EU TO STEP UP ENFORCEMENT AGAINST FOREIGN STATE-BACKED COMPANIES

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Following political agreement among legislators, the European Union ("EU") Foreign Subsidies Regulation ("FSR") is expected to receive formal approval later this year and will enter into force in mid-2023. The new rules will give the European Commission ("Commission") far-reaching powers to go after investments and activities in the EU by companies that are owned or backed by foreign governments. These include:

(a) mandatory notification and approval of mergers, acquisitions or joint ventures ("JVs") that meet certain financial thresholds, separate from existing EU merger control. These transactions are subject to a mandatory waiting period of 25 working days for a Phase 1 inquiry and a possible additional 90 days for a Phase 2 inquiry;

(b) mandatory notification and approval for foreign-subsidized entities participating in public tenders with a contract value greater than €250 million if the bidder received a foreign financial contribution of at least €4 million per third country; and

(c) a broad market investigation tool that the Commission can use for smaller M&A transactions and procurement procedures that fall below these notification thresholds, and more generally for any commercial activity in the EU where foreign subsidies may have a distortive effect on competition.

The FSR is a major change in European competition law enforcement, in particular for merger control. The broad definition of a foreign subsidy will capture many forms of foreign state grants, incentives or forbearance (for example, tax waivers), no matter how remote from the EU, subjecting them to scrutiny by the Commission. It will apply irrespective of the foreign country or industry involved. Finally, it will concern not only companies from outside the EU, but also EU companies that have received subsidies from third countries. This is likely to create substantial legal uncertainty, administrative burden and potential delays for companies investing in the EU, especially in contested M&A.

Foreign companies will need to plan in advance and develop a robust risk assessment for their future investments in the EU.

Wide Scope of "Foreign Subsidies"

The FSR defines a "foreign subsidy" broadly, borrowing heavily from the EU's state aid regime as it applies to subsidies from EU governments. It includes any financial contributions by third-countries that confer a benefit to a company engaging in an economic activity in the EU's internal market. However, contributions for these purposes are limited to those benefitting an individual company or industry, or to several companies or industries; contributions available generally to all businesses are not covered. Financial contributions may come in different forms, as the final text of the FSR

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only provides an indicative list of relevant state practices. These include:

- 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;
- the foregoing of revenue that is otherwise due;
- the provision of goods or services, or the purchase of goods and services, and
- the granting of special or exclusive rights in a non-EU country.

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. 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.

However, the EU legislators provided two safe harbors:

- foreign subsidies aimed at repairing the damage caused by natural disasters or "exceptional" situations should not be considered distortive;
- subsidies below €4 million are considered unlikely to distort the EU's internal market, whereas those under €200,000 should never be considered to distort the internal market.

Impact on M&A Transactions

The FSR introduces a new, additional EU merger control regime, modeled after the existing EU Merger Regulation ("EUMR").

(A) Notification Thresholds

As under the EUMR, the FSR requires a notification and pre-closing approval obligation for mergers, acquisitions and JVs that meet certain thresholds. These transactions would have to be notified if (i) the target, the JV or at least one of the merging parties is established in the EU and has a total turnover in the Union of at least €500 million and (ii) all undertakings involved in the transaction received an aggregate financial contribution of more than €50 million from third countries in the three financial years prior to notification.

The FSR casts the net widely as the €500 million target threshold is not limited to revenue generated from EU assets, but also includes sales into the EU from outside, as long as the target, the JV or at least one of the merging parties is established in the EU.

The €50 million financial contribution threshold is also a low bar. 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 generate 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.

Reportable transactions may not be implemented before clearance. Even transactions that are not

subject to mandatory notification may be called in by the Commission for notification at any time prior to their implementation if the Commission suspects that the companies concerned have benefited from foreign subsidies in the three years prior to the transaction.

(B) Assessment of Market-Distorting Effects

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

A distortion on 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 FSR gives broad discretion to the Commission in this assessment. Potentially relevant indicators include the amount and nature of the subsidy, the position 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 financial support granted to ailing businesses (absent a viable restructuring plan), unlimited guarantees, foreign subsidies directly facilitating a concentration and enabling a business to submit an unduly advantageous tender, on the basis of which it would be awarded the public contract.

(C) Balancing Test

The negative effects of a distortive foreign subsidy may be balanced with positive effects "on the development of the relevant economic activity." The Commission would also take into consideration whether the non-EU countries are implementing subsidy-review systems equivalent to that of the EU.

Both the EU Parliament and Council (representing the EU's member states) urged the Commission to publish guidelines before the FSR comes into force that will cast more light on the principles guiding the balancing test. By comparison, the Commission has developed extensive guidance with regard to whether intra-EU subsidies may be approved by the Commission as compatible with the internal market.

(D) Remedies

If the Commission 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 Commission 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.

The Commission will also have the power to temporarily restrict the commercial activity of a company, require a company to adapt its governance structure, or temporarily oblige a company to inform the Commission of all concentrations and tenders in which it takes part.

(E) Timeline and Procedure

Procedurally, the review process under the FSR will largely mirror the one under the EUMR:

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1. Phase 1 review will last 25 working days, after which the Commission will either clear the transaction or open a Phase 2 investigation.

2. Phase 2 would last 90 working days and may be extended by 15 working days if the parties offer commitments.

It remains unclear whether the FSR allows for clearance subject to commitments in Phase 1, similar to the EUMR, or if commitments can only be accepted following an in-depth investigation.

The parties are barred from closing the transaction until the Commission's decision and the Commission may stop the clock if the parties fail to respond to requests for information. After an in-depth investigation, the Commission may either decide not to object to the transaction, accept commitments or adopt a prohibition decision. If a transaction has already been implemented, the Commission would have the power to unwind it.

The Commission would be given the usual broad investigatory tools as under the EUMR and EU competition laws 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 Commission would be allowed to adopt final decisions "on the basis of the facts available" if parties fail to cooperate with the investigation.

Notification-Based Tool for Public Procurement

The FSR includes a separate mandatory notification regime for EU public procurements in excess of €250 million, when the bidding company received financial contribution from third-countries of at least €4 million per third country. For public procurement procedures that are divided up into lots, notification would be required if the aggregate value of the lots the company is applying for surpasses €125 million. The filing obligation also extends to *main* subcontractors and *main* suppliers that received financial contribution from third countries.

The Commission 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 Commission would have 20 working days from notification (extendable by 10 working days in duly justified cases) to complete its Phase I review, and a possible further 110 working days (extendable by 10 working days in duly justified cases) for in-depth probes.

"*Ex Officio*" Fallback Investigation Tool

Finally, the FSR authorizes the Commission to act on its own initiative to investigate any potential distortion of the EU internal market by a foreign subsidy. The only threshold is that the total foreign subsidies exceed the safe harbor threshold of €4 million over three consecutive fiscal years. The Commission has the power to investigate foreign financial contributions as far back as five 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 Commission will have the same procedural powers and may adopt the same remedies as it has under the new proposed merger control regime, although, unlike under the above *ex ante* tools, the Commission's investigation process will not be bound by specific deadlines. If the Commission 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 Next Steps for Companies

This new regime is a new chapter in the history of EU competition law enforcement. If the Commission will follow through on its statements to actively enforce the FSR, this could have far reaching implications for the activities and investments in the EU by foreign state-owned/backed companies.

In the M&A context, one immediate implication of the FSR will be the need for additional due diligence regarding the nature, scope and amount of government contributions of the other party to the transaction, and a detailed assessment of the potential distortive effect of those contributions, as well as of the potential delays and remedial actions that could affect the transaction.

The FSR is expected to be adopted formally by the EU institutions in the autumn of 2022. The notification obligations under the FSR will come into force nine months later (likely towards summer 2023) and are expected to apply to transactions signed or public bids announced following that date.

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