ECJ: Investment ban against EU companies with third country-owners may violate the freedom of establishment

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In its judgment of 13 July 2023 in Case C-106/22 (Xella), the ECJ ruled that the objective of ensuring 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 cannot justify a restriction on the freedom of establishment. The judgment is the first time the ECJ has taken a ruled on the scope of Regulation (EU) No 2019/452 (*EU-Screening-Regulation*). In addition, it tests the interference with the freedom of establishment by a national investment control regime against established, strict criteria.

Prohibition of the acquisition of a Hungarian company by another Hungarian company?

The case concerns the prohibition by the Hungarian Ministry for Innovation and Technology (*HMIT*) of the acquisition of the Hungarian company Janes és Társa, which operates a gravel, sand and clay pit, by the Hungarian company Xella Magyarország (*Xella*, a producer of concrete construction materials).

The acquirer, Xella, is owned by a company established under German law, which in turn is owned by a company established under Luxembourg law. The latter is indirectly owned by the holding company of a group registered in Bermuda, which is ultimately owned by an Irish national.

The HMIT prohibited the acquisition because it considered that the transaction harmed or threatened to harm "national interests". According to the HMIT, the security and predictability of raw material extraction and supply were of strategic importance. A prohibition was only possible because the HMIT had classified Xella as a "foreign investor" because it is indirectly owned by a company registered in Bermuda.

Xella Magyarország argued that the prohibition constituted arbitrary discrimination or a disguised restriction on the free movement of capital or freedom of establishment.

The Budapest High Court referred the case to the ECJ.

The question of the court concerned the compatibility of Hungarian investment control law with EU law. In particular, the referring court asked whether the free movement of capital in Article 65(1)(b) TFEU, read in conjunction with recitals 4 and 6 of the EU Screening Regulation and Article 4(2) TEU, must be interpreted as meaning that the Hungarian

investment control law is compatible with EU law. Article 2 TEU must be interpreted as precluding a Member State investment control regime which allows the acquisition of the ownership of a resident company by another resident company, but which belongs to a group of companies established in several Member States and over which a company from a third State has a determining influence, to be prohibited on the ground that the acquisition impairs or threatens to impair the State's interest in ensuring security of supply for the benefit of the construction sector.

The EU Screening Regulation does not apply to EU investors

The ECJ first held that the acquisition did not fall within the scope of the EU Screening Regulation.

The EU Screening Regulation only applies to "foreign direct investments" which are aimed at the establishing or maintaining a lasting and direct participation of a "foreign investor" (Article 1 para. 1, Article 2 No. 1 EU Screening Regulation). However, according to the definition in the Regulation, a "foreign investor" is a natural person of a third country or an undertaking of a third country (Article 2 No. 2 EU Screening Regulation). However, the investor Xella was a company with its registered office in Hungary and thus a resident of the EU. Its ownership structure was not taken into account.

This was not changed by Article 4 (2)(a), Article 9 (2)(a) of the EU-Screening-Regulation, according to which the ownership structure of the foreign investor could be taken into account as a factor in the assessment of a potential risk to public security or public order. This is because the assessment explicitly refers to the ownership structure of a "foreign investor", which Xella is not.

In such a case, the EU Screening Regulation could only be applied if there is a circumvention constellation. This could be the case, if the EU-based company acts as a "straw man" for a non-EU company (cf. Article 3(6) EU-Screening-Regulation). However, such circumvention was not apparent to the ECJ and did not emerge from the case files.

The EU-Screening-Regulation was therefore not applicable to the case.

Examination solely on the basis of the freedom of establishment

Consequently, the prohibition had to be assessed solely on the basis of the freedom of establishment under Article 49 TFEU. The ECJ emphasised that the possibility of invoking the freedom of establishment depends solely on the EU residency of the company concerned and not on the nationality of its shareholders.

In contrast, the freedom of movement of capital under Article 63 (1) TFEU does not need to be examined, as it concerns a shareholding that enables a definite influence to be

exerted on the decisions of a company and to determine its activities. In this case, according to the established case law of the ECJ, the prohibition of the investment has to be examined primarily on the basis of the freedom of establishment.

The ECJ has affirmed the existence of a sufficient cross-border link despite the fact the two acquiring parties were from the same EU Member State (Hungary) due to the shareholders concerned were resident in different EU Member States (Germany, Luxembourg and Ireland).

The ECJ recognises a "particularly serious restriction" in the prohibition of the acquisition, as it makes the exercise of the freedom of establishment impossible.

The ECJ then examines whether the interference could be justified on grounds of public policy and public security pursuant to Article 52(1) TFEU. The ECJ then discusses that purely economic reasons related to the promotion of the national economy or its proper functioning do not justify an interference with the fundamental freedoms. There must be a " genuine and sufficiently serious threat to a fundamental interest of society". Here the ECJ draws an interesting parallel. In Case C-244/11 (Commission v Greece), it had emphasised that security of supply by undertakings in the petroleum, telecommunications and electricity sectors is such a fundamental interest of society. The situation was different in the Xella case. The objective of ensuring security of supply for the construction sector, particularly at the local level, in relation to certain basic raw materials such as gravel, sand and clay, was not such a fundamental interest of society, in particular when measured against the seriousness of the interference.

The ECJ has expressed doubts as to whether the acquisition actually poses a "genuine and sufficiently serious threat” to the supply of basic raw materials for the local construction sector. One reason for this was that prior to this acquisition, the acquirer had already purchased approximately 80% of the production of the relevant basic raw materials of the acquired company's extraction plant in order to process them in its plant located close to the extraction plant, and that the remaining 10% of the production was purchased from local construction companies. In addition, the basic raw materials in question have a low market value by nature, so that the realisation of the risk of exporting a significant part of the production of this extraction plant instead of selling the raw materials on the local market seems unlikely to be excluded.

Consequently, the "particularly serious restriction" of the freedom of establishment could not be justified.

Implications for German investment control law

In addition to Hungary, a number of other EU Member States also take the acquirer structure into account when determining nationality. With this decision, the ECJ clarifies that such constellations do not fall under the scope of the EU-Screening-Regulation. The

provisions of the Regulation, such as those on the exchange of information between the EU Member States and the European Commission, do not apply in these cases. The only exception is in cases of circumvention (parallel, German investment control law in Section 55 (2) sentence 1 of the Foreign Trade and Payments Ordinance).

German investment control law generally focuses on the legal establishment or the place of the headquarters when determining the EU residency of companies (Section 2 (18) No. 2 of the Foreign Trade and Payments Act).

Section 55a (3) sentence 1 No. 1, sentence 2 of the Foreign Trade and Payments Act also provides for an examination criterion relating to the structure of the acquirer. However, there are two differences compared to Hungarian investment control law. Firstly, the test criterion only concerns the control of the acquirer by a third country and not by an enterprise. Secondly, this screening criterion also presupposes that the acquirer is foreign to the Union. The EU-Screening-Regulation thus continues to apply to situations falling under German investment control law.

However, not only direct but also indirect acquisitions are subject to German investment control (Section 55 (1) of the Foreign Trade and Payments Ordinance). An indirect acquisition is also deemed to exist in constellations in which non-EU nationals acquire domestic companies or shares in domestic companies through their shareholdings in a resident company. This applies irrespective of the number of companies in the chain between the non-EU citizen and the direct acquirer. Consequently, the Federal Ministry for Economic Affairs and Climate Action also focuses on the structure of the acquirer. The question therefore remains as to how the ruling will affect cases of indirect acquisition that are subject to German investment control.

With this ruling, the ECJ also confirms its case law from the early 2000s, beginning with Case C-54/99 (Église de scientologie). An interference with fundamental freedoms is only permissible if there is a "genuine and sufficiently serious threat to a fundamental interest of society". Consequently, restrictions on the freedom of establishment must meet these high standards. The security of the populations' supply with petroleum, telecommunications and electricity meets these requirements. In any case, the supply of gravel, sand and clay to the construction industry at a local level is not sufficient.

In any event, the ECJ confirms the anticipatory element inherent in an investment test. A concrete danger does not have to exist at the time of the prohibition. There need only be a risk that this risk will materialise in the future (C-106/22, para. 73). In our understanding, the criterion of probable impairment in Sections 55 (1), 60 (1) sentence 1 of the Foreign Trade and Payments Ordinance is to be interpreted in the same way.

The impact on German investment control law is therefore likely to be less than on the investment control regimes of other EU member states such as Hungary.

BLOMSTEIN will continue to monitor further developments in case law and administrative practice. If you have any questions, please do not hesitate to contact Dr. Roland Stein and Dr. Leonard von Rummel.