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Tightening the rules: Increasing scrutiny of foreign investments in Germany and beyond

On 1 August, just hours before an anticipated prohibition decision by the German Government under its foreign investment rules, Chinese Yantai Taihai Corporation abandoned its proposed takeover of Leifeld Metal Spinning (see here).

This development is of interest to dealmakers considering investing in Germany. In recent years, the Federal Ministry of Economics and Energy (responsible for foreign investment control in Germany) has been paying increasingly close attention to transactions concerning critical infrastructures, key technologies and “hidden champions”. With the present case, the Ministry has shown that it is not afraid to flex its muscles and put a stop to deals which it perceives would harm the “*ordre public*” of Germany. This is an unprecedented step as, so far, no single transaction has been prohibited in Germany under the foreign investment rules since their coming into force in 2004.

It also forms part of a wider trend. The “arms race” towards tighter foreign investment control is sweeping the globe, with wide-ranging reforms of the CFIUS regime expected imminently in the U.S. and developments underway in France, Switzerland and the UK.

It is clear that greater scrutiny of foreign investments by authorities needs to be factored into deal-making for a broader range of deals. Potential investors should expect an increase in timeframes and complexity.

Background

Leifeld Metal Spinning is a leading manufacturer of metal forming machines used in the automotive, aerospace, and nuclear industries. Yantai Taihai Corporation is a privately-owned Chinese industry group with focus on metal processing, forging and smelting services to the civil nuclear industry.

Earlier this year, Yantai Taihai announced its intention to acquire *Leifeld*. The transaction gave rise to foreign investment review in Germany.

The review in *Leifeld*

The Ministry reviewed the *Leifeld* case under the general (non-sector specific) foreign investment rules. These apply to (direct or indirect) acquisitions of 25% or more of voting rights in any German company by a non-European investor.

Contents

Unless the target is active in a critical infrastructure, such notifications are voluntary. However, if no voluntary filing is made, the Ministry has the power to open an *ex officio* review within five years of signing of the transaction agreement. We understand that the review process in *Leifeld* was initiated by Yantai Taihai's voluntary request for a certificate of non-objection.

In the course of its review, the Ministry identified concerns, including about the transfer of know-how to China and the potential use of Leifeld technology for Chinese nuclear military purposes, and initiated an in-depth review under foreign investment rules. Following the in-depth review, the Ministry upheld its concerns and requested the German Government's consent to prohibit the deal. Even though by that time Yantai had pulled its bid, the Government issued the authorisation to the Ministry to prohibit the deal.

Why is this such an important development?

To date, no transaction has been prohibited in Germany under the foreign investment rules since they came into force in 2004, with *Aixtron* having been the only case where the German Government came close to a prohibition.

In the end, Yantai Taihai anticipated the prohibition and abandoned its takeover offer a few hours before the Government meeting. However, the Government nonetheless invoked its powers and authorised the Ministry to prohibit the deal.

Yantai Taihai's only other option was to wait for the decision and then appeal it. However, prospects of success would have been doubtful and any judgment would have likely come too late to have kept the deal alive.

Leifeld is the latest example of an increasingly strict regulatory environment in Germany

Until 2016, the Ministry took a rather lenient approach towards foreign investment control. Clearance was often a formality, and formal investigations remained the rare exception. For an acquisition to be prohibited, the Government has to demonstrate that there is an "actual and sufficiently serious danger affecting a fundamental interest of society". This is generally considered to be a high substantive threshold. Up until now, no transactions have been prohibited under these rules. The Government's prohibition in *Leifeld* underpins the trend of more intense scrutiny of acquisitions by non-European investors. This relates to Chinese companies in particular but also to investors from other countries.

The build up to *Leifeld*

The investment activities of Chinese companies in Germany became the focus of public attention for the first time in 2016, with the acquisition of the mechanical engineering company Kuka by MIDEA and also MLS' acquisition of OSRAM's spin-off LEDVANCE. Both deals were ultimately cleared but only after intense discussions. In particular the Kuka clearance was criticised due to the company's technological leadership in robotics.

The next significant case was *Aixtron*, where the Ministry revoked a clearance decision on the basis of incomplete/misleading information provided by the acquirer and reopened the review. However, before the German foreign investment review process could be completed a second time, this transaction was prohibited under the U.S. CFIUS regime and the acquirer withdrew from the transaction.

These developments led to tightening of the German foreign investment rules in July 2017. Specifically, the revised rules give the Ministry greater control over acquisitions of companies that possess key technologies and brings operators of a wide range of so-called "critical infrastructures" into focus. These range from energy companies and certain healthcare businesses to the insurance and transportation sector. Under the revised rules, notification of acquisitions of 25% or more of voting rights in a company providing "critical infrastructures" is mandatory. At the same time, the Ministry is given more time to exercise its control function by extending investigation deadlines. This allows it to conduct longer and more thorough examinations into foreign acquisitions (see our previous alert here).

What does all of this mean for foreign non-EU investors in Germany?

Delays: The longer review deadlines as well as the introduction of a notification requirement for the acquisition of critical infrastructures are increasingly causing delays in relation to the closing of transactions. Nevertheless, non-critical investments are still being cleared within the regular two-month review period by the Ministry.

More in-depth reviews: In the first 13 years of the existence of the German foreign investment regime only 36 out of 383 notified transactions were subject to an in-depth review. This number has been exceeded in the past year alone, with more than 40 transactions having gone to in-depth review.

More commitments by foreign companies: We observe that in an increasing number of cases, the Ministry requires commitments from the acquirer to secure a non-objection certificate. Often these commitments are behavioural remedies such as supply obligations or requirements to license technology.

Uncertainty: We note increasing interference with transactions outside of the scope of German foreign investment rules. In July, it was announced that the German state-owned development bank KfW would acquire a 20% stake in the German transmission grid operator 50Hertz. The acquisition was made at the request of the Federal Government to prevent a Chinese buyer from acquiring that share. The Government considered this necessary because the acquisition fell short of the current foreign investment intervention threshold of 25%.

We understand the Federal Government is currently examining to what extent the intervention thresholds for foreign investment control could be lowered. An amendment to the relevant legislation is expected later this year.

Foreign investment trends globally: What businesses need to do

Stricter enforcement of foreign investment rules is by no means limited to Germany or indeed other countries in Europe.

In Europe, a number of countries including France, Switzerland and the UK have recently considered or proposed changes which would significantly increase their national security screening of foreign investments. This is against the backdrop of draft EU-wide rules for vetting inward investment which would see the European Commission taking on a co-ordinating role between its member states. The proposals are progressing rapidly through the EU legislative process and are likely to be adopted by the end of 2018. In the U.S., wide-ranging reforms of the CFIUS regime are expected to be enacted imminently.

An analysis of the risk in foreign investment proceedings has now clearly become a key aspect of many M&A transactions with foreign investors.

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