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Foreign Subsidies Regulation– New challenges for M&A transactions

Until now, states outside the European Union (EU) have been able to support companies based in the EU without facing competition law scrutiny. The European Commission lacked the necessary Union tools to address distortions of competition caused by foreign subsidies. As investment from non-EU countries increased, concerns had long been raised about the impact of subsidies from these non-EU countries on fair competition within the EU internal market. These concerns have been reinforced by an increase in state-subsidised activities companies by Chinese investors.

The Regulation on foreign subsidies distorting the internal market (the "Foreign Subsidies Regulation" (EU) 2022/2560 of the European Parliament and of the Council of 14 December 2022), which entered into force on 12 January 2023, intends to fill existing gaps and establish adequate control to ensure a level playing field in all economic sectors in the European internal market. The Regulation will be directly applicable in Member States as of 12 July 2023. It introduces new notification requirements for mergers, acquisitions and joint ventures above certain turnover and subsidy thresholds effective 12 October 2023. These notification requirements will accompany mergers and acquisitions (M&A) transactions that aim to acquire sole or joint control or to create a joint venture.

Our blog post highlights the key aspects of the content of the Foreign Subsidies Regulation (Section I). It also outlines the significant impact the Regulation may have on ongoing or planned M&A transactions and emphasises the importance for companies to familiarise themselves with the Foreign Subsidies Regulation, even in the absence of concrete M&A plans (Section II).

I. KEY POINTS OF THE REGULATION

Until now, state aid control at EU level has been limited to aid granted by EU Member States, while the scope of merger control did not extend to competition-distorting foreign subsidies. This year, with the Foreign Subsidies Regulation, the European Commission will have an additional control instrument at its disposal, in addition to state aid and merger control, which will enable it to counter distortions of competition caused by foreign subsidies in all sectors of the economy.

1. Definition of Foreign Subsidies

Applicability of the Regulation requires the existence of a subsidy from a non-EU country. The definition is broad and covers any financial contribution provided directly or indirectly by a non-EU country, which is limited to one or more companies or industries, and which confers a benefit on a company engaging in an economic activity in the EU (see Article 3 of the Regulation).

Overall, the definition is in line with existing State aid law and thus with Article 107 Treaty on the Functioning of the European Union, which is not surprising given the similar objectives. Article 3(2) of the Regulation lists specific areas identified by the European legislator where distortions of the internal market are most likely to occur: tax advantages, capital injections, unlimited guarantees, namely guarantees without any limitation as to the amount or the duration of such guarantee, and interest-free loans.

2. Distortions of the internal market

Article 4(1) of the Regulation sets out the circumstances in which there is a distortion of the internal market. This is the case when a subsidy from a non-EU country is capable of improving the competitive position of an enterprise within the internal market and actually or potentially affects competition in the internal market. According to Article 4(2) of the Regulation, distortion of the internal market is unlikely if the total amount of the subsidy from the non-EU country does not exceed EUR 4 million over a period of three consecutive financial years.

Article 5 of the Regulation provides an illustrative list of certain categories of foreign subsidies where distortion of the internal market is most likely to occur. An example of such a category is a subsidy granted by a non-EU country to a company in economic difficulties which, without such a subsidy, would withdraw from the EU internal market.

3. The Commission's main control mechanisms

In terms of content, the Regulation provides for three different instruments to assess the compatibility of foreign subsidies with the EU internal market. Further to (i) general abuse control, there is (ii) a notification-based control instrument. In addition, the Commission has (iii) investigative powers which allow it to carry out investigations and to request information from the companies concerned.

The notification requirement applies to:

- Mergers where the EU turnover of at least one of the merging companies, the acquired company or the joint venture exceeds EUR 500 million and the involved aggregate foreign financial contribution granted in the three years prior to the conclusion of the agreement, the announcement of the public bid or the acquisition of a controlling interest totals EUR 50 million (Article 20(3) of the Regulation);

- Bids in EU procurement procedures where the estimated value of the contract exceeds EUR 250 million and the foreign financial contribution granted in the three years prior to notification or, if applicable, the updated notification, is equal to or greater than EUR 4 million per non-EU country (Article 28(1) of the Regulation).

Failure to notify (intentionally or negligently) may result in a fine of up to 10% of the company's annual worldwide turnover. Notifiable transactions are also subject to a standstill obligation, similar to competition law. This means that a notifiable transaction cannot be completed (suspension of concentration) or the offer from the subsidized foreign company cannot be accepted until the Commission has completed its investigation. Transactions carried out in breach of the standstill obligation are provisionally invalid and may be subject to fines of up to 10% of the company's annual worldwide turnover.

Beyond these notification-based procedures, the Regulation provides for a general market investigation instrument for any other market situation where the Commission suspects that a foreign subsidy distorts competition. The Commission is entitled to request an ad hoc notification and to investigate ex officio the existence of a distorting subsidy from a non-EU country. In the course of its investigation, the Commission has the right to obtain information by means of requests for information or enquiries.

4. Procedure

In the context of M&A, the review process for notifiable mergers will play a similar role as the already existing merger control procedure. Understanding the filing and clearing process is therefore of great importance for the successful completion of a notifiable M&A transaction.

The review procedure consists of a preliminary investigation and, if there are sufficient indications of a distortive foreign subsidy, an in-depth investigation. Overall, this two-step procedure is similar to the merger control procedure.

Preliminary review

In a preliminary review, the Commission examines whether there are sufficient indications of a subsidy from a non-EU country and whether such subsidy is likely to cause distortion to the EU internal market. The deadline for the preliminary review is 25 working days from receipt of the complete notification. If there are sufficient indications, the in-depth investigation procedure is initiated. Otherwise, the Commission informs the parties and closes the investigation. In this case, the standstill obligation also ends.

The in-depth investigation

In the main examination procedure, the Commission reviews its previous assessment as per the preliminary examination and conducts a thorough investigation to establish whether there is actually a distorting subsidy from a foreign country and not just the likelihood of its existence. In principle, the deadline for the main investigation is 90 working days. This period can be extended by a further 15 working days if the companies involved voluntarily propose commitments to avoid distortions of the EU internal market. In such cases, the parties may also request a one-off extension of the deadline or agree a deadline with the Commission. The total duration of possible extensions is 20 working days. In exceptional cases, the Commission may suspend the deadlines. If the Commission has not taken a decision by the end of the deadline(s), the parties may proceed with the merger.

The "*balancing test*" serves as the basis for the decision taken in the main investigation procedure (see Article 6 of the Regulation). The Commission weighs the negative effects of the subsidy on the EU internal market against possible positive effects. Criteria such as the amount and nature of the subsidy, the conditions of competition, the economic activity, the purpose, conditions and use of the subsidy and any impact on relevant EU policy objectives may serve as indicators during the substantive examination. With regard to the balancing test, the Commission has an obligation to issue guidelines by no later than 12 January 2026.

Legal consequences

Once the Commission has concluded its assessment of the compatibility of the foreign subsidy with the Internal Market, it may approve or prohibit the merger or the award of the contract. If they have already taken place, the unravelling of such actions may cause significant damage to the companies involved.

However, the Commission can also impose structural and non-structural remedies on the companies involved if it has not accepted commitments from the company under investigation. Such remedies may include, for example, the divestiture of certain assets, the reduction of capacity or market presence including by means of a temporary restriction on commercial activity, or the prohibition of certain market conduct. In determining whether and to what extent these remedies are necessary, the Commission must take into account the results of its balancing test. The commitments or measures must fully and effectively eliminate the distortion caused by the actual or potential subsidy from the foreign country (see Article 7 of the Regulation).

Commission decisions may be challenged by an action for annulment before the General Court of the European Union under Article 263 of the TFEU.

II. IMPLICATIONS FOR M&A-PRAXIS

In larger M&A transactions, mergers and joint ventures, the control of foreign subsidies and the related notification requirements will play a significant role. The scope of the new rules is extremely broad. Although the focus of the new instrument is on foreign (i.e. non-EU) subsidies, both non-EU and EU companies will be affected by the new rules. In particular, these rules may have an impact on the timing of the transaction, as well as on due diligence and contract drafting. Companies should familiarise themselves with the new rules and their implications at an early stage, whether they are planning a major acquisition in the EU, entering into a joint venture or are regularly involved in significant acquisitions. This also applies to advisers involved in large M&A projects.

Reliable information on financial contributions from third countries will be crucial for successful M&A processes in the future. To remain effective, this information should be collected and centralised at an early stage. Global companies may find it difficult, if not impossible, to compile ad hoc information on subsidies received outside the EU unless they have already established a data collection process in advance. Even in the case of intended divestments of business units above the threshold, it will be necessary to disclose the foreign subsidies received to potential acquirers during the due diligence process so that they can assess the notification requirement.

In the specific acquisition process, in addition to the notification requirements under merger control and, where applicable, investment control, it will always be necessary to assess whether there is a notification obligation under the Foreign Subsidies Regulation. Clarity that no notification is required or that it can be made quickly and efficiently is likely to give an advantage over other bidders, particularly in competitive procedures. Where foreign subsidies have been granted, acquirers should also consider in advance whether these subsidies have a negative impact on the internal market. In the future, it may be advisable to carefully document the receipt of subsidies from or in third countries that only have an impact there. In the case of companies that have changed ownership after the notification obligation has come into force, the due diligence process should also examine whether the acquisition of the seller's shares in the target company required approval under the provisions of the foreign regulation and whether such approval was obtained. In the worst-case scenario, if the transfer of the target's shares to the vendor has not become effective, the shares cannot be acquired in the transaction. In view of the Commission's power to investigate suspected anti-competitive effects of third-country subsidies on its own initiative, it is advisable to carry out a brief assessment of the potential anti-competitive effects on the internal market, even if the thresholds are not met. Such an assessment will allow a quick and efficient response to a possible investigation.

When planning the timing of transactions and structuring M&A contracts, in addition to a possible merger and investment control notification, a possible notification obligation must also be taken into account. The standstill obligation means that purchase agreements must include a condition precedent for notification if the thresholds are exceeded. In addition, resources and time should be allocated for a procedure before the Commission, as the total examination period can be up to 150 working days, even if the Commission does not suspend the deadline. From the seller's point of view, it is also worth considering obtaining guarantees from the purchaser - if the size of the target warrants it - that the purchaser has not received any foreign subsidies which, taking into account any foreign subsidies received by the target, would exceed the EUR 50 million threshold.

Overall, the new Regulation adds a significant level of complexity to transactions falling within its scope. Until reliable practices are established, including within the Commission, it is advisable to pay particular attention to this issue in the preparation, negotiation and contractual structuring of M&A projects.

Kontakt

DR. ACHIM GLADE

Partner

Phone: +49 211 20052-200
Email: a.glade@glademichelwirtz.com

MEJDULIN SECER

Associate

Phone: +49 211 20052-490
Email: m.secer@glademichelwirtz.com