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Be Careful What You Wish For… The Foreign Subsidies Regulation Triggers Buyer's Remorse

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In Goethe's famous poem "Der Zauberlehrling", a sorcerer's apprentice enchants a broom to do the work for him, using magic in which he is not yet fully trained. The floor is soon flooded with water, and the apprentice realizes that he cannot stop the broom because he does not know how. His famous words "*The spirits that I summoned / I now cannot rid myself of again*" are often used to describe a fatal development that spirals out of control and can no longer be stopped by the person who caused it. A similar saying from the Anglo-Saxon world "*Be careful what you wish for*" sums it up in a somewhat friendlier and less demonic way. But the core message remains the same.

Some stakeholders may have remembered these words when the European Commission recently published its draft implementation acts concerning the EU Foreign Subsidy Regulation (FSR). The proposed draft implementing regulation has given the legal community an initial glimpse of what the application of the FSR will look like in practice. It seems that this is very much different from what European industry had hoped for.

A new toolbox to protect European industry

Until recently the underlying concept of the FSR was enormously popular with European industry. When the Commission proposed the new tools nearly three years ago, the EU business world was highly supportive of this instrument. The idea that competition within the internal market should not be undermined by non-EU players benefitting from distortive foreign subsidies was certainly compelling. The "regulatory gap" resulting from the fact that EU State aid rules restrict EU Member States from subsidising their domestic companies, while third countries may provide unlimited support to their players even if they are active in the EU, seemed grossly unfair. In particular, third-country subsidies were often used to fund company acquisitions in the EU and to win lucrative public procurement contracts financed by the European taxpayer.

By introducing a mix of State aid and merger control instruments, the FSR has established a new regime, under which parties to a transaction will be under an obligation to notify M&A deals where: (a) the target/joint venture is established in the EU and generated an aggregate EU turnover of at least EUR 500 million and (b) the undertakings involved in the concentration were granted combined aggregate financial contributions of more than EUR 50 million by third countries in the

last three years. Notifiable M&A transactions cannot be closed before clearance has been granted by the EU Commission ("standstill obligation"). A failure to notify or respect the standstill obligation ("gun jumping") may be subject to substantial fines. Although the main focus of the FSR is on third countries, both non-EU and EU players will be caught by the new rules. The new system comes on top of other regulatory work streams, such as merger control, foreign direct investment and export control.

The honeymoon period is over

After business leaders had initially praised the new instrument, the mood has radically shifted in recent months. The main reason for this change of heart is probably the new draft implementing regulation, which has thoroughly spoiled companies' celebratory mood.

From the point of view of the business community, the image of the FSR has changed fundamentally. As is apparent from the consultation process, most companies do not perceive the FSR system as a shield of protection anymore, but as "*excessive red tape*", which "*loses the sight of the big picture" and "ignores the operating practices of undertakings*". The feedback from 75 stakeholders is overwhelmingly negative. In their opinion, the new tool "*risks overwhelming the European Commission with information on millions of minor transactions amongst which it will be hard to spot the distortive ones*". Lawyers and their clients believe that the rules represent a "*humongous challenge*" for companies, "*are unworkable in practice*", "*excessively complicated*" and "*extremely burdensome*". The thresholds for reportable transactions would be too low and it would be "*simply impossible for a financial contribution so low to impact a transaction of this size nor to distort the internal market*". According to the devastating verdict of the public, the new rules put an "*extraordinarily burdensome workload both on affected companies as well as on the Commission*" and "*the uncertainties surrounding the concept of financial contributions are simply unacceptable*".

These are harsh words, but the critics have a valid point. Although the general objective of the FRS is reasonable, it suffers from a fundamental problem. The notion of "*third-party financial contributions*" that determines the notification obligation is extremely broad. It covers hundreds or even thousands of transactions that ultimately may not be "subsidies" at all. Relevant "*financial contributions*" include all types of measures, such as fiscal incentives, tax breaks, capital injections, grants, loans, setting off of operating losses, guarantees, compensation schemes, debt waivers, debt to equity swaps or rescheduling as well as any foregoing of revenue. Even the mere provision or purchase of goods or services is included (i.e. the full amount of the revenue generated or the sales price paid), regardless of whether these transactions are conducted at market terms. Thus, the FSR goes far beyond the notification requirement under State aid law, according to which only measures that involve an "economic advantage" have to be notified. In addition, the FSR system lacks a mechanism comparable to the General Block Exemption Regulation (GBER) in State aid law, under which certain types of aid are automatically exempted from notification.

Déjà vu

The vast majority of observers expect the new system to become a very onerous burden in M&A deals. The Commission has basically taken Form CO used in EU merger control as a blueprint for

the FSR notification forms. However, in terms of the volume of information the new FSR system goes even beyond that and makes a merger control filing look like a child's birthday party. The draft form contains detailed questions on the recipient, grantor, type, amount, award, conditions, purpose and sector concerned, and much more. Parties will have to provide vast amounts of paper and data, such as transactional documents, legal and economic details, financial data, turnover figures in all variations, contact details of other players, "*analyses, reports, studies, surveys, presentations and any comparable documents*", recent annual accounts, etc. If these documents are not in an official EU language, they have to be translated.

While the harsh criticism is understandable, it has to be said that this could have been expected. It does not come as a big surprise that the Commission intends to handle the new instrument in exactly the same way as it has used its tools in other fields. Any EU law practitioner is familiar with the heavy-handed and extremely burdensome approach which the Commission has pursued over many decades in merger control, antitrust, State aid, trade law and other areas. This is the expression of a mindset that is increasingly focusing on quantity, i.e. the sheer mass of information. Nobody makes this clearer than Commissioner Vestager herself who regularly prides herself on collecting hundreds of thousands of documents during investigations.

Stakeholders seem to realize that this is just the beginning of a feast for lawyers and advisors. Competitors are also likely to use their position for strategic purposes, e.g. by making critical submissions and demanding far-reaching commitments. Such opposition by vocal complainants can drive the process into "*phase 2*" and significantly delay closing. Moreover, the fight can be expected to continue before the Union courts. Competitors and their lawyers will certainly test the boundaries when it comes to challenging a positive decision.

Look on the bright side

Not everybody shares this pessimism, however. Some observers are confident that the Commission will act with restraint when using the new instruments. Such optimism is also based on recent statements of Commissioner Vestager that "*we intend to focus on major distortions [and that the FSR] is a net that is designed to catch the big fish … .And one way to achieve this, of course, is to focus on large transaction*s." This sounds reasonable, but under the new system, the Commission has only limited flexibility. The FSR provides for a compulsory notification mechanism, which is subject to heavy fines, and the Commission does have to take a decision, so there is little leeway for the enforcer. In any case, any softer treatment of EU players would inevitably lead to legal challenges and would also undermine the credibility of the system.

By the way, in Goethe's poem, when all seems lost, the old sorcerer returns, quickly breaks the spell and saves the day. The poem finishes with his statement that powerful spirits should only be called by the master himself. Applying this finding to the FSR, probably means that is therefore mainly up to the legislator, i.e. the Commission or even the Council and the Parliament, to fix these shortcomings – and sooner rather than later.

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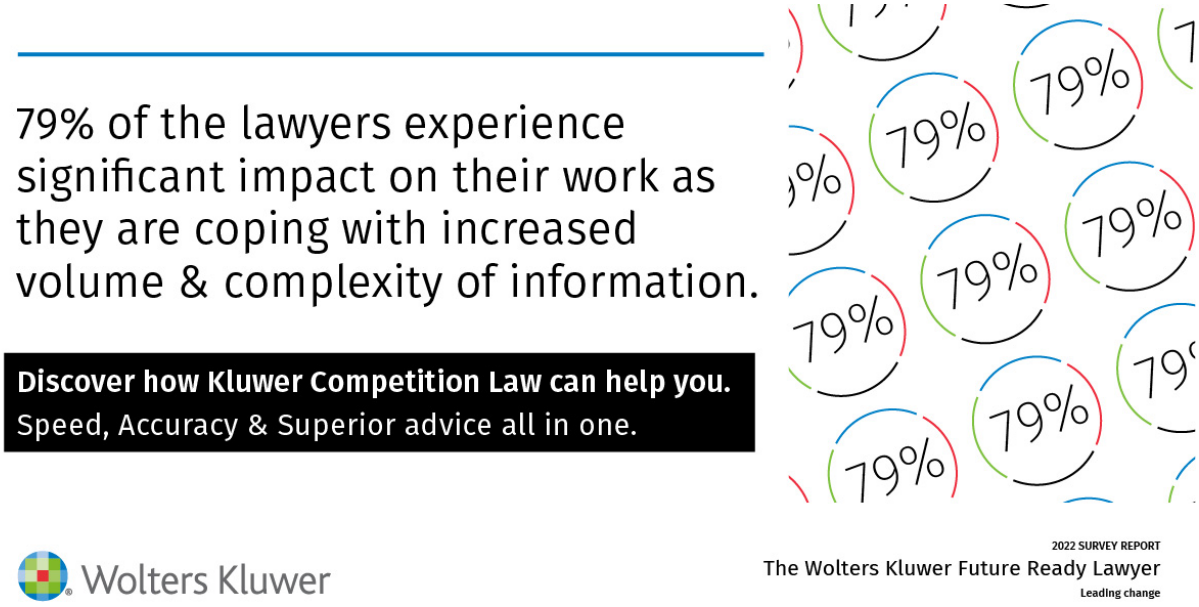

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