KEY POINTS

- Investments in the UK defence sector are less regulated than in France and Germany.
- French regulations are strict requiring prior authorisation and licences.
- In Germany, the far-reaching powers of intervention as regards both acquisitions by foreign investors and the requirement for licences, means that contractual change-of-control clauses are not necessary.

Feature

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The legal framework for foreign investment in the French, UK and German defence sector

This article provides a comparative overview of the legal framework for foreign investment in the defence sector in France, the UK and Germany, highlighting the differing approaches of the state.

Due to several factors, in particular relating to the reduction of defence budgets and high competition between national defence groups, the defence sector is becoming more consolidated in Europe. There are some forerunners. In 2012, there was the merger attempt between BAE Systems and EADS/Airbus group. More recently, in France, the French group Nexter Systems was privatised in view of its partnership with the German group Krauss-Maffei Wegmann (KMW) to create a leading European player in the land defence sector. Also, BAE Systems and Dassault Aviation entered into a partnership with the UK and French governments to create a new generation of unmanned jet.

Beyond political stakes, such mergers and strategic alliances present legal challenges, for example: (i) foreign investments control; (ii) obtaining certain permits or licences to conduct defence activities, which may face change of control issues; and (iii) restrictions and obligations around government contracts.

This article aims to provide an overview of the legal framework of investments in the defence sector in France, the UK and Germany.

French law is, unsurprisingly, quite strict. The control implemented by public authorities is carried out at several levels. Thus, some acquisitions, even of a minority interest, may require the prior approval of the French Ministry of the Economy. Furthermore, public authorities are also likely to withdraw certain permits or licences required to conduct defence activities in the event of a change of control of defence groups. Lastly, public procurement contracts regulations enable public co-contractors to terminate contracts early for any reason in the "public interest", which could include a change of control of the private co-contractor.

On the contrary, investments in the UK defence sector are less regulated than in France. Moreover, regulation does not derive from statutory provisions. Non-statutory restrictions are presented below.

Finally, the legal framework of foreign investments in the German defence sector is akin to the French one: investments are subject to strict official control. The trigger for adoption of this legislation was the takeover of the Howaldtswerke Deutsche Werft AG group (HDW – construction of conventional submarines) by US financial investor One Equity Partners in 2002 – a transaction that the German government was unable to exert any influence on at the time.

LEGAL FRAMEWORK OF FOREIGN INVESTMENTS IN THE FRENCH DEFENCE SECTOR: THE PROTECTION OF NATIONAL DEFENCE INTERESTS

In order to be subject to the prior approval of the French Ministry of the Economy, investments must qualify as "foreign investment" and relate to a "sensitive" activity, according to the criteria defined by the French Monetary and Financial Code (CMF).

More specifically, the prior authorisation regime depends on the origin of the investor (EU[1] or non-EU), as this determines both: (i) the scope of the operations considered as "foreign investments"; and (ii) the list of "sensitive activities". The regulations are more restrictive for a non-EU investor.

In what situations can a foreign investment consisting in the acquisition of a minority shareholding in a defence group be subject to prior approval?

There are at least three situations pursuant to the regulations relating to foreign investments provided by the French Monetary and Financial Code (FMFC). First, where the acquisition by a non-EU investor consists of a 33.33% (or more) shareholding or voting rights in a company that has its registered office in France.[2]

Second, where the acquisition of a minority shareholding grants the foreign investor (whether EU or non-EU) "joint-control" over the target company. A minority shareholder will be considered to jointly control another company when it holds veto rights on the strategic decisions of the company, (eg the appointment of the management). On the contrary, if the governance rights essentially aim at protecting the value of its investment, the foreign investor will not be considered as jointly-controlling the target company.

Third, prior approval may be required where a foreign investor (whether EU or non-EU) acquires a minority interest in a partnership with no share capital governed by French law.

The French administration considered under the previous regulations on foreign investments that the acquisition of a minority interest in an Economic Interest

Grouping (GIE) having no share capital could qualify as a foreign investment. This analysis could still be relevant as the FMFC defines investments as taking control over an "entreprise" (and not only companies having share capital).

Could the French administration apply other criteria to qualify a foreign investment or submit an investment to prior approval?

French regulations provide that some foreign investments not subject to prior approval must be *declared* to the French Ministry of the Economy, for example: material financing or guarantees or the purchase of patents or licences can qualify as a "de facto" control.

Additional approvals from the French Ministry of the Economy may also be required: where the French State holds a Golden Share (as is the case for Thalès). A Golden Share comes with specific rights, such as the possibility for the French Ministry of the Economy to approve or refuse any increase of a direct or indirect shareholding in Thalès, from 10% of the share capital or voting rights. It is worth noting that the so-called "Macron law" adopted on 6 August 2015 has reinforced the rights attached to Golden Shores, providing for prior approval of French State upon foreign investors reaching certain thresholds, also conciliating such regime with EU regulation.

Consequently, any foreign investor contemplating acquiring or partnering with a defence group in France should seek confirmation from the French administration. A ruling procedure is available for this purpose.

The withdrawal of the permit to manufacture and sell war materials if the nationality condition is not met

The manufacture or sale of category "A" (war materials) or "B" defence products (certain weapons) can only be carried out by companies which have obtained authorisation from the French Ministry of Defence. The granting of this permit is subject to certain prerequisites, including the French nationality of the applicant company.

For applicant companies limited by shares (*sociétés par actions*), the implementation regulations provide that the majority of the share capital must be held by French nationals or citizens of other EU or assimilated countries, and that both the legal representatives and the members of their boards must be French nationals or citizens of other EU or assimilated countries

Any changes regarding the legal structure of the permit holder, the nationality of its management or shareholders and, in particular, any transfer of shares that is likely to transfer control[3] of the permit holder to foreign investors, must be notified immediately to the Ministry of Defence, following which the Minister may withdraw the permit.

The risk of withdrawal of licences relating to the importation and exportation of defence products

The general principle is that imports of war materials in to France from non-EU countries, or exports from France to non-EU countries, as well as transfers within the EU are subject to the relevant company holding the requisite licence. Such licences are granted by the Ministry of Customs for imports from non-EU countries or by the Ministry of Defence for exports to non-EU countries and transfers between EU countries.

The risk of early termination of defence public procurement contracts for reasons of public interest

Defence public procurement contracts, such as those with the *Direction Générale de l'Armement* (DGA) may contain provisions, which impose a requirement, in the event of a change of control, to notify the domestic public entity or to obtain from the public entity a prior authorisation.

With regard to defence public procurement contracts, the domestic public entity may impose General Administrative Terms (*Cahier des clauses administratives generales*),[4] which must be read in conjunction with the Particular Administrative Terms, specific to the given public procurement, and which derogate to the General Administrative Terms.

Particular Administrative Terms can include the obligation on the foreign investor to notify the domestic public entity of information relating to the shareholding, the persons or groups which control the private co-contractor, or the group to which such co-contractor belongs, 'especially for certain defence public procurements concerned by restrictive provisions in terms of involvement of foreign companies or companies controlled by foreign groups'.

Pursuant to these General Administrative Terms, the French administration may terminate the agreement in the interest of national defence.

Also, even in the absence of a change of control provision or application of these General Administrative Terms, the domestic public entity is, as a matter of general administrative law principles, entitled to terminate the contract if in the "public interest" (*résiliation pour motif d'intérêt général*).[5]

FOREIGN INVESTMENT IN THE UK DEFENCE SECTOR: AN UNREGULATED PRACTICE?

Against a backdrop of ever more frequent calls for governments to impose tighter controls on foreign investment in the defence sector, the UK continues to take a more *laissez faire* approach. This has encouraged growth in the defence sector, as an examination of the proportion of large defence companies located in the UK displays.[6]

The Defence Growth Partnership, a public-private body tasked with the development of the defence sector in the UK, has recently stated that 'as defence spending in some markets stabilises or decreases and other markets expand and emerge, the UK Defence Industry needs to enhance its competitiveness'.[7] The government has identified foreign investments in the defence sector as a key driver to achieve this goal.

The legislative structure

As a general rule, and in contrast to the position in France or Germany, there are no legal provisions in the UK governing

or restricting foreign investment. Foreign investors are able to acquire a UK incorporated company with the same relative ease enjoyed by companies incorporated in the UK.

Although there is no over-arching legislation restricting foreign investment in the UK generally, in the defence sector (amongst others), certain restrictions may be imposed. The UK follows what is referred to as 'The Review Model', whereby acquisitions of companies may be subject to review where they give rise to certain specified public interest considerations. The most relevant public interest considerations in the defence sector are in relation to national security.

Specifically, under the Enterprise Act 2002, the UK government may intervene, at any point in the takeover/merger process, where:

- it believes that the investment opportunity is one of importance and relevance to national security;
- one of the parties involved in the transaction is carrying out activities in the UK; and
- the contemplated investment is in relation to a company which is or has been privy to classified information.

Pursuant to the EU Treaty, the UK government is not obliged to disclose the grounds for intervention where the 'public interest' criteria is invoked.

Notwithstanding the above, the provisions are – in practice – scarcely used in relation to foreign investment in the defence sector.

Other non-statutory measures enabling the control of foreign investments in the defence sector

Whilst there exist few statutory restrictions on foreign investment in the defence industry, certain other non-statutory restrictions can exist which may restrict foreign investment.

Corporate constitutional restrictions

Restrictions on the level of foreign investment in a UK incorporated company may be provided in the company's constitutional documents. However, as a starting point, no foreign investment specific restrictions exist in standard constitutional documents. As an example, The Companies (Model Articles) Regulations 2008, outline three sets of "model" form articles of association – these apply as the default articles of association for companies incorporated under the Companies Act 2006 – of note, these do not contain any restrictions on foreign investment.[8]

"Golden Shares"

That said, over the past thirty years, the UK government has purchased so-called "Golden Shares" in certain newly privatised companies, often for nominal value (of £1 each).

The UK government currently holds golden shares in 24 companies, including BAE Systems plc and Rolls-Royce Holdings plc. This has meant that, despite privatisation, the UK government has retained a powerful, often controlling, stake in the company in question.

The precise rights attached to the Golden Shares vary; however, as a general rule, these shares provide the right to veto in the event of foreign investment. The Golden Share typically grants the UK government a 15% shareholding in the company, and consequentially the ability to block any foreign investment.

Ministry of Defence (MoD) Approval

Where a defence company, whether UK incorporated or otherwise, has ongoing contractual relationships with the MoD, there is usually an informal clearance process that is undertaken prior to any proposed divestment or foreign investment. However, the current approval procedures are not publically available.

Notwithstanding the above statement, the MoD's powers to restrict and control the defence sector investment are broad and are not limited by statute.

Manufacturing, export and import of defence products under UK legislation

UK incorporated companies involved in the manufacture, export and import of defence products are subject to numerous regulations controlling these processes and shipments.

Companies are treated identically regardless of whether their investor base is domestic or foreign. Accordingly the granting of licences depends on a number of factors not connected to the nationality of the shareholders.

FOREIGN INVESTMENTS IN THE GERMAN DEFENCE SECTOR

In Germany, cross-border investments in defence companies are subject to extensive state control. The Foreign Trade Act (*Außenwirtschaftsgesetz* (AWG)) in particular and, indirectly, the War Weapons Control Act (*Kriegswaffenkontrollgesetz* (KrWaffG)) as well as regulations issued on the basis of these laws contain a number of provisions on the control of foreign investments in German defence companies.

Foreign trade restrictions on foreign investments in German defence companies

The AWG restricts the acquisition by foreign investors of German companies that manufacture or develop war weapons or other defence products, including the acquisition of shares in such companies by non-EU buyers where the protection of material security interests of the Federal Republic of Germany is at stake.

For example, orders restricting the general acquisition of German companies can be issued by the Federal Ministry for Economic Affairs. This *multisectoral* review (ie applying not only to the defence sector) presupposes that the "public order or security of the Federal Republic" is impaired.

In addition, there is a *sector-specific* review for the defence industry which can be initiated by the Federal Ministry for Economic Affairs. This includes companies that manufacture or develop goods within the meaning of Part B of the War Weapons List or specially constructed engines or transmissions to power battle tanks or other

armoured military tracked vehicles. The object of this review procedure is to determine whether the relevant acquisition jeopardises the 'material security interests of the Federal Republic of Germany'.

Transactions covered by these restrictions

The Federal Ministry for Economic Affairs can intervene in the case of an acquisition of a German company or of a direct or indirect participation in a German company by a foreign party. The acquisition can be by means of an asset deal or a share deal. The industry in which the acquirer is active as well as the annual turnover it generates is irrelevant, meaning that foreign sovereign wealth funds can be caught.[9]

In an asset deal, the acquirer must end up with actual disposal and decision-making powers in the overall business organisation.[10]

In a share deal, the acquirer must have direct or indirect voting rights in the German company totalling at least 25%. The spirit and purpose of this percentage is that the acquirer then generally obtains a blocking minority under German corporate law which he can use to influence the company.

An "indirect participation" refers to shares in a company that, in turn, has shares in a German defence company. Section 56(3) AWV stipulates that, together, the acquirer and the intermediate company must hold at least 25% of the voting rights. If the acquirer has concluded an agreement on the joint exercise of voting rights with another shareholder, the shareholding of that other shareholder can be aggregated to the shareholding of the investor.

The review procedure, possible obligations and restrictions

The direct acquirer has a duty to report to the authorities setting out basic details concerning the acquisition and the acquirer, as well as the domestic company being purchased and the sectors it operates in.

At the end of its review, which must not take more than one month, the Federal Ministry for Economic Affairs can either prohibit the acquisition altogether (alternative 1) or impose restrictions (alternative 2). If the transaction is not at odds with Germany's material security interests, or if the transaction is not a relevant foreign acquisition, it will be given clearance. Clearance is presumed if no review procedure has been opened one month after delivery of the report.

A defence-related transaction completed without the required licence is provisionally invalid. The transaction becomes legally valid (with retroactive effect) only after the licence has been granted.

The Federal Ministry for Economic Affairs must take its decision in consultation with the Foreign Office and the Federal Ministry of Defence. The decision to clear, prohibit or impose restrictions becomes an immediately enforceable administrative act, against which, objections and actions for avoidance have no suspensory effect. If prohibitions are deemed by the courts to be unlawful, the acquirer can sue the authorities for damages.

Indirect control of foreign investments: licences required for the activities of defence companies

Besides the direct restrictions on the acquisition of German defence companies by foreign investors, there are other indirect controls. These controls do not apply at the level of the acquisition process itself, but instead apply "one level higher" – namely at the level of the licences that defence companies require to conduct their business. If need be, these licences can be revoked in the event of an acquisition by foreign investors.

Licences required for the manufacture and sale, etc of defence products under the KrWaffG

Both the manufacture and the sale of war weapons are subject to a licence issued by the Federal Government. Putting war weapons into circulation, ie ceding actual control over them, is also subject to a licence.

In addition, any import/export/transit of war weapons into/out of/through the territory of the Federal Republic of Germany is subject to a licence, as are the carriage of war weapons outside of German territory and the trade in war weapons outside of German territory.

The granting of these licences *may* be refused, if, in particular, the applicant is not German or has its residence or place of customary abode outside Germany.

In addition, a licence will be *automatically* refused if foreign applicants do not possess the requisite reliability to conduct the planned business. Persons who 'based on their character as manifested in their overall behaviour, provide no guarantee that the business will be duly *and properly conducted*' are deemed unreliable.[11]

Possibilities for revoking a licence in the event of acquisition by foreign investors

A licence may be revoked at any time. Indeed, a licence *must* be revoked if one of the grounds for refusal listed in s 6(3) KrWaffG subsequently becomes evident or comes about, unless the situation is redressed within a deadline to be determined. This may be the case, for instance, if, following the acquisition, the applicant no longer meets the reliability test.

Revocation is a last resort, however. When exercising their discretion the authorities must at the very least consider issuing a licence subject to substantive limitations, for a limited period of time, or with attached conditions. Based on the principle of proportionality, if these softer means would be a possibility, an outright prohibition would be unlawful.

Premature termination of existing procurement contracts in case of acquisition of the contracting party by a foreign investor?

Contracts entered into by the Federal Ministry of Defence do not usually contain a change-of-control clause to cover the eventuality of an acquisition by a foreign investor.

Given the far-reaching powers of

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intervention as regards the acquisition itself, and also as regards the company-specific licences (see above), a contractual provision of this kind is not actually necessary.

It should be noted here that any public subsidies the defence company may have received for research and development could be clawed back if a foreign investor takes control. ■

1 Legal entities that have registered offices in a Member State of the European Economic Area that has signed an administrative agreement with France are assimilated to EU investors for the purpose of the foreign investment regime.

2 On the face of it, such an acquisition, if completed by an EU investor, would not be submitted to prior approval, except where it constitutes a takeover of the target company within the meaning of Art L. 233-3 of the French Commercial code.

3 "Control" is not defined by the implementation decree, but we assume that it must be read in conjunction with the nationality criteria set forth in the same decree.

4 There are five different General Administrative Terms, which may apply depending on the nature of the public procurement: industrial public procurements, day-to-day supply and service public procurements, intellectual performance public procurements, public work contracts and information and communication technologies public procurements.

5 See cases: *Conseil d'Etat*, 31 July 1996, *Société des téléphériques du Mont-Blanc*, No 126594.

6 More than 10% of the top 100 defence companies in the world are located in the UK, and a further 20 have significant operations in the country – ICD Research 'The UK Defence Industry – Market Opportunities and Entry Strategies, Analyses and Forecasts to 2017', February 2012 p 18.

7 Defence Growth Partnership 'Delivering Growth – Implementing the Strategic Vision for the UK Defence Sector', July 2014, p 9.

8 It is important to note that these "model" articles can be amended entirely in favour of fully bespoke articles of association, tailored to the specific requirements of the company in question.

9 Kaspar Krolop, *Schutz vor Staatsfonds*, ZRP 2008, 40.

10 Cf. Hocke/Friedrich, *AWG- Kommentar*, 181st update, 02/2015, s 7, margin No 21.

11 Federal Administrative Court, decision of 2 November 1994, 1 B 215/93, headnote 1.

Further reading:

- A moving target for foreign investors: recent developments in Chinese RMB funds [2012] 2 JIBFL 110.
- Indian real estate: foreign direct investment and financing [2008] 11 JIBFL 616.
- LexisPSL: Public law: Risk management in defence projects.