CELIS Country Note

on

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by

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Abstract

The framework for investment screening in Hungary is dual. There is a screening mechanism established in force since 2019, focused on the risks posed by foreign direct investment (FDI) to national security. The second mechanism was adopted due to the emergency situation brought about by the pandemic in 2020 and is focused on protecting Hungary's economic interests in strategic sectors. A foreign investor may find that it falls within the purview of both mechanisms, as both are still in force.

This country note includes a short presentation of Hungary's attitude towards FDI, and the main features of the two investment screening mechanisms. This includes the conditions for triggering review under these mechanisms, the investors and economic activities that are covered under both, the competent authorities and a brief outline of the screening procedure.

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Bálint Kovács and Csongor István Nagy

1. Introduction

The Hungarian Government has been engaging in efforts to attract foreign investors since the end of the 1980s, and these efforts intensified with the collapse of the communist regime. Until 1989, Hungary was a party to the Warsaw Pact and was a planned economy. After the collapse of the communist regime, the economic system was transformed into a market economy and most of the state-owned enterprises were privatized. As the country made its way from a one-party socialist state, with a planned economy, to a democratic open-market economy, attracting foreign investors became one of Hungary's most important goals. At this time foreign investments served the transition from a state-run economy to capitalism, providing economic growth, technology, know-how, and knowledge of entrepreneurship which ultimately solidified the transition.

Foreign direct investment (FDI) has played an important role in the development of Hungary as a market economy, and in its integration into the global economy. Foreign investments were welcomed by Hungarians with hopes for more opportunities and economic prosperity at home. For this purpose, there have been a number of legislative measures and incentives programs initiated by the governments of Hungary over the years.

During the communist era, for more than four decades, the Central and Eastern European region was removed from the mainstream of global economic growth. While Hungary was eager to receive FDI, at the time of its transition to a market economy, similar to countries in the Central and Eastern Europe (CEE) region, it attracted only a small fraction of the world FDI inflows.[1] Nevertheless, in a regional setting, Hungary managed to become one of the frontrunners.[2] Hungary's economy was gradually opened up, with a wave of privatization of state-owned enterprises, and inflow of FDI contributing to the modernization of its economy.

[1] See figures for the years 1986-2001, featured in the 2002 UNCTAD World Investment Report, p. 7. https://unctad.org/system/files/official-document/wir2002_en.pdf (Accessed 08.06.2023)
[2] Id., p. 169.

The 1990s also saw the implementation of various governmental programs in Hungary, aimed at promoting the inflow of FDI.[3] Since early in its transition, the European Union (European Economic Community at the time) assisted the countries in the region through the PHARE program, and prepared them for their eventual accession to the EU. Hungary and Poland were among the first in the region to benefit from this program, while also receiving guidance from the part of the EU on several matters related to their economies.[4] Hungary entered the EU with the wave of accession which is also called the “Big Bang”, with which in 2004 the EU grew into a club of 25 Member States. In the period before its accession, some EU Member States had become Hungary’s main economic partners, a fact which remains true to this day.

Today, government efforts to attract foreign investment may be considered as being at their pinnacle. At least from the point of view of the results they produce. Hungary noted a number of 76 FDI projects for 2021, a 58% increase compared to the previous year.[5] Representing just a small fraction of both the EU’s population (~2.2%) and its territory (~2.1%), Hungary’s 76 FDI projects in 2021 represent merely 1.3% of total EU FDI projects (totalling 5,877). In terms of value, however, Hungary fared well among its Visegrád Group (V4) regional partners, but also EU-wide, taking home €5.3 billion worth of investment commitments in 2021, or upward of 3.5% of the total value of EU-wide FDI projects. The year 2022 was considered even more successful, with a number of high value commitments being announced, most notably in the field of electric vehicle battery technologies.[6]

[3] In the 1990s for the market-based privatisation of SOEs, in the early 2000s the Smart Hungary Investment Promotion Program, in the 2010s the setting up of an agency (HIPA) to promote the inflow of FDI. These included, among other incentives, tax breaks, state support for innovation, financial support for research and development, breaks for customs and duties. In addition, the state also engaged in the development of industrial parks with the purpose of facilitating the establishment of foreign investments. Other programs focus on disadvantaged regions of the country, with the purpose of creating jobs.

[4] In fact, before the expansion of the program, Phare was launched as PHARE - Poland and Hungary: Assistance for Restructuring their Economies.

[5] Granted, it was the year when the SARS-COV2 pandemic started, 2020 can still be considered a successful year for Hungary in terms of FDI commitments. HIPA: Investments in Hungary Reached New Highs in 2021 Yet Again, 17.01.2022, available at: https://hipa.hu/investments-in-hungary-reached-new-highs-in-2021-yet-again (Accessed 08.06.2023).

[6] The investment of CATL stands out as the largest ever investment commitment in Hungary’s history. See FDI Intelligence: CATL announces Hungary’s largest ever investment https://www.fdiintelligence.com/content/news/catl-announces-hungarys-largest-ever-investment-81374 (Accessed 08.06.2023); Also notable is the expansion of SK Innovation’s operations in Hungary. These investments are expected to put Hungary on the global map of battery technologies. See also: Financial Times: The electric vehicle boom in a quiet Hungarian town – https://www.ft.com/content/fafda4ff-0385-4007-9a27-869c1fdad69f (Accessed 08.06.2023).

Three quarters of FDI projects in Hungary come from its European partners. German investors are dominant, with market leaders from the automotive industry making large investments[7] employing around 50,000 workers, generating approximately 2.5% of the country's gross domestic product. German companies are not the only ones eyeing Hungary,[8] as investors from Asia (especially South Korea and China) have also shown great interest in having a foothold in the country, and in expanding their existing operations. Top investors in Hungary also include actors from outside the EU, mainly the United States and Australia.[9] Chinese investments, one of the main catalysts for investment control policies, are in the lower single digits as a percent of total FDI projects in Hungary.[10]

The Government also set up an agency with the sole purpose of attracting foreign investment—the Hungarian Investment Promotion Agency (HIPA)—that works under the auspices of the Ministry of Foreign Affairs and Trade. According to its website, HIPA "provides management consulting services to interested companies free of charge in an end-to-end, one-stop-shop service model, supporting them in selecting a business location, providing tailor made incentive offers and information on state aid issues."

2. Domestic Framework

2.1. Overview of Domestic Screening Mechanisms

Before the entry into force of the EU FDI Regulation,[11] Hungary had already adopted a national security screening mechanism that entered into force on 1 January 2019 (hereinafter 2018 Mechanism).[12] Since its entry into force, the law has been amended a number of times, and adapted to the specific challenges the country had to face in the past couple of years, most

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[7] See Hungarian Insider: German companies have invested EUR 7 billion in Hungary over 6 years. https://hungarianinsider.com/german-companies-have-invested-eur-7-billion-in-hungary-over-6-years-6524/ (Accessed 08.06.2023).
[8] See Hungarian Insider: German companies continue to see Hungary as a good investment destination. https://hungarianinsider.com/german-companies-continue-to-see-hungary-as-a-good-investment-destination-10148/ (Accessed 08.06.2023).
[9] See HIPA: https://hipa.hu/news/investments-in-hungary-reached-new-highs-in-2021-yet-again/ (Accessed 08.06.2023).
[10] For more details on this matter see Tamás Matura: Chinese Influence in Hungary. Center for European Policy Analysis, 18 August 2022. https://cepa.org/comprehensive-reports/chinese-influence-in-hungary/ (Accessed 08.06.2023). Of course this might change with the announcement made in the middle of 2022 by China-based battery maker CATL.
[11] Regulation (EU) 2019/452 of the European Parliament and of the Council of 19 March 2019 establishing a framework for the screening of foreign direct investments into the Union.
[12] Act LVII of 2018 on controlling foreign investments violating Hungary's security interests, published in Official Gazette no. 157 of 11 October 2018.

notably the coronavirus pandemic and the effects of the Russian aggression against Ukraine. The amendments were also meant to harmonize the mechanism with the EU FDI Regulation.

Government Decree no. 246/2018 (December 17) *on the implementation of Act LVII of 2018 on controlling foreign investments violating Hungary's security interests*, contains the rules of implementation of the 2018 Mechanism.[13]

The SARS-COV2 pandemic ushered in a wave of new and innovative legislative measures aimed at redressing the economy. Among these were measures to control the inflow of FDI in order to safeguard strategic sectors of the economy.[14] One of the larger pieces of legislation adopted with this aim was Act LVIII of 2020 *concerning the transitional rules and epidemiological preparedness related to the ending of the state of emergency*, which replaced a previous government decree,[15] and established a new and parallel screening mechanism to the one established in 2018. Chapter 85 of this massive piece of legislation, as per its title, established the *measures necessary for the economic protection of companies incorporated in Hungary*. Through this, a screening mechanism was set up for a limited period, which existed simultaneously and in parallel with the 2018 Mechanism (this will be referred to hereinafter as the 2020 Mechanism). This screening mechanism and the adjacent rules for its application have subsequently been brought under Government Decree no. 561/2022.[16]

The simultaneous existence of the two investment screening regimes means that in case foreign investors' activities will fall under the application of both regimes, investors will have to submit two separate applications in accordance with the rules laid down by the two legislative acts.

For the purposes of making the two regimes more readily identifiable, the year of their adoption will be used, naming them accordingly: the "2018 Mechanism" and the "2020 Mechanism". These denominations also include all additional regulatory modifications and supplementations, which form part of the respective legislative acts. The two regimes have

[13] Published in Official Gazette no. 201 of 17 December 2018.

[14] As shown in the 2022 World Investment Report by UNCTAD, p. 14. https://unctad.org/system/files/official-document/wir2022_overview_en.pdf (Accessed 08.06.2023).

[15] Government Decree no. 227/2020 (May 25) concerning the measures necessary for the protection of the economic interests of companies established in Hungary in order to prevent a human pandemic threatening the safety of life and property and to avert the consequences thereof, which contained the most important measures for countering the negative economic and social effects of the pandemic.

[16] Government Decree no. 561/2022 (23 December) on certain provisions necessary for the protection of Hungarian companies for commercial purposes during a state of emergency, published in Official Gazette no. 213 of 23 December 2022.

also been dubbed by some practitioners as “permanent” and “temporary”, respectively.[17] The 2020 Mechanism, or ‘temporary’ screening regime, was enacted for the duration of the state of emergency introduced pursuant to the SARS-COV2 pandemic. The state of emergency was subsequently extended due to the Russian aggression against neighbouring Ukraine.[18]

2.2. The Screening of FDI Violating Hungary’s Security Interests: The 2018 Mechanism

The 2018 Mechanism was adopted with a focus on *national security*, aiming to protect sensitive economic sectors from investors whose activities might constitute a threat to Hungary’s security interests. The review of investments under this mechanism is done by the Cabinet Office of the Prime Minister.

The 2018 Mechanism does not contain a financial threshold, with only a corporate threshold applying as shown below. This Mechanism applies to foreign investors, defined as follows:

a) a national of a state outside the European Union, the European Economic Area and the Swiss Confederation or a legal entity or other organization registered in such a state,

b) a legal entity registered domestically (in Hungary), in another Member State of the European Union, another member state of the European Economic Area or the Swiss Confederation, acquiring ownership or interest as specified under art. 2 (1) of the Act in an economic entity registered in Hungary, with activities laid down under art. 2 (4) of the Act, if the person with *decisive influence* in the legal entity as specified in the Act on the Civil Code (hereinafter: HCC) is a national of a state outside the European Union, the European Economic Area or the Swiss Confederation, or a legal entity or other organization registered in such a state.

The foreign investor, as defined above, must obtain the prior approval of the competent minister in case it plans to establish a commercial entity (meaning that the screening regime also applies to greenfield investments) or acquire ownership within an entity registered in Hungary. The list of economic activities subject to notification obligation is found in Annex 1 to Government Decree 246/2018. (XII.17.).[19]

[17] See e. g. https://www.engage.hoganlovells.com/knowledgeservices/news/hungarian-fdi-veto-lifted-after-pressure-from-eu-commission-alls-well-that-ends-well-or-dangerous-precedent. The two systems have also been dubbed as lasting and temporary, see e. g. https://www.wolftheiss.com/insights/status-report-on-newly-implemented-fdi-regimes/ -- Accessed August 28, 2022.

[18] The Parliament gave authorization to the Government in this regard via Law no. XLII of 2022. The state of emergency was declared via Government Decree no. 424/2022 (X.28.). It was subsequently extended until 24 May 2024, via Government Decree no. 515/2023 (XI.22.).

[19] An unofficial translation of the Government Decree: https://circabc.europa.eu/rest/download/ef86a9d8-23d9-439f-8d18-85a2d9bb2cd7 (Accessed 5 November 2023).

Regarding the acquisition of ownership, this must be notified in case it meets the conditions set out below:

a) direct or indirect acquisition of more than a 25% ownership (in the case of a listed company, more than a 10% ownership) in an existing or yet to be established company with its registered seat in Hungary, provided that this company pursues activities that are deemed sensitive from a national security point of view;
b) acquisition of decisive influence in such a company, pursuant to the definition of the Hungarian Civil Code (HCC) of decisive influence.

The notification obligation is also applicable in case the acquisition by the foreign investor extends to less than 25% of the company, but as a result of the acquisition, more than 25% of the company will be owned by foreign investors. Publicly traded companies are exempted from this rule.

The notification obligation is also applicable in case a foreign investor wishes to establish a branch office in Hungary, or in case it wishes to acquire a right to operate or use infrastructure and equipment related to activities in the field of utilities services (electricity, natural gas, water). Other covered fields include weapons and ammunition manufacturing, production of dual-use items, media, and the insurance sector.

Notifications will be replied to within eight days by the competent minister, in order to confirm receipt. The notifications will be responded to within 60 days, which may be extended by another 60 days.

Non-compliance will be fined as follows: (a) a fine of HUF 100,000 to HUF 1,000,000 in the case of investors that are natural persons; (b) a fine of HUF 1,000,000 to HUF 10,000,000 in the case of legal persons.

The law does not provide for mitigating measures or any intermediate solution between allowing and prohibiting an investment. Decisions of the competent authorities prohibiting the investment under the 2018 Mechanism may be appealed on the grounds of "violation of the essential rules of the procedure", or in connection with being branded as having attempted to circumvent the application of the law. The Metropolitan Court of Budapest has exclusive jurisdiction to hear such actions.

2.3. The Screening of FDI for the Protection of Hungary's Economic Interests: The 2020 Mechanism

With the 2020 Mechanism, a new procedure and a new set of considerations were introduced for screening foreign investments, aimed at the protection of Hungarian *economic interests* in strategic economic sectors, considered by the government as requiring protection during the state of emergency. The Ministry of Technology and Industry has competence to review investments under the 2020 Mechanism.

The law establishing the 2020 Mechanism includes the following definition for *national interest*: “the public interest in ensuring the safety and security of networks and equipment, the continuity of supply[ing goods and services], or essential strategic economic interests, that are not covered by sectoral EU and national law.”[20] Additionally, the 2020 Mechanism also introduced the concept of a *strategic company*, defined as a limited liability company, a private joint-stock company or a publicly traded joint-stock company established in Hungary, the main or secondary activity of which falls within the energy, transport or communications sectors or a sector of strategic importance within the meaning of Article 4(1)(a)-(e) of the EU FDI Regulation, excluding financial infrastructure. The covered areas of economic activity are included in Annex 1 of the Government Decree.

The threshold for triggering the screening obligation is set at HUF 350 million (just under EUR 1 million). There is an additional, so-called corporate threshold, which is now set at 5% ownership acquired in a strategic company (either directly or indirectly), and at 3% for publicly traded companies. The obligation to notify a transaction is also triggered in case there is an acquisition of convertibles, of rights in usufruct, in the case of corporate transformations, of asset acquisitions, of capital injections and in-kind contributions, even in cases where such transactions are free of charge.

Under the 2020 Mechanism, an entity shall be considered a foreign investor whenever it acquires a determined share or influence in a Hungarian economic entity, and it is a legal person or another entity registered domestically (in Hungary), in another Member State of the European Union, a Member State of the European Economic Area, or the Swiss Confederation, in case the majority influence (or control) over said legal person or other entity belongs to a citizen of, or a legal person or other entity registered in a state outside the EU, the EEA or the Swiss Confederation.

[20] Article 2 section 3 of Government Decree 561/2022.

The 2020 Mechanism applies to sectors such as the defence industry, nuclear sector, government facilities, as well as tourism, communications, construction, energy, the financial sector, healthcare, and food and agriculture, among others.[21]

Investors must retain legal representation for the procedure and notify their investments accordingly to the Ministry of Industry and Technology, in 10 days after the investment (in whichever form) was agreed upon. Eight days after receiving the notification, the minister sends out a response to confirm receipt. The minister will give a reply on the merits within 30 working days of receiving the notification. This may be extended with an additional 15 working days if the need arises, with the condition that the parties must be notified.

Non-compliance, in cases where this does not turn into a felony, are sanctioned as follows: (a) a fine of at least HUF 100,000 in the case of an investor that is a natural person; (b) investors that are legal persons and other entities will be fined for at least 1% of the net revenues for the previous fiscal year of the targeted strategic entity.

The law does not provide for mitigating measures or any intermediate solution between either allowing or prohibiting an investment. Competent authorities' decision prohibiting an investment under the 2020 Mechanism may be appealed on the grounds of "violation of the essential rules of the procedure", or in connection with being discovered to have circumvented or at least attempted circumvention, of the regulations on reporting and screening. The Metropolitan Court of Budapest has exclusive jurisdiction to hear such actions.

3. Developments to follow Resources and Cases

Despite the two cases that have reached the attention of the European Commission and the Court of Justice of the European Union, there have not been many cases as a consequence of the entry into force of the two investment screening regimes. We will be paying attention to potential new cases reaching the courts.

Another important question pertains to the length of time that the 2020 Mechanism will be maintained. Because the war in neighbouring Ukraine is protracted, the Government may

[21] Complete list is contained in Government Decree 289/2020 (17 June) defining the activities required for the economic protection of companies having their seat in Hungary, https://circabc.europa.eu/rest/download/f1843240-0536-46dd-abf6-f2ffac3953c3 (Accessed 5 November 2023).

further extend the states of emergency, maintaining the 2020 Mechanism in force. This allows for robust control over incoming FDI.

We will also be paying attention to possible amendments to the existing screening regimes pursuant to the Xella case, but there have been no developments in this regard as of the closing of this country note.

Annex 1: Relevant laws, ordinances, regulatory guidelines

Hungary has notified to the Commission the applicable legislation on investment screening, and also provided unofficial translation for some of them. The list is frequently updated.[22]

- Act LVII of 2018 on Controlling Foreign Investments Violating Hungary's Security Interests
- Government Decree 246/2018. (XII. 17.) on the Implementation of Act LVII of 2018 on Controlling Foreign Investments Violating Hungary's Security Interests
- Act No. LVIII of 2020 on the Transitional Rules related to the End of the State of Danger and Pandemic Preparedness (section 85. paragraphs 276-292)
- Government Decree 289/2020 (VI. 17.) defining the measures required for the economic protection of companies having their seats in Hungary
- Section 299 of Act XCIX of 2021 on transitional rules related to emergencies Affecting Hungary's Security Interests
- Government Decree 802/2021. (XII. 28.) - the amendment of Government Decree 246/2018 on the implementation of Act LVII of 2018 on the Control of Foreign Investment
- Government Decree 561/2022 (XII. 23.) on the different application of certain provisions necessary for the economic protection of Hungarian companies during an emergency
- 610/2022 (XII. 28.) Government Decree amending Government Decree No 246/2018 (XII. 17.) on the implementation of Act LVII of 2018 on the control of foreign investments damaging Hungary's security interests
- Government Decree 129/2023. (IV.17.) on the rules of asset sales for the purposes of continuity of Debtor's business operations in a state of emergency

Annex 2: Relevant administrative and court cases

There are two notable cases stemming from Hungary:

- The VIG/AEGON case, which is notable due to the mixing of EU merger rules with the use of the novel national security investment screening mechanism (the 2018 Mechanism);[23]

[22] See *List of screening mechanisms notified by Member States*: https://policy.trade.ec.europa.eu/enforcement-and-protection/investment-screening_en (Accessed 10 June 2023).
[23] See Case No. M.10494 available at https://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=2_M_10494 (Accessed 10 June 2023). A brief analysis of the case can be found here: Bálint Kovács, Facilitating and Scrutinizing National Security Measures: Analysis of an Investment Screening Case in the European Union (June 10, 2023). Available at SSRN: https://ssrn.com/abstract=4475471 or http://dx.doi.org/10.2139/ssrn.4475471.

- Case C-106/22 - Xella Magyarország, stemming from a request for a preliminary ruling submitted by the Budapest High Court concerning the application of the 2020 Mechanism.[24]

Annex 3: Relevant literature

Szilárd Gáspár-Szilágyi, Country Report on Hungary and Romania, in: S Hindelang, A Moberg (eds.), YSEC Yearbook of Socio-Economic Constitutions 2020 – A Common European Law on Investment Screening (Springer, 2020).

Bálint Kovács, Facilitating and Scrutinizing National Security Measures: Analysis of an Investment Screening Case in the European Union (June 10, 2023). Available at SSRN: https://ssrn.com/abstract=4475471 or http://dx.doi.org/10.2139/ssrn.4475471.

Hungarian FDI veto lifted after pressure from EU Commission – all's well that ends well or dangerous precedent? 14.07.2022 https://www.jdsupra.com/legalnews/hungarian-fdi-veto-lifted-after-3725622/.

Mergers: Commission finds that Hungary's veto over the acquisition of AEGON's Hungarian subsidiaries by VIG breached Article 21 of the EU Merger Regulation, Press release, 21 February 2022 https://ec.europa.eu/commission/presscorner/detail/en/IP_22_1258.

Vienna Insurance Group and Hungary reach an agreement on the outlines of a cooperation and the further procedure regarding the Hungarian insurance companies AEGON and UNION, 22.12.2021.

https://www.vig.com/en/investor-relations/ir-newsinside-information/detail/vienna-insurance-group-and-hungary-reach-an-agreement-on-the-outlines-of-a-cooperation-and-the-further-procedure-regarding-the-hungarian-insurance-companies-aegon-and-union.html.

[24] See Bálint Kovács: National Interest and Freedom of Establishment: The CJEU's Judgment in Xella, CELIS Blog, 14 August 2023, https://www.celis.institute/celis-blog/national-interest-and-freedom-of-establishment-the-cjeus-judgment-in-xella/ (Accessed 25 November 2023).

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CELIS Country Reports (hereafter "Report") are produced by leading experts for any European and select non-European jurisdiction following an elaborate model, allowing for comparison and evaluation across jurisdictions. The project's aim is to identify and suggest best practice and to propose a common European (model) law on investment screening.

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