EUCLID LAW

Taking Security and Options Seriously: the UK and German Investment Screening Regimes

Arrangements involving current and potential future events, such as taking security and agreeing options, require careful scrutiny under investment screening regimes. It is not safe to assume that a trigger will operate in the same way as under another more developed regulatory regime, such as merger control. Moreover, taking a security or agreeing an option needs to be considered upfront and not just when the security is about to be enforced or the option exercised.

In this piece we consider the position under the UK's forthcoming National Security & Investment Act (NSI Act) regime and briefly compare this to the position under the recently reformed German regime. We assume that the other requirements for triggering are satisfied and focus on whether a security or an option could in itself take the transaction over the jurisdictional threshold.

Taking security

When a security is actually enforced, then this may well trigger an investment screening regime, as enforcement will typically involve the lender gaining control over the relevant target or its assets which are the subject of the security. The more difficult question, which will likely arise many years earlier at the initial transaction stage, is whether merely taking the security is sufficient.

It is common for a lender to take a security over a borrower's shares as collateral for a loan. This may involve an actual transfer of the shares to the lender as at the time the loan is granted. However, the agreement will typically provide that the lender can only exercises its rights over the shares once the security has been enforced, i.e. where an event of default has occurred under the agreement.

Under the NSI Act, an acquirer of a target's shares may trigger a mandatory filing (if the target is active in one of the specified sensitive sectors) or a government call-in right (in respect of other sectors). However, where those shares are taken as security, the borrower is still treated as owning the shares, provided either (a) the rights

attaching to the shares are only exercisable in accordance with the borrower's instructions (other than for preserving or realising the value of the security) or (b) the shares are held in connection with the granting of loans as part of normal business activities and the rights are only exercisable in the borrower's interests (other than for preserving or realising the value of the security).[1]

Ordinary debt finance transactions where the borrower's shares are taken as security and the lender's rights are merely designed to protect its security would therefore not trigger a mandatory filing or a call-in right. Where the lender's rights go beyond this, then the transaction could be brought back into the category of those requiring a mandatory filing, if the target is in one of the sensitive sectors. Even if a mandatory filing is not triggered, the call-in right could in theory be triggered where the lender has "material influence" over the target, i.e. where the borrower becomes so dependent on the lender that the lender gains a considerable degree of influence over the target's commercial policy. According to the CMA's guidance, this would include where the lender could threaten to withdraw the loan if a particular policy is not followed or where the lender has unusual rights going beyond those needed to protect its investment, such as veto rights over strategic decisions.[2] That said, according to the Government's guidance, "although loans … are not exempt from scrutiny, the overwhelming majority of these are expected to pose no national security concerns"[3].

A lender could also take other forms of collateral than shares, such as security over some or all of the assets of a target. A party gains control of an asset for the purposes of the NSI Act where, *inter alia*, they are able "to direct or control how the asset is used, or direct or control how it is used to a greater extent than prior to the acquisition"[4] and where "references to the use of an asset include references to its exploitation, alteration, manipulation, disposal or destruction"[5]. Since a lender would typically obtain rights to control the collateral's disposal or destruction, this trigger would appear to be engaged. Gaining control over a target's assets is not sufficient under the NSI Act to trigger a mandatory filing. It could, however, theoretically enable the Government to intervene using its call-in power. That said, this may be rare in practice, as the Government's guidance makes it clear that "the Secretary of State generally only expects to intervene when an actual acquisition of control will take place (e.g. a lender seizing collateral)"[6].

[1] NSI Act, Schedule 1, paragraph 7.

[2] CMA, Mergers: Guidance on the CMA's jurisdiction and procedure, December 2020, para 4.36. The UK Government has indicated that the concept of "material influence" under the NSI Act will be applied in the light of the CMA guidance for merger control: see Department for Business, Energy & Industrial Strategy, National Security and Investment Act: prepare for new rules about acquisitions, 20 July 2021

[3] Department for Business, Energy & Industrial Strategy, Statement of policy intent, dated 2 March 2021

[4] NSI Act, s.9(1)(b)

[5] NSI Act, s.9(2)

[6] Department for Business, Energy & Industrial Strategy, Statement of policy intent, dated 2 March 2021

Under the German investment screening regime, the relevant trigger for a filing is the acquisition of voting rights or control over a target. However, based on some recent discussions on a live matter, practitioners are divided as to whether merely taking a security, even absent other rights, could amount to control. We understand that where a borrower pledges shares, then this would not amount to a trigger, in accordance with an express exception. However, where other assets, such as IP rights, are taken as security, the position is unclear. Some practitioners believe that this would be insufficient, and that only enforcing the security could potentially be a trigger. Others believe that merely taking the security could be sufficient where the asset technically transfers to the lender. There seems to be a consensus that the Federal Ministry for Economic Affairs and Energy needs to clarify the position, as there appears to be no precedent, at least in the public domain.

Holding options

Similar to the scenario where a security is taken but only later enforced, an option may be agreed now but only exercised in the future. This raises the question whether the investment screening regime is triggered as at the point when the option is agreed or merely later when the option is exercised, assuming the subject matter of the option otherwise fulfils the requirements of a notifiable or reviewable transaction.

The likely treatment of options under the NSI Act does not appear to be the same in all cases and requires consideration of a number of provisions of the Act:

- The mandatory notification requirements and call-in powers under the NSI Act are triggered at the point at which "arrangements are in progress or contemplation which, if carried into effect, would result in a trigger event taking place in relation to a qualifying entity or qualifying asset"[7];
- The NSI Act also provides specific guidance for "an agreement or arrangement that enables the person (contingently or not) to do something in the future that would result in a trigger event taking place"[8]. This guidance is two-fold. First, "entering into the agreement or arrangement does not necessarily establish that arrangements are in progress or contemplation which, if carried into effect, would result in a trigger event taking place"[9]. Second, "whether such arrangements are in progress or contemplation (at the time of entry into the agreement or arrangement or subsequently) is to be determined by reference to all the circumstances, including how likely it is in practice that person will do the thing that would result in a trigger event taking place."[10]
- Where a party has rights exercisable "only in certain circumstances", the NSI Act provides that these rights are treated as being held by that party only "when the circumstances have arisen, and for so long as they continue to

[7] NSI Act, ss.18(2)(b) and 1(1)(b)
[8] NSI Act, s.12(2)
[9] NSI Act, s.12(3)
[10] NSI Act, s.12(4)

obtain" or "when the circumstances are within the control of the person": Schedule 1, paragraph 6(1).

Put together, this appears to suggest the following propositions, although we will have to see how the legislation is interpreted by the Department for Business, Energy & Industrial Strategy (BEIS) and, if litigated, the courts in practice:

- If the option can only be exercised at a future point in time or subject to a future event occurring, then the trigger event would not be earlier than that future point in time or future event occurring;
- Once the option holder can exercise the option at will – which could in some cases be as soon as the option is granted – the trigger still depends on how likely it is in practice that option holder will exercise the option. If there is evidence that the option holder is not minded to exercise the option for the foreseeable future, then arguably the trigger has still not occurred. This evidence could be an internal strategy plan which envisages exercising the option only in the future once certain market developments have occurred. Given that this may be a grey area, some parties may want to seek comfort by filing the option agreement at an earlier stage, but they may well need to convince BEIS that exercising the option is not merely a distant possibility.

Outside the scope of a mandatory filing and where merely the call-in power applies, the Government's guidance, cited above, suggests that it would only intervene when an actual acquisition of control takes place and that merely holding an option would be unlikely (but not impossible) to pose national security concerns.

By way of brief comparison with the German investment screening regime, we understand practitioners are divided on the point in time at which an option triggers a filing, assuming the other conditions for a filing are satisfied. Some practitioners we have spoken to on a live matter believe the relevant time for a filing is immediately prior to the option holder exercising the option. The logic here is that it is only in the circumstances prevailing at this time that the Federal Ministry for Economic Affairs and Energy can assess the implications of the acquisition for Germany, not those potentially many years earlier when the option was agreed. However, other practitioners take the view that, on a close reading of the legislation, it is the contractual basis for the acquisition, i.e. the option agreement being agreed, rather than the later exercise of the option, which is the relevant trigger. Given the apparent lack of precedent, at least in the public domain, it remains to be seen how the Ministry, and if applicable, the courts, will interpret the legislation in practice. Therefore risk averse clients may be minded to make precautionary filings upfront until the position is settled.

Conclusions

Options and securities under investment screening regimes need to be considered carefully on a case by case basis. Taking shares as a security, absent any unusual rights, is unlikely to trigger the UK or German regimes at the time security is taken. A security over assets will not trigger a mandatory UK filing, but the position is less clear in Germany. Taking an option in the UK is unlikely to be a trigger unless it is imminently about to be exercised, whereas the position in Germany is less clear. Precedents and further guidance will hopefully clarify these scenarios.

Finally, even if the analysis is that it is the future event, not the current agreement, which is the trigger, the current agreement may need special drafting to cater for that future event. For example, both the UK and German regimes are suspensory for mandatory filing scenarios, and therefore a condition precedent, a period pending completion and co-operation requirements with the target may need to be enshrined in the original agreement.

Michael Reiss, Euclid Law

About Euclid

Euclid Law was created by experienced competition lawyers with a common desire to build a new competition law and foreign direct investment firm that is agile, collaborative, highly commercial in its thinking, innovative in its approach to delivering results and free from the constraints of larger law firms.

Our core expertise covers all aspects of competition law, including cartels and anti-competitive agreements, merger control, abuse of dominance, state aid, competition litigation, market investigations, audit and compliance, as well as the expanding field of foreign direct investment controls. With offices in both London and Brussels, in-depth experience and a network of contacts in key jurisdictions around the world built up over many years of practice, we have the ability to advise clients across Europe and worldwide. We represent clients before EU, UK, German and Belgian authorities and courts.

More information on: https://euclid-law.eu/