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Government Aid to Failing Businesses: The EU State Aid Rules

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Governments and local authorities are frequently called upon to financially favour one company over another on grounds of impending business failure and loss of jobs. The creation of the Common Market in Europe has, however, required the removal of state aids and there are strict rules on the circumstances in which aid can be granted, powers of the European Commission to monitor aid and of aggrieved competitors to challenge aids in the national courts. The possibility of seeking aid should not be overlooked if trying to put together a rescue or restructuring package, but great care must be taken to ensure that a difficult situation is not made worse and much more damaging to the recipient, by the illegal grant of aid.

Introduction

The EU state aid rules will be relevant in many different situations. A company may be experiencing financial difficulties and seeking a rescue package from the Government, whether from Central Government or through a local or regional fund. The technology downturn produced many such cases in the last few years. From a different angle, if the insurer of the company applying for aid is asked to offer cover for the risk of any grant being declared illegal, so as to be liable for making good the payment to the company, the rules will equally be of importance. Alternatively, a competitor may be seeking to complain to the European Commission or raise a challenge in the High Court to strike down and order repayment of aid which was not notified by the Government to the European Commission. Aid may be a straightforward grant, a loan guarantee or tax exemption, or even the exclusive use of a government or EU-funded facility, like a terminal at a port or airport, which only one single company is allowed to use.

The EU rules on state aid are in most respects the most strict in the world,[1] and they require the repayment of aid which was wrongly granted, even if this threatens the existence of the recipient. While the rules are designed to promote efficiency in the EU by preventing governments from supporting the 'dead wood', these rules can damage specific industries when their counterparts outside the EU are being subsidized by governments of countries where such subsidies are allowed. One example of this is the aviation industry, where EU airlines have suffered due to aid offered by the US government in the last $2\frac{1}{2}$ years following September 11, though the EU Transport Council is shortly due to adopt a Regulation which will enable airlines to complain to the European Commission with a view to imposing duties on US (or other non-EU) airlines using government funds to operate at abnormally low prices so as to compete unfairly with EU airlines.

This article will focus on the rules applying to EU businesses, which should be of relevance to all readers. Before addressing the specific circumstances of the rescue of ailing firms, it is necessary to discuss the basic prohibition of aid, the market investor principle for assessing aid to public companies, the broad categories of aid which will, or may, or will almost never be acceptable, and the procedural aspects – the duty to notify aid, risks of repayment and the role of the European Commission and the national courts in enforcement. Rescue and restructuring will be discussed in some detail, including proposals to tighten up the rules further, and the final section will address the accession of the ten new member states and likely developments in the law on state aids.

EU prohibition of state aid

The EC Treaty prohibits all governments of the EU member states from illegally subsidizing any individual company or industry. Article 87 (formerly 92) of the EC Treaty provides that any aid from the state to a company or industrial sector will be illegal if it distorts or is likely to distort competition by favouring certain companies or industries over others. There is a

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1 One exception is the farming industry which is heavily subsidized to enable it to compete in the global market.

requirement that there be some effect on trade between member states though, in practice, the Commission will pursue complaints about assistance from the State even when there appears to be little or no impact on inter-state trade. In this regard, if aid distorts or has the potential to distort competition and relates to an activity that is 'tradable', even if solely in a particular region, the requisite effect on inter-state trade is probably met.[2] A measure affecting all business across all sectors, e.g. a tax discount or exemption, is, however, outside the State aid rules.

There is no definition of 'aid' but the decisions of the European Commission and European Court of Justice have made clear that the definition 'aid in any form whatsoever' is an all-embracing definition which includes not only subsidies or grants – which could be grants for investments, or indeed, training, as well as cash injections to public enterprises, but any other pecuniary advantage such as loans, guarantees, tax exemptions (including deferral of tax, social security or other payments to the State), consultancy advice, sale of land or property at a discount, writing-off operating losses of public enterprises, and less obvious assistance such as aid to help companies invest in environmental projects or creation of Enterprise Zones for urban renewal.

Finally, state aid will include aid from any public source, whether central government, local or regional authorities, Training and Enterprise Councils or EU funding such as structural funds.

There are numerous sets of Commission Guidelines on aspects of state aid, such as rescue and restructuring of firms in difficulty (discussed below), state guarantees, SMEs[3], regional aid and short-term export credit insurance. There is also a further layer of Regulations laying down the conditions under which aid may be granted to sectors such as shipbuilding, transport, agriculture and others.

Market economy investor principle – public undertakings

The provision of funds to a *public* company will constitute aid if the company would not have been able to obtain the funds on the same basis from private capital markets. It is assumed that the private investor will not take into account any considerations – whether social or other policy – other than obtaining a return on his investment within a reasonable period of time. Applying this test, therefore, the rescue of companies in difficulties on the basis of purely national interest will be prohibited.

This principle, which has been developed by the European Commission and ECJ in case law, was originally applied to capital injections but is also now applied to other aid such as loans and guarantees. The Commission has stated that investment decisions will, of course, involve a wide margin of discretion and that it will only make a finding of state aid in situations where it is beyond reasonable doubt that there is no other plausible explanation for the provision of public funds.[4] While this Communication is stated to apply to the manufacturing sector, the Commission has stated that it will also apply the principles to service sectors such as banking, insurance, audio visual, entertainment and leisure industries where there is competition between state-owned companies and private companies.[5] The Commission has occasionally departed from this principle, however, declaring grants to be aid, even where recommended by independent financial consultants.[6]

Where a capital injection is part of a restructuring and modernization plan, it will constitute aid if it fails to fulfil the market economy investor principle.[7]

To prevent abuse in the relationship between a Member State and public undertakings, the Commission adopted in 1980 the *Directive on the Transparency of Financial Relations*. This has been amended several times (most recently by Directive 2000/252) and now requires public undertakings to maintain separate accounts for separate activities to ensure financial transparency within their accounts – the goal being to clearly identify any cross-subsidization.

Overview of categories of aid and likely assessment

The very narrow categories of state aid which will always be acceptable are where it has a social character or seeks to make good damage caused by natural disasters or other exceptional circumstances. More importantly in practice, aid *may* be acceptable to promote economic development in disadvantaged regions, or to promote certain economic activities,

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2 European Court of Justice (ECJ) in Case 280/00 *Altmark Trans* [2003] ECR I-0000 – local bus services.

3 An SME is defined as an independent enterprise with fewer than 250 employees and an annual turnover not exceeding EUR 40 million or an annual balance sheet total not exceeding EUR 27 million (*Community Guidelines on State Aid for SMEs*, OJEC 1996 C213 page 4).

4 *Communication on State Aid to Public Undertakings*, OJEC C303 1993 page 3 paras. 27–29.

5 *XXI Report on Competition Policy – 1991*.

6 Case 301/87, *France v EC Commission (Boussac)* [1990] ECR I-307.

7 Case 142/87, *Belgium v EC Commission (Tubemeuse)* [1990] ECR I-959.

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such as research and development in certain areas. These will be a matter for the Commission's discretion, though it has issued numerous sets of Guidelines. Further, aid will be permissible in cases where aid is so small as to be 'de minimis' (discussed below), where SMEs are the main beneficiaries, capacity is reduced and investment is tied to a clear restructuring programme, or if the needs of poorer regions are being recognized.

'Horizontal aid' – aid which is not aimed at a region, sector, or individual company, but rather at broader Community-wide policies such as R&D, environment, SMEs and promotion of employment, will tend to be viewed more favourably than other aid. Certain categories of aid, such as rescuing and restructuring aid for firms in difficulty are, however, subject to much more stringent requirements and these are discussed below.

Finally, the Commission will generally prohibit operating aid, to assist the day-to-day activities of a business to reduce its costs and prices, general investment aid, aid to increase capacity in a sector which is already overproducing or struggling to be competitive, and subsidies on exports.

Duty to notify aid to the EC Commission

Where an EU government is proposing to grant aid, it is obliged to notify its proposal in advance for clearance from the European Commission.[8] The Commission has two months in which to issue a decision approving aid or, alternatively, state that it has doubts as to its compatibility with the Common Market and initiate a formal investigation.[9] After the opening of a formal investigation, the Commission has a further 18 months in which to reach a final decision, though this may be extended by agreement with the Member State concerned. Particularly in cases of rescue and restructuring, time constraints will sometimes make notification very difficult. In such cases there must be a careful risk assessment as to likely compatibility of the grant with the Common Market and the likelihood of a challenge by a competitor.

Unnotified aid – orders for repayment

In the event that aid has been granted without Commission approval, the Commission has the power to abolish or modify the aid and order the repayment of aid (plus interest accrued). In practice it will order the Member State to take all necessary steps to recover the funds. If the beneficiary is unable to repay, the Member State must institute winding-up proceedings and pursue the recipient as an unsecured creditor. The Commission also has powers to monitor that its decisions are being complied with, including the use of on-site visits.

If the Commission decides to investigate aid that was not notified, it is not bound by the time limits for the assessment of aid which has been properly notified, which can obviously be damaging to the recipient and its investors. The Commission has ten years from the award of unlawful aid in which to commence proceedings for recovery of such aid.[10]

Finally, the Commission may adopt interim measures, such as an injunction to suspend or provisionally recover aid granted, pending a final decision.[11] It will do this by adopting a decision, after giving the Member State concerned the opportunity to submit its comments.

No need to notify – Block Exemptions

There are cases where the Commission has adopted 'Block Exemption Regulations' to exempt categories of aid that would otherwise have to be notified. Three exceptions where it will be acceptable for the government to grant aid without the need for notification are: aid to SMEs, aid for training and 'de minimis' aid (no more than EUR 100,000 [approximately GBP 65,000] granted over a three-year period). There is no Block Exemption specifically for rescue and restructuring aid.

The Block Exemption Regulations apply in national courts in the same way as an Act of Parliament. An aggrieved competitor may, therefore, sue directly in the High Court if it believes that aid granted does not comply with the applicable Regulation and therefore should have been notified to the Commission. Such a challenge could be made, for example, under the de minimis Exemption if aid was granted to a company which already received aid in the previous three years exceeding EUR 100,000 – loans, rent or tax rebates or any other advantageous treatment from the state all count as aid, of course, so checks of past aid should always be made.

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8 Article 88(3) EC Treaty.

9 *Council Regulation (EC) No. 659/1999 laying down detailed rules for the application of Article 93 [now Article 88] of the EC Treaty* ('Regulation 659/99') Article 4.

10 Article 15 Regulation 659/1999.

11 Article 11 Regulation 659/99.

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Challenging aid in the national courts

Other than the Block Exemption Regulations described above, which can be directly applied by national courts, only the Commission can adjudicate on the compatibility of aid with the Common Market. Given the politically sensitive nature of such cases, it is understandable that it may not in any case be appropriate for the national courts.

Aggrieved competitors may, however, sue in the national court to challenge an aid which either has not been notified or has been paid before securing Commission approval. In such a case, the national court has the power to declare the aid illegal and order its recovery. While the national court has no jurisdiction to rule on whether aid is 'compatible with the Common Market', the very fact of not notifying aid which should have been notified will of itself, however, open the grantor of the aid to a challenge in the national court. If the court decides that the aid had indeed been illegally granted, it can, in theory, order repayment. The ECJ has made clear however that unnotified aid is not automatically 'incompatible with the Common Market', such a finding only being made following a formal investigation by the European Commission.[12]

Rescue and restructuring aid

The Commission views state subsidies to ailing firms as one of the most distorting forms of aid and therefore adopts a strict approach to the grant of aid to firms which are deemed to be 'in financial difficulties'. Clarification of when a company is in financial difficulty and of the likely assessment of aid to such a company is provided by the *Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty*.[13]

Obviously, if a firm can be said not to be in financial difficulties, aid is much more likely to be approved and, in some cases, may not even constitute aid at all and, therefore, not be notifiable. The Commission will regard a firm as in difficulty where it is unable, whether through its own resources or with the funds it is able to obtain from its shareholders or creditors, to stem losses and, without outside intervention by the public authorities, it will almost certainly go out of business in the short or medium term. More specifically, the notion of a 'firm in difficulty' includes firms where more than half the registered capital has disappeared and more than one-quarter of that capital has been lost over the preceding 12 months. Newly created firms, including new firms emerging from the liquidation of a previous firm, will not be eligible for rescue or restructuring aid and firms belonging to larger groups will usually not be eligible.

A distinction is made between rescue and restructuring – a rescue temporarily maintaining the position of a firm that is in acute difficulties while a plan to remedy those difficulties is devised, restructuring being the reorganization of the firm's activities and finances to restore viability. The recipient undertakings' survival must therefore be the goal. The Commission has decided in this regard that aid granted at the same time as a decision to liquidate cannot constitute rescue or restructuring aid.[14]

Among the requirements for rescue aid to be acceptable are that it consists of liquidity support in the form of loan guarantees or loans, is offered at commercial interest rates, is linked to loans that are reimbursed no more than a year after the last instalment, and is accompanied, no more than six months after the rescue aid is authorized, by a restructuring or liquidation plan, or by proof of repayment. The rescue aid must be warranted on grounds of serious social difficulties and must not adversely affect other Member States.

Since rescue aid and restructuring aid are two separate issues, the approval of rescue aid does not mean that restructuring aid will also be approved. Indeed, restructuring raises greater risks of distortion of competition due to the shifting of the burden of structural adjustment and the attendant social and economic problems onto other producers surviving without aid. Restructuring aid will only be permitted if it is certain that any distortions of competition will be outweighed by the benefits flowing from the firm's survival. More stringent conditions are therefore laid down for restructuring aid.

In particular, the restructuring plan must be capable of restoring the long-term viability of the firm within a reasonable time scale and on the basis of realistic assumptions as to future operating conditions; the plan must include measures to offset, as far as possible, adverse effects on competitors – this is less likely to be a concern in the case of SMEs; it should describe the circumstances which led to the company's difficulties, providing a basis for assessing whether the proposed measures are appropriate; and it should provide for a turnaround that will enable the company, after completing its restructuring, to cover all its costs including depreciation and financial charges. Other conditions include limiting the aid to

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12 *Boussac*, supra n.6.

13 OJEC C288 1999 page 2.

14 Decision 94/343, *Merco*, OJEC L154 1993 page 37.

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the minimum required and restricting the Member State from granting other types of aid to the company during the restructuring period. A 'one time, last time' condition will also apply. If the company has already received restructuring aid in the last 10 years, further aid will be allowed only in exceptional circumstances for which the firm is not responsible and which could not be anticipated when the restructuring plan was drawn up. The Commission will also take account of the extent of any private investment contributing to the restructuring.

In cases where there is a risk that the company may have to file for bankruptcy before a final Commission decision on the aid, approval may be granted if the rescue aid was given in the form of a guarantee or a loan bearing normal interest rates, was restricted to the amount absolutely necessary to keep the company in business and was paid only for the time needed to devise the recovery plan – generally not more than six months.[15]

Commission revision of rescue and restructuring guidelines

The Commission has been reviewing the current Guidelines and is proposing a series of amendments to tighten up the Rules. These include the formal introduction of a 'one time, last time' principle to rescue aid; a requirement that a significant proportion of restructuring costs should be borne by private investors; that aid be limited to reversible and short-term support which is granted only so long as necessary to implement a comprehensive restructuring plan; that the closure of long-term loss-making activities should not be counted against the level of capacity reduction that is considered necessary as a compensatory measure to protect competition; and that aid is never used to artificially maintain the presence of a company in a market which is in chronic long-term over-capacity.

There is also an indication from the Commission that it will be sceptical about restructuring aid to large companies. In a speech in December, the Competition Commissioner, Mario Monti stated '… we should perhaps undertake a longer-term reflection of the future of this type of aid, its relationship with national insolvency laws and rules for the social protection of the workforce of the companies concerned'.[16]

Accession of new Member States and future developments

In addition to the revision of the rescue and restructuring guidelines (discussed above) the Commission will be proposing further changes, partly to take account of the accession of 10 new Member States on 1 May. This will increase the Commission's state aid workload by around 40%.[17] The vast majority of the Commission's workload consists of notifications of state aid from Member States and third party complaints. To deal with this increase, the Commission has proposed the adoption of further Block Exemption Regulations to remove the need for notifications of aid. It is also considering introducing new approaches to identifying state measures of lesser concern, based on the limited amount of state aid and on the limited effect on trade, simplified procedures to speed up the notification and approval of aid, and a further liberalization of the permissible categories such as SMEs and de minimis aid.

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15 Decision 97/450, *Bestwood E F Kynder* OJEC 1997 L194 page 32.

16 New Developments in State Aid Policy, British Chamber of Commerce, Brussels, 1 December 2003.

17 The greater part of the new countries will receive assisted region status, so that a number of regions within the current Member States will lose their eligibility to higher amounts of regional aid. This will be on the basis that their GDP exceeds 75% of the enlarged EU.

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