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European Court of Justice Rules on Foreign Direct Investment Screening

The Court's first decision on FDI screening limits the scope of the EU FDI Screening Regulation and underlines that national regulators must meet a high legal standard to block foreign investments.

On July 13, 2023, the Court of Justice of the European Union (Court) held that the decision by the Hungarian government to block the planned acquisition of a Hungarian sand and gravel quarry under its national foreign investment screening laws was incompatible with EU Treaty rules and in particular in violation of the freedom of establishment.

Most importantly, in this first judgment (C-106/22) regarding foreign direct investment screening, the Court held that:

- the EU FDI Screening Regulation (Regulation) is limited to investments in the EU made by undertakings constituted or otherwise organized under the laws of a non-EU country; and
- national FDI regulators must meet a high legal standard when restricting the freedom of establishment (either by imposing remedies or, more importantly, issuing prohibition decisions). The Court therefore applied its settled case law that any such restriction for security and public order reasons was only justifiable if it prevented a "genuine and sufficiently serious threat to a fundamental interest of society."

In commenting on the scope of the Regulation and reiterating the high legal standard for EU Member States to block transactions, the Court seems to challenge some of the more recent political and legislative developments, in particular, some of the EU Member States lowering the thresholds for intervening with foreign investment into the EU. At the same time, the Court leaves many questions unanswered.

Facts of the Case

The blocked transaction relates to the planned acquisition of a Hungarian company (the Target) operating a quarry (extraction of gravel, sand, and clay) by another Hungarian company (Xella), whose ownership chain contains a German, a Luxembourg, and a Bermuda company and is ultimately owned by an Irish national. The Hungarian FDI authority blocked the transaction (1) since the acquisition of Hungarian companies producing construction aggregates (sand, gravel, and clay) could threaten the security of supply in the construction sector, and (2) more generally to prevent speculative investments in strategic companies in Hungary by companies from third countries, including Bermuda.

Xella challenged that decision before national courts and the Budapest High Court referred two questions to the Court on the interpretation of EU law.

The Court's Ruling

1. Scope of applicability of the Regulation

The Advocate General (AG) had argued in its opinion on March 30, 2023, that Hungarian national FDI Law and therefore the transaction fell within the scope of applicability of the Regulation. Limiting its application to direct investments by companies established in third countries would undermine the very objective of screening foreign investments for potential threats to security and public interest. The Court dismissed this interpretation and instead agreed with the European Commission (in a strict interpretation of the definitions set out in the Regulation itself), finding that only "direct investments" in EU companies by non-EU investors (legal entities established outside the EU) are subject to the Regulation. Importantly, companies established in the EU must be able to rely on their freedom of establishment, even if they are ultimately foreign-owned.

2. Blocking decisions under national FDI laws restrict the freedom of establishment and need to be justified

Against this scope of applicability, the Court found that the decision by Hungary to block the transaction constituted a restriction of Xella's freedom of establishment. Such restrictions can be justified; however, since the restricted action constitutes a "genuine and sufficiently serious threat to a fundamental interest of society," Hungary had not met this justification test in the case at hand.

The Court held that objectives linked to the security of supply could in principle be relied on (if the threat to a fundamental interest of society was sufficiently serious). However, in light of the very low market value of the raw materials extracted, and the fact that Xella had already purchased approximately 90% of the Target's production prior to the transaction, the Court was not convinced that the transaction would constitute such a "genuine and sufficiently serious threat to a fundamental interest of society." Hungary did not provide sufficient proof in this regard.

Practical Implications

The Court's decision is the first genuinely FDI-related ruling at EU level. However, rather than providing some general guidance on how to interpret the relevant provisions under EU law and then apply the existing national FDI regimes in line with EU law, the decision raises a number of questions.

1. Most importantly, the Regulation may not apply to any or at least most indirect acquisitions of EU companies by ex-EU investors (in particular if the investment decision is taken by an EU-based acquirer who is controlled by a non-EU holding company which in turn is not involved in the investment decision). The Court does not define "direct investments," therefore the question remains whether certain investments we would consider indirect (for example investment decisions driven by the ex-EU owner of the direct EU investor) falls within scope of the Regulation. In any event, EU Member States are free to adopt FDI laws that cover all kinds of indirect investments.

2. In practice, the EU cooperation mechanism would no longer apply to any indirect investments that do not fall under the scope of the Regulation, but are being reviewed by the EU Member States based

on their national FDI laws. EU Member States would no longer need to or potentially be able to notify each other of their national screening processes and would not be obligated to consider any comments received by other Member States or the European Commission. While this practice could significantly speed up many M&A transactions and remove one layer of complexity from the FDI processes in Europe, whether national FDI regulators will change their approach in this regard remains to be seen.

3. According to the Court, EU Member States will need to comply with a high legal standard when justifying any negative decision (blocking foreign investment or only allowing it subject to conditions). National regimes allowing seemingly low thresholds to authorize national governments to block transactions, such as "likely effect on the public order or security*"* in Germany, will have to assess whether their approach to blocking investments complies with EU law, in particular if the regimes apply to transactions not within the scope of the Regulation.

Outlook

Future implications depend on whether the EU Member States will react to the Court's ruling and whether it will cause them to better explain the substantive concerns behind any negative FDI screening decision. In the meantime, foreign investors who directly (or indirectly) invest into EU companies will continue to face a large number of national FDI regimes in parallel (currently 19) and assess potential filing obligations and substantive issues based on individual jurisdictions. The Court's ruling should, however, encourage investors to appeal in court any negative decision that does not appear to be sufficiently justified on grounds of national security or public order.

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