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Why Int'l Investors Should Keep An Eye On German M&A Regs

By **Marcus Geiss and Sonja Ruttmann** (June 29, 2023, 3:23 PM BST)

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One of the first things that international first-time investors in Germany tend to notice is how German corporate law focuses on formalities.

Comparatively high notarial fees — five figures are not uncommon — is a well-known feature of German mergers and acquisitions practice.

Other common practices include the physical presence of party representatives in a notarial office for the recording of share purchase agreements and for other routine corporate matters like the formation of corporations or the acquisition of shelf entities, mergers, conversions or changes to the articles of association.

Despite the pressures of international competition and a worldwide trend toward digitization and globalization, German corporate customs have largely remained resistant to change.

The pandemic and the war in Ukraine, however, recently triggered an unusual flurry of reforms and new initiatives that have the potential to change the legal landscape and significantly move the goal-posts over the medium term.

In the next three or four months alone, several important changes and new procedural options and requirements will be introduced. International investors and other interested M&A players should be aware of these changes.

There are two specific areas of the law that German and European lawmakers recently focused most keenly on: the digitization of corporate law and the introduction of further, or the tightening of existing regulatory requirements used to either protect fair competition or control foreign investment in Germany.[1]

So, what are the most notable changes on the immediate horizon? And how will they affect the German M&A market and anyone looking to invest in Germany?

Digitization of Corporate Formalities

Since Aug. 1, 2022, based on the European Digitalization Directive,[2] the incorporation of limited

liability companies in cash no longer necessarily requires the physical presence of the parties before a notary.

Instead, it can be conducted by the notary via a special online conferencing portal operated by the German Chamber of Notaries,[3] based on specific and secure electronic IDs.

A number of other notarial measures specifically listed in the law can also be completed online now. This applies, in particular, to the certification by notaries of signatures in the context of German commercial register filings — a common German formality required for managerial exchanges, carve-outs, mergers, conversions, capital measures or other changes to articles of association.

The scope of what can be notarized online in Germany will be extended further on Aug. 1 to include:

- The incorporation in kind of German GmbHs, but not if other GmbH shares or real estate are being contributed in kind as their transfer is subject to a separate, independent notarization requirement;

- Online notarial recordings of changes to articles of association, including decreases or increases of share capital, but only if resolved unanimously by all shareholders; and

- The notarial certification of signatures for partnerships, oHG and KG.

However, in an international context, key limitations remain.

In particular, the technical requirements regarding how foreign signatories can prove their identity to a notary are likely to preclude signatories from outside Germany or the European Union from using this online option.

To muddy the waters further, German courts recently passed several important decisions that highlight the requirements for when a signature certification obtained before a foreign notary is considered equivalent and acceptable in Germany.

In the first decision on March 3, 2022, the Berlin Appellate Court[4] reiterated that the foreign notarial signature certification must respect two minimum requirements: the personal presence of the signatory, signing the document in their own hand before the notary and due verification of the signatory's identity.

In a similar vein, an even more recent court decision by Karlsruhe Higher Regional Court on the April 20, 2022,[5] ruled that the certification of signatures by a Swiss notary — even though notaries in Switzerland generally are deemed equivalent to German notaries in terms of education and functionality — was not admissible in Germany in that particular case because the Swiss notary did not witness the signatory signing in his own hand but merely compared his signature to a precollected sample signature.

When viewing the legal reforms and court edicts in conjunction, the conclusion is that, while German law generally is moving toward liberalizing its corporate formalities and is starting to make inroads toward alternative online and digital procedures, access to such alternatives for foreign-based investors, particularly those outside the EU, remains closed off for now. For them, the way business is conducted in Germany has hardly changed for the time being.

Furthermore, feedback from notaries in Germany shows that even German M&A players and corporations have not yet availed themselves of the new online procedures to any significant extent.

Notaries also report that they have not yet pushed aggressively toward establishing the necessary technical infrastructure to conduct online notarizations as routinely as they do in-person recordings or certifications as the demand has not been there so far.

Regulatory Requirements as Regular Features of M&A

If the message for international investors is somewhat mixed on digitization, trends in regulation seem clear, at least at first sight: Regulatory control procedures in Germany are more prevalent and getting tighter.

At the same time, the number of transactions that are affected by these regulatory procedures, or where specialist legal advice is needed to establish what procedures may not apply to a specific case, is also on the rise.

This is readily apparent when looking at simple numbers: Where traditionally only merger control proceedings featured on the regulatory menu of almost every M&A transaction of a certain value, with foreign investment control mostly a niche feature, now investors and their lawyers need to have two additional regulatory pre-clearance procedures on their radars — namely, the vastly expanded foreign investment control regime and the new EU review of non-EU or non-Electronic Fund Transfer Act third-party subsidies.

Foreign Direct Investment

Screening procedures on foreign direct investment, or FDI, control pursuant to the German Foreign Trade and Payments Act and the German Foreign Trade and Payments Ordinance recently moved center stage.[6]

What was initially designed mainly as a control mechanism in the defense sector and for certain other limited applications has gradually evolved and been expanded by lawmakers in a series of reforms to cover further sensitive sectors and industries to such an extent that lawyers with specialist FDI expertise are now a standard part of any reasonably staffed German M&A team.

This is evident in the absolute number of reviewed cases, which increased to 570 transactions[7] in 2022, compared to 78 in 2018 and 190 in 2020. Of the 2022 transactions, 4.5% were either not cleared or cleared subject to certain conditions and mitigation measures.

But this proliferation of absolute case numbers does not tell the whole story when viewed through the lens of globalization, because at the heart of this extension of the scope of FDI rules and the industries and sectors potentially covered by them is a desire by local governments to control and limit foreign influence on the German economy and avoid the kind of dependencies that proved troublesome in the gas and energy sector when the war in Ukraine broke out.

The idea of protectionism and the selection of suitable trade partners via legal avenues also infuses the government's recent first draft of a "China strategy paper" that is expected to be adopted by the second half of 2023 and to amend the FDI review process.

The paper covers primarily:

- Making new company incorporations and risk capital financing by non-EU investors subject to FDI review;
- The ability to prohibit or restrict German outbound investments;
- An increased exchange with EU and Group of Seven member states;
- Tightened investment control, particularly regarding investments in critical infrastructure; and
- The introduction of Germany's and the EU's technological sovereignty as a new review criterion.

The strategy paper can also be interpreted as a direct response to the fact that the most notable recent proposed M&A transactions that were objected to or otherwise modified tended to involve proposed inbound investment from Chinese investors.

Third-Country Subsidies

Another new clearance procedure was introduced in Germany and the rest of the EU by the EU's Foreign Subsidies Regulation, or FSR,[8] which came into force on Jan. 12.

The FSR introduces, inter alia,[9] a new clearance procedure for proposed mergers or other relevant M&A transactions whenever (1) participating entities meet certain turnover thresholds in the FSR and (2) third-country, i.e., countries that are not EU member states, subsidies in excess of €50 million ($54.8 million) were received within the three fiscal years preceding the notification.[10]

The key dates to keep in mind in terms of potential transactional regulatory requirements are July 12, when the regulation starts applying in earnest, and Oct. 12, when the formal pre-transaction notification requirement to the European Commission kicks in.

In terms of the procedure to be observed, third-party subsidy control proceedings will follow procedural requirements similar to classic EU merger control filings — i.e., they will involve a strict prohibition against closing and implementing the transaction prior to clearance or deemed clearance by the European Commission. Going forward, this will have to be factored into the transaction timeline as a potential delaying factor.

As the FSR applies to the entire territory of the EU, this procedure will require investors to adopt a broader, EU-wide approach to establish whether any critical third-country subsidies were granted.

It should also be noted that the U.S. and, following Brexit, the U.K. will be among the third countries the FSR takes aim at, meaning that U.S. and U.K. subsidies will also be screened by authorities.

At this stage, immediately prior to this new screening tool going live, it is difficult to predict the extent to which the procedure will become part of the standard repertoire in many or most M&A transactions like traditional merger control clearances or FDI proceedings.

This will depend on the prevalence of relevant third-country subsidies, and will be one of the most

interesting regulatory questions in the M&A sector in the next couple of years when this newly introduced feature will start being tested in practice.

It is estimated, however, that some 100,000 entities in the EU have third-country owners, so the potential for the procedure to apply in practice should not be underestimated.

Conclusion

The recent political and macroeconomic upheaval has caused significant changes to the general framework of German corporate and transactional law. Strict formalities that have been immune to change for many decades have recently been opened up to online alternatives to modernize the law in an increasingly fast and international world.

At the same time, new or tighter regulatory hurdles have been erected at EU and national level to control inbound investment into Germany.

It would, therefore, be wrong to assume that the twin forces of digitization and globalization always pull in the same direction: More modern does not necessarily mean more open.

Foreign investors in Germany will be wise to keep a keen eye on the current flurry of German legislation, mindful of the fact that globalization and digitization are neither a curse nor the cure, or a bit of both, when it comes to dealing with the traditional specifics of German law.

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[1] For further details, see the English-language corporate alert, published at https://www.gibsondunn.com/german-corporate-law-update-2023/, which was originally published as a German- language article by the M&A Review on February 11, 2023, available online under: https://www.gibsondunn.com/wp-content/uploads/2023/02/Friedl-Geiss-Ruttmann-Englisch-Deutsches-Gesellschaftsrecht-2023-Ein-turbulentes-Jahr-MA-Review-02-2023.pdf.

[2] Directive (EU) 2019/1151 of June 20, 2019 amending Directive (EU) 2017/1132 as regards the use of digital tools and processes in company law, published under: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019L1151.

[3] https://www.bnotk.de/aktuelles/details/erste-online-gruendung-einer-gmbh-in-deutschland.

[4] KG Berlin, case no. 22 W 92/21, dated March 3, 2022, published inter alia at NZG 2022, 926, reviewed in greater detail in our alert (see footnote 1) under section 3.1.

[5] OLG Karlsruhe, case 1 W 25/22 (Wx), dated April 20, 2022, published inter alia at NZG2022, 1603.

[6] See in greater detail our alert (see footnote 1) under section 1.

[7] This figure comprises 306 national screenings and 264 EU screenings.

[8] EU Regulation (EU) 2022/2560 of the European Parliament and of the Council of December 14, 2022, on foreign subsidies distorting the internal market; available in English at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32022R2560&qid=1673254237527.

[9] A notification and review process also applies for tenders in public procurement procedures subject to certain thresholds. In addition, the EU Commission has the right to conduct ad hoc ex officio investigations if foreign subsidies are at issue that potentially distort the internal market.

[10] See in greater detail our alert (see footnote 1) under section 2.