

# Changes to the German Foreign Direct Investment Control Regime Take Shape Amid the COVID-19 Crisis

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Even before the COVID-19 pandemic, the German Federal Ministry of Economics and Energy (*Bundesministerium für Wirtschaft und Energie – BMWi*), led by federal minister Peter Altmaier, announced a major revision of Germany’s foreign direct investment control regime (**FDI Regime**) to come into force in 2020, in what would become the third amendment of the FDI Regime since 2017. This announcement was made as part of the introduction of the BMWi’s “National Industry Strategy 2030”. The aim of this new industrial policy is to “protect and regain Germany’s commercial and technical expertise, competitiveness and industrial leadership at national, European and global level”.

The amendment of the FDI Regime is primarily envisaged to align it with the new EU Investment Screening Regulation (**Regulation**), which came into force on April 11, 2019 and will take full effect as of October 11, 2020. The Regulation implements an EU-wide mechanism, institutionalizing the exchange of information and the cooperation between Member States and the European Commission with respect to foreign direct investment reviews. Although the Regulation does not provide for a separate European screening regime, it allows Member States as well as the European Commission to participate in national foreign direct investment investigations, *inter alia*, by requesting information and issuing opinions.

The FDI Regime consists of two sets of statutory rules. The Foreign Trade and Payments Act (*Außenwirtschaftsgesetz – AWG*) which provides the framework for the FDI Regime, and the Foreign Trade Ordinance (*Außenwirtschaftsverordnung – AWW*) which translates the AWG’s general rules into more detailed provisions for the FDI Regime’s review procedure conducted by the BMWi.

The revision of the FDI Regime has been initiated in late March when the German government introduced a draft bill for an amended AWG (**Draft AWG Amendment**). The legislative process is currently pending and is expected to complete in the coming weeks. Initially, it was the government’s intention to amend the AWW only after a revised AWG had taken effect. In the meantime, however, the COVID-19 pandemic took its course, causing several Member States to bolster their respective foreign direct investment rules to specifically address the implications of the pandemic, and inducing the EU Commission to issue policy guidelines

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

FRANKFURT

**Michael J. Ulmer**  
+49 69 97103 180  
[mulmer@cgh.com](mailto:mulmer@cgh.com)

**Mirko von Bieberstein**  
+49 69 97103 204  
[mvonbieberstein@cgh.com](mailto:mvonbieberstein@cgh.com)



to the Member States urging them to make full use of the tools available to protect the EU's and each Member State's security and economic sovereignty.

Against this background, the German government accelerated the process of the AWW amendment and brought forward a partial revision of the AWW (**Revised AWW**) that is specifically aimed at the medicinal industry. The Revised AWW took effect on June 3, 2020. Further changes of the AWW aiming at implementing the Regulation, especially introducing additional sensitive sectors, will follow later in the year and are already being prepared by the BMWi.

## Key elements of the AWW amendment

### 1. Changes under the Revised AWW

#### (i) Introduction of new sensitive sectors in cross-sector review

The Revised AWW defines five new sensitive sectors. As a result, the acquisition by a non-EU/non-EFTA investor of at least 10% of the voting rights in a German entity that carries out any of the respective activities must be notified to the BMWi.

As a direct reaction to the COVID-19 pandemic, the following activities in the medicinal industry will be addressed:

- Development or manufacture of personal protective equipment, such as FFP2 and FFP3 masks, protective gloves and protective suits (as defined in more detail in EU Regulation (EU) 2016/425).
- Development, manufacture or distribution of pharmaceuticals, their raw materials or active components that are essential for ensuring healthcare provision (as defined in more detail in the German Pharmaceutical Act (*Arzneimittelgesetz*)), also holding a license for such activities.
- Development or manufacture of medicinal products for the diagnosis, prevention, monitoring, prognosis or treatment of life-threatening and highly infectious diseases.
- Development or manufacture of medical devices for in-vitro diagnostics used to detect or monitor therapeutic measures in life-threatening or infectious diseases.

In addition to these, and unrelated to the COVID-19 pandemic, the Revised AWW adds the provision of services for the operation of governmental communication infrastructure (including maintenance, repair, installation and facility management) as a sensitive sector.

#### (ii) Additional assessment criteria with investor focus

Already following the Regulation, the Revised AWW includes an non-exhaustive list of factors pertaining to the investor that can be taken into account in the BMWi's assessment of any acquisition:

- Control over the investor, i.e., whether the investor is directly or indirectly controlled by a foreign government, other foreign governmental institutions or by a foreign country's armed forces, provided that control can be exercised, *inter alia*, by way of shareholding or financing (other than minor financing measures) by such group.
- Past conduct of the investor, i.e., whether the investor has in the past been involved in activities that had a detrimental effect on Germany's public order or security or that of another EU Member State.
- Criminal conduct, i.e., whether, based on concrete and objective circumstances, there is a significant risk that the investor or its representatives are or have been involved in activities that would constitute certain administrative offences, including violations of the AWG, the German War Weapons Control Act, or certain criminal offences, including fraud, money laundering, bribery or financing of terrorism.

Already before the Revised AWW, the BMWi took the background of the investor into account in its review. The specific criteria introduced now, however, remain rather vague. In particular, it is unclear whether the concept of control is that of a corporate/capital markets perspective of control (i.e., voting rights majority or other legal or factual controlling influence), or the rather abstract perspective of the AWW itself (i.e., applying the direct or indirect 10% or 25% voting rights threshold). It is also unclear what minor financing

measures are, compared to measures that might be deemed to convey control. For example, state aid measures such as subsidies or loans granted by government-owned banks to mitigate the impact of the COVID-19 pandemic could be regarded as control-like financing measures, although such measures are not necessarily aimed at the government having a say in the borrower's affairs. In a post-COVID-19 environment, the rather imprecise concept of control will therefore likely result in an increased number of private investors being deemed state "controlled". This will draw greater attention and scrutiny in relation to such investors than before.

*(iii) Asset deals can be deemed reviewable transactions*

The Revised AWV expressly stipulates the BMWi's already existing practice of applying the FDI review to an acquisition construed as an asset deal if such acquisition comprises (a) a separable business unit of a German undertaking, or (b) all material assets of a German undertaking or of a separable business unit of a German undertaking required to continue the undertaking's or business unit's operations.

While this is a clarification of the BMWi's approach to prevent circumvention of the FDI review by substituting a share deal with an asset deal, the Revised AWV does not provide any further criteria for asset deals. In particular, it remains unclear what materiality threshold the BMWi is applying. However, in practice the majority of asset deals that constitute a transfer of undertakings under German TUPE rules (i.e., involving an automatic transfer of employees) should be captured by that provision.

*(iv) Obligation to notify transactions without undue delay*

Mandatorily notifiable transactions will in the future have to be notified "without undue delay" after signing of the respective purchase agreement. Prior to the Revised AWV, the FDI Regime did not stipulate a timing for mandatory notification; instead, it was up to the parties when to "start" the review process by making the notification.

Given that the notifications need only comprise very limited information regarding the acquisition (description of the acquisition itself, the acquirer, the target and basic information on the acquirer's and the

target's business) and not the detailed information the BMWi usually requests in the course of its review procedures, a notification should be made within a few days after signing.

This rather minor change will have a more substantial impact on how applications for FDI clearance in mandatorily notifiable transactions are handled in the future by the applicant and by the BMWi. In the past, the notification was usually included in the application for clearance itself. Such application was usually prepared after signing and furnished with detailed information in order to anticipate the BMWi's information requests and thereby save time during the BMWi's actual review. Depending on the individual case, the preparation and submission of such application and thus the notification could take several weeks.

The new timing requirement will no longer allow for this. In most cases, in order to notify without undue delay, in a first step there will have to be a "simple" notification, and only in a second step will the full-fledged application be submitted, once all required information has been gathered. Although the parties could start preparing the application and gather information prior to signing, they will mostly not be willing to devote resources to this at a time when signing is not imminent and negotiations and other work streams are more pressing.

This two-step approach induced by the new timing requirement may potentially result in more phase II reviews. The BMWi's phase I review period will start upon receipt of the initial notification. The actual application for clearance will only be submitted when a substantial part of such phase I has lapsed already. In order to fully assess the application (and the information submitted with it), the BMWi will in many cases feel compelled to open a phase II in order to prevent a notional clearance due to the phase I review period having lapsed. Significantly longer review procedures will be the result.

## **2. Potential future changes**

Further changes to the AWV to follow later in the year, implementing additional requirements under the Regulation, will potentially also include the following:

*(i) Additional sensitive sectors in cross-sector review*

Additional sensitive sectors comprising artificial intelligence, robotics, semi-conductors, biotech, quantum and satellite technologies have already been announced as enhancements to cross-sector review, thereby making a non-EU/non-EFTA investor's acquisition of at least 10% of the voting rights of a German entity operating in any such sector mandatorily notifiable. The addition of these sectors and their equivalent treatment with the sensitive sectors already subject to mandatory notification under the AWV also show that the German government adopts a broader understanding of public order and security. Other than the sensitive sectors already defined under the AWV, not all of these new sectors do necessarily have a distinctive relevance for society's fundamental interests such as security, supply with essential goods and functioning of essential infrastructures.

*(ii) Change of review periods*

It is not fully clear whether the current review periods will be altered. However, the BMWi has already indicated it would add clarifications with regard to the start and end of review periods, and consider implementing an option to prolong review periods in individual cases to accommodate the involvement of all stakeholders involved. As the Regulation provides for the involvement of other Member States and the European Commission in a national foreign direct investment review procedure, it could be expected that review periods will be extended. It should in any case be expected that review procedures will factually be prolonged to accommodate the EU-wide cooperation mechanism under the Regulation.

*(iii) Review of acquisitions above the voting rights thresholds*

The BMWi has indicated that it is considering implementing a right to review acquisitions above the respective thresholds of 10% or 25% of voting rights (e.g., a subsequent acquisition leading to the increase from 30% to 60% of voting rights in a German entity). According to its current FAQ paper, the BMWi already understands to have the right to review such subsequent acquisitions. However, this

point has been heavily debated amongst practitioners because of the AWV's unclear wording in this regard. It also remains to be seen whether such subsequent acquisitions will trigger mandatory notification requirements, or whether the BMWi only reserves the right of *ex officio* investigations in such cases. While such right of review would enhance the BMWi's monitoring abilities, it will certainly have a detrimental effect on legal certainty for the parties to an M&A transaction, as well as for transaction structuring.

### **Key elements of the Draft AWG Amendment**

It is unclear to what extent the Draft AWG Amendment will be accepted by the German parliament. However, the following changes of the Draft AWG Amendment are noteworthy:

*(i) Change in the review standard*

Under the current AWG the BMWi needs to assess whether a proposed transaction endangers public order or security for Germany, e.g., whether the transaction negatively affects fundamental interests of society such as security, supply with essential goods and functioning of certain critical infrastructures.

Pursuant to the Draft AWG Amendment, the BMWi in the future is required to determine whether the proposed transaction *probably impairs* public order or security. This change from "endangerment" to "probable impairment" means, that in order to intervene in a transaction, the BMWi needs no longer identify a concrete and severe risk to public order or security. It will be sufficient that the proposed transaction could potentially have a detrimental effect. This change allows the BMWi to take a more forward-looking approach and a broader view in its assessment.

*(ii) Consideration of EU-wide factors*

In its assessment, the BMWi shall in the future also consider the impact of a proposed transaction on the public order or security of other Member States, as well as on projects and programs of interest to the EU, such as EDIDP, Copernicus or ESA projects. As a result, the interests of a wider group of

stakeholders will have to be considered in German FDI processes.

(iii) *Suspensive effect*

The validity of any transaction subject to mandatory notification shall be suspended pending BMWi clearance. Currently, this only applies to transactions under sector-specific review, i.e., foreign direct investments in the defense and cryptography sector. Pursuant to the Draft AWG Amendment, this effect shall also apply to foreign direct investments under cross-sector review, in case sensitive sectors are involved, e.g., IT and telecommunications, energy, water, transport and logistics, finance and insurance, healthcare, media, medicinal industry and governmental communication infrastructure.

(iv) *“Gun jumping” restrictions and sanctions*

In support of the suspensive effect, the Draft AWG Amendment further stipulates certain restrictions to prevent a legal or factual completion of an acquisition while the assessment procedure is taking place.

Until the acquisition has been granted FDI clearance, the following actions shall be prohibited:

- enabling the acquirer to exercise voting rights directly or indirectly, in particular by handing over securities, through voting agreements, or by accepting instructions for the exercise of voting rights, as well as comparable actions;
- distributing profits to the acquirer or economic equivalents;
- disclosing to the acquirer information regarding the target’s business that is subject to FDI review on grounds of essential security interests or public order or security of Germany, or information that has been declared as significant in that regard by the BMWi.

The BMWi shall have the authority to monitor compliance with such restrictions, in particular by requesting information and accessing business premises. A breach of these restrictions or a breach of an enforceable order issued by the BMWi can result in administrative fines of up to EUR 500,000 and, in the event of a willful breach, in imprisonment of up to five years.

According to the German government, this extension of the suspensive effect, the gun-jumping restrictions and the sanctions are necessary to close an enforcement gap. At the same time, in order to avoid a liability risk under the new sanctions regime, the parties to an M&A transaction may in the future feel induced to make an application, where they would not have done so in the past. They will also have to exercise more caution as to which information is being exchanged in the course of due diligence and in preparation of the clearance application. A clean-team approach or an exchange solely between external advisers may potentially mitigate the risk of premature information disclosure in violation of the new restrictions. To prevent the acquirer from exercising voting rights prior to FDI clearance, it will be inevitable to make German FDI clearance a closing condition or to implement temporary hold-separate arrangements in transactions that are mandatorily notifiable under the FDI Regime.

### **Significant impact on inbound M&A transactions**

A comprehensive assessment of the new FDI Regime will only be possible once the revision of the AWG and further changes to the AWV have been completed. However, with a view to the developments described above it is foreseeable that the FDI Regime and the BMWi’s practice of reviewing foreign direct investments will change more substantially than under any change of the FDI Regime made in recent years. The repercussions of the revised FDI Regime on inbound M&A transactions in Germany will in any event be significant:

- In particular with respect to acquisitions in the medicinal industry, foreign investors will be required to notify transactions they would not otherwise have notified. In consequence, the number of foreign direct investments being scrutinized by the BMWi will increase.
- The broader scope of decision-relevant factors and a lowered review standard will allow the BMWi to investigate and intervene in foreign direct investments more easily and more discretionary. This will result in uncertainty for an increased number of proposed transactions.

- Should the suspensive effect, gun-jumping restrictions and potential sanctions proposed by the Draft AWG Amendment become binding law, this will give the BMWi greater leverage to apply the FDI Regime more vigorously.
- German foreign direct investment review processes will become more complex and will potentially comprise an increased scope of information to be submitted by the parties to a transaction. The larger number of transactions to be reviewed by the BMWi, combined with coordination with other Member States and the European Commission, seem to make longer review processes inevitable.

In consequence, the German FDI Regime will become a major factor in German M&A inbound transactions for which such review could come into play. The parties' structuring of the FDI procedure, their risk assessment, information gathering and notification preparations need to be considered in the structuring of the overall transaction process much more deeply than before.

The German government continues to emphasize that Germany maintains an investment-friendly environment. It makes clear, however, that increased monitoring and greater scrutiny is required to protect German and European undertakings from "predatory" buyers taking advantage of decreased valuations resulting from the COVID-19 pandemic's impact on the global economy. Following global developments, the FDI Regime is thereby trending more toward an industrial policy focus with a hint of protectionist tendencies.

While it is unlikely that the revised FDI Regime will result in a considerable increase in foreign investments being prohibited, a more cumbersome and longer review procedure can factually render foreign investments significantly more complex and may even prevent certain transactions from taking place at all. Not surprisingly, the German business community, being concerned that vital foreign investments may fall away, has reacted to the amendments with restraint.

In applying the revised FDI Regime, the BMWi in the future will have to balance – partly divergent – objectives of various stakeholders, including German

and European security interests, industrial policy as well as the market participants' economic and business requirements. It will also have to find means to accommodate concerns that the revised FDI Regime entails greater uncertainty for foreign investors looking at transactions in Germany. Providing more general guidance, but also specific guidance in the course of pre-notification discussions or by publishing decisions and cases (subject to confidentiality restrictions), could be an essential step in this regard. Although this may require further adjustments of the FDI Regime, such transparency would certainly help foreign investors to conduct a meaningful feasibility and risk assessment of their potential acquisition, and to keep Germany attractive for foreign direct investments in the future.

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