European state aid law and M&A transactions

By Dr Christoph Wünschmann, Hogan & Hartson LLP, Berlin/Brussels

Introduction

Recently, the German state-owned bank Kreditanstalt für Wiederaufbau (KfW) announced the divestiture of its subsidiary IKB Deutsche Industriebank AG (IKB) to the US-investor Lone Star Funds. IKB had become one of Europe's highest-profile casualties of the international financial crisis after having heavily invested in the US subprime mortgages market. Its financial collapse could only have been prevented through an extensive financial rescue operation by KfW and the German state.

At this point, KfW initiated a bidding procedure to sell its IKB shares in which Lone Star prevailed against other interested parties. Germany's supporting measures in favour of IKB and the divestiture process have subjected the deal to close scrutiny by the European Commission (the "Commission") for compliance with European state aid law. Already on the day of the public announcement of the planned sale of IKB, the Commission stated "it had further questions concerning the transaction." The sale of IKB illustrates possible state aid law issues which could arise in the context of privatisations and M&A transactions in general. This article provides an overview of the main aspects of state aid law that need to be taken into account when participating in M&A transactions.

II. Acquisition of publically subsidised companies

1. State aid risks of target company

During the due diligence process, potential state aid risks of the target company must be thoroughly analysed. There are many different forms of direct or indirect subsidies or aids which are classified as notifiable state aid under EC law and, accordingly, can create considerable risks for the acquirer if they were not notified to or approved by the Commission.

Pursuant to Article 87 of the EC Treaty, any aid granted by a Member State or through state resources in any form whatsoever that distorts competition by favouring certain undertakings or the production of certain goods is, insofar as it affects trade between Member States, incompatible with the common market. This very broad concept of state aid could cover such diverse state measures such as tax benefits or loans, guarantees or capital increases under preferential conditions.

These measures have to be assessed as to whether, among other things, they constitute a commercial advantage to the undertaking concerned which would not be obtainable under regular market conditions. The Commission applies the so-called "Private Market Investor Test" or "Market Economy Investor Test (MEIT)" to examine whether state measures favour the recipient of the aid and distort competition. For instance, if the state is acquiring a shareholding in a company, the Commission assesses whether the terms of this acquisition would be the same for private investors acting under regular market conditions. In the case of discounted loans, the market level of interest has to be taken into account in order to evaluate whether it was also possible to receive the loan in question also from a private investor on the capital market. Likewise, state guarantees have to be checked as to whether a private person or bank would also be willing to provide a guarantee under similar circumstances with comparable interest rates.

Applying the Private Market Investor Test has a considerable valuation risk resulting from the hypothetical transfer of the measure to the private sector. Hence, for the buyer of a publically subsidised company there remain doubts whether state aid formerly granted to the company is compatible with EC state aid rules. State measures are often politically driven and are intended to fulfill local and social requirements which typically would not be in the interest of a private investor. Special legal questions may arise where a public grant is intended to compensate a company that fulfills certain public service obligations, for example in the fields of waste management or local public transport. Therefore, the buyer of such a company would have to evaluate whether the compensation constitutes adequate compensation commercial terms for the service provided.

© mergermarket 2008

The Commission has adopted a large number of legislative measures, namely regulations, communications, notices, guidelines and letters to the Member States, in order to improve the transparency and predictability of EC state aid law and thus guarantee more legal certainty. All relevant legislation can be found on the website of the Directorate General for Competition of the Commission (http://ec.europa.eu/comm/competition/state_aid/legislation /..). Despite the substantial body of legislation, companies may still experience difficulties with the assessment of certain state measures, as shown by the significant number of cases concerning the recovery of unlawful aid. The total amount of aid to be recovered on the basis of Commission decisions adopted between 2000 and 2007 is at least €9bn, of which about €7bn including interests of €2.4bn had been effectively recovered by the end of 2007.

2. Buyer's obligation to reimburse unlawful aid

If the target company has received state aid without prior notification to and approval by the Commission, the state aid has to be returned. In order to guarantee the full application of Community Law and to restore a level playing field in the relevant markets, Member States are obliged to recover the aid in question. The recovery also has to be enforced by the Member States against the purchaser of the company that received the unlawful aid.

During the acquisition process of a company that may have received unlawful aid the buyer should therefore carefully assess whether and, if so, how it could eliminate the risk of such recovery in the purchase agreement. The buyer may want to insist that the seller assumes the risk of liability with regard to state aid. In the event that state assistance was identified as a potential state aid risk during the due diligence process it should become classified as unlawful aid, the buyer would then be entitled to reduce the purchase price or to withdraw from the contract. Admittedly, such clauses may raise new questions concerning compliance with EC state aid law. So, under certain conditions the Commission declares the assumption of liability for state aid issues by state-owned sellers to be incompatible with the rules of the EC Treaty, as this may constitute an illegal avoidance of Article 87 of the Treaty or even a state aid issue. These aspects must be taken into consideration when negotiating the liability clauses of the purchase agreement.

III. Privatisations

The privatisation of public entities in particular requires an in-depth assessment of state aid issues. In many cases, the company gets "prepared" for sale by its public owner, who in many case will undertake certain measures before the privatisation takes place, e.g. discharging the company's debts, taking over guarantees, compensating legacy issues or transferring estates to the company. These measures often constitute state aid within the meaning of the EC Treaty and therefore have to be notified to the Commission prior to their implementation. The buyer therefore has to examine carefully whether such measures undertaken prior to the privatisation were executed in accordance with state aid law.

As a matter of principle, the Commission favours privatisation. For instance, the Commission frequently approves so-called restructuring aid granted to companies that are in difficulty only on the condition that the state gives up its equity investment or that the company sells-off certain (non-profitable) divisions. One such example is the Commission's approval of restructuring aid granted by the federal state of Berlin to the *Bankgesellschaft* Berlin in 2004 on condition that the publicly owned bank would be sold. Equally, the French bank *Crédit Lyonnaise* was also privatised according to a conditional approval by the Commission of substantial restructuring aid.

Even though privatisation is favoured in general, the particular privatisation process may attract the Commission's attention. For example, the buyer is not allowed to benefit from a lower purchase price for the target company that does not objectively represent the actual market value and thus creates an advantage over its competitors. In the case of privatisation,

© mergermarket 2008

the Commission also applies a test to hypothetically transfer the transaction to the private sector *(private vendor test)*. Given that a private vendor is normally interested in a high sale price, if there are several interested parties, it will initiate competitive bidding in order to raise the sale price and ultimately sell the target to the party who offers the highest price. Alternatively, depending on the particular company and market conditions, the seller may initiate a public offering *(dual track process)*.

These typical selling processes for *private vendors* are used by the Commission to set the benchmark for the investigation of privatisation procedures of public undertakings to assess whether the process itself or any of the conditions could constitute state aid. The Commission takes the view that state aid risks do not arise if the state initiates a transparent and non-discriminatory competitive bidding process comparable to a public tendering procedure under public procurement law, in which the target firm is ultimately sold to the highest bidding party. If the state chooses to privatise the public company through an offering over the stock market, the Commission will not be concerned about the level of the sale price with regard to state aid rules.

By way of contrast, the Commission is highly skeptical of and will frequently investigate privatisations of public companies where the seller did not initiate a well structured competitive bidding process, but sold the company to a buyer selected without any benchmark that could have revealed the market value of the target. The same applies in a case where the seller, after the completion of a structured bidding procedure, does not enter into a contract with the highest bidding party but with another bidder it prefers, e.g. for reasons of regional politics. In these cases the Commission states that the amount that corresponds to the difference between the purchase price actually paid and the highest offer constitutes state aid and therefore generally has to be notified.

Only recently, the Commission made clear that it doubted whether the privatisation of the Austrian Hypo Bank Burgenland AG in 2006 was compatible with state aid law. In the course of the selling process, the Austrian insurance group GRAWE and a Ukrainian consortium of investors were selected as preferred bidders and submitted two concurring offers. The federal state government of Burgenland concluded the deal with GRAWE even though the purchase offer of the Ukrainian consortium exceeded GRAWE's offer by €50m.

One of the justifications offered by the government for its decision was the fact that the deal with GRAWE would offer a higher degree of transaction security and leave the federal state with a lower liability risk. The Commission did not approve this reasoning as a justification for the advantage granted to GRAWE by accepting a €50m lower sale price. Thus the Commission concluded that the remaining difference constituted unlawful state aid in favour of GRAWE.

This decision, predictably, received significant criticism because the Commission intervened in the sale and decision-making process of the seller and virtually prescribed who the public enterprise had to be sold to from a state aid law perspective. This rigorous approach of the Commission may indicate that a seller is not able to contract with the party of its choice.

IV. Future prospects

It remains to be seen whether the Commission will apply a similarly strict control of state aid law in future privatisations as it did in the *Bank Burgenland* case, or whether the Member States will have more freedom in deciding to whom they sell a public enterprise. However, private investors need to be aware of the fact that in either case, state aid law has to be taken into consideration during competitive bidding and that the public seller might be bound to choose a buyer due to state aid law rules.

However, state aid law also provides opportunities for investors, for example, for a losing bidder if the public enterprise is later sold to one of its competitors who offered a substantially lower purchase price. The losing bidder may lodge a state aid complaint with the Commission which may lead to an in-depth investigation of the selling process as well as the annulment of the contract. In addition, an investor can itself apply the private vendor test during the negotiation process in order to reject certain conditions of the purchase agreement (such as the obligation of the seller to guarantee a certain level of production and employment) that do not correspond to market terms, given that a market-oriented private seller would not impose them.

© mergermarket 2008