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WHY THE LEIFELD CASE MARKS A NEW ERA FOR GERMANY'S FDI REGIME

The German government's cabinet decision to authorize a prohibition of the planned acquisition of Leifeld Metal Spinning by Yantai Taihai Corporation marks a watershed moment for FDI in Germany. The investor's decision to withdraw from the transaction at the last minute might mean that this case will not technically constitute the first ever FDI prohibition. However, investors nonetheless face a new environment which will see FDI assessments play a much more prominent role.

There was a time – not too long ago – when not many people in the M&A community knew that the German Außenwirtschaftsgesetz (AWG)¹ even existed. And those who did considered it a purely theoretical hurdle to deal approval. That certainly has changed in recent years, in particular since the now (in)famous Kuka/Midea transaction.

Now, the government has demonstrated its willingness to block Yantai Taihai Corporation's acquisition of Leifeld Metal Spinning, a small Westfalian-based manufacturer of mechanical engineering solutions used in automotive, aviation, and nuclear applications: the cabinet's decision to authorize a prohibition (which empowers the Ministry of Economics to issue a formal prohibition) means that the German FDI regime has reached a watershed moment that will change the playing field for future cross-border transactions in Germany.

¹ The AWG allows the Federal government to prohibit investments in German companies amounting to at least 25 percent from non-EU

What does the Leifeld-case spell for the future environment for FDI in Germany? Here are our first thoughts:

I. The government's decision marks a conscious and substantive policy shift regarding FDI

The Leifeld case represents the culmination thus far of a conscious shift of attitude among Germany's key policy-makers that has been occurring over the last few years. This shift was originally triggered by the massive surge in inbound FDI from China, but has been amplified by the widespread perception of the "Made in China 2025" strategy, as well as by a growing realization by leading policy-makers including Chancellor Merkel of the magnitude of the competitive, technological and geopolitical challenge that Germany is facing in light of technological change and disruption.

The view which has emerged is that given that other states are actively pursuing industrial strategies and the lack of a level regulatory and financial playing field, Germany needs to adopt a more realist policy towards inbound FDI in order to protect its long-term interests. This is both a conscious and substantive change of policy, and one that has been pursued in spite of opposition from business associations and critical reactions from some opinion leaders.

This changed attitude has manifested itself in three ways: First, a broader definition of what constitutes national security (including, to a degree, strategic economic interests), as stipulated in last year's reform of the AWG's implementing regulation that significantly extended the scope of its application². Secondly, a more active and strategic approach to reviewing transactions on the part of the Federal Ministry of Economics, with a stronger interest and involvement at political level than was traditionally the case. And finally, a willingness to actually use the available instrument. The latter point will certainly be the key legacy of the Leifeld case, regardless of the fact of whether it formally constitutes the first prohibition case. However, the underlying policy shift has been underway for a while and, more importantly, can be expected to stay.

II. Rather than a one-off case, Leifeld spells the beginning of a new phase of FDI control

Which leads us straight to our second point: in our view, rather than a one-off warning case, Leifeld signifies the changeover to a new environment, in which the AWG review – including potentially negative decisions – will over time become a much more natural part of deal reviews. This is in line with the government's argument that FDI controls are a regular part of regulatory approval processes in many jurisdictions and hence do not represent a shift towards protectionism or undue interventionism.

² Though German policy-makers involved in the overhaul have repeatedly expressed their frustration with the limits imposed by EU law.

That said, to some degree Leifeld is intended to set a precedent, as it is clearly meant to deter unwelcome investors or investments from the outset.

By setting such precedent, the government also sets the stage for the future: in light of the growing interconnectedness of infrastructure and industrial production (IoT), even under a narrow interpretation of national security an increasing number of sectors and transactions will fall under the AWG's remit and hence might give rise to concerns. The revamped AWG explicitly names digital services such as cloud computing or software for critical infrastructure as sectors affected.

Finally, Economics Minister Altmaier has already indicated his intention to expand the remit of the AWG to capture transactions that thus far fall under the 25% threshold, ensuring that bids like the recent China State Grid/50Hertz case can be dealt with under the AWG.

III. But: prohibitions will remain the exception to the rule

Despite these shifts, however, there still remains an understanding that interference should be kept to an appropriate extent, given the importance international investments and business co-operations have for German businesses and the German economy, both from an export and increasingly from a technology and R&D perspective.

A major challenge going forward will be to ensure predictability and not risk causing investor uncertainty to a degree that impinges on Germany's attractiveness as an investment location. The fact that Yantai's acquisition of Duisburg Tubes Production, a company producing specialty valves used in the nuclear industry, was cleared earlier this year shows the degree of unpredictability the Leifeld case raises. The government will take notice of the uncertainty created by recent CFIUS-decisions for the FDI climate in the US.

Also, while the priorities have shifted towards a greater willingness to protect German security interests, there is still an awareness that Germany's FDI enforcement practice must be carefully calibrated to not risk undermining its overall political interest in maintaining free trade and a market-based environment, and limit government interventions to those instances of legitimate national security concerns.

IV. Investors must adapt, address concerns, and credibly articulate their intentions

Foreign investors and domestic companies will need to respond to this shift described in three ways.

First of all, they need to adapt to the new environment, in which securing AWG approval will become a more prominent aspect of the transaction approval process. The willingness of the government to use its tools, coupled with the potentially wide scope of the revised AWG, means that transactions in a broad range of sectors, particularly energy, transport, communications infrastructure, and advanced industrial goods, could be affected.

Secondly, where security concerns exist or are perceived to exist, parties must be willing to substantively engage and find creative solutions to address them, be they mechanisms to firewall security-relevant technology and data, or ensuring the long-term maintenance of key R&D functions and expertise in Germany.

Thirdly, they need to be transparent – not only about the strategic rationale of the transaction (which needs to convince decision-makers), including the plans for the company and the benefits involved for the German partner, but also about the background of the investing company and the ownership structure.

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