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The Xella Judgment

EU Court Limits Member States' Discretion in Applying FDI Control Laws

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On 13 July 2023, the European Court of Justice (ECJ/Court) issued an important judgment with relevance for the foreign direct investment (FDI) screening practice across the EU (Case C-106/22).

In summary, the Court found that the national legislation prohibiting the acquisition of a strategic company by undertakings organised in accordance with the laws of a member state, over which an undertaking of a third country has majority control,[1] on the grounds of national security interest, falls under the scope of the EU provisions on freedom of establishment.

The judgment concerns a dispute between the Hungarian company Xella Magyarország (Xella) and the Hungarian minister for innovation and technology (Minister) concerning the acquisition of 100% of shares in Janes és Társa, a Hungarian company active in the extraction of gravel, sand and clay. Xella is 100% owned by a German company, which is in turn 100% owned by a Luxembourg company, which in turn is indirectly owned by the ultimate parent company registered in Bermuda, the latter company belonging, ultimately, to an Irish national.

The Minister classified Xella as a "foreign investor", within the meaning of national law because it is indirectly owned by a company registered in Bermuda and prohibited the acquisition on the basis of the national interest in ensuring security of supply in the construction sector.

Xella challenged the decision, arguing that it infringed *inter alia* the freedom of establishment and the principle of the rule of law due to the lack of clarity of the concept of 'national interest', within the meaning of the national law.

The national court referred to the ECJ for a preliminary ruling and asked, *inter alia*, whether the national legislation, which allows the prohibition of the acquisition of a strategic company by a resident company with foreign influence on grounds of national interest, is compatible with EU law, in particular with the Article 65(1)(b) of the Treaty on the Functioning of the European Union (TFEU).

Companies having Their Seat in the EU Can Rely on Freedom of Establishment Despite Non-EU Ownership

The Court clarified that the relevant fundamental freedom at stake is the freedom of establishment. The Court held that Xella, as an EU company, was entitled to rely on the freedom of establishment, even though it had a foreign parent company. The Court emphasised that the nationality of the shareholders does not affect the company's right to freedom of establishment:

> "It does not follow from any provision of EU law that the origin of the shareholders, whether natural or legal persons, of companies resident in the EU affects the right of those companies to rely on freedom of establishment, since the status of an EU company is based, under Article 54 TFEU, on the location of the registered office and the legal order of which the company is incorporated, and not on the nationality of its shareholders."

The Freedom of Establishment Applies Also to National FDI Laws

The Court acknowledged that the national legislation restricting acquisition constituted a restriction on the freedom of establishment. It then examined whether the restriction was justified by an overriding reason relating to the public interest. The Court held that the objective of ensuring security of supply in the construction sector, in particular as regards gravel, sand and clay, did not constitute a fundamental interest of society justifying such a restriction. The Court also held that there was no evidence of a genuine and sufficiently serious threat to the supply of those materials.

The Court therefore held that the provisions of the TFEU on freedom of establishment precluded the application of the national legislation in question, which prohibited the acquisition on grounds of national interest.

1 Please note that the ultimate beneficial owner in this case was an EU national.

Narrow Interpretation of Restrictions on Fundamental Freedoms and Review by the ECJ

The Court emphasised that restrictions on fundamental freedoms must be justified by overriding reasons relating to the public interest, that such justification is subject to judicial review by EU courts and that purely economic reasons are not sufficient to justify such restrictions:

> "It is nevertheless clear from the case-law of the Court that, while member states are still, in principle, free to determine the requirements of public policy and public security in the light of their national needs, those grounds must, in the EU context and, in particular, as derogations from a fundamental freedom enshrined in the TFEU, be interpreted strictly, so that their scope cannot be determined unilaterally by each member state without any control by the EU institutions."

The Court continues to explain that security of supply in the petroleum, telecommunications and energy sectors … may constitute a public security reason and, therefore, possibly justify an obstacle to a fundamental freedom. This suggests that the ECJ, also in those sectors – or other sectors that are clearly critical, such as supply of semiconductors – wishes to retain the last word. It remains to be seen, however, whether the ECJ would engage in complex factual or economic assessments that, in other contexts, it refrains from.

Consequence of the Decision for the FDI Practice

The judgment provides investors with a welcome second and independent instance of judicial review and may indeed lead to the disciplining of national authorities in borderline cases. Investors, if they have a choice to use an EU subsidiary or a non-EU subsidiary, are well advised to make the investment through an established EU subsidiary if there is a risk of an overreaching authority.

It remains to be seen, however, how the ECJ will approach a more complex case – unlike the Xella case, which involved gravel, and where it is difficult to support a position that national security – and not economic protectionism – was the motivation behind the decision.