Protectionism and investment restrictions in the US and Germany

Corporate analysis: The 2017 Lex Mundi Global Seminar on Cross-Border Transactions was held on 2 November 2017 in London, United Kingdom. The seminar brought together legal practitioners, financial institutions and advisers, commentators and market participants in the cross-border M&A sphere to discuss key trends and developments in cross-border transactions. This article summarises the discussions and conclusions in relation to protectionism and investment restrictions in the US and Germany which were considered in the third session of the conference.

Developments in protectionism and foreign investment in Europe

Recently, there has been an increase in protectionist sentiments globally, typified by the Brexit vote in the UK and the rhetoric of President Donald Trump in relation to the building of a wall along the Mexican border in the US. However, many countries (the US, Canada, Australia, China, India, Japan) have been screening foreign direct investment (FDI) for decades.

In Europe, there have been instances of political interventions in takeovers, eg, PepsiCo's bid for Danone in 2005 which was famously blocked by the French government that passed laws listing yogurt as a strategic sector for France.

Europe is the largest recipient of foreign direct investment in the world (a fraction more than the US). It receives four times the amount of foreign investment in China. The US is the largest investor in Europe, but the centre of economic gravity is moving from the West to the East. Investment from the US has decreased by 20% over the last two decades while investment from BRIC countries, ie, from Brazil, Russia, India and China has increased by 1000%. Much of this investment from BRIC nations is made up of investments from Chinese state-owned enterprises (SOEs).

The political reaction to the shift of investment from West to East varies country by country. The Nordic countries and the UK have been more open to this development but France, Germany and Italy have been more opposed to it and have opted for strengthening their FDI screening regimes.

On 14 September 2017, the European Commission unveiled proposals to set up a European legal framework for screening FDIs into the EU. The two main objectives of the proposed framework are to:

- open foreign markets for EU companies
- protect Europe's strategic sectors (critical strategic technologies, infrastructure, inputs and sensitive information)

The proposal is both highly political and highly controversial. It only applies to FDI from third countries and EU Member States are free to adopt their own screening systems, amend or terminate them.

The proposed framework sets out the conditions when screening FDIs on grounds of security or public order only. The conditions, which may limit the Member States' powers to screen FDIs, include:

- the requirement for transparency
- non-discrimination between/equal treatment of companies
- that there is a judicial review process in relation to decisions made

The proposed legal framework introduces:

- the possibility for the European Commission to screen on grounds of public order and national security for cases in which FDI may affect projects or programmes of EU interest (this includes projects and programmes in the areas of research, space, transport), energy and telecommunications)
- a co-operation mechanism between Member States and the Commission which can be activated when a specific foreign investment in one or several Member States may affect the security or public order of another

Committee on Foreign Investment in the US (CFIUS)

Origins and history

The FDI regime in the US — the Committee on Foreign Investment in the US (CFIUS) — was introduced in 1975 to address Middle East 'petrodollar' investment concerns. It was initially created to monitor such transactions, rather than intervene or block them.

The committee is comprised of personnel from various US government agencies. The committee reviews transactions that could result in control of a US business by a foreign person (covered transactions) to determine the effect of such transactions on the national security of the US. The interpretation of what falls within 'national security' is at the discretion of the committee. Filing notifications of proposed or current 'covered transactions' with CFIUS is not mandatory.

From 1983 until the Trump presidency, every President in the US issued an 'open investment policy' statement. In 1988, following concerns about Japanese investment, the Exon-Florio amendment gave the President the power to black transactions.

1990 saw the first divestment order (China National Aero-Technology) made under the revised regime.

In 2007, CFIUS was further reformed — in response to the Dubai Ports World case — to give Congress increased oversight. At this period in time, mitigation also became more common.

Between 2008 and 2017, there has been a significant increase in Chinese investment and a buy-in to CFIUS process (CFIUS expects to receive nearly 200 filings between 1 January and 31 December 2017). Most deals during this period were cleared but there have been a few high profile exceptions, including:

- divestment order given by President Obama in relation to the acquisition by Ralls Corporation (a US company affiliated to the Chinese manufacturer, Sany) of wind farms in Oregon, citing national security concerns — this divestment order led to Ralls Corporation instituting legal proceedings against CFIUS
- Fujian Grand Chip Investment Fund LP's takeover tender offer for Aixtron SE (which was blocked by President Obama)

There are indications that the CFIUS review process may be changing under the Trump administration.

CFIUS in the Trump administration

So far, CFIUS, under the Trump administration, has blocked one deal: the attempted bid by China's Canyon Bridge for Lattice Semiconductor. There has also been an increase in the number of 'stuck' deals – where a deal is not rejected but is not cleared — featuring Chinese investment, and there are examples of such deals being held up or 'stuck' for six to nine months. This creates investment uncertainty. To counter this uncertainty, companies can provide conditions and when no agreement has been reached, they can withdraw their notification to CFIUS and refile to provide additional time for CFIUS to review and try to reach an agreement on how to mitigate national security concerns.

To some extent, there have been some delays in the process of clearing or blocking deals because of delays in political appointments to the committee under the current administration.

In terms of policy considerations:

- there has been a broadening of the scope of national security (eg, US citizen non-sensitive personal data)
- economic security and trade reciprocity has been elevated, and
- there has been a move to rescind or modify the 'open investment' policy based on target countries or industries of concern

Potential CFIUS reforms on the horizon include:

- Executive Branch action: formal (amend authorities) v. informal (ad-hoc):
    - Formal action: The Treasury Department could amend the CFIUS regulations to, eg, broaden the scope of the types of transactions subject to CFIUS jurisdiction by eliminating loopholes (eg, passive foreign investment under 10%). The President could issue a new Executive Order (which has the force of law) to, eg, add additional factors to trigger national security concerns, such as economic security considerations
    - Informal action: The Committee could scrutinise deals by taking the foregoing factors into consideration without publishing formal guidance, but rather on an ad hoc, deal-by-deal basis
- CFIUS reform legislation:
    - broadening the definition of 'covered transactions' subject to CFIUS review
    - close loopholes/safe harbours (JVs, follow-on transactions)

- require filings for certain types of transactions (critical infrastructure, sensitive technologies)

Process and timeline

There are various stages to filing notifications to CFIUS:

- the pre-filing stage (which lasts for one month) in which the foreign investor will gather relevant information and submit it to CFIUS for review/provide comments on the draft notification
- Phase 1 stage (the 30-day review period) in which CFIUS will accept a notification, review the transaction, engage in Q&A with the foreign investor, undertake a national security threat assessment and make a decision to either clear the transaction or enter into an investigation
- Phase 2 (the 45-day investigation period) in which CFIUS will undertake further review, engage in further Q&A, produce a CFIUS briefing and make a decision to clear, pursue mitigation or recommend the President block the deal
- Withdraw and refile the notification, which restarts the clock if more time is needed for negotiation — many deals are stuck in perpetual withdrawal and refile. If concerns are not mitigated, the President has 5 days to block the deal

There is a system of judicial review of CFIUS decisions. In the Ralls Corporation v CFIUS case, an investor backed by China bought land (for wind farm projects) near a US military base and CFIUS recommended blocking the deal (which happened). The investor sought a judicial review of the decision and the court stated that the US government has to explain the reason for blocking the transaction (the explanation can be short).

CFIUS filing considerations

Investors seeking to acquire interests in US businesses should assess whether or not they wish to file a voluntary notification about a transaction with CFIUS. Key considerations in determining whether a transaction would be a 'covered transaction' and therefore fall within the remit of CFIUS are:

- would the transaction result in 'foreign' control over a US business?
- is there a national security nexus?

Investors may find it useful to know how CFIUS will consider and assess risk. Among other things, when considering a notification and conducting an investigation, will consider:

- the threat of the acquirer — what is the intent/capability of the acquirer
- the vulnerability of assets being acquired
- the consequence of the transaction—in particular, the possible adverse effect of successful exploitation of assets by the acquirer

Investors will usually undertake a cost/benefit analysis of whether or not to make a filing with CFIUS.

It is worthwhile remembering that CFIUS can request a filing or conduct its own filing and draw an adverse inference from non-filing by an investor. In addition, the US government has a full time staff member who screens transactions to see if relevant CFIUS filings should have been made by the transaction participants.

A transaction could fall within a safe harbour protecting it from future government interference.

Separately, the President has the power to block or unwind a transaction. When contemplating a filing, the investor may also wish to consider how burdensome any mitigation that CFIUS might require would be.

M&A considerations and recommendations

Foreign investors seeking to acquire interests in US companies or assets in the US should undertake an assessment of CFIUS risk analysis:

- what is the likelihood that CFIUS will assert jurisdiction over this deal?
- can/should the deal be structured to avoid CFIUS review?
- what are the risks of not filing?
- would spinning off or firewalling assets decrease the CFIUS risk?

The parties should negotiate the deal and draft the documents with CFIUS in mind. Where the parties avail themselves of safe harbours, they should ensure that provisions in the documents fall within them. Ensure that the transaction timetable is long enough to be able to cope with CFIUS involvement.

The parties should also consider who will bear the costs of CFIUS (eg, should the seller get a reverse break fee if CFIUS cannot clear the deal and how much mitigation is acceptable to the acquirer).

Of paramount importance is the need to be honest, transparent and responsive during the CFIUS review which is a very invasive process for businesses.

German Foreign Direct Investment (FDI) Restrictions

History and rationale of the German FDI review mechanism

The FDI review mechanism was introduced in Germany in 2004 for the protection of certain defence and IT security targets, following a spate of financial investments by the US in the German defence sector.

In 2009, the FDI rules were extended to all sectors following the debate about geostrategic investments by state-owned funds from China, Russia and the Middle East. Although the rules were adopted across all sectors, they were not rigorously enforced.

During the 2015–2016 period, Chinese FDI in Germany trebled and Germany was engaged in a controversial debate about Chinese investments triggered by Chinese 'Made in China 2025' strategy.

In March 2017, Germany, Italy and France wrote a letter to the EU Trade Commissioner Malmström, stating that the countries would like to focus on reciprocity (but nothing has happened).

In July 2017, there was a tightening of the FDI rules to focus on critical infrastructures and procedural rules. Subsequently, in September 2017, the European Commission set out its proposals for a new regulatory framework on screening FDIs.

FDI review mechanism—scope, process and timeline

The German government can assess whether the public order or security of Germany is endangered where a non-EU or non-EFTA resident acquires 25% or more of voting rights (directly or indirectly) in a German company.

A non-EU/non-EFTA foreign investor can notify the German Ministry for Economic Affairs and Energy (Ministry) of a transaction which will start deadlines for the Ministry to react. The Ministry will have two months from notification to open an investigation into the transaction (Phase 1). Following the investigation, the Ministry will have up to four months to impose restrictions or prohibit a transaction (Phase 2) – the government will need to approve the restriction or prohibition.

Where there has been no notification submitted, the Ministry can commence an investigation at its own behest three months after becoming aware of a transaction, up to five years following completion of a transaction.

In relation to acquisitions in sensitive security areas (ie, defence and IT security) more stringent rules apply to all non-German resident investors. The Ministry will be able to examine and then restrict or prohibit a transaction without requiring government approval.

M&A considerations

Foreign investors should identify and evaluate the target company's activities of relevance for an FDI clearance and should file for clearance in the following circumstances:

- investments in specifically mentioned target companies
- high-profile transactions concerning German companies
- Russian and Chinese investments
- US investments in IT-security sector

The parties should contemplate deal structure with regard to future investment clearance (eg, carve-out for particular sensitive assets) and ensure that information regularly requested by the Ministry, eg, annual accounts, have already been translated into German prior to signing.

Finally, it is important to ensure that enough time has been built into the transaction timetable between signing and completion to obtain clearance, eg, two months as of filing in regular cases, six months or more as of filing in complex cases.