BREXIT – UK investors face German foreign direct investment control – (un)justifiable lack of equal treatment?

On 1 January 2021, after the Brexit transition period, the United Kingdom of Great Britain and Northern Ireland ("**UK**") left the Single Market and the Customs Union of the European Union ("**EU**"). On Christmas Eve 2020, the European Commission and the UK eventually reached an agreement on the terms of their future cooperation: the EU-UK Trade and Cooperation Agreement ("**Trade Deal**"), that is currently being provisionally applied. In our Newsletter of 30 December 2020, we have taken a closer look at the main implications of the Trade Deal from a customs perspective. In the increasingly important domain of foreign direct investment screening, our focus of the present note, the Trade Deal brings about a sobering reality for investors on both sides of the Channel.

Background – increasing importance of foreign direct investment screening

Over the past few years, the screening of foreign direct investments has become an increasingly important policy tool for EU Member States, most of which have developed their own national screening mechanisms. These national mechanisms are part of a coordinated framework established by the EU-wide cooperation mechanism introduced by the EU Screening Regulation (Regulation (EU) 2019/452 of March 19, 2019). Against that backdrop, investors on both sides of the Channel had been impatient to find out the extent to which the Trade Deal would impose any constraints on the ability of UK investors to invest in the EU-27 and vice versa.

In Germany, the 16th amendment to the German Foreign Trade and Payments Ordinance (Außenwirtschaftsverordnung or "**AWV**") has been in force since 29 October 2020. That amendment was a first step of implementing the EU Screening Regulation. Further amendments are expected for the first quarter of 2021. Germany distinguishes between a sector-specific and a cross-sectoral examination of foreign investments in Germany. Thus, under the so-called sector-specific investment screening according to §§ 60 et seq. AWV, the Federal Ministry of Economic Affairs and Energy ("**BMWi**") may examine whether essential security interest of the Federal Republic of Germany are endangered by investments in Germany made by foreigners. According to the rules of the cross-sectoral examination according to §§ 55 et seq. AWV, the BMWi may further investigate whether the acquisition of a domestic company by a non-EU resident poses a threat to the public order or security of Germany.

While there is no doubt that, as from 1 January 2021, UK-investors in Germany will be viewed as non-EU residents, the Trade Deal still has a major impact on how cross-Channel investments will henceforth have to be treated on both sides.

The Trade Deal and its rules on foreign investments: the principle of equal treatment vs. the security exception

One of the main objectives of the trade agreement is to prevent unequal treatment of citizens and economic operators of both contracting parties in various areas in the EU/UK relationship, including the area of foreign direct investment. Even though the Trade Deal does not contain any explicit requirements for the domain of foreign direct investment screening, it still contains rules on the free movement of capital that impact foreign investment screening.

Article SERVIN.2.3 of the Trade Deal is of central importance for the EU, Germany and many other Member States, as it establishes a principle of equal treatment: investors from the territory of the other party must not be treated less favorably than investors from their own territory. Article SERVIN.2.2 prevents further, less common restrictions on the movement of capital, such as maximum percentage limits on foreign participation. In the EU, such outright restrictions on foreign direct investments have gradually been eliminated in most Member States but still exist in critical sectors such as, notably, the aviation industry.

However, the Trade Deal also contains a security exception similar to that contained in Article XXI of the General Agreement on Trade in Goods ("**GATT**") that forms part of the treaty framework of the World Trade Organization ("**WTO**"). Thus, Article EXC.4, entitled "security exceptions", preserves, inter alia, each party's right to take "an action which it considers necessary for the protection of its essential security interests" connected to, *inter alia*, the production of or traffic in arms, ammunition and implements of war, or those relating to fissionable and fusionable materials or the materials from which they are derived.

The provisions of the Trade Deal are not only binding on the EU, but also on its institutions and Member States (cf. Art. 216 (2) TFEU). The Trade Deal also binds the authorities of the Member States and the affected private persons as directly applicable law. This applies in any case to Articles SERVIN.2.2 and SERVIN.2.3 of the Trade Deal, as they are sufficiently clear and unconditional. This has consequences both for the applicability of the EU Screening Regulation and for the national regulations on investment control.

The rules on equal treatment enshrined in the Trade Deal support the view that the substantive provisions of the EU Screening Regulation should, as a matter of principle, not apply to UK investors. The EU Screening Regulation differentiates between EU-based and non-EU-based investors and therefore contains unequal treatment, which the Trade Deal is intended to prevent in the EU-UK relationship.

Consequently, Germany should put UK investors on an equal footing with investors from EU Member States and should not subject them to cross-sectoral examination within the meaning of §§ 55 et seq. AWV unless it can be demonstrated, on a case-by-case basis, that the unequal treatment of UK investors by subjecting them to foreign investment screening is justified under the above-mentioned security exception of Article EXC.4 of the Trade Deal. Yet, as further discussed further below, the BMWi so far appears inclined to rely on the security exception to

justify the cross-sectoral examination of UK investors as a general matter and not just on an exceptional basis.

By contrast, applying the sector-specific examination competencies according to §§ 60 et seq. AWV to UK investors, and that without any restrictions, is consistent. In this context, there is no violation of the aforementioned principle of equal treatment, because investors from other EU countries and the United Kingdom are treated equally.

UK-investors in Germany have to expect to be subject to comprehensive investment screening as from 1 January 2021

After a brief period of coordination, internally and, apparently, also with the European Commission, the BMWi has meanwhile clearly communicated that, as from 1 January 2021, it considers UK investors to be fully subject to §§ 55 et seq. AWV. The BMWi refers explicitly to, *inter alia*, the security exception of the Trade Deal and states that investment screening is a measure to ensure public order or security in Germany and other EU Member States, as well as certain EU programs.

For M&A transactions where the signing took place in 2020 and closing is imminent when the legal change occurs, the BMWi has clarified that only those acquisitions will be subjected to investment screening for which the signing took place after 1 January 2021.

Recommendation: UK-investors should take investment control into account

UK-investors in Germany are well-advised to voluntarily apply for certificates of non-objection in cases where a risk remains that BMWi will review the transaction on its own motion and to notify any transactions potentially falling under a notification requirement. Doing so will ensure they will not jeopardize the lawfulness of their investment. It is to be expected that the UK will position itself in the same manner as regards future investments in the UK by investors from one of the 27 EU Member States, meaning that those, too, should expect to be subject to foreign investment screening in the UK. In that respect, we note that the UK just recently introduced proposals for a very far-reaching and restrictive foreign investment screening regime, the draft National Security and Investment Bill, which is currently under parliamentary consideration.

Concerns about the BMWi´s announced approach

The BMWi's announced approach of fully subjecting UK investors to cross-sectoral investment screening according to §§ 55 et seq. AWV seems at least questionable, as it may disregard the fundamental requirement of equal treatment enshrined in the Trade Deal. The BMWi seems to have recourse to an exception provision, without verifying, on a case-by-case whether the conditions for relying on the exception are actually met.

We note that in relation to the requirement not to discriminate between investors from the UK and the EU, the BMWi's explanation does not contest that requirement but immediately points at the security exception, seemingly taking the view that that exception is broad and vague enough

to allow the German authorities to disregard the fundamental treaty requirements on non-discrimination in the first place. That approach seems questionable because it disregards that the security exception enshrined in Article EXC.4 of the Trade Deal has a set of specific conditions attached to it and is not self-judging in nature, meaning that it is not enough for a party to simply invoke the provision to meet its conditions. Thus, most notably, the exception may only be invoked to justify actions considered "necessary for the protection of essential security interests" in a limited set of configurations, namely:

(i) actions connected to the production of or traffic in arms, ammunition and implements of war and to such production, traffic and transactions in other goods and materials, services and technology, and to economic activities, carried out directly or indirectly for the purpose of supplying a military establishment;

(ii) actions relating to fissionable and fusionable materials or the materials from which they are derived; or

(iii) actions taken in time of war or other emergency in international relations.

It seems safe to expect that the investment projects in Germany by many UK investors will not even remotely be covered by any of the above scenarios. Subjecting those projects to cross-sectoral investment screening, in disregard of the fundamental requirements of equal treatment, can therefore not be justified by recourse to the security exception. It remains to be seen whether, in practice, the approach taken by the BMWi will turn out to be more nuanced than what has been announced on its website.

Limited practical relevance of the changed regime considering that investors from the Channel Islands were already subject to investment screening before

The described regime change is in any event to be considered of only limited practical relevance. This is due to the fact that the practically highly relevant question as to whether (private equity) investors based on the Channel Islands are exempted from the EU and Member State rules on investment control must definitely be answered in the negative. Subjecting investors from the Channel Islands to investment screening is at any rate not unlawful discrimination. The Trade Deal expressly states that its ruleset essentially only applies to the areas of fisheries and certain areas of the trade in goods. In Germany, the BMWi treated investors from the Channel Islands as non-EU residents already before Brexit. This is unlikely to change anytime soon.

In practice, this means that many investments by UK investors were already previously subject to investment control regulations. For tax reasons, many investments are structured in such a way that a company based in the Channel Islands or in another third country is integrated between the UK company and the target company in the EU. Even before Brexit, the BMWi treated investments structured in such way as third-country investments.