EU Proposes New M&A and Procurement Control Legislation To Combat Foreign Subsidies

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The European Commission (EC) has proposed legislation to curb M&A, public procurement and market conduct by foreign-subsidized companies that may distort the European Union's internal market.[1] New requirements include:

- Mandatory notification of acquisitions where the target's EU turnover exceeds €500 million and the parties benefited from over €50 million in foreign subsidies in the previous three years. These acquisitions are subject to a mandatory waiting period of 25 working days for a Phase 1 inquiry and a possible additional 90 working days for a Phase 2 inquiry;
- Mandatory notification for foreign-subsidized entities participating in public tenders with a contract value greater than €250 million; and
- A right for the EC to investigate market conduct, including M&A below these thresholds, by any entity benefiting from foreign financial contributions over €5 million over three consecutive years.

The foreign subsidy notification process is a step change in European merger control. The broad definition of foreign subsidy will capture many forms of foreign state grants, incentives or forbearance (for example, tax waivers), no matter how remote from the EU. This is likely to create substantial legal uncertainty and potential for complaints by competitors in contested M&A.

The proposal is the first step in the EU legislative process and requires approval by the European Council, on which each EU member state government is represented, and the European Parliament. The passage of the legislation is likely to be contentious.

The Chinese Chamber of Commerce to the EU has expressed its "concerns about the rationality and necessity of the new legislative initiative" and noted that, "with two existing EU tools for FDI screening and antitrust review in place, the new regulation on foreign subsidies could make investments in Europe by Chinese companies in particular trigger multiple reviews, increasing transaction costs and risks and creating greater uncertainty over transaction timelines and outcomes."[2]

The proposal essentially transfers control of inward investment by foreign-subsidized entities from EU member states to the EC. Many EU states may believe such decisions are best made at the national level as part of member states' national foreign investment screening regimes. Adoption of any regulation is unlikely before the end of 2022, and may require significant changes to be acceptable to EU lawmakers and national governments.

Wide Scope of 'Foreign Subsidies'

The draft regulation defines "foreign subsidies" in very broad terms. It includes any intervention where a third country provides a financial contribution that confers a benefit to a company engaging in an economic activity in the EU internal market where that contribution is limited to an individual company or industry, or to several companies or industries.

[1] Proposal for a Regulation on Foreign Subsidies Distorting the Internal Market COM(2021) 223 final, 5 May 2021. The proposal follows the White Paper on Levelling the Playing Field as Regards Foreign Subsidies COM(2020) 253 final, 17 June 2020. For a detailed overview of the proposals, see our 24 June 2020 client alert, EU Proposes Controls on Mergers, Market Conduct and Public Contracts To Combat Foreign Subsidies and 16 September 2020 client alert, EU Will Propose Merger Control Legislation for Foreign-Subsidized Companies' Acquisitions in 2021.

[2] China Chamber of Commerce to the EU Statement on EC Proposal for Regulation on Foreign Subsidies, 6 May 2021.

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Financial contributions may come in very different forms, including (i) the transfer of funds or liabilities, such as capital injections, grants, loans, loan guarantees, fiscal incentives, offsetting of operating losses, compensation for financial burdens imposed by public authorities, debt forgiveness, debt-to-equity swaps or rescheduling; (ii) the foregoing of revenue that is otherwise due; or (iii) the provision of goods or services, or the purchase of goods and services.

Third-country financial contributions include those provided by government authorities at all levels, foreign public entities whose actions can be attributed to the third country and even private entities whose actions can be attributed to the third country.

In practice, the new regime captures any benefit conferred by a non-EU government or public body on specific companies or industries, regardless of its form. As currently drafted, any preferential tax treatment or fiscal incentives such as zero-tax agreements or tax credits by a non-EU government, whether or not supported by a ruling, could fall within the scope of the new regime.

The new regime would potentially allow the EC to export its aggressive stance on EU member state national tax rulings (which a series of EC decisions has sought to challenge as illegal state aid) to the tax practices of non-EU countries by defining these as unlawful foreign subsidies. The accompanying impact assessment report specifically refers to the potential distortions caused by foreign tax advantages. The report discusses how such advantages may either divert investments away from the EU and promote delocalization, or be passed on to subsidiaries located in the EU through intragroup transactions, creating distortions in the internal market.[3]

The only safe harbor in the draft regulation would be for foreign subsidies of a total amount below €5 million over any three consecutive fiscal years. Below that level, foreign subsidies would escape any risk of notification or investigation *ex post* by the EC.

Controls for M&A and Joint Ventures Involving Foreign-Subsidized Businesses

The draft regulation presents a new, additional EU merger control regime, closely modeled after the existing EU Merger Regulation (EUMR), but separate from it.

[3] Impact Assessment accompanying the Proposal for a Regulation on Foreign Subsidies Distorting the Internal Market SWD(2021) 99 final, 5 May 2021.

Notification Thresholds

As under the EUMR, transactions requiring notification include mergers, acquisitions of control and full-function joint ventures.

However, the financial thresholds are very different from those under the EUMR. A transaction would require notification to the EC if (i) the target or at least one of the merging parties is established in the EU and generates an aggregate turnover in the EU of at least €500 million, and (ii) the companies concerned received an aggregate financial contribution of more than €50 million from third countries in the three calendar years prior to notification.

"Full function" joint ventures (joint ventures that create an autonomous business) require notification where (i) the joint venture itself or one of its parents is established in the EU and generates an aggregate turnover in the EU of at least €500 million, and (ii) the joint venture itself and/or its parents received an aggregate financial contribution from third countries of more than €50 million in the three calendar years prior to notification.

Although the EC proposes relatively high financial thresholds, the draft still casts the net widely. The €500 million target threshold is not limited to revenue generated from EU assets, but would also include sales into the EU from outside, as long as the target is established in the EU. For joint ventures, notifications may be required even for transactions that lack any nexus with the EU. For example if one parent meets the EU revenue threshold, it does not matter where the other parent or joint venture is established.

The €50 million foreign subsidy threshold is a low bar. It is the value of the entire state contribution, rather than just the incremental benefit. In comparison, under the EU state aid rules, the quantum of any state aid is determined by reference to the relevant counterfactual (*e.g.*, the normal tax regime, the arm's-length financial conditions of a loan or the market value of a piece of real estate). There also need be no nexus between the foreign subsidy and the EU. A foreign state grant or tax waiver for, say, new premises or a plant established in any country — no matter how remote from the EU or completely unrelated to the target acquired — is sufficient.

In practice, this is likely to require significant diligence and engender material substantial business uncertainty. For example, it may be unclear whether a foreign acquirer benefits from a selective tax benefit that the EU treats as a relevant foreign subsidy or simply engages in prudent tax planning available to any entity.

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Reportable transactions may not be implemented before clearance. And even transactions that are not subject to mandatory notification may be called in by the EC for notification at any time prior to their implementation if the EC suspects that the companies concerned have benefited from foreign subsidies in the three years prior to the transaction.

Assessment of Market-Distorting Effects

The EC will assess whether there is "a distortion on the internal market", an assessment which will be "limited to the context of the concentration at stake", although this does not seem to require the EC to establish a direct causal link between the transaction and any market distortion.

A distortion of the internal market would arise where a foreign subsidy is liable to improve the competitive position of the business in the internal market and where, as a consequence, it actually or potentially negatively affects competition on the internal market.

The draft regulation gives broad discretion to the EC, listing as potentially relevant indicators the amount and nature of the subsidy, the situation of the company and the markets concerned, the level of economic activity of the business in the internal market and the purpose and conditions attached to the foreign subsidy, as well as its use on the internal market.

Types of foreign subsidies "most likely" to distort the internal market include foreign subsidies granted to ailing businesses (absent a viable restructuring plan), unlimited guarantees, foreign subsidies directly facilitating a concentration and foreign subsidies enabling a business to submit an unduly advantageous tender, on the basis of which it would be awarded the public contract.

The EC would be permitted to balance the negative effects of a foreign subsidy in terms of distortion on the internal market with positive effects "on the development of the relevant economic activity", but further guidance is required on how this would work in practice. By comparison, the EC has developed extensive guidance with regard to whether intra-EU subsidies may be approved by the EC as compatible with the internal market.

Remedies

If the EC finds that a foreign subsidy distorts the internal market, it may impose measures to redress the harm. Companies may also submit commitments to remedy alleged distortions and the EC can make those commitments binding. Commitments or redressive measures may include offering access under fair and nondiscriminatory conditions to infrastructure, licensing assets acquired or developed with the help of foreign subsidies, reducing capacity or market presence, refraining from certain investments, publication of R&D results, divestment of assets, repayment of the foreign subsidy to the third country with interest or dissolution of the transaction.

Timeline and Procedure

The draft regulation borrows heavily from the EUMR in terms of procedure, with a Phase 1 review of 25 working days, after which the EC may decide to open a Phase 2 investigation. Phase 2 would last 90 working days and may be extended by 15 working days if the parties offer commitments. The EC may stop the clock if the parties fail to respond to requests for information. After an in-depth investigation, the EC may either decide not to object to the transaction, accept commitments or adopt a prohibition decision. If a transaction has already been implemented, the EC would have the power to unwind it.

The EC would be given the usual investigatory tools under the EUMR and EU antitrust rules to issue information requests, carry out inspections, adopt interim measures and impose fines and periodic penalty payments for, *e.g.*, failure to notify or the supply of incomplete or misleading information. Borrowed directly from EU state aid rules, the EC would be allowed to adopt final decisions "on the basis of the facts available" if parties fail to cooperate with the investigation. Also noteworthy is the proposal to extend the EC's jurisdiction to carry out inspections outside of the EU, provided that the company concerned has given its consent and the government of the third country has been officially notified and agrees to the inspection.

The legislative process will need to clarify the interaction between the new regime and the EU's existing merger control regime. While the notification thresholds and substantive assessment would be different, many deals may end up being notified to the EC under both regimes in parallel, raising the possibility of inconsistent timelines and outcomes.

Public Procurement

The draft regulation proposes a separate mandatory notification regime for EU public procurements in excess of €250 million. Companies participating in such tenders shall either notify the relevant contracting authority of all foreign financial contributions received in the three years preceding that notification or confirm in a declaration that they did not receive any foreign financial contributions in that span.

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Contracting authorities are required to transfer notifications to the EC without delay. The EC may call in non-notified bids at any time before the award of the public contract, regardless of whether the $250 million threshold is met. The EC would have 60 days from notification to complete its preliminary review, and a possible further 140 days for an in-depth investigation, extendable further in exceptional circumstances. Notifications will not suspend the public procurement procedure, but the contracting authority may not award the contract to a company under investigation. If companies fail to notify, the EC may impose fines of up to 10% of their aggregate turnover.

"*Ex Officio*" Fall-Back Investigation Tool

Finally, the draft regulation authorizes the EC to act on its own initiative to investigate any potential distortion of the EU internal market by a foreign subsidy. The only requirement in order for the EC to investigate is that the total foreign subsidies exceed the safe harbor threshold of €5 million over three consecutive fiscal years. The EC has the power to investigate foreign financial contributions as far back as 10 years prior to the start of its investigation, and may even examine foreign subsidies granted in the 10 years prior to the effective date of the new regulation where those foreign subsidies distort the internal market after the new regulation takes effect.

The EC will have the same procedural powers and may adopt the same remedies as it has under the new proposed merger control regime described above, although, unlike under the above ex *ante* tools, the EC's investigation process will not be bound by specific deadlines.

If the EC has a reasonable suspicion that foreign subsidies are distorting the internal market in a certain sector, under the draft regulation, it can carry out a full-fledged sector investigation.

Implications and Legislative Outlook

With the draft regulation, the EC maintains most of the far-reaching proposals in its June 2020 white paper, following stakeholder consultation. According to the EC's estimates, the enforcement of the new rules is expected to require an additional 145 full-time staff (a nearly 20% increase) spread almost evenly between the new merger control regime, public tender review and *ex officio* investigations. If adopted:

- M&A transactions involving large targets (over €500 million EU revenues) and over €50 million in foreign subsidy support require a separate preclosing foreign subsidies notification and approval in the EU. Even below these thresholds, the EC has a discretion to investigate. The foreign subsidies review would come on top of mandatory merger control filings (to the EC or at member state level) and national foreign investment filings. The new rules may also open up a new battleground for strategic complaints by competitors.
- The risk of *ex officio* investigations and wide-ranging public tender review adds to the regulatory risk and burden for companies operating and investing in the EU. This includes foreign players investing in the EU and EU-based companies that may rely on foreign financial contributions (either through foreign investors or foreign aid for specific projects). Companies would need to closely monitor any foreign subsidies received to assess and anticipate exposure under the new rules.

The draft regulation now enters the EU legislative process, which we expect to last at least 18 months. Any final text will require the approval of the European Council and European Parliament. The draft regulation will likely lead to intense political debate about the possible effects of the new proposals on foreign inward investment.

Though stated to be targeting primarily subsidies from countries such as China and Russia, where there is a high degree of state involvement in the economy, the proposal is also likely to have effects on nearer neighbors such as the U.K. and Switzerland (where companies can benefit from negotiated canton-level tax advantages) and major inward investors from other countries, such as the U.S., where state or city-level subsidies such as grants and tax waivers are common.

The draft regulation states that a foreign subsidy investigation by the EC shall not be carried out and measures shall not be imposed or maintained where such investigation or measures would be contrary to the EU's obligations under any relevant international agreement it has entered into. That leaves it unclear how or whether the draft regulation will bear on the U.K.'s obligations to control U.K. state aid under the EU-U.K. Trade and Cooperation Agreement, which laid out terms for the U.K.'s exit from the EU.

Foreign states may also respond negatively through trade or legal pressure to the proposals, and may question the proposals' compatibility with existing multilateral anti-subsidy regimes. It remains to be seen if the regulation will gain the support of a qualified majority of EU member states, and what changes may be required before it is adopted.

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