WHITE & CASE

Cancellation of State guarantees made more difficult

The Residex ruling of the ECJ requires national courts to look for more proportionate measures to remedy unlawful State aid

December 2011

Cancellation of State guarantees made more difficult

On 8 December 2011, the European Court of Justice ("ECJ") gave its hotly anticipated ruling in the Residex case on guarantees under the State aid rules. The issue is whether EU law requires State guarantees to be cancelled when non-notified, i.e. unlawful, State aid is involved. This has caused much uncertainty for businesses under both EU and national law, because regularly it is only the borrower, and <u>not</u> the lender, who benefits from the unlawful State aid. However, the cancellation of a guarantee punishes both parties. This shifts the risk to the lender, and may create a disincentive for lenders to offer loans when State guarantees are involved, because the guarantee might be cancelled later on. The ECJ's ruling does not clearly resolve the issue. It states that EU law neither requires nor precludes the cancellation of unlawful State guarantees and passes the responsibility to national courts to determine whether to cancel guarantees. However, according to the ruling, national courts are required to examine whether there are other less onerous procedural measures to restore the competitive situation which existed before the aid was granted. Whether such alternative measures exist will depend on the national law at stake. It remains to be seen how national courts will apply the ruling and whether in some circumstances they may come to the conclusion that they are required to cancel a State guarantee. Although the ruling does not provide legal certainty for lenders, it nevertheless gives important guidance to national courts.

Background: Implications of a non-notified State aid

State aid which is put into effect without prior notification and approval of the European Commission ("the Commission") is unlawful under EU law, because it breaches the standstill clause set out in Article 108 of the Treaty on the Functioning of the European Union ("TFEU"). Normally, when unlawful State aid has been awarded, aid recipients have to pay it back. The European Courts have repeatedly confirmed that the *"withdrawal of an unlawful aid measure by way of recovery is the logical consequence of a finding that it is unlawful"* and that *"it is only in exceptional circumstances that it would be inappropriate to order repayment of the aid"*.

The ECJ has also confirmed that the national courts should *"draw all appropriate legal consequences"* from the unlawful aid. In principle, this means that national courts should order recovery of unlawful aid. In some Member States, such as Germany and the Netherlands, the mere breach of Article 108 TFEU also requires the invalidity of the act granting the aid.

For more information on the topics discussed in this alert, please contact:

Mark Powell
Partner, Brussels
mpowell@whitecase.com

Kai Struckmann
Partner, Brussels
kstruckmann@brussels.whitecase.com

Christoph Arhold
Counsel, Berlin
carhold@berlin.whitecase.com

Emma Roarty
Associate, Brussels
eroarty@brussels.whitecase.com

Are lenders at risk?

In a "typical" scenario, the application of these principles is straightforward. There are two parties; the public authority granting the aid and the beneficiary. The beneficiary of the unlawful aid must normally pay it back and the underlying contractual provisions concluded between the two parties may be invalid under national law. When State guarantees are at issue, the situation becomes more complex. Three parties are involved; the borrower, the lender and the State. The beneficiary of the aid could be the lender, the borrower, or both.

The Commission adds to the uncertainty and tries to shift the risk to the lenders when it states in its Notice on Guarantees:

> *"The question whether the illegality of the aid affects the legal relations between the State and third parties is a matter which has to be examined under national law. National courts may have to examine whether national law prevents the guarantee contracts from being honoured, and in that assessment the Commission considers that they should take account of the breach of Community law. Accordingly, lenders may have an interest in verifying, as a standard precaution, that the Community rules on State aid have been observed whenever guarantees are granted."*

However, cancelling the guarantee, as the Commission suggests, would penalise both the lender and the borrower. Arguably, this is not a proportionate remedy for the breach of the EU State aid rules.

The Residex case

The Residex case came before the ECJ as a reference from the Supreme Court of the Netherlands. The Supreme Court asked the ECJ how it should treat an unlawful State guarantee. In particular, it wanted to know whether Article 108(3) TFEU allows or even requires national jurisdictions to cancel a guarantee that was not notified and approved.

The Residex case concerned a guarantee made by the Port of Rotterdam (the State) over a loan which Residex (the lender) made to Aerospace (the borrower). The guarantee had not been notified to the Commission under the State aid rules and was therefore unlawful. Later on, Aerospace defaulted, leading Residex to activate the guarantee. However, the Port of Rotterdam refused to pay on the grounds that the guarantee constituted an unlawful State aid. The Dutch authorities sought to cancel the guarantee, arguing that it was contrary to EU law.

The Advocate General in Residex: Arguing for legal certainty for lenders

In her opinion on the Residex case, Advocate General Kokott argued for a clear-cut rule which – had she been followed – would have brought much-awaited legal certainty.

Kokott suggested that, <u>if the lender is not the beneficiary of the aid</u>, national courts must not be allowed to cancel State guarantees even if their national laws allow for such cancellation. Instead of cancelling the entire guarantee, the State should only recover the advantage that arose from the guarantee from the borrower. The advantage would be the difference between the interest rate enjoyed by the borrower, and the market rate that would normally be applied in the absence of the guarantee.

This would mean that the lender would only need to investigate the question of State aid if the guarantee would benefit the lender itself. If the borrower is the only beneficiary of the aid, it would be disproportionate to transfer the risk associated with the illegality of the aid to the lender. According to Kokott, transferring the risk to the lender leads creates an incentive for Member States to grant unlawful guarantees, and a disincentive for lending to the "real economy". Moreover, she argues that a different approach in different Member States towards cancellation would distort the level paying field and thus be contrary to single market rules.

However, <u>if the lender is the beneficiary of the aid</u>, the national court must cancel a State guarantee granted in breach of Article 108(3) TFEU.

The ECJ's ruling in Residex: Lenders might be at risk; National courts to decide

The ECJ did not follow the clear-cut rule suggested by Kokott. Nevertheless, the ECJ's ruling has brought some clarity to the issue. On the question of whether the State aid rules <u>require</u> national courts to cancel an unlawful State guarantee to prevent the infringement from continuing, the ECJ clearly said no:

> *"...with regard to cancellation of the guarantee, and irrespective of who the beneficiary may be, European Union law does not impose any specific consequence…with regard to the validity of the acts"*

However, on the question of whether the State aid rules <u>allow</u> national courts to cancel an unlawful State guarantee, the Court said yes. The Court did not prescribe a clear rule to prohibit national courts from cancelling a guarantee. Instead, it passed the responsibility to the national courts:

> *"Accordingly, it is for the national court to determine whether cancellation of the guarantee may, given the circumstances specific to the dispute before it, be a more effective means of achieving the restoration of the competitive situation prior to the aid than other measures."*

It is therefore for the Member States to determine whether cancellation of a guarantee is the most "effective" remedy, or whether other less onerous procedural measures to restore the competitive situation which existed before the aid was granted are available. For example, according to the Court it is not excluded that the cancellation of a contract (e. g. the loan contract) may be a better way to achieve this objective.

Thus, in this regard the Court seems to follow the proportionality arguments brought forward by Kokott whereby State guarantees should only be cancelled if it is appropriate and proportionate to do so.

Comment

Given the diverging approaches under national law which may or may not imply the cancellation of the State guarantee in case of unlawful aid, the Residex ruling does not provide much comfort for lenders. Lenders still risk having unlawful State guarantees cancelled by national courts, even where they did not benefit from any State aid. The national courts continue to be responsible for drawing the necessary consequences under national law if State guarantees are awarded in breach of EU law. They are, however, obliged to verify whether there are any remedies which would be better than cancellation. It remains to be seen whether in applying the Residex ruling, national courts will find other remedies and conclude that cancelling the guarantee would be disproportionate, particularly in cases where the lender is not the beneficiary of the State aid.

Worldwide. For Our Clients. 38 Offices. 26 Countries.

Brussels
White & Case LLP
Avocats-Advocaten
rue de la Loi, 62 Wetstraat
1040 Brussels
Belgium
Telephone: +32 2 239 16 20
Facsimile: +32 2 219 16 26

www.whitecase.com