JONES DAY

OCTOBER 2014

COMMENTARY

Foreign Investments Into the EU: Demystifying National Protectionism

Capital is global. Business is globalizing. Yet politics and fiscal matters, primarily jobs and taxation, are inherently local in nature.

The collision between capital/business interests and political/fiscal interests primarily comes to the fore in cross-border M&A. With the surge of big-ticket M&A activity beginning at the end of 2013, this has played out in the United States primarily as a fiscal issue, with U.S. politicians voicing concerns about so-called "inversion" transactions in which large U.S. corporate buyers have relocated their tax domiciles from the U.S. to more tax-friendly countries like Ireland and England. At the same time, as the EU economy has begun to stabilize after the financial crisis, European companies have increasingly become the targets of large, sometimes hostile takeover bids by non-EU headquartered companies, raising national political issues in the countries in which the targets are headquartered.

This *Commentary* discusses a recent transaction that has reignited the debate regarding protectionist measures against attempted foreign takeovers of so-called "national champions": Pfizer's £69 billion ($118 billion) unsolicited takeover proposal for AstraZeneca.

The debate is not new. The public interest test of the sort recently discussed in the UK is likely to be opposed by the European Commission ("EC") as contrary to EU merger control law and the EU internal market principles. These prohibit most measures that would prevent or restrict the free movement of services, goods, people and capital or the freedom of establishment within the EU.

So, while national politicians debate how best to protect so-called national champion businesses from foreign takeovers, a threshold question in respect of takeovers of EU-based companies is whether national governments actually have the power to do so in light of well-established EU legal principles.

Pfizer-AstraZeneca

U.S.-based Pfizer withdrew its unsolicited offer proposal for Anglo-Swedish AstraZeneca following the expiry of the May 26, 2014 "put up or shut up" deadline imposed under the UK's Takeover Code. It is unlikely, however, that Pfizer's withdrawal will extinguish the public debate about whether a public interest test should be applied to foreign takeovers of UK companies involved in sectors of particular importance to the UK economy. The same issue arose in the course of Kraft's unsolicited offer for Cadbury (even though most of Cadbury's operations were situated outside the UK, Cadbury was considered a national champion) and, because the issue is gaining political momentum, particularly on the left of the political spectrum, it will undoubtedly arise the next time a foreign bidder seeks to take over a large UK company.

Despite calls from many sides to do so, the British government was initially reluctant to intervene in the Pfizer–AstraZeneca transaction. In its view, it was the shareholders of AstraZeneca who, as its owners, should decide the outcome of any offer. In addition, given that the UK benefits from having an open and transparent economy, an intervention could send a potentially damaging signal that Britain was not open for business. Furthermore, the political and public reaction to the Kraft-Cadbury deal led to a significant rewrite of the UK's takeover regulations to tilt the balance of power in hostile takeover bids more in favour of the target company and its board. Despite these changes, Chuka Umunna, the opposition Labour Party's shadow business secretary, publicly stated that the party's policy, should it come to power following the May 2015 general elections, would be to subject deals of this nature to a public interest test and block them if the result was negative. The timeframe of the deal would have supported this threat given that it could have taken over a year to clear regulatory hurdles in Europe, the U.S. and China. Mr. Umunna said that Labour would amend the criteria for a public interest test on sensitive takeovers to include the impact on Britain's science and research and development ("R&D") base. A deal would be blocked if a panel composed of scientists and businesspeople warned that it would have an adverse effect.

As a result of mounting public pressure, the UK government gave the go-ahead for officials to explore the government's options with Brussels for a new public interest test and its compatibility with EU law. The Secretary of State for Business, Innovation and Skills, Vince Cable, has confirmed in an open letter of September 4, 2014, that the challenge the government faces in introducing such a new test that complies with EU law "should not be underestimated" but noted that it is not insurmountable.

The EU Dimension

The EC has exclusive jurisdiction over transactions such as Pfizer–AstraZeneca because the parties' revenues meet the EU Merger Regulation ("EUMR") thresholds, i.e., they have an *EU dimension*. The general rule is that no EU member state may apply its domestic competition rules to a deal that has an EU dimension. There are exceptions, but none of them would be likely to apply to Pfizer–AstraZeneca. For example, the national competition authority of an EU member state may ask the EC to refer the merger control review of whole or part of a deal to that member state if the deal threatens to have specific adverse effects on competition in that member state. The EC retains discretion in assessing such request unless the markets are local (smaller than national). In the Pfizer–AstraZeneca case, the markets would likely be considered by the EC to be national (not local) at their narrowest, and, perhaps more importantly, any adverse effects on competition in any EU member state could be remedied through concessions given at the EU level. Therefore, even if the UK Competition and Markets Authority had grounds to make a referral request, it seems likely that the EC would have denied it.

However, the EUMR does allow member states to take measures to protect legitimate public interests other than competition if they are compatible with the general principles and other provisions of EU law.

Public Interest Test

The EUMR contemplates three specific areas of legitimate public interest: (i) public security, (ii) plurality of media, and (iii) prudential rules in the financial services sector. None of these would apply to Pfizer–AstraZeneca. While this list is not exhaustive, if an EU member state wishes to take measures based on other public interest grounds (e.g., protection of R&D capabilities), it must obtain clearance from the EC *before* adopting the measures. If the member state intervenes without approval, it runs the risk of infringement proceedings at the EU level, and unless the member state is able to convince the EC that the grounds for its requests are legitimate—and case law suggests that member states are very rarely successful in this regard—the EC is likely to reject them. In a scenario where it cannot block a deal, a member state's option might be to sabre-rattle enough to negotiate a bilateral arrangement with the foreign acquirer to secure certain protections as a matter of practice.

Europe Has Seen This Before

Various EU member states threatened or implemented protectionist measures against foreign takeovers in the mid-2000s. The EC showed then that it was prepared to go to court to uphold EU merger law and the laws on the free movement of capital. However, although none of these attempted protectionist measures was compliant with EU law, they disrupted and interfered with the overall deal timetable and structure of particular deals.

For example, in 2006, Poland successfully intervened in a merger involving a Polish company over which the EC had exclusive jurisdiction. Following the EC's clearance of the acquisition by Italian bank UniCredito of German bank HVB under the EUMR, the Polish Treasury instructed UniCredito to sell its shares in BPH (a Polish subsidiary of HVB). It cited a breach of UniCredito's obligations under a noncompete clause from a 1999 privatisation agreement (under which UniCredito acquired Polish bank Polska Kasa Opieki) and threatened to revoke the agreement failing such a sale. The EC launched infringement proceedings against Poland on the basis that the measures infringed both the EC's exclusive jurisdiction under the EU's merger control regime and the EU's rules on free movement of capital. The dispute did not reach court, as UniCredito agreed with Poland that it would divest certain Polish branches and the BPH brand. Although Poland did not succeed in blocking the deal, it managed to secure structural changes that, as a matter of EU law, it arguably ought not to have been able to secure.

Later that year, Italy sought to prevent Spanish motorway network operator Abertis from acquiring its Italian counterpart Autostrade, even though the EC had exclusive jurisdiction over the deal and had cleared it unconditionally. The EC launched infringement proceedings against Italy and Italy backed down, but its initial opposition led to Abertis's withdrawal of the proposed takeover.

The outcome of such protectionist battles can be unpredictable. Around the same time as the Italian and Polish cases, the EC took action against a ruling by the Spanish national energy watchdog, CNE, imposing 19 conditions for approving German power group E.ON's €27 billion takeover of Spanish power group Endesa, despite the fact that Brussels had already cleared the deal. The CNE ruling required E.ON to divest one-third of Endesa's electricity generating capacity in Spain. The EC regarded this as illegitimate and opened infringement proceedings against Spain, which resulted in a judgment from the Court of Justice, the EU's highest court, confirming the EC's position that EU member states should not adopt measures that negatively affect mergers with an EU dimension and that are not necessary and proportionate for the protection of a legitimate public interest. Nevertheless, the judgment came too late. In the face of opposition from Spain, whose government wanted to create a national champion and supported a lower bid for Endesa from Gas Natural, E.ON's offer failed. To Spain's chagrin, Gas Natural subsequently dropped its bid, E.ON entered the Spanish market through another deal with Enel, an Italian electricity giant, and Acciona, a Spanish construction and services group, and Endesa's European arm's ultimate fate was to be broken up.

The National Dimension

All the above cases concerned deals having an EU dimension. The legal analysis differs where a deal does not have an EU dimension and therefore falls under national merger control rules.

In the UK, the government has the power to issue an intervention notice if it believes that one or more public interest considerations are relevant to the review of the merger. The effect of an intervention can be either to allow a merger to proceed when it might be blocked on competition grounds or to prevent a merger from proceeding unchecked, in order to protect the public interest. The UK government may specify a new public interest consideration at any time, including after a merger has been announced. This is achieved by an affirmative order, which must be approved by Parliament within 28 days. For example, faced with the potential collapse of the UK banking sector following the fall of Lehman Brothers in 2008, the UK government issued an intervention notice in the proposed merger of UK banks Lloyds TSB and HBOS on the basis of a new affirmative order that the stability of the UK financial system constituted a public interest consideration and this was relevant to the consideration of this merger. The UK competition authority (then called the OFT) contended that the deal would result in a substantial lessening of competition in the UK. However, the government considered that the stability of the UK financial system outweighed the competition concerns identified in the OFT's report and cleared the deal unconditionally on public interest grounds.

Where a merger does not have an EU dimension, member states may find it easier to block takeovers provided they comply with EU free movement rules, such as the free movement of capital and freedom of establishment, pursuant to which, if intra-EU trade is affected, restrictions must be necessary, proportionate, nondiscriminatory and aimed at protecting a legitimate public interest (usually public health or public security, but also the broader concept of public policy).

Conclusion

We expect any new attempts to implement protectionist measures against foreign investments across the EU to meet strong resistance from the EC. With respect to the UK, given that competition in R&D within the EU internal market as a whole and not within each member state is one of the key factors that the EC takes into account in the review of pharmaceutical mergers under the EUMR, a request for intervention aimed at protecting the UK's R&D capabilities risks being rejected or challenged in court by the EC as being incompatible with the aims of the EU internal market.

The bottom line is that where a merger falls under the EC's merger control jurisdiction, there is little, as a matter of law, that an EU member state can do to block it unless it affects national defence, media or financial prudential matters. Nevertheless, a member state may be able to create enough heat and light to negotiate a bilateral arrangement with the foreign acquirer to secure protections. That said, such intervention can have unpredictable results and fail to achieve what the national government intended. Where a deal does not have an EU dimension, member states may find it easier to block a takeover provided that free movement rules, such as the free movement of capital and freedom of establishment, are complied with.

All of this is taking place, of course, in a broader context in which global capital/business interests collide with local political/fiscal interests. The U.S. subjects transactions affecting national security, including anti-terrorism, to a special level of security by an interagency federal governmental committee, called CFIUS, and ultimately the President of the U.S. This scrutiny frequently imposes restrictions on, and in rare instances has even resulted in blocks on, takeovers of U.S. companies by non-U.S. buyers, sometimes in instances such as energy and food in which the connection to national security interests seems attenuated. Other countries such as Canada have merger controls with a broader scope. The key for dealmakers in any cross-border transaction is, in our view, approaching it in a localized manner, understanding not only the host country's legal regime but also developing a multifaceted political, employee and investor-relations strategy in an effort to defuse the now almost certain likelihood that local interests will be elevated independent of shareholder interests. Properly approached in a localized, multifaceted way, we believe that these often very conflicting interests can be effectively satisfied without unduly burdening the buyer's economic rationale for the transaction.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Robert A. Profusek
New York
+1.212.326.3800
raprofusek@jonesday.com

Sophie Hagège
Paris
+33.1.56.59.39.39
shagege@jonesday.com

Matt Evans
London
+44.20.7039.5180
mevans@jonesday.com

Francesco Liberatore
London
+44.20.7039.5221
fliberatore@jonesday.com

Leon N. Ferera
London
+44.20.7039.5213
lnferera@jonesday.com