New European Union Foreign Subsidies Regulation Targets Inbound M&A Activity

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Summary. M&A deals involving a target active in the European Union (“EU”) stand to become more complex in 2023 as a result of the EU’s new Foreign Subsidies Regulation (“FSR”). Businesses that have received “financial contributions” from a foreign (i.e. non-EU) government within the last three years will need to consider whether they fall within its remit and, from 12 October 2023, qualifying M&A transactions will be subject to a new mandatory notification requirement. What amounts to a “financial contribution” is so widely defined that gathering the information needed for the filing assessment and then submitting any notification is likely to place a significant ongoing burden on those involved in large M&A.

Background. The European Commission (“Commission”) has been concerned for some time about subsidies from foreign governments that would not be permitted under EU law because they create an uneven playing field, including in the context of corporate acquisitions. Based on the Commission’s own Impact Assessment, of specific interest are those EU trading partners such as China that are pursuing industrial strategies aimed at achieving global leadership in key industrial and hi-tech sectors such as robotics, semiconductors, electric vehicles, medical equipment, energy, aerospace and aviation, maritime and railways.

Up to now, however, there has been no regulatory mechanism allowing the Commission to take action against businesses that are receiving substantial foreign state support, including government financing for M&A activity. Focusing on the potential distortive effect of such subsidies, the FSR gives the Commission wide-ranging powers to investigate any financial contributions received from foreign governments by companies engaging in large M&A deals in the EU. The FSR is therefore designed to complement and operate in parallel with the EU merger control regime, which assesses the impact on competition, and foreign direct investment regulations at a Member State level that allow intervention on grounds of national security or public order.

The Commission’s recent draft Implementing Regulation is meant to clarify the applicable rules and procedures, and is currently subject to a public consultation until 6 March. However, the draft does little to limit or to answer many of the questions

about the scope of the FSR, such that the regulatory impact of the new regime is potentially going to be greater than had been expected.

How Is a Foreign Financial Contribution Defined? The FSR filing thresholds, as set out below, are in part based on the amount of financial contributions received by the parties to a transaction. What amounts to a qualifying financial contribution is broadly drafted and catches direct and indirect assistance provided by non-EU governments and public authorities, as well as any public and even private entities whose actions can be attributed to a third country government. The definition includes:

- the transfer of funds or liabilities such as capital injections, grants, loans, loan guarantees, fiscal incentives, the setting off of operating losses, compensation for financial burdens imposed by public authorities, debt forgiveness, debt-to-equity swaps or rescheduling;
- the forgoing of revenue otherwise due, such as tax exemptions or the granting of special or exclusive rights without adequate remuneration; and
- the provision or purchase of goods and services (even when these transactions are conducted on normal arm's-length market terms).

It remains to be seen how the regime will actually operate, but at least in principle, a subsidy such as economic support given by governments to help businesses during the COVID-19 pandemic or in support of green investment initiatives (e.g. the U.S. Inflation Reduction Act) would count for jurisdictional purposes, i.e. whether a filing is triggered, but would likely not be considered "distortive".

Future guidance from the Commission may clarify matters but may not be available for another three years. As it stands, therefore, the new FSR regime will require potentially impacted businesses to conduct extensive data collection exercises informed to some extent by their own interpretation of the rules. That will be both time-consuming and require ongoing monitoring and updating. Unlike the financial information required for a merger control or foreign direct investment filing analysis, information on financial contributions is unlikely to be held centrally or otherwise be easily accessible. Moreover, the EUR 200,000 *de minimis* threshold for an individual contribution to be disclosable is so low as to be meaningless.

The FSR also creates particular additional issues for private equity and asset management houses that receive investments from government-aligned entities such as public sector pension providers or sovereign wealth funds. Such investments could qualify as a relevant "financial contribution" in two ways: it may be that an LP investment into a fund itself constitutes a financial contribution as a "transfer of funds"

or any management fees paid by the investing entity may amount to a "purchase of services" under the FSR. It remains to be seen what approach the Commission takes to SOEs and sovereign wealth.

What Deals Will Be Caught? The FSR is modelled on the EU Merger Regulation in applying only to acquisitions of "control" and the creation of "full function" joint ventures and does not, therefore, catch non-controlling minority economic investments.

The FSR review period is similarly designed to align with the EU merger control review timeline. Parties pre-notify in draft and can use that time to request waivers from certain of the information in the form, which the draft Implementing Regulation specifically allows for. The Commission then has 25 working days from the receipt of a complete notification for a preliminary investigation ("Phase I"), potentially followed by an in-depth investigation lasting an additional 90 working days (which can be extended, including if remedies are offered). The same "stand still" obligation applies in that a notifiable transaction must not be closed before it has been approved by the Commission.

The jurisdictional thresholds that trigger a mandatory filing requirement are where:

- at least one of the merging parties (in case of a full merger), the target (in case of an acquisition), or a joint venture had EU-wide turnover exceeding **EUR 500 million** in the previous financial year; and

- parties have received combined **foreign financial contributions** exceeding **EUR 50 million** in the **three years** prior to the conclusion of the agreement, announcement of the bid or the acquisition.

For the purposes of the calculation, the financial contributions are aggregated, do not need to come from the same non-EU country and do not need to relate to the acquisition in question. In a private equity context, if the Commission takes the same approach as it does to merger control, the jurisdictional thresholds will apply to the "financial contributions" both the sponsor and their portfolio companies have received from non-EU state entities.

Non-compliance with the new regime through a failure to notify a reportable transaction or closing prior to approval may result in severe fines of up to 10% of the parties' combined worldwide turnover.

In addition, the FSR introduces a notification system for companies taking part in public procurement tenders, and the Commission also gains the power to examine any foreign subsidy in any sector of the economy on its own initiative for a period of up to

10 years after it has been granted. The latter ability can also be used to intervene in smaller transactions that fall below the jurisdictional thresholds.

When Is a Subsidy Likely to Be Distortive? Once a notification is made under the FSR, the Commission will assess whether the financial contribution results in a **distortive foreign subsidy**, i.e. whether the associated benefit is liable to improve the competitive position of the beneficiary whilst potentially negatively affecting competition within the EU.

The Commission has a wide discretion in making this assessment. In doing so, it will consider the amount and nature of the foreign subsidy, the amount of economic activity in the EU, and the purpose and conditions attached to the foreign subsidy as well as its use on the EU internal market. The FSR specifies certain categories of foreign subsidies that are presumed distortive, in particular where the subsidy is directly linked to an M&A deal or one that allows someone to submit an unduly advantageous tender offer.

Finally, if the subsidy is distortive, the Commission has the discretion to conduct a balancing test, taking into account the positive effects on the development of the economic activity or on supporting a broader EU policy objective such as environmental protection. If the conclusion remains that the harm outweighs the benefits, then the Commission has a wide variety of remedial options measures available to it. Those range from prohibiting the acquisition outright to structural measures such as divestments or behavioural commitments: for example, repaying the subsidy or mandating access to infrastructure or production capabilities.

Potential Impact. Businesses that might be subject to the new regime should be considering the following:

- Those doing large M&A deals should identify (i) whether they could principally be considered to have received financial contributions from non-EU governments and, if so, (ii) start putting in place the processes for collecting the requisite data concerning any such financial contributions on a group-wide basis and in a central database.
- In addition to the potential merger control and foreign direct investment filings, companies will now need to consider if an FSR filing is triggered and assess the related impact on the deal timeline and long stop date in the sale and purchase agreement.
- Appropriate conditionality will need to be included in the transaction documents, with hell-or-high-water and risk allocation provisions taking account of the specific disclosure obligations and range of different remedial outcomes that the FSR allows.

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