designed engines or transmissions for armored military tracked vehicles, and of products with IT security functions that are used for processing government classified information.

RELEVANT THRESHOLDS AND TYPES OF TRANSACTIONS

The threshold to initiate a review requires an acquisition of at least 10% of the voting rights in a German entity, branch or business establishment. It also applies to certain types of asset deals.

The sector-specific review applies if a foreign, i.e. non-German, investor acquires, either directly or indirectly, at least 10% of the voting rights in a German target.

NON-GERMAN INVESTOR IN A DOMESTIC COMPANY

The sector-specific review applies if a foreign, *i.e.* non-German, investor acquires, either directly or indirectly, at least 10% of the voting rights in a German target. In calculating the 10% threshold, voting rights in the target held by other entities in which the acquirer holds at least 10% of the voting rights, or with which the acquirer has entered into a voting pool agreement, have to be taken into account. The applicability of the sector-specific review does not depend on the legal form of the investor and cannot be circumvented by using a German entity as a direct investor.

CRITERIA FOR REVIEW

The German Ministry assesses whether a transaction endangers major security interests of the Federal Republic of Germany. It will allow the transaction to complete if no concerns arise in respect of major security interests of the Federal Republic of Germany. In that regard, (i) investor-related and (ii) target-related criteria are requested and analyzed by the German Ministry.

In terms of investor-related criteria, the following catalogue was recently added to the FTPO:

- the investor is directly or indirectly controlled by (including by receiving financing from) the government or quasi-governmental bodies of a third country;
- the investor has already been involved in activities that have had an adverse effect on public order or security; or
- there is a significant risk, that the investor or the person acting on his behalf has been involved in activities which would constitute a criminal offence under section 123 paragraph 1 of the German Act Against Restraints of Competition or a criminal or administrative offence under the FTPA or under the Military Weapons Control Act.

TIMELINES, FILINGS AND APPROVALS

A **mandatory notification obligation** applies to the direct acquirer and must in particular detail the planned investment, the investor, the target and the respective business segments.

A two phase intervention period follows:

- (i) Within two months of the notification, the German Ministry must decide whether it wants to open a formal investigation procedure.
- (ii) If the German Ministry opens a formal investigation procedure, it must resolve on prohibitions or restrictions within four months after receipt of the complete documentation that is to be provided to the German Ministry. Extensions may apply in certain cases (e.g. due to the special complexity of the deal or further documentation being requested).

The transaction may not be closed until the German Ministry either approves the transaction or does not prohibit it within the aforementioned deadlines.



2. Cross-sector Review for all Industries, in particular “Key Industries”

RELEVANT SECTORS

The cross-sector review is applicable to all industries. Within its framework, a crucial distinction is made between Key Industries and all other industries as significantly more scrutiny is given to the protection of Key Industries:

THE FOLLOWING INDUSTRY SECTORS CURRENTLY QUALIFY AS KEY INDUSTRIES:

-  transport and traffic;
-  energy;
-  information technology and telecommunication;
-  finance and insurance sector;
-  food;
-  water;
-  healthcare; and
-  media and culture.

The FTPO describes the relevant businesses which qualify as Key Industries in some more detail. Generally, the definitions are broad and the list has been extended continuously. In the context of the Covid-19 pandemic, healthcare providers (including diagnostic companies) have been added to that list. The current FTPO list does not yet explicitly mention key technologies that are regarded as critical by the EU FDI Screening Regulation, namely artificial intelligence, robotics, semiconductors, cybersecurity, aerospace, energy storage, quantum and nuclear technology, nanotechnology and biotechnology. It is to be expected that the next amendment of the FTPO will again expand the list of Key Industries.

RELEVANT THRESHOLDS AND TYPES OF TRANSACTIONS

The threshold to initiate a review requires an acquisition of at least 10% of the voting rights in a target company that is active in a Key Industry. For target companies active in all other industries the threshold is 25% of the voting rights. The FTPO stipulates extensive rules on the attribution of voting rights in case of an indirect acquisition. In addition, certain types of asset deals are covered. The FTPO does not include an exemption for intra-group reorganizations which may therefore be subject to FDI filing requirements.

NON-EU/NON-EFTA INVESTOR

In order to trigger a cross-sector review, the investor must be a non-EU/non-EFTA investor. As in the case of the sector-specific review, the applicability of the rules cannot be circumvented by using a German acquisition vehicle as a direct investor. In practice, also acquisitions by companies with seat and business operations in the EU whose (ultimate) shareholders are non-EU/non-EFTA are notified and reviewed by the German Ministry.

In the absence of any specific agreement, UK investors will be treated as non-EU/non-EFTA investors after the end of the Brexit transition period on 31 December 2020.

CRITERIA FOR REVIEW

The German Ministry assesses whether a transaction is a potential threat to the public order or security of the Federal Republic of Germany, other Member States or certain EU projects. The latest amendment of the FTPO has reduced the requirements for an intervention; whilst previously a threat to public order or security was required, it is now sufficient that an adverse effect on public order or security can be expected. If the German Ministry believes that interests of other Member States are engaged, then the German Ministry should not review those effects itself, but trigger the cooperation mechanism under the EU FDI Regulation.

The FTPO assumes that a threat to public order or security might particularly be expected if the target operates in a Key Industry. As regards the investor, the same investor-related criteria mentioned above for the sector-specific review (see III.1.d) can be taken into account for the cross-sector review.

...previously, a threat to public order or security was required, it is now sufficient that an adverse effect on public order or security can be expected.

TIMELINES, FILINGS AND APPROVALS

A mandatory notification obligation applies only to investments into Key Industries and must in particular include details on the planned investment, the investor, the target and the respective business segments. The signing of an agreement triggers the notification obligation.

For all cross-sector investments, the investor can apply to the German Ministry for a **certificate of non-objection** (*Unbedenklichkeitsbescheinigung*). The application must include certain information on the acquisition, the investor and the domestic company to be acquired. If the German Ministry issues such certificate or remains inactive for more than two months, the transaction is cleared from an FDI perspective (and the certificate is then deemed to be granted).

The notification or the application for the certificate of non-objection triggers a two-phase intervention period for the German Ministry:

- (i) Within two months, the German Ministry must decide whether it wants to open a formal investigation procedure.
- (ii) If the German Ministry opens a formal investigation procedure, it must resolve on prohibitions or restrictions within four months of receipt of the complete documentation that is to be provided to the German Ministry. Extensions may apply in certain cases (e.g. due to the special complexity of the deal or further documentation being requested).

Transactions in Key Industries may not be closed until the German Ministry issues the certificate of non-objection, approves the transaction or does not prohibit it within the aforementioned deadlines.

Transactions outside of Key Industries do not have to be notified. They can also be closed without a certificate of non-objection, an explicit approval of the German Ministry or before the aforementioned deadlines have expired, but the German Ministry could prohibit the transaction or impose conditions before the aforementioned deadlines.

If the German Ministry is neither notified nor otherwise aware of a transaction it can take action within a timeframe of five years from signing of the SPA.



IV. Overview of FDI Screening Mechanism

The following table summarizes the FDI screening mechanism for the different types of targets:

Criteria	Sector-specific Review	Cross-sector Review for Key Industries	Cross-sector Review outside of Key Industries
Investor	Non-German (also applicable if (ultimate) shareholder is non-German)	Non-EU/ non-EEA investor (also applicable if (ultimate) shareholder is non-EU/non-EFTA)	Non-EU/ non-EEA investor (also applicable if (ultimate) shareholder is non-EU/non-EFTA)
Domestic target company's business	Manufacturers or developers of military weapons and other key military technologies, of specially designed engines or transmissions for armored military tracked vehicles and of products with IT security functions used for processing government classified information	Key Industries: transport and traffic, energy, information technology and telecommunication, finance and insurance sector, state and administration institutions, food, water, healthcare, media and culture	All other industries (i.e. non-Key Industries)
Threshold to initiate a review	10%	10%	25%
Notification obligation towards the German Ministry	Yes	Yes	No
Prohibition to close a deal without clearance	Yes	Yes	No

Criteria	Sector-specific Review	Cross-sector Review for Key Industries	Cross-sector Review outside of Key Industries
Timelines and filings	<p>Mandatory notification</p> <p>Intervention period(s): (i) two months after notification if the German Ministry does not initiate a formal investigation procedure and (ii) additional four months after receipt of further documents if the German Ministry initiates a formal investigation. Extension may apply in certain cases (e.g. special complexity of deal).</p>		<p>Knowledge of the German Ministry (e.g. request for a certificate of non-objection)</p> <p>Intervention period(s): (i) two months after notification if the German Ministry does not initiate a formal investigation procedure and (ii) additional four months after receipt of further documents if the German Ministry initiates a formal investigation. Extension may apply in certain cases (e.g. special complexity of deal).</p>
Request for a Certificate of non-objection	No	Yes (in parallel to notification obligation)	Yes



V. Key Considerations for M&A Deals

1. Structuring and Timing of the Transaction

Any transaction involving non-German and non-EU investors should be reviewed from an FDI perspective early on. This is an important aspect for both sides, seller and buyer.

From a seller's perspective, it should be analyzed whether the target is active in a sector-specific area or in a Key Industry. While this is obvious in many cases, it can be less obvious if only a small part of the business relates to such critical areas. In such case, it may also be appropriate to consider carving-out certain parts of the business from the transaction. In an auction process, the buyer's (and its shareholders') origins may be an important selection criteria. Information in that respect should be requested via bid letters. The seller may consider contacting the German Ministry in advance of a transaction in order to discuss potential concerns.

From a buyer's perspective, it is important to know which regulatory approvals need to be obtained and which information on the investor and its shareholders needs to be disclosed. In an auction process, the buyer will typically not be allowed to contact the German Ministry (or other relevant authorities) before signing.

Both parties should bear in mind that FDI clearance may be required in multiple jurisdictions. The acquisition of a German company with subsidiaries in other Member States could potentially trigger FDI review processes in Germany and in other relevant Member States. In addition, the EU cooperation mechanism may prolong the review process and delay the closing of the transaction.

2. Due Diligence and Disclosure of Information

A recent amendment to the FTPA introduced restrictions on the exchange of information in sector-specific transactions and transactions in Key Industries. Before FDI clearance, it is prohibited to disclose information which is FDI-sensitive, *i.e.* such information which relates to business areas of the target which are regarded as particularly sensitive under the German FDI rules. This shall not include information which the investor needs in order to assess the economic chances and risks of the business. However, the wording of the FTPA is broad and vague. This results in risks for the parties, as a violation may lead to fines or even criminal charges. Clean team agreements which are familiar from competition law can help to reduce the risk.

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3. SPA Considerations and Gun-Jumping Rules

FDI aspects must be addressed in M&A deals in several ways:

- FDI clearance must be a closing condition in (at least) all sector-specific transactions and transactions in Key Industries. The FTPA prohibits the closing of a transaction before FDI approval or the expiry of certain deadlines (without prohibition). The violation of these gun-jumping rules can result in fines or even criminal charges being brought against the parties.
- The prohibition extends to other measures that might be implemented before closing, such as the exercise of voting rights, conclusion of voting pool agreements, granting of dividend rights or economic equivalents. This must be taken into account when provisions on conduct of business between signing and closing are negotiated. This is particularly relevant as at the same time the timeframe between signing and closing may become longer as the FDI review process becomes more complex. The timing for the FDI process must be considered in light of the long-stop date and rights to withdraw.
- The seller may want the buyer to accept potential remedies which the German Ministry may impose (instead of a complete prohibition). On the other hand, the buyer may explicitly disagree with certain scenarios (e.g. no German individual as co-CEO at the target, no sell-off of a certain business segment).

**FDI clearance
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VI. Conclusion and Outlook

The German FDI review system has seen many legislative amendments in the last few years which have constantly tightened the regime. The list of Key Industries has been extended considerably and the screening process for transactions in Key Industries has been tightened in particular by mandatory notification obligations, a prohibition to close or implement certain pre-closing actions before clearance, and restrictions on disclosing certain information (in due diligence). The German legislator has also announced to soon expand the list of Key Industries.

The EU FDI Screening Regulation lists industries that are regarded as critical and establishes a framework for those Member States that have an FDI regime in place. It provides for a cooperation

mechanism to be used between Member States and the European Commission. The European Commission has excluded the UK from participating in the cooperation mechanism already before the end of the transition period for Brexit on 31 December 2020. As of 1 January 2021, investments from the UK into the EU will be treated as “foreign” under German FDI rules, absent specific arrangements.

FDI screening is a hot topic for M&A transactions. Analyzing the applicable framework and reflecting it in the timeline of the deal and in transaction agreements is of key importance in order to foster deal certainty.



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