

Germany Tightens Rules on Foreign Direct Investment

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Key Points

- On 19 December 2018, the German government adopted the 12th regulation for the amendment of the German Foreign Trade Regulation. The amendment, which came into force on 29 December 2018, expands the ability of the German Ministry for Economic Affairs and Energy to prohibit certain direct or indirect acquisitions of shareholdings in German companies by foreign investors if the acquisition poses a threat to the security of the Federal Republic of Germany.
- The amendment lowers the threshold for screening and prohibiting acquisitions of shareholdings in companies that carry out activities that are defined as being relevant for the security of the Federal Republic of Germany from 25 percent to 10 percent. The new 10 percent threshold applies, in particular, to acquisitions of companies in the defense sector and operators of security-relevant civil infrastructure. Based on statements of the German Ministry for Economic Affairs and Energy during the last months, observers had expected the threshold to be lowered to only 15 percent.
- The amendment also adds certain media enterprises to the list of industry sectors where an acquisition may, in particular, pose a threat to the security of the Federal Republic of Germany. The new 10 percent threshold also applies to acquisitions of shareholdings in such media companies.
- The establishment of a state fund to preempt acquisitions of certain critical companies by foreign investors, which was considered as a complementary tool to the screening and prohibition powers of the German Ministry for Economic Affairs and Energy in the run-up to the amendment, has not been progressed in connection with the amendment.

Background

In a cabinet meeting held on 19 December 2018, the German government adopted the 12th regulation for the amendment of the German Foreign Trade Regulation (*Außenwirtschaftsverordnung,AWV*) ("Amendment")¹ The Amendment provides,

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amongst other things, for a further tightening of the rules on foreign direct investment in Germany by lowering the threshold for screening and prohibiting acquisitions of shareholdings in certain companies from 25 percent to 10 percent.

Growing skepticism regarding Chinese investments in Germany

The move comes only 18 months after the last expansion of Germany's foreign investment rules² amid growing skepticism among German policy-makers about the acquisition of high-tech companies and critical infrastructure by (primarily government-related) Chinese investors, which recently manifested itself in the first formal decision of the German government to prohibit an acquisition following the introduction of the foreign investment rules in 2004: On 1 August 2018, the German government authorized the German Ministry for Economic Affairs and Energy (*Bundesministerium für Wirtschaft und Energie*, "BMWi") to prohibit the acquisition of Leifeld Metal Spinning AG, a German technology company, by Chinese Yantai Taihai Corporation.

As regards the lowering of the threshold, which has already attracted criticism from industry associations and research institutes that point out that a stricter screening regime discourages foreign investment in Germany, the German government argues that the ability to exert control is not necessarily tied to the holding of a 25 percent blocking stake and that according to the 2008 benchmark definition of the OECD, a shareholding of at least 10 percent typically indicates the aspiration of an investor to exert control³. The German government further points out that individual cases have shown a need to screen acquisitions of shareholdings of less than 25 percent. This likely refers to the attempt of State Grid Corporation of China to acquire a 20 percent shareholding in the German transmission grid operator 50 Hertz GmbH in July 2018, which the German government was able to prevent only by orchestrating an acquisition of the shareholding by the German state bank *Kreditanstalt für Wiederaufbau*.

In light of the 50 Hertz situation, and with the unavailing efforts of the German government to find a "white knight" for the acquisition of German robot system producer KUKA AG in 2016 in order to prevent the controversial takeover by Chinese Midea group in mind, the German government had, over the last months, also considered the establishment of a state fund to, amongst other things, acquire, in exceptional circumstances, critical German companies in order to preempt acquisitions by unwanted foreign investors. Details of these plans, such as its funding and its operating principles, in particular, whether the fund would have a preemption right, have not become public, and there is no reference to them in the legislative materials in respect of the Amendment. Whether these plans are finally off the agenda is not clear though. A revival seems conceivable should the screening and prohibition powers turn out to be insufficient to prevent the acquisition of critical infrastructure or if situations arise where the prohibition of an acquisition turns out to have severe consequences on the target company's sustainability.

European context

The Amendment comes shortly after the European Parliament, the Council of the European Union and the European Commission reached a political agreement on a European framework for the screening of foreign investment⁴. The agreement, which has yet to be transposed into a European regulation, in particular, foresees a cooperation mechanism that requires EU member states to inform the European

Commission and other EU member states about any transactions that are being screened by it, and it proposes that the European Commission shall issue nonbinding opinions as to whether acquisitions that relate to several EU member states pose a threat to the public order or security of one or more EU member states.

Pursuant to the agreement, the decision whether a transaction in their territories should be allowed or not is however left to the individual EU member states, and the member states are not required to implement mechanisms for the screening of foreign investment. Moreover, EU member states can maintain existing screening regimes⁵ or introduce new ones. The implementation of the agreement should therefore not require an amendment of the substance of the AWV's foreign investment rules. It will, however, likely trigger an adjustment of the relevant procedural rules particularly in order to account for the cooperation mechanism, which may result in the review procedure becoming even lengthier, and may lead to the introduction of new screening regimes in EU member states that do not have such regimes in place yet.

Overview of the German Foreign Investment Screening Regime

The German foreign investment screening regime is set out in Sections 55-62AWV⁶. Under these rules, the BMWi is empowered to screen and prohibit certain direct or indirect acquisitions of German companies by foreign persons.

The AWV distinguishes between the cross-sectoral screening of corporate acquisitions pursuant to Sections 56-59 AWV ("Cross-Sectoral Screening") and the sector-specific screening of corporate acquisitions pursuant to Sections 60-62 AWV ("Sector-Specific Screening"). While the Cross-Sectoral Screening applies only where the acquirer is not based within the EU or the European Free Trade Association, the Sector-Specific Screening applies to acquisitions by any non-German acquirer.

Sector-Specific Screening

Relevant acquisitions

Under the rules on the Sector-Specific Screening, the BMWi has the right to screen whether the acquisition of a German company or a direct or indirect relevant shareholding in a German company by a non-German acquirer poses a threat to essential security interests if the German company manufactures or develops any of the following goods:

- Weapons of war, which are specified in Part B of the weapons of war list, such as missiles, combat aircrafts, combat vehicles, guns, ammunition and certain other military goods
- specially designed engines and gear units for combat tanks or other armored and tracked military vehicles
- products with IT security functions for the processing of governmental classified information (i.e., certain types of crypto-technology) if the product has, with the company's knowledge, been approved by the German Federal Office for Information Security (*Bundesamt für Sicherheit in der Informationstechnik*).

The BMWi assesses whether the acquisition poses a threat to “essential security interests” of the Federal Republic of Germany. While the term “essential security interests” is rooted in EU law, it leaves room for interpretation by EU member states. According to the German legislator, “essential security interests of the Federal Republic of Germany” are particularly concerned where (i) the access to core competencies of the German military industry is at risk, and/or (ii) the reliability of crypto-technology used by public authorities in critical areas (in particular, in military and other sensitive communication) is endangered.

Prior to the Amendment coming into force, the ability of the BMWi to screen an acquisition was limited to acquisitions that resulted in the acquirer, alone or together with certain related persons, holding 25 percent or more of the voting rights in the German company. The Amendment will reduce the threshold to 10 percent, but it leaves the rules on the Sector-Specific Screening otherwise unchanged.

Two-phase screening procedure

The Sector-Specific Screening is organized as a two-phase procedure:

- Phase 1 is initiated by the obligatory notification of the acquisition to the BMWi. The notification, which should be made prior to entering into the acquisition agreement, triggers a three-month period during which the BMWi assesses whether there are any indications that the acquisition poses a threat to essential security interests of the Federal Republic of Germany. If the BMWi, after consultation with the German State Department and the Federal Ministry of Defense (and, in certain cases, the Federal Ministry of the Interior), does not find any such indications, it will clear the acquisition. Moreover, the acquisition is deemed cleared if the BMWi does not initiate a Phase 2 screening within the three-month period.
- If the Phase 1 assessment indicates that the acquisition poses a threat to essential security interests of the Federal Republic of Germany, the BMWi will initiate Phase 2 by notifying the acquirer within the three-month period. The notification obliges the acquirer to provide the BMWi with the documentation necessary for the screening of the acquisition, the scope of which is further specified in a decree of the BMWi. The BMWi can prohibit the acquisition or impose conditions within a three-month period from the receipt of the complete documentation in order to protect essential security interests of the Federal Republic of Germany. A prohibition of the transaction is possible only where essential security interests cannot be sufficiently protected by imposing conditions, such as the obligation to carve out critical business units or a restriction of voting rights. Conditions are usually imposed by way of concluding a public-law contract with the acquirer.

Cross-Sectoral Screening

Relevant acquisitions

In contrast to the rules on Sector-Specific Screening, the rules regarding the Cross-Sectoral Screening are not limited to specific industry sectors. Under the rules on Cross-Sectoral Screening, the BMWi has the right to screen any transaction as to whether it poses a threat to the public order or security of the Federal Republic of Germany.

However, the AWW contains, a non exhaustive list of industry sectors where the public order or the security of the Federal Republic of Germany can, in particular, be jeopardized. The list includes the following sectors:

- the operation of critical infrastructure (as defined in the statute governing the German Federal Office for Information Security)
- the development of specific software for such critical infrastructure
- the manufacturing of certain technical devices for the surveillance of telecommunication
- the provision of cloud-computing services where the infrastructure used for the provision of such services surpasses certain critical thresholds
- the holding of a license for certain components or services regarding telematics infrastructure
- media enterprises that contribute to the shaping of public opinion by way of broadcasting, telemedia or print media, and that have a particular topicality and a broad reach.

Media enterprises have been newly added to the list as a result of the Amendment. According to the reasoning of the legislator, media enterprises are increasingly facing pressure on their independence as a result of foreign interference, which can also be based on the acquisition of shareholdings in media enterprises by foreign investors, and highlights the dangers resulting from disinformation campaigns. It remains unclear, though, whether there have been any practical examples of critical acquisitions in the media sector by foreign investors recently that have shown an urgent need to add media companies.

As noted above, the aforementioned list of industry sectors is not exhaustive. Acquisitions in non listed sectors can therefore also be screened and, if the acquisition poses a threat to the public order or the security of the Federal Republic of Germany, be prohibited by the BMWi pursuant to the rules on Cross-Sectoral Screening. The acquisition in a non listed sector can, in particular, pose a threat to the security of the Federal Republic of Germany if it relates to operators of civil infrastructure that is critical to guarantee a sufficient supply of the German population in case of a crisis, such as telecommunication (including internet and data transfer services), and the supply of electricity, energy and water, as well as other services and functions of strategic importance.

It is important to note that the lowered threshold of 10 percent of the voting rights will apply only to acquisitions in sectors that are included in the abovementioned list. As regards acquisitions in sectors that are not listed, the threshold remains at 25 percent of the voting rights. Insofar, the Amendment falls short of the proposals that were initially considered by the BMWi.

Screening procedure

Like the Sector-Specific Screening procedure, the Cross-Sectoral Screening procedure is, in principle, structured as a two-phase procedure. There are, however, certain differences:

- Phase 1 is initiated by the acquirer notifying the BMWi of the conclusion of a written agreement that provides for the acquisition of a relevant participation. The

notification triggers a period of three months during which the BMWi can initiate a Phase 2 screening by giving notice to the acquirer. If there are no concerns that the acquisition poses a threat to the public order or the security of the Federal Republic of Germany, the BMWi must clear the acquisition. Moreover, the acquisition is deemed cleared if the BMWi does not initiate a Phase 2 screening within the three-month period.

- The acquirer can shorten the three-months period by applying for a clearance certificate. A clearance certificate has to be granted if the acquisition does not raise any concerns regarding the public order or security of the Federal Republic of Germany. A clearance certificate is deemed to be granted if the BMWi does not open a Phase 2 screening within two months after the clearance certificate has been applied for.
- If there are indications that the acquisition poses a threat to the public order or the security of the Federal Republic of Germany, the BMWi can open a Phase 2 screening by notifying the acquirer and the target company thereof in writing within three months after gaining knowledge of the proposed acquisition. The opening of a Phase 2 screening obliges the acquirer to provide the BMWi with the documentation for the screening of the acquisition. Within a period of four months from the receipt of the complete documentation, the BMWi can prohibit the acquisition or impose conditions in order to protect public order or security of the Federal Republic of Germany. Other than under Sector-Specific Screening, both the imposing of conditions and prohibiting acquisitions requires the consent of the German government. Again, a prohibition of the transaction is possible only where German security interests cannot be sufficiently protected by imposing conditions.

¹ *Zwölfte Verordnung zur Änderung der Außenwirtschaftsverordnung* of 19 December 2018, BAnz AT of 28 December 2018.

² *Neunte Verordnung zur Änderung der Außenwirtschaftsverordnung* of 12 July 2017, BAnz AT of 17 July 2017.

³ Reasoning of the German government regarding the 12th regulation for the amendment of the German Foreign Trade Regulation dated 19 December 2018, p. 9.

⁴ European Commission press release of 20 November 2018.

⁵ Screening regimes currently exist in 14 EU member states.

⁶ The rules on the screening of foreign investment are being enacted by the German government pursuant to the authorizations granted to it pursuant to §§ 4 (1), 5 and 12 of the German Foreign Trade Act (*Außenwirtschaftsgesetz*).