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European Commission Targets €500 Billion + In "Foreign Subsidies" Worldwide: How Global Businesses Can Address New Compliance Risks And Burdens

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Introduction

A common current buzzword in Brussels, at the European Commission's Directorate-General for Competition, is that of "**regulatory gap.**" Recently, officials at DG Comp (as it is known), with the impulsion of **Ms. Margrethe Vestager**, **Executive Vice-President of the European Commission** (whose portfolio includes competition), have been attempting to fill the gaps with fervor.

The latest and more notable development is the proposal, announced on **May 5, 2021**, for a new EU Regulation to address "**distortions**" caused on EU markets by "**foreign subsidies,**" which may be broadly defined as "selective" economic advantages granted by non-EU governments. The new Regulation should be adopted by the end of 2021, for effective application in 2022.

The **compliance risks and burdens** for multinational businesses, *including EU companies receiving subsidies from non-EU governments*, will be considerable. The concept of "foreign subsidy" will be aligned with the well-established concept of "**State aid**" under EU law. This concept is, however, complex, full of subtlety and nuances, honed by decades of decisional practice and case law.

As further explained below, multinationals should approach these new risks and burdens with **method**. We propose that multinationals rapidly conduct a **group-wide mapping** of foreign subsidies received, by any entity of the group anywhere in the world, with a view to compiling a **Foreign Subsidy Scorecard,** to be used by multinational businesses for purposes of future compliance in all sorts of business dealings within the EU, ranging from M&A transactions to public procurement bids.

The recently created "**Paul Hastings Foreign Subsidy Scorecard**" is intended to guide companies in navigating this complex environment. We would be pleased to assist clients on how to implement such a scorecard.

In a Nutshell: The New Foreign Subsidies Regulation

The new Regulation sets out control and enforcement mechanisms by the European Commission applicable where a multinational company generating revenues in the EU has received foreign subsidies from any public authority outside of the EU, subject in some cases to thresholds in terms of revenues and the amount of foreign subsidies received over the previous three years. Non-compliance is subject to heavy fines. There are three cases which enter into the scope of the new

Regulation, encompassing a broad swath of economic activity carried out by multinational companies:

- Where the European Commission, acting upon its own initiative at any time, has reasons to believe that foreign subsidies granted to a multinational company doing business in the EU have a net distortive effect on competition in an EU market.

- Where a company intends to carry out an M&A transaction (acquisition of sole or joint control of a target, joint ventures), provided that (i) one of the parties to the proposed transaction (at group level, what is called an "undertaking" in EU legal language) has a significant presence in the EU (more than **€ 500 million** in EU revenues *and* that (ii) the parties (their groups) have received, together on a cumulative basis, more than **€ 50 million** in subsidies from non-EU public authorities over the previous three years.

- Where a company submits a bid in public procurement procedures in the EU valued at more than € 250 million and has received (or its main suppliers or sub-contractors have received), at group level, any foreign subsidies whatsoever.

Opening a Pandora's Box: How the new Regulation could Profoundly Disrupt the EU's Merger Control Practices, even in Unexpected and Feckless Ways

Once into force, the new Regulation will have considerable **disruptive effects** on how multinational companies do business in the EU, in cases where they receive subsidies from non-EU government sources. There is, of course, a compliance risk with regard to day-to-day business operations (investigation risk) and for public procurement bidding processes (compliance risk). But the most telling, and most variable, risk will be in the area of M&A transactions, due to the creation of a new control procedure which will run parallel to the existing one.

An acquisition will potentially give rise to three separate and distinct control scenarios in the EU:

- the European Commission's "subsidy control" under the new Regulation,

- notification and control by the Commission under existing EU Merger Regulation n°139/2004, and

- where they apply (security and public order criteria), notification(s) to EU Member State authority(ies) under Foreign Direct Investment (FDI) rules, coordinated by the European Commission under the cover of a recent EU regulation.

The new Regulation involves considerable **complexity** in its merger control component by introducing a **two-pronged test,** which has no equivalent anywhere else in the world. The regime will be suspensory (subject to heavy fines in the event of non-compliance):

- *Firstly*, at least one of the parties concerned must, at group level, be "established" in the EU and generate aggregated revenues in the EU of more than **EUR 500 million**.

- *Secondly*, over the previous three years, the various enterprises concerned (purchaser(s) group(s) and target) must have received at least **EUR 50 million** in subsidies (unremunerated economic advantages granted on a selective basis) from non-EU public authorities of any nature. State-Owned Enterprises ("SOEs") are included within the concept of public authorities. For the second threshold, the enterprises concerned will need a precise three-year scorecard of subsidies received from non-EU public authorities throughout the world by any affiliate of their groups.

And now the **Pandora's Box**: logically, there are many Chinese, American, and EU multinationals which meet these thresholds and will be required to notify and obtain clearance, prior to completion, of *all* acquisitions, big or small, that they realize *anywhere in the world*, subject to fines in the case of non-compliance and detection by the European Commission. The problem is that, based on the thresholds of the new Regulation, a purchaser can meet the thresholds regardless of the target's size or where it does business. For instance, the acquisition by a Chinese multinational of a small business hidden in the depths of China could be subject to the new Regulation, if the multinational as a group has an establishment in the EU, generates the requisite amount of EU revenues and has received foreign subsidies above the threshold. Perhaps this anomaly will be corrected during the consultation and legislative adoption processes in order to avoid repetitive and potentially feckless notifications.

Establishing an Inventory of Foreign Subsidies: Broad Scope of the Concept and How to Deal with it

The new Regulation includes, in its Article 2, a broad definition of "subsidy" based on the notion of "**financial contribution:**" "*any non-remunerated transfer of economic value from any non-EU public authority to any business or businesses on a selective basis.*" This can range from outright transfer of funds, to guarantees (not remunerated at market rates), to transactions conducted by a public entity which are not in economic conditions comparable to a private investor. In its explanatory memorandum for the new Regulation (the "Legislative Financial Statement"), the European Commission recognizes that the concept of "foreign subsidy" is "*based on principles similar to EU state aid rules.*" These principles, refined by decades of EU decisional practice and case law, are infinitely broad in their possibilities, once a public authority is involved in dealing with business interests, but can be distilled down to the following basic components: (i) an un-remunerated economic advantage of any kind (including cases of transfer of public goods/property or services which are remunerated, where the remuneration is below market rates, thus creating a "delta" of unremunerated economic advantage), (ii) granted by or through the impulsion of any public body or publicly-controlled body whatsoever, provided that it is not an EU public body (central government, local government, SOEs) and that the economic advantage is at their expense, and (iii) of a selective nature, meaning that the advantage is granted to a limited number of beneficiaries / designated industries only. With so many variables at work, the possible scenarios of the granting of public subsidies throughout the non-EU world, to a multinational with its hundreds of subsidiaries or branches, would seem to be almost infinite (and it is, in reality).

How can multinational businesses deal with this approach? Through a minutious **audit** of the entire group throughout the non-EU world by specialists steeped in the complexity of EU State aid concepts in order to establish an up to date scorecard of subsidies received.

Extra-territorial Effects but not Only: EU Multinationals are also Concerned by the New Regulation

The new Regulation sets out an ambitious and unprecedented **extra-territorial reach**. In the three scenarios of application of the new Regulation, described above, there is one unifying element giving rise to potential control: the triggering event takes place in the EU (via the existence of sales or conducting business in the EU, or a contemplated M & A transaction involving at least one enterprise generating significant revenues in the EU, or a response to a public procurement procedure in the EU), but the subject of control and enforcement action by the European Commission takes place outside of the EU: the granting, within the previous three years, of subsidies by a non-EU public authority. For control and enforcement, the new Regulation thus has an unprecedented extra-territorial reach. Even more extraordinary: the Commission proposes to exercise its broad enforcement powers, such as on-site investigations, outside of the EU, but only provided that the host government and the targeted multinational have given their prior consent. This extra-territorial reach applies in all cases, even to EU multinationals in their business operations outside of the EU, provided that they have received subsidies from non-EU public authorities.

The True Target of the New Regulation: More than €500 bn in non-Controlled, non-EU Subsidies

The European Commission, relying on "underestimated" data recorded by Global Trade Alert (GTA), sets out the public subsidy figures at the origin of the proposal. According to the Commission, at the end of 2020, the EU's top five trading partners (China, USA, the U.K., Russia, and Switzerland) alone had some 1,724 subsidy measures in effect totaling around **€ 542 billion,** *about **99%** of that amount being granted by **China** and the **U.S***.

The European Commission will Use new Powers of non-EU Market Surveillance with a View to Obtaining Information on Foreign Subsidies

Starting in 2022, the European Commission intends to engage 145 new full-time DG Comp officials to enforce the new Regulation (there are currently about 800 DG Comp staff members in Brussels).

It is foreseeable that a specific surveillance unit will be put in place to monitor foreign subsidies granted throughout the world. Litigation-savvy multinationals may put in place their own surveillance methods, to attack competitors (whether EU or non-EU) by transmitting information on foreign subsidies granted to their competitors to the European Commission.

Beneficiaries of Foreign Subsidies will be Exposed to Cartel-style Investigations and Severe Fines in the Event of non-Compliance

The new Regulation innovates radically with regard to the role of beneficiaries.

EU rules on State aid are, as a procedural matter, directed at the EU Members States level, not at companies themselves. The new Regulation is a **game-changer** in this regard. It is addressed not to foreign governments but directly to companies. The European Commission will transpose and apply, *mutatis mutandis*, the same vast investigative powers which it has with regard to suspected anti-competitive cartels to the realm of foreign subsidies, including powers to conduct so-called **"dawn raids**" by which teams of DG Comp officials, including IT experts, arrive unannounced at a company's premises, and undertake an on-site investigation in search of evidence, in particular through information in the company's IT system.

Companies which are recalcitrant, or supply incorrect or incomplete information, will be exposed to an administrative fine of up to one percent of their aggregate annual revenues (calculated at the level of the entire group) and periodic non-compliance penalty payment (up to five percent of daily revenues, at group level).

Beneficiaries of Foreign Subsidies will be Exposed to Risks of Commitments or Redressive Measures, even Repayment

Following a formal investigation into foreign subsidies, the European Commission will issue a decision, potentially negative. To issue commitment orders or corrective measures, which can go as far as an order of repayment, the Commission will have to demonstrate: (i) the existence of a foreign subsidy attributed to the beneficiary, (ii) a distortion of competition in an EU market as a direct result, and (iii) the absence of "*positive effects on the development of the relevant economic activity*" which would outweigh the negative effects in a "balancing" exercise. This final condition gives to the Commission, of course, considerable leeway in the formulation of a potential remedy. The Commission will have the power to order remedies, including divestment orders or, in the case of a foreign subsidy being granted in the context of an M&A transaction, to order the unwinding of the transaction.

Relationship between the new Regulation and WTO rules on the Granting of Subsidies

A final question on the relationship between the new Regulation and **World Trade Organization** (WTO) rules arises naturally, since the subject of foreign subsidies has traditionally related to the WTO context and in particular in the Agreement on Countervailing and Subsidy Measures (ASCM). According to the European Commission, the new Regulation is "*coherent with EU trade policy and complements existing* [WTO] *trade instruments."* Indeed, the new Regulation is distinct from existing WTO and EU instruments as to the definition of "subsidy" (the EU definition of "foreign subsidies" is much more extensive than the WTO concept). The remedies in the event of non-compliance within the WTO are applied after a long and tortuous intergovernmental process and generally involve extra import duties. Therefore the new Regulation represents a whole new ball game in this regard. It brings to the table new EU concepts and procedures that multinationals will have to learn to deal with and to comply with, while still being attentive to other existing rules such as the WTO rules. It is interesting to note in this respect that, in presenting its new Regulation, the European Commission states that "*as a top priority, we will work to reform the WTO, including with new rules on competitive neutrality. In addition, we will continue to improve rules on subsidies in our bilateral trade agreements.*" It will remain to be seen if the European Commission will be able to "multilateralise" the new Regulation in a WTO context. Meanwhile, the risk of conflict between European Commission enforcement decisions under the new Regulation and WTO law and its own enforcement mechanisms could potentially lead to international commercial tensions.

Next steps

The proposal is now open for consultation and comment from all parties interested for an eight week period. The new Regulation will have to be approved in identical terms by the Council of EU Member States and the European Parliament. Given the political context, it is likely that an agreement on the proposal could be found between the two legislative bodies in an expeditious manner so that the new Regulation could be enacted by the end of 2021 or early 2022. The new Regulation, as it stands today, provides that it will apply directly to multinationals as from six months after entry into force.

Our Advice: Prepare a Foreign Subsidy Scorecard

There remains little time to prepare for the resulting compliance burden imposed upon multinationals doing business in the EU, which may benefit from subsidies granted by non-EU governments.

Our recommendation is to set out new compliance methods and procedures. As a first step, we suggest that companies create a group-wide **Foreign Subsidy Scorecard**. To establish the scorecard, an audit should be conducted, with the assistance of specialists of EU State aid law, for the entire group with regard to all dealings with public authorities (even local, even SOEs), and this to identify and quantify the un-remunerated, selective economic advantages which could potentially be characterized as foreign subsidies under the new Regulation.

Our other recommendation concerns M&A transactions and public procurement bids in particular: we recommend including in all due diligence requests to the target those specific questions relating to foreign subsidies received outside of the EU.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Paris lawyers:

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