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Check Out My Gravel Pit – Court of Justice of the European Union On The Scope of The FDI Screening Regulation and Restriction on The Freedom of Establishment

Judith Feldner, Felix Frommelt (E+H Attorneys-at-Law) · Tuesday, July 25th, 2023

Loosely based on the lyrics of the band Wu-Tang Clan, the Court of Justice of the European Union (**CJEU**) took a closer look at the acquisition of a Hungarian gravel pit in its judgment of 13 July 2023, C- 106/22, and found some rather big "*stones*" to turn around with regard to FDI in Europe.

The key takeaways are:

- The FDI Screening Regulation – except for exceptional circumstances of "*circumvention*" – does not apply to investments by EU-based companies.
- FDI screening mechanisms of EU Member States may restrict the fundamental freedom of establishment and such restrictions can only be justified by genuine and sufficiently serious threats to a fundamental interest of society (which the veto decision by the Hungarian FDI authority did not meet).

Hungary blocks the acquisition of a quarry

Xella Magyarország (**Xella**), a Hungarian company, was blocked from acquiring Janes és Társa, another Hungarian company active in the extraction of gravel, sand and clay (the **Target**), by Hungary's FDI authority in July 2021 for the second time after the Budapest High Court had annulled its first decision, *inter alia*, because it failed to state reasons for the prohibition.

The Hungarian FDI authority considered the Target as a "*strategic*" company on account of the extractive activity and Xella to be a "*foreign investor*" under Hungarian law because it is the subsidiary of a German parent and Luxembourg "*grandparent*" company, the latter indirectly owned by a company based in Bermuda that itself is ultimately owned by an Irish national. According to the Hungarian FDI authority, such indirect ownership by a Bermudan company would pose a longer-term risk to the security of the supply of raw material to the construction sector, in particular at the local level, and would also reduce the proportion of domestic-owned companies. Noteworthy in this regard is that the Target has a market share of 0.52% on the Hungarian market (locally 20.77%) and pre-transaction Xella had already been purchasing 90% of the Target's annual production for its own bricks production.

Xella challenged this decision arguing, *inter alia*, a violation of the free movement of capital and freedom of establishment and stressing the fact that its ultimate owner was in fact an EU national.

The judgment of the CJEU

The FDI Screening Regulation had recently been criticised as leading to a non-transparent proceeding involving the European Commission and the other EU Member States, which can result in delays in the closing of a screened transaction. As (so far) the EU Member States have decided for their respective national FDI regimes which transactions (e.g. all FDI filings submitted in the respective national regime or only certain constellations of transactions) and when in the proceedings (e.g. before Phase I starts or only Phase II cases) are forwarded to the EU cooperation mechanism, a complex hotchpotch exists. In this respect, the judgment definitely comes as a relief.

The CJEU first provided important clarifications concerning the regulation's scope. The scope is limited to investments in the EU made by undertakings constituted or otherwise organised under the laws of a third country. Therefore, the FDI Screening Regulation does not apply to investments made by undertakings organised in accordance with the laws of a Member State over which an undertaking registered in a third country has majority control – except for cases of "*circumvention*" of the screening mechanism where the investor is ultimately owned or controlled by a natural person or an undertaking of a third country by means of artificial arrangements not reflecting economic reality. Thereby, the CJEU dismissed the Advocate General's view that "*indirect*" foreign direct investments are caught by the FDI Screening Regulation because "*any other interpretation would run counter the purpose*" of the regulation but confirmed the European Commission's position.

Second, the CJEU reiterated – in accordance with its settled case law – that acquisitions allowing the acquiring company to exert a definite influence on the management and control of the target company must be examined in light of the rules of freedom of establishment under the TFEU (and not the rules on the free movement of capital). In addition, it also reiterated that the right of companies to rely on the freedom of establishment is based on the location of the registered office and legal order of which the company is incorporated and not on the nationality of its shareholders. Therefore, Xella could in fact rely on the freedom of establishment. In addition, the CJEU stressed that provisions on freedom of establishment under the TFEU only apply in cross-border situations and not to situations that are confined in all respects within a single Member State. Given that the case seems to be confined within Hungary, it can be viewed as rather remarkable that the CJEU held that the cross-border ownership of Xella's German parent and Luxembourg grandparent company provides for a sufficient "*relevant foreign element*" for the examination under the freedom of establishment (even if those EU companies of the group did not appear to play any direct role in the acquisition of the Target).

Third, the CJEU confirmed that the restriction on Xella's freedom of establishment was "*particularly serious*" as the objective of ensuring the security of supply to the construction sector with gravel, sand and clay, "*in particular at the local level*" does not constitute – unlike the ensuring security of supply in the petroleum, telecommunications and energy sectors – a "*fundamental interest of society*". Furthermore, the CJEU even stated – somewhat *obiter dictum* – that it does not appear that Xella's acquisition of the Target is capable of giving rise to a "*genuine and sufficiently serious threat to a fundamental interest of society*" in accordance with settled case

law, as regards the supply of basic raw materials to the local construction sector, because: (i) prior to the acquisition, Xella had already been purchasing 90% of the Target's production and (ii) the risk of export of these materials is "*unlikely or even non-existing in practice*" due to the high transport costs compared to the relatively low market value of those raw materials.

Lessons to takeaway

The CJEU's ruling is *a priori* rather specific. It deals with the interplay of freedom of establishment and a Member State's FDI screening mechanism enabling it to veto acquisitions of a resident company by another resident company which is a member of a group of companies established in several Member States, over which an undertaking of a third country has decisive influence, based on the ground that the acquisition harms or risks the security of supply to the construction sector, in particular at the local level, with respect to basic raw materials such as gravel, sand and clay.

However, the CJEU provided some important general clarifications with regard to foreign investments in the EU that may also have further implications for Member States' FDI screening mechanisms:

- The scope of the FDI Screening Regulation is "*limited to investments in the European Union made by undertakings constituted or otherwise organised under the laws of a third country*". Therefore, only direct investments by third-country investors fall in the scope of that regulation. Except for "*artificial arrangements*" that are chosen to circumvent the screening mechanism – a concept that must be narrowly applied – the foreign ownership of an EU company is not relevant in this regard. This clarification may have far-reaching implications for Member States whose national foreign investment screening mechanism extends to so-called "indirect" foreign investments (e.g. investments by EU companies that are controlled by third-country investors), because the FDI Screening Regulation would not apply in this regard. In light of the CJEU's Xella-ruling, the EU cooperation mechanism would not be triggered in this regard, but only the Member State's national screening mechanism applies.

- Notwithstanding the foregoing, the CJEU also reiterated that in situations of "indirect" foreign investments the freedom of establishment under the TFEU must be respected. Restrictions to this EU fundamental freedom can only be justified by a "*genuine and sufficiently serious threat to a fundamental interest of society*" under national law. The CJEU's reminder that the objective of guaranteeing the security of supply of products or services regarding the petroleum, telecommunications and energy sector has been found to justify restricting the freedom of establishment raises some further doubts: Is the rather broad scope of activities some Member States have adopted that trigger the national foreign investment screening in line with the strict requirements laid down in the CJEU's case law? Or is this only a reminder as regards the substantive assessment of FDI cases?

Although the Xella decision is the first ruling by the CJEU on the FDI Screening Regulation, it may have far-reaching implications for FDI screening in the EU. It remains to be seen whether and how the Member States and the European legislator respond to this ruling. The consultation on the revision of the current EU framework, which started in mid-June 2023, is the perfect opportunity to deal with the many open questions deriving from the Xella judgment and the lessons learned in recent years. Any amendments to the legal provisions of the national FDI regimes will take some

time. Therefore, it will be interesting to monitor the approach of the national FDI authorities following the Xella judgment, as they will sometimes have to ignore certain national provisions which are not in line with the CJEU's clarifications in Xella.

In any event, there will be no summer lump for everybody working on FDI matters in the EU.

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