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Concurrences Quarantine Webinar Series #3 STATE AID IN THE COVID-19 CONTEXT

| Webinar - 14 April 2020

On April 7th 2020, Karl Soukup, DG COMP Director for State aid General Scrutiny and Enforcement, presented at the occasion of the inaugural webinar of the Concurrences Quarantine Webinar Series, the measures taken by the European Commission with regard to State aid in the context of the health crisis. In this debriefing webinar, Jacques Derenne, Fran ois-Charles Lapr vot , Nicole Robins and Georges Siotis reacted to his intervention and shared their point of view as private practitioners.

Jacques Derenne

Jacques Derenne introduced the webinar by stressing that EU State aid control is a unique mechanism whose objective is to achieve EU market integration. He also noted that, if the common meaning of the term "crisis" refers to serious diseases, it in fact means, according to its true Ancient Greek etymology, « κρ σις », the ability to discern, choose, judge and decide, thereby finding a remedy to an important issue, in order to avoid the "chaos" (which the Ancient Greek called κρ σις, by a word game).

Since 1958, the Treaty on the Functioning of the European Union has been providing the Member States, under the control of the European Commission, with a wide toolbox for aid in times of crisis. Four types of measures are available to cope with the economic consequences of the COVID-19 outbreak: measures that do not qualify as "State aid" (non-selective measures accessible to all economic operators); State aid measures to compensate damages caused by exceptional occurrences (Article 107(2)(b)); State aid measures to remedy a serious disturbance in the economy of a Member State (Article 107(3)(b)); and State aid measures to facilitate the develop-

ment of certain economic activities or areas where such aid does not adversely affect trading conditions to an extent contrary to the common interest (Article 107(3)(c)).

Focusing on Article 107(2)(b), Mr Derenne mentioned that most cases relate to the compensation of damages caused by natural disasters; less cases relate to exceptional occurrences, i.e. wars, internal disturbances and strikes, major industrial accidents resulting in widespread economic loss. The Commission confirmed from the outset that the COVID-19 outbreak constitutes an exceptional occurrence. Of note is that aid granted under Article 107(2)(b) is compatible by law provided that it



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JACQUES DERENNE

satisfies the objective criteria. The exemption is automatic; the Commission is not required to carry out a discretionary assessment. Only two Member States took the initiative to notify measures under Article 107(2)(b) so far: Denmark and France.

The scope of application of Article 107(2)(b) must be construed narrowly. Jacques Derenne explained that only the damage caused by the exceptional occurrence may be compensated, that a direct link between the damage and the State aid is required, and that the assessment of the damage suffered must be as precise as possible. The reference period is that for which the companies could not operate normally; the damage amounts to the income recorded during the reference period minus the income recorded prior to the event, plus further costs incurred from the hibernation of operations until operations are resumed, provided that there is a direct causal connection. Mr Derenne outlined the methodology applied to quantify compensation by referring to relevant EU case law.

However, aid may not be granted on the basis of Article 107(2)(b) to undertakings in difficulty at the time of the exceptional occurrence (in substance, undertakings which losses exceed 50% of the capital; undertakings which are subject to collective insolvency proceedings; undertakings which debt to equity ratio exceeds 7.5 and the EBITDA interest coverage ratio is below 1.0). In addition, aid should be granted in a non-discriminatory manner and should not circumvent the rescue and restructuring aid principles.

Furthermore, Jacques Derenne advanced that the application of aid measures exempted under Article 107(3)(c) is less appropriate in times of crisis. However, this provision constitutes the legal basis

for temporary aid measures added to the Temporary Framework on 3 April 2020: aid to fight COVID-19 itself. Mr Derenne also confirmed that rescue and restructuring aid can still be granted if the undertaking has been coping with difficulties prior to 31 December 2019. He left open the question of the relevance of reviewing the 2014 Rescue & Restructuring Guidelines to adjust them to the Covid-19 crisis as they had been reviewed following the financial crisis, shaped by the 2009 Guidelines on the return to viability and the assessment of restructuring measures in the financial sector.

Finally, Mr Derenne raised the issues of moral hazard associated with the Temporary Framework and that of the accurate determination of the beneficiaries of State aid measures adopted under this framework, in particular when subsidiaries in different Member States of an international group of companies are concerned, drawing an analogy with the rescue and restructuring and aid recovery principles. He also mentioned the forthcoming possible more flexible rules on recapitalisations which will raise issues similar to those addressed in favour of banks during the financial crisis.

François-Charles Laprèvote

François-Charles Laprèvote elaborated on the Temporary Framework adopted by the European Commission in response to the Covid-19 outbreak in March 2020. He first described the structure of the framework, comparing it with the temporary framework implemented in 2008 in relation to the financial crisis. Mr Laprèvote noted the similarities between the measures allowed under the two frameworks but stressed that caps and duration periods

are higher in the Covid-19 framework. He then detailed the types of measures, starting with direct grants, selective tax advantages and advance payments up to 800,000 euros per undertaking, which are particularly well suited for SMEs. Mr Laprèvote also noted that state support can now be extended to export credit insurance relating to marketable risks. Another category of measures consists in subsidised loans and guarantees, which are not subject to an absolute cap as the maximum amount is calculated on the basis of the wage bill of the beneficiary, its total turnover or the amount of liquidity needed for the next 12 months. Guarantees, however, are capped to 90 per cent of the underlying loan. On April 3, the Commission added new types of measures to the Temporary Framework aimed at combating Covid-19 directly: aid for Covid-19 and other antiviral relevant R&D; investment aid for testing and upscaling infrastructures required to develop Covid-19 related medicinal products; and aid for the production of Covid-19 relevant products. Finally, sectoral aid to preserve employment and maintaining the companies' liquidity has also been allowed in the form of temporary deferrals of tax and/or social security contributions or obligations as well as wage subsidies schemes for employees to avoid lay-offs during the outbreak.

François-Charles Laprèvote emphasised the challenge of articulating aid granted under the Temporary Framework with other state aid measures. All measures can be combined, with two exceptions (with respect to guarantees and underlying loans as well as support to Covid-19 activities and aid for the same costs). It is also possible to consider these measures as complementary with other public support tools: general aid measures, *de minimis* aid up to 200,000 euros per beneficiary over 3 years, compensation aid for direct damages, rescue or restructuring aid to companies in financial difficulties (although aid granted under the Temporary Framework will presumably be taken into account to assess the necessity of granting additional aid under Article 107(3)(c)).

Reviewing the recent decisional practice, Mr Laprèvote observed that loan guarantees are more resorted to than other types of measures. He explained that the Tempo-

rary Framework contains provisions aimed at avoiding spillovers to the benefit of banks.

Furthermore, François-Charles Laprèvote raised a few issues for further consideration. Regarding the interaction of the Temporary Framework with Article 107(2) (b), he noted that the framework can be regarded as a complement or a substitute. Besides, a number of additional conditions that are not required under the framework can be imposed by Member States, such as a prohibition on dividends and in relation to the use of proceeds. It remains to be discussed to what extent these conditions should be covered by the Temporary Framework. Obviously, an overarching question also relates to the different levels of support among Member States. Finally, the framework is of a temporary character and mainly aims at providing liquidity. Recapitalisation and structural measures will require a further amendment to the framework, which the Commission has announced is currently subject to consultation with Member States.

Georges Siotis

Georges Siotis then dwelt on the economics of the Temporary Framework. The COVID-19 Temporary Framework and the financial crisis temporary framework were adopted due to different circumstances. Currently, interest rates are extremely low but in some Member States, debt to GDP ratios are much higher than in 2009. The exogenous shock was common to all Member States but its impact differs across Member States in terms of incidence, in part because policy responses varied. Significant differences in terms of fiscal headroom are also noticeable.

Mr Siotis emphasised three aspects of the current crisis. The scene setter: an exceptional number of credit rating downgrades—according to Moody's more than 300 firms have seen their ratings drop to B3 or below, a large number of firms have scrambled for liquidity, and default rates are expected to spike above 10%. The first aspect of the 2020 Temporary Framework (TF) worthy of attention is that the granting of subsidised loans and guarantees is not conditioned by the credit



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rating of the recipient. Second, the amounts of direct grants deemed as “no aid” are larger as compared to the 2009 TF. As regards this instrument, the take-up and amounts disbursed are likely to differ significantly across Member States. Third, the Commission is contemplating large scale public equity participation or recapitalisation. He observed that the Temporary Framework adopted in response to the COVID-19 crisis is much more generous and flexible than that adopted in 2009.

Given the scale of public intervention, a related issue to be considered is that of the sustainability of public intervention, which will, according to Georges Siotis, depend on the shape of the recovery. Mr Siotis assessed different hypothetical cases. The best scenario he identified is that of a V-shaped contraction followed by a quick recovery. Under this (plausible) scenario, borrowing costs for highly indebted Member States remain low, the abrupt shortfall in aggregate demand is neutered by heavy public spending and the temporary framework is part of the solution. Contingent liabilities (e.g. guarantees) would not be activated. However, another possible scenario consists of an L (or flat U)-shaped contraction followed by a rather long period of stagnation before growth resumes.

The decline in GDP could exceed 10% in some Member States, bond spreads on sovereign debt would rise up and the productive capacity would be significantly reduced, leading to creeping stagflation. Both the private and public sector debts would reach unsustainable levels. The situations in Spain and Italy exemplify the downside risks.

Georges Siotis then focused on the medium term, noting that in the context of a protracted contraction the risk of an economic “attrition war” between Member States is manifest. The Temporary Framework provides the desired flexibility; however, the ability of some Member States to exploit that flexibility is curtailed by their fiscal position. According to him, there is nothing that can be done by the DG COMP in that regard: through general measures (i.e. non-selective and thus non-aid), some Member States’ are able to maintain productive capacity largely intact, while other Member States’ ability to do so is severely curtailed. Mr Siotis also advanced that the outbreak may cause permanent shifts in both supply and demand, noting that, in the context of scarce public resources, it may not be desirable to sustain activities for which demand has permanently



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decreased. An additional challenge relates to the sharing of the increased fiscal burden.

Nicole Robins

Elaborating on the economics related to the measures adopted under Article 107(2)(b) and Article 107(3)(c), Nicole Robins discussed the calculation of compensation for damages and aid under the Rescue & Restructuring Guidelines.

First, Ms Robins stressed the importance of establishing a direct link between the losses suffered by the companies and the Covid-19 pandemic and explained how financial analysis may be helpful in that regard. Beneficiaries are required, one year after the Commission's decision, to produce a report demonstrating the absence of overcompensation. A difficulty relates to the uncertainty as to the length of the pandemic; an option to limit the amount of aid in this context is to use clawback mechanisms. Building on the specific example of compensation in the transport sector, Ms Robins detailed the calculation method, emphasising how the factual and counterfactual scenarios can be determined as well as the difficulties associated with determining the length of the reference period given the uncertainty.

Second, Nicole Robins dealt with rescue aid, noting that there is limited financial analysis in rescue aid cases. However, in the context of the COVID-19 pandemic, companies that are not yet in financial difficulty may receive rescue aid if they face liquidity needs as a consequence of the outbreak. In this case, financial analysis is helpful to quantify the extent to which the company is already suffering (or likely to suffer) from liquidity issues due to the pandemic and to assess the period over which liquidity support is required, taking into account the availability of other financing support. Such analysis can be based on

financial data prior to the Covid-19 situation and short-term cash flow forecasts used to determine the factual and counterfactual scenarios. Regarding restructuring aid, Ms Robins explained that financial analysis is helpful to demonstrate the appropriateness of the restructuring plan to restore the company's long-term viability (modelling central and downside scenarios and assessing the return to viability based on projections of financial metrics and comparisons against the appropriate benchmarks) as well as the proportionality of the aid.

To conclude, Ms Robins pointed out that the economic and financial analysis described to assist applications for aid for compensation for damages and rescue and restructuring aid is part of a toolbox of measures. There may be potential, alternative market-conforming approaches that would be apposite, especially if the State has prior economic exposure to the company concerned; forgoing debt repayments over a temporary period might be the less costly option compared to a counterfactual scenario where the company enters into liquidation.

Questions & Answers

Answering a question about the relevance of notifying aid under Article 107(3) b) or c) as opposed to Article 107(2) b), Jacques Derenne reminded that both legal bases are complementary. Article 107(2) b) is more suited for past damages that have already materialised, since evidence of future losses to be incurred may not be available. Under Article 107(3) c), a recovery plan can be drafted. However, it is not a tool appropriate in times of crisis. François-Charles Laprèvote agreed.

Mr Laprèvote then answered a question about the reaction of third countries to massive public intervention, especially under WTO rules. Korean authorities have alluded to the possibility of adopting countervailing measures to protect local companies from subsidies granted by other countries. Mr Laprèvote stressed that it remains uncertain to what extent COVID-related state aid would qualify as actionable subsidy under the WTO rules. Mr Derenne also mentioned that although the EU State aid regime is unique in controlling the grant of aid by States, it is more and more "exported" by the EU in new generation free trade agreements, "FTAs" (its enforcement rules being, of course, less efficient under the dispute mechanism of these FTAs).

Regarding loans and guarantees, Ms Robins confirmed that there is no specific criterion for determining whether an undertaking is to be considered as having financial difficulties prior to the Covid-19 crisis. She advanced that applying the criteria set out in the Rescue & Restructuring Guidelines, such as the debt to equity ratio and the EBITDA interest coverage ratio, are relevant.

A participant asked whether COVID-19 considerations will be taken into account by the Commission with respect to State aid measures that do not fall under the temporary framework or Article 107(2) b). Jacques Derenne confirmed that it is legally possible, although it is unlikely that Member States deprive themselves of the flexibility offered by the temporary framework.

François-Charles Laprèvote, in response to a question about the articulation between *de minimis* aid and measures adopted under the temporary framework, explained that both can be cumulated, arguably without taking the *de minimis* cap into account in granting aid under the temporary framework.

On the issue of the extent to which aid granted to private equity shareholders could be justified by a particularly badly affected portfolio interest, Mr Derenne emphasised difficulties associated with considering controlling and active shareholding. The beneficiaries of State aid measures are the directly affected undertaking, not the private equity shareholders, which situation is not relevant to the analysis. ■



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NICOLE ROBINS

