Dentons Newsletter

The Czech Republic's New Act on Foreign Direct Investment

February 2021

The President of the Czech Republic signed the Act on Foreign Investment ("FDI Act")[1], which will take effect as of May 1, 2021. The Act follows the EU legislative framework on the examination of selected foreign investments for security reasons given by the Regulation No. (EU) 2019/452. The FDI Act introduces the obligation for foreign investors from countries outside the EU, investing in strategic sectors of the Czech economy, to obtain prior clearance from the Ministry of Industry and Trade (the "Ministry").

The new FDI legislation will primarily affect foreign investments in the fields of energy, water management, food and agriculture, healthcare, transport, communication and information systems, the financial market and dual-use goods. The Act will relate to both to transactions in which a shareholding in the company is acquired (*share deal*) as well as where only the company's assets are transferred (*asset deal*).

As the FDI Act takes effect on May 1, 2021, investors should now make a preliminary assessment of their settlement transactions planned after May 1 to determine whether they are subject to the new legislation and if so, what effects the planned transaction may have.

In the text below, we have summarized the new legislation and offered practical observations from our experience. In general, the FDI Act provides the state (Ministry) with a relatively wide range of discretion in determining which transactions require the prior consent of the Ministry. In our opinion, FDI Act is a relatively vague, which creates a considerable degree of legal uncertainty for foreign investors as to whether or not their planned investment is going to be subject to prior authorization. On the other hand, it does not differ from similar "traditional" legislative acts such as the CFIUS in the US or the FIRB in Australia.

Which investments are subject to prior authorization by the Ministry of Industry and Trade?

The FDI Act obliges non-EU investors, or persons controlled by these investors (including persons from Switzerland, Liechtenstein or Norway), to obtain prior investment permits, if they plan to make an investment which will give them effective control over a legal entity operating in selected strategic activities in the Czech Republic, or resources through which the selected strategic activities are carried out. For this purpose, it will be necessary to reflect in the transaction documentation a new condition precedent, similar to the approval of the merger of undertakings by the competition authorities.

The following four strategic areas in the Czech Republic are subject to the strictest assessment regime:

- Production, research, development, innovation or control of the life cycle of military material;
- Operation of an element of critical infrastructure (e.g. designated energy providers, mobile operators, pharmaceutical manufacturers, designated banks, etc.);
- Administration of the information or communication system of critical information infrastructure, administration of the information system of a basic service or basic service provider(e.g. designated energy providers and energy infrastructure owners, telecommunications companies, etc.); or
- Development or manufacture of dual-use items.

Acquiring effective control under the FDI Act is a much broader concept than the usual definitions of control for merger control purposes, and means any of the following:

[1] Act No. 34/2021 Coll., on the examination of foreign investments and on the amendment of related acts (Foreign Investment Examination Act).

(i) The ability to exercise at least 10% of the voting rights or exercise adequate influence;

(ii) The ability to exercise ownership rights over the acquired entity;

(iii) The membership of the investor or a closely related person in the supervisory or management body of the target legal entity; or

(iv) Another level of control, which results in the ability to obtain information, systems or technologies important for the security of the Czech Republic or public or internal order.

It is therefore a different concept of control than the one we know from corporate or competition law. The final part of the control test is particularly extensive and in our opinion, it will be very difficult to apply it in practice with certainty. From this point of view, it would be appropriate for the Ministry to issue interpretative guidelines which, for the purpose of greater predictability, would give examples of when the test is completed and when it is not.

Request for permission or consultation?

The FDI Act is kind of a hybrid model for approving foreign investment. In the above-mentioned four strategic areas (i.e. military material, critical infrastructure, etc.), it introduces a strict obligation for a foreign investor to ask the Ministry for prior consent, without which it will not be possible to settle the transaction. For other types of investments, it is up to the foreign investor to assess in advance whether a particular transaction may endanger the security or public or internal order of the state and if so, to initiate the consultation with the Ministry.

If the target company is a license holder for nationwide radio or television broadcasting or a publisher of periodicals with a minimum print run of 100,000 copies per day, the Ministry has to be consulted at all times. On the grounds of an expert consultation, to which other public administration bodies will be invited to participate, it will be decided whether such a foreign investment is subject to prior authorization or not. The Ministry will have the authority to review transactions from the past five years, which are suspected of endangering the security or public or internal order of the state and for which no consultation has been requested.

The FDI Explanatory Memorandum provides examples of which transactions need to consider their implications for national security or public or internal order. They primarily concern investments in various forms of infrastructure in the Czech Republic (energy, transport, water management, medical, aviation, etc.), or in cybernetics, robotics, aeronautical technologies, food, various forms of media and media technologies, and objects important for state defense. The Ministry will evaluate each situation on an individual basis. Although the explanatory memorandum emphasizes that the Ministry is not obliged to prepare a list of typical investments for which prior notification of the Ministry would be mandatory, such a list would be useful for practical reasons and the Ministry should consider the possibility of drafting such guidelines.

Given the extensive power of the Ministry to intervene in various forms of foreign investment, investors have to carefully consider almost every major investment and whether they are affected by this new obligation, or whether it will be at least necessary to at consult the Ministry with the contemplated transaction. As mentioned, this new legislative requirement has to be reflected by the parties in the transaction documentation as well, e.g. as one of the conditions for the effectiveness of the transaction.

Ministry decisions and sanctions for violations of the law

According to the FDI Act, the Ministry is obliged to issue its decision within 90 days from the day of the commencement of the investment verification procedure. In more complex cases, it is possible to extend this period by another 30 days. The Ministry has the authority to prohibit or allow foreign investments under certain conditions. In this respect, the deadlines and powers of the Ministry are similar to those of the Office for the Protection of Competition (ÚOHS). Of course, it will be important to see whether the Ministry will be able to approach the submission and approval process with similar professionalism as the Competition Office, which has issued a number of interpretative guidelines for the approval process and introduced a pre-notification process, and which publishes all its decisions, holds regular conferences around its decision-making practice and is open to informal consultation before and during approval procedures as any other modern public administration.

If an investor fails to submit an application for investment authorization in required cases or to initiate mandatory consultations, or if it breaches conditions set out in the decision, it runs the risk of the Ministry examining the investment in the future and setting further conditions for the investment. The Ministry has the authority to suspend investor's proprietary or voting rights, or it can even request the resale of the target company.

The violation of legal obligations could result in a possible fine of up to 2% of the total net turnover (for the last completed accounting period) achieved by the foreign investor. Therefore, it is crucial to see whether the Ministry issues interpretative guidelines, as for example the Competition Office does in a great detail, on the concept of turnover and its calculation and to clarify which companies can be fined as business groups and how to ensure that such sanctions are proportionate to the respective circumstances.

Practical impact on international transactions

In practice, many foreign investors already assess their planned investments from the point of view of local rules

on the examination of foreign investments, and the new regulation in the Czech Republic is no exception. Since the FDI Act takes effect from May 1, 2021, the new regulation has to be considered in any future transaction settled after that date.

Unfortunately, as it is common with similar foreign regulations, the FDI Act will also have an impact on purely intra-group restructurings. Unlike merger control laws, the FDI Act does not contain an intra-group exemption and does not take into account the concept of a single economic unit. In our opinion, this will lead to an unnecessary approval processes and to a higher frequency of possible FDI violations in cases that have already been substantively assessed by the Ministry. The question for the Ministry is whether to create a simplified and accelerated approval process for these situations, similar to the one used by the Competition Office in not problematic cases.

Experience form France, Germany or Italy, where similar legislation has a longer tradition, the epidemiological crisis caused by the global spread of COVID-19 resulted in a significant expansion of investment (especially in pharmaceuticals, medical supplies, protective equipment, etc.) for which prior state permission is required. This has to be taken into account in the future.

Foreign legislation

Foreign investment approval has a long tradition in some OECD countries. The US' CFIUS has been in effect since 1975, and Australia's FIRB has been in effect since 1976. Given the EU legislative framework for the screening of selected foreign investment for security reasons under the Regulation No. (EU) 2019/452, effective as of October 2020, the approval regime is now common in the EU. Although these regimes show some similarities, they are not identical and there are significant differences between them, in particular in the approach to defining foreign investors or investments subject to scrutiny or sanctions for breaches of legal obligations. The reason for these different approaches is that the Regulation only provides a framework for cooperation if the EU Member State has put such a system in place. For example, some Member States have introduced a different regime for investors from the EU, the European Economic Area (EEA), the European Free Trade Association (EFTA) or the Organization for Economic Co-operation and Development (OECD) and a different regime for investors from third countries. The above-mentioned Regulation does not oblige Member States to introduce a regime for the examination of foreign investment, but "only" to cooperate in this area with other Member States and the European Commission.

From the Ministry's point of view, it would be appropriate to evaluate best practices in these foreign regulations so that the new approval procedure in the Czech Republic is as short and fast as possible, given that in most of the cases the transactions are going to be non-problematic.

Dentons' FDI Global Tracker

If you are interested in learning more about the individual national regimes, Dentons has prepared a global interactive search engine called the Dentons FDI Global Tracker, with which you can easily compare selected national legislation on foreign investment protection when preparing your transaction plans. **Find out more here**

We will keep you up to date about legislative development in this area. If you have any questions, do not hesitate to contact us.

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