The Hellenic Shipyards decision: Limits to the application of Article 296 and indemnification provision in privatisation contracts

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On 2 July 2008, the Commission closed its investigation concerning 16 state measures implemented in favour Hellenic Shipyards S.A. (‘HSY’) by ordering Greece to recover aid in excess of EUR 230 million from the firm. A summary of this long decision (2) would be of limited interest to most readers, as many parts of the assessment are specific to the case or involve the customary application of the State aid rules. This article will therefore focus on two specific issues which the Commission had to deal with in this case, and which may be of relevance for other cases, namely: the application of Article 296 of the EC Treaty and the existence of aid in an indemnification provision written into a privatisation contract.

1. Limits to the application of Article 296 of the EC Treaty

Each time the Commission starts investigating alleged support in favour of a firm producing war material, Member States are keen to invoke Article 296. Indeed, this Article provides with a broad exemption to the other rules laid down in the Treaty, including the State aid rules, by allowing the Member States not to disclose certain security-related information and to support the production of military products.3 The Commission therefore has the difficult task of verifying whether the claims of the Member State concerned are reasonable or whether it is manifestly asking for too broad an application of this Article.

In previous decisions regarding HSY (4), the Commission consistently accepted Greece’s claims that its financial support to the military production of HSY fell within the scope of Article 296 and was thereby exempted from State aid rules. It should be recalled that HSY’s military production has consisted of war ships and — more recently — submarines for the Hellenic Navy and is therefore manifestly related to the security of Greece.

In the framework of the procedure closed by the decision of 2 July 2008, Greece also invoked Article 296. On the basis of this claim, and in accordance with its past practice, the Commission decided not to include within the scope of the formal investigation procedure all the measures which were clearly financing the military production of HSY (5). This investigation and the final decision adopted on 2 July 2008 therefore concerned only ‘problematic’ measures, in the sense that following an initial investigation the Commission still had doubts as to whether the measures were financing the military or the civil activities of HSY, or both. To understand the problem, one should keep in mind that, over the period during which these measures were granted, HSY did not keep separate accounts for military and civil activities, which made it virtually impossible to trace the use of a given financing.

A first group of controversial measures concerned capital, loans and guarantees granted by Greece and by a State-owned bank. These funds were not assigned to finance a particular activity. They were financing the yard as a whole, and the management was free to decide how to use them. Greece claimed that, since the majority of HSY’s activities were military, this financing falls within the scope of Article 296. In its final decision, the Commission has adopted the following approach. It calculated the average size accounted for respectively by the military and the civil activities. This division was based on sales and man-hours figures of the two activities over several years. The Commission

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(1) Directorate-General for Competition, unit E-3. The content of this article does not necessarily reflect the official position of the European Commission. Responsibility for the information and views expressed lies entirely with the author.


(3) Article 296 provides that ‘The provisions of this Treaty shall not preclude the application of the following rules: (a) no Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security; (b) any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material.’


(5) See the decision of 4 July 2006 by which the current procedure was extended (OJ C 236, 30.9.2006, p.40), in which the Commission founds that certain measures falls within the scope of Article 296 and therefore can not be assessed under State aid rules.
concluded that military activities accounted for three quarters of HSY’s activities. On that basis, and in view of the absence of separate accounts for military and civil activities which would have allowed a more refined approach, the Commission considered it reasonable that three quarters of the capital injections, loans and guarantees at stake have financed military activities and are exempted from State aid rules on the basis of Article 296. Conversely, the Commission considered that the remaining quarter financed civil activities and had therefore to be assessed under Article 87.

A second group of controversial measures consisted of loans granted by a State-owned bank and which were (partially) secured by HSY’s receivables from the military Navy. Greece claimed that, in view of the type of securities provided to the lending bank and the already mentioned fact that HSY was mainly active in the defence sector, these measures fell within the scope of Article 296. In the final decision adopted on 2 July 2008, the Commission partially rejected this claim. First, the Commission observed that it cannot automatically be assumed that because a loan is secured by receivables coming from a military contract it will be used to finance these military activities. The Commission further noted that, contrary to other loans contracts which were concluded between HSY and the state owned bank and which precisely defined the use of the funds lent, Greece did not adduce any evidence that there were any contractual provisions under which HSY was obliged to use these funds to finance the production of war material (4). Conversely, Greece indicated that the loans were granted to cover HSY’s needs for working capital and were not assigned to the financing of a particular activity. In these circumstances, the Commission decided to apply the approach described in the previous paragraph; namely, it considered that one quarter of these loans financed the civil activities of HSY and may be assessed under State aid rules.

A third group of problematic measures took the form of advance payments paid by the Hellenic Navy to HSY in the framework of military contracts. According to HSY’s own statements, these funds, immediately after they were received by the yard, were used at least during several quarters to finance activities other than the execution of the contracts on the basis of which they had been paid. Greece claimed that these advance payments clearly fall within the scope of Article 296 since they were paid in the framework of military contracts. In the final decision, the Commission considered that these advance payments, in the period during which they were not used for the execution of the contracts in question (estimated to be one year), did not automatically fall within the scope of Article 296. In particular, since according to HSY itself these funds were not used to finance the execution of these military contracts during that period, the Commission inferred that they were not deemed ‘necessary for the protection of the essential interests of [Greece’s] security’, as indicated in Article 296. The Commission therefore considered that the excess advance payments are equivalent to a one-year interest-free loan from the Greek government. It then applied the reasoning outlined above, concluding that three quarters of this loan was financing military activities and one quarter civil activities. As regards the existence of aid in this ‘interest-free loan’ to the civil activities, it could have been claimed that, if the State purchases products in a way which would be acceptable to a private firm, the purchase contract — including the terms thereof, such as advance payments — cannot confer a selective advantage on the producer. In particular, advance payments are regularly included in shipbuilding contracts between private parties. In its final decision on the investigation, the Commission did not accept this claim and concluded that these advance payments convey a selective advantage to HSY. The Commission noted that under the military contracts awarded to HSY, the State has never behaved in a manner that would be acceptable for a market economy firm wanting to purchase goods. In particular, a market economy firm would have sought to pay the lowest price possible by considering all potential suppliers in the world. Greece, on the contrary, has always limited its choices to Greek producers (or to consortia having a Greek component), in order to support employment in Greece and in order to maintain the capacity of production of military products in Greece. Therefore, a private firm would not have concluded these purchase contracts.

A fourth and last issue related to Article 296, which is dealt with in the final decision, is the cross subsidisation of civil activities by military activities which would take place if aid was recovered from HSY. As explained above, the Commission has accepted that if State financing was provided to the yard without being earmarked to finance a specific activity, it is possible to take the view that three quarters of the support benefited the military activities and one quarter benefited the civil activities. This conclusion follows from

(4) A similar approach was followed in the case of a loan for which the internal documents of the state owned bank show that the latter was concerned about the continuation of the military activities of the yard. In its assessment, the Commission similarly observes that no provision of the loan contract forces HSY to use that loan exclusively for the financing of its military activities.
the fact that HSY has no separate accounts, and therefore the use of the funds cannot be traced. However, if the Commission accepts that three quarters of any inflow of State money will finance the military activities of the yard, it must also conclude that three quarters of any outflow of money from the yard will be provided by the military part of HSY. In other words, 75 eurocent of every euro recovered from HSY would be paid by the military part of HSY. The Commission considers that, since the State has repeatedly provided large amounts of financial support and financing to the military activities of HSY, the use of funds — which otherwise would have financed the military activities — in favour of the civil activities of HSY is akin to a transfer of State aid to the civil activities of the yard. In other words, a part of the financial support granted by the State to the military activities would in fact support the civil activities of HSY, and therefore does not fall within the field of application of Article 296 of the Treaty. Indeed, these funds cannot be deemed to be necessary for the financing of war material production because they are not used for that purpose. In the case of recovery without further conditions, the original situation in the civil markets would therefore not be restored and, moreover, additional incompatible aid would be automatically granted to the civil activities of HSY. Asking HSY to reimburse the aid received by the civil activities will restore the initial situation of the civil activities of the yard only if this reimbursement is financed exclusively by the civil part of the yard. Consequently, the final decision lays down that Greece will have to reimburse the aid received by the civil activities — in favour of the civil activities of HSY — if this reimbursement is financed exclusively by the civil part of the yard. (It can be expected that this may only be ensured by legal separation, or at least by the introduction of separate accounts.)

The four issues discussed above illustrate the difficulty of applying State aid rules to firms that have both military and civil activities, especially in the absence of separate accounting between the two activities. They also demonstrate the sharp contrast between the civil markets, where all the EC competition rules are applicable, and military activities in the context of the protection of national essential interests, which are exempted from these rules on the basis of Article 296 of the EC Treaty.

2. Indemnification provisions in privatisation contracts

Another complex issue that is also dealt with in the decision adopted on 2 July 2008 was whether or not a refund guarantee granted by the State to the purchaser of HSY at the time of the privatisation of the yard in 2001-2002 contained an aid component of any kind. With this provision, the State, as seller of HSY, had committed to refund the consortium HDW/Ferrostaal (the purchaser of HSY) any State aid which would be reimbursed by HSY following the potential adoption of a recovery decision by the Commission.

In the final decision, the Commission assessed whether this guarantee fulfilled all the conditions to qualify as State aid. The Commission first analysed whether the State had acted as a market economy seller or not and, second, assessed who was the beneficiary of this guarantee (?). The following paragraphs summarise the claims of the parties and the line adopted by the Commission on these two issues.

a. Market economy seller

Some parties claimed that, by granting this guarantee, the State acted as a normal seller. Indeed, they pointed out that indemnification provisions are normal practice in private contracts for the sale of a firm. It is common for the seller to contractually agree to take responsibility for future liabilities of the firm being sold which could arise as a consequence of past operations of the firm. In the present case, these parties were claiming that it was financially more favourable for the State to sell the yard and to issue this indemnification guarantee in favour of the seller, rather than to put the yard into liquidation. They asserted in particular that the risk for the State of the guarantee being called was very low, whereas, at the same time, in the event of liquidation, the State would lose the entire value of the tens of millions of euro of loans and guarantees granted to HSY. They concluded that, by deciding to privatise the yard and to grant the guarantee to HDW/Ferrostaal, the State had acted as a well-advised shareholder and, as a consequence, this guarantee would not constitute aid.

In its assessment, the Commission makes the following points.

First, the State owned and sold only 51% of the shares of HSY, the remaining 49% being sold by HSY’s employees. However, the State agreed to refund HDW/Ferrostaal 100% of any aid which would be recovered from HSY. A well-advised investor would not have accepted to take full responsibility alone for potentially very large past liabilities of the firm. It would have asked the other shareholders to commit to finance a part of the potential refund to HDW/Ferrostaal.

(?) The decision also analysed in detail the imputability of the measure to the State, since the guarantee had been granted by ETVA and not by the State directly.
Second, when calculating the costs which were to be supported by the State in the case of liquidation, the costs supported as public authority should be distinguished from those which place a burden on the State as market economy operator (8). Only the latter costs, which constitute the normal costs of winding up a firm, should be taken into account when assessing whether the State had acted as a market economy seller. In the present case, all the loans and guarantees granted by the State either constituted State aid to the civil activities or were measures to protect the security of Greece under Article 296. Since they have been granted by Greece as the public authority, they do not constitute a normal cost of winding up a firm and should not be taken into account in the assessment. For that reason the costs for the State as market economy operator in the case of liquidation of HSY would have been very limited. Conversely, the sale price received by the State amount to only a few million euro and, by issuing this refund guarantee, the State runs the risk of having to pay tens of millions. The Commission also observes that the risk of the guarantee being invoked was not negligible or very limited, since a well-advised investor like HDW/Ferrostaal insisted on being protected against the repayment of the State aid by HSY and made the closing of the sale agreement conditional on the receipt of the refund guarantee. On the basis of all of the foregoing, the Commission concludes that a market economy seller would have preferred to let the firm go bankrupt rather than sell it.

Third, the Commission considers that the indemnification guarantee cannot be analysed independently of the other interventions of the State at the time of the privatisation. The Commission notes that the State granted several large aids in 2001 to facilitate the sale of the yard to a private investor. All these elements illustrate that, when the entire intervention of the State is considered, it is clear that during the sale of HSY it did not behave with the objective of maximising its revenues and minimising its costs, but with the aim of facilitating the sale of HSY and the continuation of the yard’s activities.

On the basis of the three foregoing considerations, the Commission dismissed the claim that a market economy seller would have agreed to issue such an indemnification guarantee.

b. Identification of the beneficiary

The guarantee has been contractually concluded between the State and HDW/Ferrostaal, which would be the formal beneficiary of any indemnification payment. On that basis, one party was claiming that, in addition to HSY, HDW/Ferrostaal was also a beneficiary of the guarantee. Conversely, several parties, in addition to contesting the existence of any advantage to HDW/Ferrostaal, were also contesting the presence of any advantage to HSY, since the latter was not even a party to the guarantee contract and would never receive any indemnification payment from the State.

In its assessment, the Commission started by recalling that no investor would have purchased HSY in its entirety (i.e. including its civil activities) without receiving such a guarantee. This conclusion was confirmed by a consultant report, which indicates that no rational investor would have been prepared to acquire HSY and, in parallel, assume any additional risk related to potential recovery of State aid. In addition, in a letter to the Commission, Greece had also acknowledged that point and indicated that it was the reason why, in all the documents submitted to potential bidders, it had been made clear that the State would take responsibility for any issues related to past aid. The Commission notes that, since aid can only be recovered from the civil activities, the guarantee was necessary in order to find a purchaser for the civil activities. If the yard was entirely military, no such guarantee would have been necessary in order to find a purchaser.

In the second step of its assessment, the Commission observed that the financial situation and the efficiency of HSY were so bad that, if no investor had purchased the firm, it would have rapidly gone bankrupt.

On the basis of the two foregoing considerations, it was concluded that the beneficiary of the State guarantee is HSY and the advantage received is, as a result of the take-over, the continuation of the civil activities. The claim that HDW/Ferrostaal was a beneficiary of the guarantee was also dismissed, since all the documents submitted by Greece to potential bidders indicated that the purchaser of the yard would be indemnified in the event of recovery of the aid. This means that when HDW/Ferrostaal made its bid for HSY, it was already relying on the receipt of such a guarantee and included it in the proposed price. In other words, HDW/Ferrostaal paid the State for receiving this guarantee.

Since the guarantee constitutes aid and there is no legal basis to find it compatible, the guarantee had to be stopped immediately.
This case illustrates how difficult it is for investors, who understandably wish to be protected against the recovery of aid from the firm in which they invest, to design a refund mechanism which is compatible with State aid rules. In fact, it is far from certain that such a mechanism exists.