Cooley

Court of Justice Sets Lightning Rod for EU Foreign Direct Investment Screening

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On 13 July 2023, the Court of Justice of the European Union (CJEU) handed down its first ruling on the European Union Foreign Direct Investment Screening Regulation, which entered into force in October 2020. In short, the CJEU clarified in *Xella Magyarország* that the regulation does not apply to acquisitions by EU-based buyers, regardless of whether they are ultimately controlled by non-EU shareholders. Cross-border acquisitions by EU-based buyers are subject to EU law on the freedom of establishment. While EU Member States are free to decide – and pursue in investment screening – their own public policy and public security goals, investment screening measures cannot restrict fundamental EU freedoms unless the measures are justified by a genuine and sufficiently serious threat to a fundamental interest of society. No such threat existed in the case before the CJEU. The judgment has important implications for companies, EU Member States, EU Institutions and especially the European Commission (EC).

Multiple parallel investment screening systems in the EU

Investment screening in the EU is by no means a 'one-stop-shop' affair. Constitutionally, 'foreign direct investment' (FDI) is an exclusive competence of the EU, though historically only a few Member States maintained any system for national security or public policy screening of inbound investment. In 'fully decentralized' reviews, those Member States had to factor in EU law in the screening, but the EC and other EU bodies played no operational role. The regulatory landscape for investment screening changed dramatically in the past few years

- The EU Foreign Direct Investment Regulation (FDI Screening Regulation) took effect in 2020. Under this regulation, it is for the Member States to decide which investments to review, approve, condition or block, but Member States are encouraged to implement and apply systems consistent with EU law. The regulation does, however, establish a common framework by setting out:
  - Certain core system requirements for Member States that maintain or adopt review systems.
  - A cooperation mechanism for the EC and Member States to exchange information and identify potential concerns regarding specific investments.
  - The possibility for the EC to issue opinions when investments present threats to the security or public order of more than one Member State or an EU initiative.
  - International cooperation on investment screening.
- Member States have expanded and strengthened their existing investment screening systems or introduced new systems altogether. The political impetus for more rigorous controls has increased in view of – especially – the COVID-19 pandemic and global security changes following Russia's invasion of Ukraine. Today, 25 of the 27 EU Member States either have, or are introducing, systems for the review and approval of inbound investments.

This 'mostly decentralized' patchwork of parallel screening mechanisms affects a large number of transactions each year. According to the EC in its second annual report on the screening of foreign direct investments into the European Union, Member States reviewed 1,563 cases in 2021, and 414 cases were submitted for cooperation among the EC and Member States under the FDI Screening Regulation. The number of cases reviewed each year is set to increase as Member States introduce and enhance screening systems. But this evolving system is fraught with problems of efficiency, as well as effectiveness. For instance, the Organisation for Economic Co-operation and Development (OECD) identified not less than one dozen such issues – as well as potential solutions – in a report published last year. Such issues also are apparent from the CJEU's recent ruling in *Xella Magyarország*.

National security threatened by the acquisition of a gravel pit?

The CJEU's ruling concerned the acquisition of Janes, a Hungarian company involved in the extraction of sand, gravel and clay, by another Hungarian company, Xella, a concrete manufacturer. Janes' market share in Hungary was minimal (0.52%), and most of its output (90%) was sold to Xella, with the remaining portion sold to other local customers. The minister for the Hungarian Ministry of Innovation and Technology blocked the acquisition on the basis that a non-EU entity (Xella was majority-owned, via German and Luxembourg entities, by a Bermuda company) would get indirect control of a strategic Hungarian company, threatening the national interest in the security of supply of critically important raw materials at the local level.

Unsurprisingly, Xella appealed against the decision before the Budapest Hight Court. Xella argued that the minister's decision involved either arbitrary discrimination or a disguised restriction of fundamental EU law on the free movement of capital and companies' freedom of establishment. The Budapest High Court requested guidance from the CJEU on the interpretation of EU law.

Not a genuine and sufficiently serious threat to a fundamental interest of society

The CJEU held that Xella's fundamental EU freedom of establishment had indeed been restricted and that the minister's decision failed to justify that restriction. This conclusion was based on five key premises.

First, the FDI Screening Regulation does not apply to any form of investment inbound to a Member State. The notion of 'foreign direct investment', as defined in the regulation, includes only investments where the direct investor is 'an undertaking constituted or otherwise organized under the laws of a [non-EU country]'. The only exception arises in case of such an investor's circumvention attempt by artificial arrangements that do not reflect the economic reality.

Second, in this case, a Hungarian company was being acquired by another Hungarian company. Since the acquirer's parent was German, with a grandparent in Luxembourg, the situation was not purely domestic, but involved indirect EU cross-border investment which should be analyzed under EU law on freedom of establishment. The ultimate ownership of the acquiring entities was irrelevant (and there was no evidence on file which indicated that there was any attempt to circumvent the FDI Screening Regulation).

Third, the CJEU reminded that 'all measures which prohibit, impede or render less attractive the exercise of freedom of establishment' restrict that fundamental freedom and are prohibited. That is settled case law which curtails Member States' ability to limit EU companies' exercise of that fundamental freedom. The CJEU held that the Hungarian legislation, as applied in this case, constituted 'a particularly serious restriction'.

Fourth, Member States may justify a restriction on the freedom of establishment on grounds of public policy, public security or public health, but these are derogations from a fundamental freedom that must be interpreted narrowly. The CJEU held that:

> While Member States are still, in principle, free to determine the requirements of public policy and public security in the light of their national needs, those grounds must … be interpreted strictly, so that their scope cannot be determined unilaterally by each Member State without any control by the EU institutions. Thus, public policy and public security may be relied on only if there is a genuine and sufficiently serious threat to a fundamental interest of society. Moreover, those derogations must not be misapplied so as, in fact, to serve purely economic ends.

Fifth, the CJEU concluded that the Hungarian goal to secure supply of raw materials, at the local level, to the construction sector (unlike the goal of ensuring security of supply in the petroleum, telecommunications and energy sectors) was not a 'fundamental interest of society'. Moreover, the prohibition at hand was incapable of posing a 'genuine and serious threat' to any fundamental societal interest.

Implications for companies, Member States and the EC

When laws and actions of Member States conflict with EU law, the latter prevails. Member States must bring conflicting aspects of national law or action in line with the requirements of EU law. The judgment in *Xella Magyarország* has important implications for companies and Member States, as well as the EC.

Companies should not expect investment screenings to be delayed by inquiries and coordination under the FDI Screening Regulation, unless the deal involves a direct acquirer based outside the EU. Can such coordination be avoided by a deal structure involving an EU-based special purpose vehicle as direct acquirer? Not necessarily. The EC has commented that it views as '[t]he most common example of circumvention … the case where foreign investment into the Union is channeled through an EU-based pure "shell/letterbox company", which has neither directly nor indirectly a genuine economic activity but serves solely the purpose of being the legal vehicle for the investment', which reflects a strict view on investment via special purpose vehicles. But the EC recognizes that each specific deal structure needs to be assessed separately.

EU-based companies, regardless of the nationality of their ultimate shareholders, can clearly rely on EU law to challenge unwarranted or disproportionate screening by Member States. Member States cannot unilaterally decide the requirements of public policy and public security in light of their national needs. Whenever Member States' screening systems or decisions fall short of the standards set by EU law rules on free movement, companies have grounds for challenge. The deal in *Xella Magyarország* involved an outright acquisition of control and accordingly engaged the EU freedom of establishment. But investments involving a lesser degree of influence may fall under the rules on free movement of capital, and those rules also embody standards that Member States must observe. Basically, Member States must justify the design of their screening systems and how those systems are applied in individual cases, on grounds recognized in EU law.

For Member States, the CJEU ruling should serve as an impetus to review (especially, recently established or expanded) investment screening systems to ensure that these systems conform to the strict requirements of fundamental EU law. This impetus is the same for screening of situations involving cross-border EU acquisitions and EU inbound investments. In *Xella Magyarország*, the Hungarian screening mechanism fell short of established EU law standards, but all Member States' screening systems merit consideration given that screening mechanisms inherently involve barriers to capital flows and establishment. While there is no question that national security and public policy screening fulfills crucial functions, those functions should operate consistent with EU law. Given that points of friction may arise between national and EU law at the level of system design (e.g., rules on jurisdiction and review process), as well as application (decisions in individual cases), any review should be comprehensive.

The EC has a key role to play in ensuring that EU investment screening works effectively, efficiently and in compliance with EU law. For instance, in October 2023, the EC is due to deliver its first evaluation of the FDI Screening Regulation to the European Parliament and the European Council. The ruling in *Xella Magyarország* confirms that the effectiveness and efficiency of the current system can be improved.

A point on effectiveness arises from the class of transactions that is subject to coordination and information exchange under the FDI Screening Regulation. As the CJEU made clear, the regulation covers only deals where a non-EU firm is a direct acquirer, but it would be naïve to think that only such transactions might give rise to concerns with respect to wide common EU interests or national security interests in more than one Member State. However, there is no mechanism for coordination outside the scope of the regulation, which points to an effectiveness 'gap'. This could be addressed by changing the scope of the FDI Screening Regulation.

The judgment also highlights key points of inefficiency, owing to the lack of convergence among the Member States' diverse and complex screening mechanisms. The EC can do more to promote harmonization of those national systems, including by specifying more specific common standards for jurisdictional rules, sectors covered, procedural fairness and substantive review. Such alignment may require further changes to the regulation, and it would be opportune to address these adjustments in the evaluation that is due in October. A 'one-stop-shop' system may not be realistic (or desirable), but a coordinated and harmonized system may be within reach.

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