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FDI SCREENING AND EQUITY FINANCINGS OF FRENCH GROWTH COMPANIES

Whilst much has been published on the subject of the evolving and increasingly wide-reaching French FDI screening regime as it applies to the acquisition of private and public companies, the application of the regime to primary equity investments in French companies has received less attention.

No segment of the French economy has a stronger or more consistent appetite for equity financing than the tech sector. Whilst not all tech companies fall within the "sensitive sectors" scope of the FDI screening regime[1], some most certainly do and others are operating in the "grey zone" characteristic of such regulatory regimes, where the application of the regime to the company is uncertain.

It's also evident that domestic capital providers alone are unable to satisfy such companies' financing needs. By way of illustration, in 2021 nearly 50 per cent of the investors in the French Next40/FT120 companies (120 French startups and scale ups determined to have the potential to become global technology leaders) were non-European foreign investors[2].

This statistic, rather than one focused on both European and non-European foreign investors, is significant for present purposes because whilst the *sectoral scope* of the FDI screening regime is the same whether applied to secondary (i.e. M&A) or primary transactions, the same is *not* true as regards the geographical provenance of the foreign investor. In the context of primary equity transactions, the regime does not apply to investors from other EU member states. Only investors from geographies outside the EU[3], such as the US, the UK, Asia or elsewhere, are concerned[4].

The 25 per cent threshold

As regards unlisted French companies[5], the regime applies if the transaction results in the foreign investor (or investors acting in concert) acquiring 25 per cent or more of the voting rights of the French company as a result of the investment.

[1] *The sectors within the scope of the French FDI regime include defense, energy, transportation, public health, space and aircraft industries, telecommunications, storage of sensitive data, activities relating to certain key technologies, including R&D activities for semiconductors, artificial intelligence, cybersecurity, robotics, additive manufacturing, dual-use goods and technologies, print and online press services for political and general information, food safety, energy storage, and quantum technologies, biotechnologies and technologies involved in the production of renewable energy.*
[2] *Source: France Digitale*
[3] *Or member states of the European Economic Area who have signed bilateral anti-money laundering agreements with France – currently Iceland, Norway and Liechtenstein.*
[4] *In practice, particularly on later stage financing rounds, the transaction can combine primary and secondary features, where one or more of the founders or an earlier stage investor secure total or partial liquidity from the new investor(s).*
[5] *Currently, FDI screening is also required when a non-EU investor cross a notification threshold of 10% of the voting rights of a French company which is listed on a regulated market and operates in a strategic sector.*

In the life of a growth company, earlier equity financing rounds tend to be more dilutive, but even the earlier ones would often not result in an incoming investor holding more than 25 per cent of the investee company's voting rights[6]. Nevertheless, there are cases and transaction types in which the FDI screening regime can come into play: take, for example, a follow-on investor in a later stage round, whose investment in that round represents a good deal less than 25 per cent of the aggregate post money voting rights, but would tip their total holding over the 25 per cent threshold because of the size of their existing position in the caps table. Or "growth capital" type deals, where the investor may take a significant minority equity position, short of control.

If the potential application of the regime in these cases is clear, the commentary that follows below suggests that there are features of a regime which has been designed principally for M&A transactions, which are arguably less well adapted for tech sector financing transactions of the kind under consideration in this note.

Issues of certainty of scope

The "shadow and light" of the scope of the FDI screening regime for French tech companies can be illustrated by reference to biotech and artificial intelligence.

First, the light (and consequent certainty of application): biotech is, since 30 April 2020, explicitly referred to in the list of sensitive sectors[7] and in practice biotech companies account for a significant proportion of the applications filed. Statistics appearing in the first annual report on French FDI control published by the MINEFI in March 2022 bear this out. According to the report, "in 2021, requests in the biotechnology sector accounted for approximately 26 per cent of the files related to public health protection". The high sensitivity of biotech is confirmed by another remark from the same report: "Half of the investments [in the biotech sector] presented significant risks to public safety, leading to their conditional authorization by the Minister".

More obscure and less certain in its application to given cases, is the impact of the inclusion of AI in the scope of the regime, being framed as it is in the following terms: "R&D activities for artificial intelligence used in activities considered sensitive or essential".

[6] *By way of illustration, see the present authors' research note "The French Tech Next40 2022: a legal survey", published in May 2022, which stated with regard to that particular cohort of French tech companies that the average dilution (on a non-fully diluted basis) for existing shareholders was 21.5 per cent on a series A round, 23 per cent on a series B round and 13 -14 per cent on series C and D rounds.*
[7] *See footnote n°1.*

Artificial intelligence is not defined in the law or in the MINEFI Guidelines[8]. It can be broadly defined as any tool used by a machine to "reproduce human-related behaviours, such as reasoning, planning and creativity"[9] and can be found in a very wide range of software and software applications.

The MINEFI's Guidelines explain that "sensitivity is determined on a case-by-case basis". The head of the MINEFI's foreign investment bureau has observed that this case-by-case approach is "all the more important [in the R&D activities for artificial intelligence sector] as activities are targeted at an early stage, even before their industrialization phase and on the basis of possible future applications".

Deals involving multiple foreign investors: The concert party principle

The FDI screening regime may apply if the 25 per cent threshold is crossed by a foreign investor acting alone or in concert with other foreign investors[10]. It is often the case in a transaction of the kind under consideration that a group of funds, led by one of their number, invest together. If two or more of them are based outside France (and not elsewhere in the EU), it may be necessary to consider the question of whether they are "acting in concert".

The legal definition of this phrase is to be found in article L. 233-10 I of the French Commercial Code, which states that: "Are deemed to be acting in concert persons who have entered into an agreement with a view to acquiring, selling or exercising voting rights, for the purpose of implementing a common policy towards the company or in order to obtain the control of such company. […]."

In an equity financing transaction, the first place to look for an answer to whether two or more of the foreign investors are acting in concert is the shareholders' agreement and articles of incorporation (*statuts*) of the French investee company.

Typical shareholder agreement provisions whose existence and terms should be taken into account include investor rights to board representation, enhanced majority and/or negative control rights (including as to such matters as budget approvals, debt and equity issuances, senior management remuneration packages, etc.) in favour of the investor(s), lock up obligations, drag along, tag along and preemption rights; and a liquidity clause.

8 *See here our overview of the French FDI screening regime which discusses some of the key points emerging from the MINEFI's Guidelines: M&A in France FDI Screening*
9 *As defined by the European Parliament.*
10 *The FDI screening regime also applies in the event of an acquisition by foreign investor(s) of the direct or indirect control of a French company, alone or jointly. The MINEFI observes in its Guidelines that the administration may consider that certain rights granted to minority shareholders in the French company's articles or a shareholders' agreement, or certain restrictions agreed amongst the shareholders, are evidence of the existence of joint control. It should be noted that within scope control transactions are subject to screening whether the investors are from within or outside the EU.*

The jurisprudence of both the French financial markets authority (AMF) and the Paris Appeals Court relating to the definition of concert parties, has focused essentially on its application in the context of takeovers of listed companies. Shareholders' agreements in relation to such companies are subject to specific rules under French securities laws and are typically on somewhat different terms to those which are agreed between investors and founders of a privately owned growth company. However, the jurisprudence does establish that "common policy is merely the strategy that the parties acting in concert determine together for the implementation of their common or particular *objectives*. They act in concert not necessarily because they all want the same thing, but because their common policy enables each of them to get what they want"[11].

The MINEFI Guidelines contain a non-exhaustive list of shareholder agreement provisions which "*could*" characterize an action in concert (a long lock-up period, an agreed limitation on the parties' respective shareholdings, a reciprocal right of approval on any purchase or transfer, or a tag-along right).

Whilst it is possible for the interested parties to consult the AMF in advance as to whether a concert party exists in a given case, there is no equivalent possibility (for example with the MINEFI) in the context of privately owned companies. The advanced FDI ruling procedure discussed below is limited to determining whether a relevant sector is in scope or not.

Timing issues and advance confirmation of scope procedures

The FDI screening procedure for the crossing of the 25 per cent threshold can take up to 75 business days, divided into two phases[12]. The MINEFI's Guidelines state that it is the parties' responsibility to allow enough time for the FDI screening procedure in their transaction timetable.

Growth companies in the tech sector, particularly early-stage companies, are typically loss making, with limited cashflow runways and a need to raise equity at relatively short intervals (typically, every 12-20 months[13]).

11 *« Actions de concert », Joly Société Edudes as of 1 March 2022 by Dominique Schmidt and Nicolas Rontchevsky*
12 *(a) A phase I review of maximum 30 business days during which the Ministry of the Economy will indicate whether (i) the transaction falls within the scope of the French FDI regime (this step will not be required if a preliminary request for a determination of this point has been filed and the Ministry has confirmed it – see above), (ii) is authorized unconditionally or (iii) requires further in-depth examination; and (b) a phase II review of maximum 45 business days during which the Ministry of the Economy will render its final decision i.e., refusal of the investment or clearance subject to conditions or the giving of undertakings by the foreign investor to ensure that the contemplated investment will not adversely affect public policy (ordre public), public safety or national security.*
13 *Source : The State of the French Tech Ecosystem 2022*

Since the onset of the downturn in the tech sector last year, led by the steep decline in value of publicly traded tech companies in the US, fundraising by privately owned companies has become more challenging and the timelines between launching a search for equity financing and successfully closing a round have extended.

The FDI screening regime offers an accelerated timetable for acquisitions of publicly traded securities which cross a ten per cent of voting rights threshold. In such cases, the MINEFI has 10 days from the date of a complete filing by the investor, within which to decide whether the investment requires further in-depth examination.

We would argue that a different, but equally compelling, policy case can be made for a fast track timetable for applications for authorization which are triggered by a primary investment in a French growth company. Unlike a typical non-distressed M&A transaction, the core purpose of a primary investment deal is to provide financing to an investee company still reaching for break even and faced with a ticking clock, which needs the funds in order to continue its development and often in order to continue its operations.

The timing challenge of navigating the screening regime is greater still where the company's activities are in the "grey zone" as regards the question of whether they are within scope. French law does provide for an advanced ruling procedure (early consultation)[14], but in practice, it is rarely used because the response time allowed to the MINEFI (two months from the date of a complete filing) is longer than Phase 1 of the FDI screening procedure (30 business days).

Finally, in considering these timetable factors, it should be borne in mind that there is no materiality threshold under the French FDI screening regime (i.e. there is no exemption from compliance for transactions or companies whose valuation falls below a defined threshold).

March 2023

[14] *The French company (or, with the approval of the French company, the foreign investor) may file a preliminary request with the Ministry of the Economy to determine whether the French company falls within the scope of the regime and that a filing is accordingly required.*

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