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State Guarantees and State aid: Some Hope for Lenders

An Advocate General to the European Court of Justice has issued an opinion that EU law does not require that State guarantees conferring unlawful State aid on a borrower are void and unenforceable.

In her opinion of 26 May 2011, Advocate General ("**AG**") Kokott re-examined statements in the previous case law of the EU Courts that had been widely construed as endorsing the unenforceability of such guarantees, and the duty of lenders to verify for themselves the lawfulness of the State guarantees against which they lend. She concluded that those statements should not, in fact, bear that interpretation. In particular, the AG opined that a lender's duty of due diligence extends only so far as confirming that a guarantee will not confer unlawful State aid on it, the lender, and that there is no such requirement to investigate whether the borrower will receive such State aid as a result of the guarantee.

It remains to be seen whether the European Court of Justice ("**ECJ**") will follow AG Kokott's recommendation. While AGs' opinions are usually followed by the ECJ, the facts of the case leave open the possibility for the Court to rule on the narrower issue of whether a guarantee conferring State aid on the lender should be declared void, without addressing what should happen when it is the borrower (and not the lender) who receives such aid.

If the ECJ does follow AG Kokott's opinion, it will considerably mitigate (but not eliminate) the risks for lenders in lending against a State guarantee, in particular in those countries, such as the UK, that do not have any national legislation or case law expressly providing for invalidity of any contractual measure through which unlawful State aid is granted.

We will circulate a further update when the Court's judgment is issued later this year.

Background

A State guarantee will amount to State aid to the *borrower* if it is granted without the borrower paying a market-rate premium for the guarantee (i.e. a rate that would be charged by a private guarantor, taking into account the risk profile of the borrower), or if the borrower's financial position is so precarious that it would not have been able to obtain a loan at all on any terms from the market. In certain circumstances a guarantee can also amount to State aid to the *lender*, for example, if it is granted *ex gratia* after the loan has been made, or if it is granted in respect of a loan that is used to pay off an unsecured loan by the same lender.

If such a guarantee is granted without prior clearance by the European Commission (as required by Article 108 of the Treaty on the Functioning of the EU ("**TFEU**")), it is unlawful State aid. However, Article 108 does not specify the consequences of that unlawfulness – rather, they are determined under the national law of the relevant EU Member State (e.g. the governing jurisdiction of the guarantee, or the country in which enforcement of the guarantee is sought). When applying their domestic law, national courts are subject to an obligation under EU law to "draw all appropriate legal consequences" from the

Key Issues

Should lenders suffer if a State body guarantees a loan that they have made, in breach of EU State aid laws?

Is voidness and unenforceability of the guarantee an appropriate consequence?

Does it make a difference if the lender receives no financial advantage from the guarantee?

Is the Advocate General's opinion, which is favourable for lenders, likely to be followed by the European Court of Justice?

To what extent can the ECJ require national courts not to hold State guarantees unenforceable, even though they result in a breach of the State aid rules?

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unlawfulness of an aid measure, which in principle includes a requirement to order the full recovery of unlawful State aid from the beneficiary.

In the context of State guarantees, an important issue is whether such "appropriate legal consequences" include a requirement that the guarantee itself must be ruled void and unenforceable, as a measure which implemented the unlawful State aid. If a guarantee is ruled unenforceable, this puts the lender in an unfortunate position: it will usually have made a loan at a lower interest rate than it would have without the benefit of a State guarantee, but will be exposed to the full risk of insolvency of the borrower – a risk that will be considerably increased if, as will usually be the case, the borrower is required to repay to the State in question the full value of the advantage that it received, plus interest.

Previous case law of the EU Courts suggested that a State guarantee should indeed be "cancelled" if granted in breach of the State aid rules, and that this was the case even if the lender would not itself have received any financial advantage from the guarantee, had it been enforceable (for example, because it had simply made a loan at a rate that reflected the lower perceived level of risk). In particular, in its judgment in the *EPAC* case in 2000, the Court of First Instance ("**CFI**", now, the General Court) ruled that the Commission was entitled to order that a State guarantee be "cancelled", and that the creditor banks could not in principle claim that they had a legitimate expectation that the guarantee was lawful, as they "*were under a duty to display the required prudence and diligence and to make the necessary checks as to the lawfulness of the aid*". While that case related to the powers of the European Commission to order cancellation of a State guarantee that conferred unlawful State aid, it has often been cited as an authority for the proposition that national courts should also hold such guarantees to be unenforceable.

The facts of the Residex case are as follows. In 2001, Residex Capital IV CV ("**Residex**") acquired a business from RDM Aerospace NV ("**Aerospace**"), along with an option to sell that business back to Aerospace in the future, under certain conditions. In 2003, Residex exercised that option, but instead of receiving the purchase price of €8.5 million, it converted this debt (plus an additional amount of €15 million) into a loan to Aerospace which was subject to a guarantee by the Port Authority of Rotterdam ("**PAR**"). Without this guarantee – which was not notified to the European Commission for State aid clearance - Aerospace would not have been able to obtain a comparable loan from the market. When Aerospace defaulted on around €10 million of the loan, Residex turned to the PAR for payment under the guarantee. However, the PAR refused to pay, on the grounds that the guarantee was unlawful State aid and therefore unenforceable. The Dutch court before which the resulting litigation ensued referred a question to the ECJ, querying whether in these circumstances EU law required, or at least allowed, national courts to order the cancellation of the State guarantee.

The Advocate General's Opinion

The AG's opinion distinguished between State guarantees that confer unlawful State aid on the borrower only, and those which also confer State aid on the lender.

Guarantees conferring unlawful State aid on the borrower only

AG Kokott has proposed a significant reinterpretation of the CFI's *EPAC* judgment. In her view, the CFI made no finding that the State guarantee should be annulled, but instead ruled only that the *advantage* arising from the guarantee should be cancelled, i.e. the difference between the interest rate enjoyed by the borrower, and the market rate that would have applied in the absence of the guarantee. Moreover, the CFI did not, in her view, give sufficient reasons for its view that lenders have a duty to verify the lawfulness of State guarantees against which they lend, in circumstances where the guarantee confers no State aid on the lender. In AG Kokott's opinion, imposing such a duty goes further than is necessary to ensure the effectiveness of the obligation to seek prior clearance of State aid measures from the European Commission. Indeed, such a duty would, in the AG's view, create perverse incentives for State bodies to grant guarantees in breach of the State aid rules, as by doing so they could transfer economic risk from themselves to the lender. The AG highlighted the recent financial and economic crisis as demonstrating the need to avoid creating unnecessary obstacles to the granting of credit to businesses operating in the EU.

Consequently, the AG advised the ECJ to rule that there is no obligation under EU law for national courts to declare that a State guarantee is void and unenforceable, solely by reason of its implementation in the absence of clearance by the European Commission, in circumstances where the lender is not itself the beneficiary of any State aid arising from the guarantee. Her opinion then goes on to state that, in her view, national courts do not even have a discretion to make such a declaration, as this would result in businesses having different rights and obligations under EU competition law, depending on which EU Member State has jurisdiction to rule on the guarantee in question. Moreover, the AG's view appears to be that this remains the case even where there is national legislation in place which expressly provides for the invalidity of legal transactions that violate State aid laws, as is the case in the Netherlands (in which the Residex case arose), and Germany. The ECJ may, however, balk at this latter proposal, as its powers to prohibit Member States from going further, in their national legislation, than is required for the effective enforcement of EU State aid laws are far from clear.

Guarantees conferring unlawful State aid on the lender

AG Kokott took a very different view of State guarantees that confer unlawful State aid on the lender. Annulment of such guarantees is, she opined, an appropriate consequence of their unlawfulness. Moreover lenders that are beneficiaries of such aid cannot rely on any principle of legitimate expectation of its lawfulness: as is the case for any other aid beneficiary, they have a duty of due diligence which means that they cannot simply rely on representations of lawfulness from the public body that grants the aid.

The AG conceded that there may be other ways in which a national court could seek to eliminate the advantage enjoyed by the lender, such as a requirement that the public body deducts from any eventual payout under the guarantee an amount corresponding to the market value of the premium that would have been payable for such a guarantee. However, she considered that such a result would be markedly less appropriate than a declaration of invalidity of the offending guarantee.

Comment

The AG's opinion offers hope to lenders that some of the legal costs and risks associated with lending against State guarantees might be eliminated. However, while the ECJ usually follows the advice of its Advocates General, many of AG Kokott's observations might ultimately prove to be *obiter dicta*, and therefore lacking any binding effects on national courts. In particular, the AG considered that the facts of the Residex case suggest strongly that the guarantee was granted in favour of an existing debt owed to Residex, and therefore amounted to State aid to the lender. If the ECJ opts to treat that as the factual context in which the referring court's question was raised - rather than concluding that there remains some uncertainty on this point for the national court to resolve - it may decide to offer no guidance on whether a guarantee should be annulled in circumstances in which (as is usually the case) the lender is not a beneficiary of the unlawful aid.

It is hoped that the ECJ seizes this opportunity to clarify the law in this area. That lenders can face such serious financial consequences as a result of breaches of the law by third parties that confer no advantage on the lender – and, indeed, can result in substantial unjust enrichment for the State body in question - raises important public policy issues. We agree with AG Kokott that such a position is inefficient, unfair and prone to creating perverse incentives.

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