European Focus

I'm About to Go Insolvent and I'm Not a Bank—Can and Will the Government Bail Me Out?

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The financial crisis following the collapse of Lehman Brothers and the subsequent sluggish European economy have thrown a spotlight on European Union ("EU") state aid rules and, in particular, the circumstances under which governments can and will intervene to support a firm in difficulty. This article looks beyond the banking sector and provides an overview of the rules governing state aid to all other firms in difficulty.

State Aid—The Basics

The rules governing the provision of state aid form an important limb of EU competition policy and go to the heart of the goal of providing a single market across the EU. The aim, in a nutshell, is to protect competition between firms across the EU and to prevent subsidy races between Member States, the effects of which can include not only the waste of public resources, but the protection of inefficient companies at the expense of their competitors.

State aid comes in many forms, most typically a capital grant, a soft loan or a loan guarantee. It is defined in Article 107(1) of the Treaty on the Functioning of the European Union as:

> any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods . . . , insofar as it affects trade between Member States.

Member States (not the aid beneficiary) must notify the European Commission (the "Commission") of proposed state aid and await clearance before granting the aid. This is referred to as the "standstill obligation", which applies to all aid proposals unless a proposal:

(i) falls within the terms of the General Block Exemption Regulation;

(ii) falls within the scope of the Commission's De Minimis Regulation; or

(iii) is awarded pursuant to an aid scheme which has received prior Commission clearance.

In the months following the onset of the financial crisis, the Commission showed itself to be flexible in applying its state aid approval procedures. In addition to taking the pragmatic step of allocating more staff within DG Competition (the part of the Commission responsible for competition law enforcement) to process state aid applications flooding in from Member States, the vast majority of which related to aid for the banking sector, the Commission issued new guidelines as to how it would apply the state aid rules during the financial crisis. Chief among these were a temporary framework for state aid measures to support access to finance during the financial crisis and a range of new guidance on the application of state aid rules to measures to support banks.

Excluding the financial sector, however, it is important to note that, if a firm is "in difficulty", it will not be eligible for state aid under any of the exemptions listed above. In fact, of the myriad frameworks setting out the legal bases upon which the Commission will approve state aid, only one can be used for aid to firms in difficulty—"rescue and restructuring" aid.

Key Points:

- Rescue and restructuring aid is the only state aid option for firms in or close to insolvency.
- Aid recipients must downsize or otherwise suffer some pain in return for the aid.
- Special rules apply to banks; everyone else has been subject to the same rules since 2004.

Rescue and Restructuring Aid—The Principles

Outside the banking sector, the legal framework governing the award of state aid to firms experiencing financial difficulties has not changed since 2004. The Commission has twice consulted third parties as to whether to amend the rescue and restructuring aid guidelines—first in autumn 2007 and more recently in December 2010—but to date has chosen to leave the guidelines unchanged. At the beginning of October 2012, the Commission decided to extend the 2004 guidelines indefinitely, pending the outcome of a wider review, or "modernisation", of EU state aid rules.

The key principles determining whether a Member State may grant rescue or restructuring aid are summarised below.

Firms in Difficulty

The starting point for assessing the availability of aid is determining whether the proposed aid beneficiary is a "firm in difficulty". If it is not, then in theory a wide range of aid may be available, under different parameters, and this should be explored fully with public (and publicly funded) bodies, which may already be administering approved aid programmes. By contrast, if a potential aid beneficiary constitutes a "firm in difficulty", the only aid available is rescue and restructuring aid.

There is no EU definition of “firm in difficulty”. However, rescue and restructuring aid guidelines identify three circumstances in which a firm qualifies as such:

(i) the company meets local legal criteria for being subject to insolvency proceedings;

(ii) a limited liability company has lost more than half of its registered capital, more than one quarter of which has been lost over the preceding 12 months; or

(iii) a company of which at least some members have unlimited liability has lost more than half of its capital, more than one quarter of which has been lost over the preceding 12 months.

Even if a firm does not fulfil one of these three criteria, it may still be deemed to be in difficulty if the company can demonstrate that it cannot recover using either its own resources or funds that it can obtain from owners/shareholders or market sources. Finally, a newly created firm—a company operating for fewer than three years—is not eligible for rescue or restructuring aid, regardless of its financial condition.

The Commission has also sought to limit the availability of rescue and restructuring aid by establishing a rule that a firm belonging to or being taken over by a larger business group is not eligible for rescue and restructuring aid unless it can be demonstrated that the firm’s difficulties are intrinsic and not the result of an arbitrary allocation of costs within the group. Furthermore, the financial difficulties must be too serious to be dealt with by the group itself.

One Time, Last Time

A final, crucial element of the regime for rescue and restructuring aid is the “one time, last time” principle. This provides that if a firm has previously received rescue and restructuring aid, it cannot do so again. In other words, there may be good reasons to intervene once in order to keep

a firm afloat, but ultimately market forces should be allowed to prevail. Repeat state intervention is not permitted.

Two Distinct Types of Aid

Rescue and restructuring aid consists of two distinct types of aid—rescue aid and restructuring aid.

Rescue Aid

Rescue aid is a form of emergency funding required to keep the beneficiary firm afloat. It is limited to liquidity support in the form of loan guarantees or loans. The loans must be granted at an interest rate at least comparable to those charged for loans to healthy firms and with reference to official reference rates published regularly by the Commission. The loans must be short-term. Loans must be repaid, and any underlying guarantee(s) must expire no later than six months after disbursement of the first aid installment. The aid must be limited to the minimum required to keep the firm in business for the period during which the aid is authorised. It must also be warranted on the grounds of "serious social difficulties", including, for example, job losses in an already economically distressed region or the cessation of essential services.

The aid must also have no unduly adverse spillover effects on other Member States. In practice, however, this condition is applied with some flexibility, such that distortions of competition brought about by the provision of rescue aid can be mitigated during the restructuring process. It is intended that Member States will notify the Commission of proposed rescue aid before it is granted, together with an undertaking that within six months of the aid authorisation, either the loan will be repaid in full and any underlying guarantee terminated or a restructuring or liquidation plan will be developed for the company.

In the real world, of course, events can move quickly, and it is not always possible to anticipate the requirement for urgent rescue aid. Member States can be persuaded to grant rescue aid forthwith and then subsequently notify the Commission of the aid package. In this eventuality, proof of either loan repayment or a restructuring or liquidation plan must be provided to the Commission within six months of implementation of the rescue aid measure.

Restructuring Aid

Following the provision of rescue aid, the Commission will undertake a separate analysis of the compatibility of restructuring aid to a firm in difficulty. The principle behind the guidelines is to ensure that a detailed restructuring plan is agreed upon with the Commission which restores the long-term viability of the firm within a reasonable time frame without undue distortions of competition. It is usually the case that, unless the aid recipient has a small market share, a condition of aid approval is the implementation of compensatory measures to outweigh the adverse effects of public-funding intervention. Such measures typically consist of divestiture of assets and/or reductions in capacity or market presence.

As with rescue aid, the amount of restructuring aid must be limited to the strict minimum required (i.e., the minimum amount necessary to implement the agreed restructuring plan) in light of the existing financial resources of the company, its shareholders or the business group to which it belongs. Aid beneficiaries are expected to make a significant contribution to the restructuring plan from their own resources by, for example, selling assets that are not essential to the firm's survival or obtaining external financing on market terms.

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