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EU Clears the Way for New Foreign Subsidies Regime Impacting Dealmaking in Europe

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Companies doing deals and business in the European Union may soon see more red tape added to the already complex set of European regulations on merger control, EU state aid and foreign investment control. On 30 June 2022, the European Parliament and the Council announced their agreement on a new regulation, which will give the European Commission (EC) far-reaching powers to intervene in, and possibly prohibit, M&A transactions and public tender bids involving companies that have received apparently distortive foreign subsidies from non-EU governments.

The EU Foreign Subsidies Regulation (FSR) is a new legislative tool that will allow the EC to review transactions affected by foreign subsidies and to remedy any possible distortive effects. In the EU there are strict State aid rules restricting subsidies from EU Member States, but the EU cannot intervene against subsidies outside the EU. The FSR will enable the EC to step in if it believes foreign subsidies are distorting the level playing field in the EU, when it comes to M&A and public tendering activities. The FSR is based on a legislative proposal made by the EC in 2021 (for details see our *Alert* here).

The FSR is expected to be adopted later this year and to come into effect by mid-2023.

How will M&A transactions be impacted?

- The FSR adds a new notification obligation for certain M&A transactions and JVs.
- M&A sellers will need to screen potential bidders for "FSR compatibility" and purchasers will need to undertake additional due diligence of the target with regard to "financial contributions" from non-EU governments in order to assess notifiability under the FSR.

- Although the FSR is aimed at foreign "subsidies", the new notification obligations are not triggered by the receipt of foreign "subsidies" but rather foreign "financial contributions". The notion of a "financial contribution" is wider than that of a "subsidy" as there is no need for a selective benefit for the recipient, and financial contributions for the purposes of the FSR are normally not tracked by M&A parties in current financial or tax reporting systems. This means that companies may need to put in place new systems in order not only to track foreign financial contributions but also to determine whether they amount to distortive foreign subsidies, which may lead to the EC requiring remedies or prohibition of a transaction.
- The parties will not be allowed to close notifiable deals under the foreign subsidies regime until the EC has completed its review. The duration of the foreign subsidy review process will therefore need to be taken into account when determining the long-stop date of a transaction. The EC can either clear the transaction at the end of the initial 25 working day review period or open an in-depth investigation, which can take several months, if the transaction raises concerns. Following an in-depth investigation, the EC can issue (i) a no objection decision, (ii) a decision with commitments, or (iii) a decision that prohibits the transaction.
- Contractual provisions will need to be added to the transaction documents, including an additional closing condition for the FSR review, and the parties to a transaction will need to agree on risk allocation with regard to this condition.
- Non-notifiable transactions that involve financial contributions may lead to an *ex officio* investigation by the EC — which may be triggered by third-party complaints. This will also need to be considered as part of transaction due diligence.

What are the EC's new tools?

The FSR will give the EC notification-based tools to investigate M&A transactions and bids in public tenders involving financial contributions by a non-EU government that meet certain revenue thresholds. In addition, the new regulation will give the EC the power to investigate *ex officio* a wide range of market situations that cover lower value M&A transactions as well as situations in which the EC suspects that a foreign financial contribution may affect the operation of companies active in the EU. The EC will be able to investigate retrospectively foreign subsidies granted *up to five years before* the entry into force of the FSR.

The FSR includes a non-exhaustive list of indicators based on which the EC will determine whether a foreign financial contribution is a distortive subsidy (e.g., the amount and nature of the foreign subsidy, the level of economic activity of the company receiving the foreign subsidy in the EU and the purpose and conditions

attached to the foreign subsidy). Foreign subsidies of less than €4 million received within the last three fiscal years are unlikely to distort competition in the EU. The FSR also includes categories of foreign subsidies that "most likely" distort the EU internal market, e.g., a foreign subsidy facilitating a transaction or a subsidy granted to an ailing undertaking.

If the EC finds that a foreign subsidy exists and that it distorts competition in the EU, it will assess the positive and negative effects of the subsidy. If the negative effects on competition outweigh the positive ones, the EC may impose measures to remedy the distortion, or accept them as commitments. The potential remedies include the repayment of the foreign subsidy, the divestment of certain assets, access remedies on fair and non-discriminatory terms or the prohibition of certain market behavior (e.g., refraining from making certain investments or reducing market presence) and in the case of completed deals, possible dissolution of the transaction.

Once effective, the FSR provides exclusive enforcement competence to the EC. Nonetheless, EU Member States will be kept informed on a regular basis and will be involved by advising the EC during its case assessment via an advisory procedure.

We provide more information below on the FSR's M&A notification tool.

When is a transaction notifiable under the FSR?

M&A transactions will have to be notified to the EC and cleared *before implementation* if the following two thresholds are met:

1. The target or one of the merging parties (in case of a merger), (i) is established in the EU and (ii) has revenues in the EU of at least €500 million; and
2. The acquirer and the target / the merging parties received a combined aggregate financial contribution of at least €50 million from non-EU governments in the three calendar years prior to notification. It is sufficient that one party received a financial contribution.

All financial contributions made to different companies belonging to the same group will be aggregated. The notion of "financial contribution" is extremely broad and includes any transfer of funds or liabilities, grants (including COVID-19 support), loans, loan guarantees, capital injections, fiscal incentives, setting off of operating losses, debt forgiveness or foregone tax or other public revenues otherwise due (even if this is in line with market terms and therefore there is no "benefit" in economic terms for the recipient).

In cases of joint ventures, the joint venture company must meet the revenue threshold of €500 million. This will likely limit the number of notifications triggered under the FSR in JV cases. However, the EC will still be able to investigate smaller transactions (e.g., greenfield investments) under the *ex officio* tool.

Which transaction parties will be impacted by the FSR?

The regime is agnostic with respect to the recipient of the foreign financial contributions and does not target specific industry sectors or countries. It can be expected that in practice the regime will particularly impact sovereign wealth funds, state-owned/state-backed companies and state pension funds investing in the EU. However, the FSR will also apply to any financial sponsors or industrial companies investing in the EU that have received financial contributions from non-EU governments. The regulation does also not necessarily require a direct link between the financial contribution and the transaction, nor do the parties have to engage in any overlapping activities in the EU.

What is the review timeline of the FSR notification process?

The review process under the notification regime is similar to the EU merger control process: Transactions cannot be completed during a phase I review period of 25 working days following notification. The review period only starts once the notification is declared complete by the EC. If the EC initiates an in-depth phase II investigation (90 working days), the transaction cannot be completed before the EC has approved the transaction. If the parties offer commitments, this period is extended by an additional 15 working days. There is no scope for the EC to accept commitments at the end of the initial phase I review period (which is different from EU merger control rules). Transaction parties will therefore have to endure a lengthy review process before having the ability to remedy any concerns by offering commitments.

Are there sanctions for failure to notify / breaches of procedural rules?

As the case under the EU merger control rules, the EC will have the power to impose very significant fines of up to 10% of the acquirer's global revenue if a transaction is not notified or prematurely implemented (i.e., closed before the clearance from the EC has been received). The EC can also impose fines of up to 1% of the undertaking's global revenue if incorrect or misleading information is provided during the review process. Given the EC's increased scrutiny of merger control-related procedural

infringements (e.g., gun-jumping violations) procedural breaches of the FSR will likely be sanctioned vigorously.

Outlook

The FSR regime is the latest addition to the quickly evolving regulatory landscape in the EU and will increase red tape for companies operating or investing in the EU with financial support from non-EU governments. It is an ambitious attempt at handling a highly politically charged topic in the EU. It is expected to create a significant amount of additional work for the EU Commission as, according to the draft regulation, it would involve ~145 FTEs and an administrative expenditure of €90 million until 2027 (including 30-45 *ex officio* investigations per year). The regime, which is widely supported by the EU Member States, will need to strike the right balance between an effective foreign subsidy control, but one that does not dis-incentivize M&A activity and investments in the EU.

The EC has announced that it will be issuing detailed guidelines on the application of the new rules following the FSR entering into force. However, until such guidance has been published, companies will be exposed to further legal uncertainty when doing deals in the EU.

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