

Covid-19 coronavirus – State aid Temporary Framework extended to recapitalisations and subordinated loans

As we have previously reported, the European Commission (**Commission**) has adopted a Temporary State aid Framework (the **Temporary Framework**) to support the economy in the Covid-19 outbreak (see our previous **alert** for more details). The Commission has already shown its willingness to adapt the Temporary Framework as the situation develops.

On 8 May 2020, the Commission published a [second amendment](#), which expands the Temporary Framework on two main points. First, it identifies recapitalisation measures that Member States may take to support non-financial undertakings and avoid unnecessary exit from the market of firms that were viable before the Covid-19 outbreak. Second, it sets out how Member States can use subordinated debt to support undertakings. Finally, the amendment also makes certain clarifications and amendments in relation to the measures that were already included in the Temporary Framework. A consolidated version of the Temporary Framework can be found [here](#).

Recapitalisation of non-financial undertakings

Where Member States take an equity stake in strategic companies on market terms – in

particular where it concerns the purchase of existing shares at market price or an investment, which is on an equal footing with private shareholders – this will normally not constitute State aid.

Recapitalisation measures, however, will generally amount to State aid. They must therefore be notified to and approved by the Commission before they can be adopted. The Temporary Framework sets out the conditions that such measures will have to comply with in order to obtain approval. These conditions apply to both recapitalisation schemes and individual recapitalisation measures. Individual aid of more than EUR250 million granted under a recapitalisation scheme will also require a separate notification.

Eligibility and entry conditions

The Temporary Framework only applies to recapitalisations of non-financial undertakings. The beneficiary of a Covid-19 recapitalisation measure must fulfil a number of conditions:

- i. the undertaking would go out of business or face serious difficulties to maintain its operations without State intervention;
- ii. it is in the common interest to intervene, for instance, because the failure of the undertaking would involve social hardship as a result of significant loss of employment or exit of an innovative company;
- iii. the undertaking is unable to find financing on the markets at affordable terms and existing horizontal aid measures are insufficient to cover its liquidity needs; and
- iv. it was not in financial difficulty on 31 December 2019.

Types of recapitalisation measures

The Temporary Framework makes it clear that recapitalisation measures can take the form of: (i) equity instruments, in particular, the issuance of new common or preferred shares; and/or (ii) instruments with an equity component (hybrid capital instruments). Any variation of these instruments or combinations of instruments is also permitted.

Amount of the recapitalisation

The aid must be proportional. The amount of recapitalisation must therefore not exceed the minimum needed to ensure viability. And it cannot go beyond restoring the situation before the Covid-19 outbreak, ie as at 31 December 2019.

Remuneration and exit of the State

The Temporary Framework first describes the general principles for remuneration. The State must receive appropriate remuneration for the investment, which should in principle be as close as possible to market terms. The recapitalisation should be redeemed when the economy stabilises and Member States must put a

mechanism in place to gradually incentivise redemption. Specifically, remuneration should be increased in order to converge with market prices.

Next, the Temporary Framework describes remuneration methodologies for equity instruments and for hybrid capital instruments. Member States may, however, also notify schemes in which remuneration is adapted in accordance with the features and seniority of the capital instrument, provided that overall it leads to a similar outcome.

Remuneration of **equity instruments** must comply with the following requirements:

- A capital injection, or equivalent measure, must be conducted at a price not exceeding the average share price of the beneficiary over the 15 days preceding the request for a capital injection. If the company is not publicly listed, its market value should be estimated by an independent expert or by other proportionate means.
- The measure must include a step-up mechanism increasing the State remuneration in order to incentivise buy-back of the capital injections. Four years after the Covid-19 equity injection, if the State has not sold at least 40% of its participation it will receive an additional share of ownership of at least 10% of its remaining participation at no additional cost. Six years after the equity injection, if the State has not sold its full participation, the step-up mechanism will again be activated. Each of these steps may be delayed by one year, if the relevant beneficiary is not publicly listed. The Commission may accept alternative step-up mechanisms if they have a similar incentives for the State and a similar impact on the State's remuneration.
- The beneficiary must at any time have the possibility to buy back the equity stake. The buy-back price must be the higher amount of: (i) the nominal investment by the State increased by an

annual interest remuneration of 200 bps higher than the amounts set out in relation to hybrid capital instruments; or (ii) the market price at the moment of buy-back. Alternatively, the State may at any time sell its participation at market prices to third parties. The State may give existing shareholders priority rights to buy at the price resulting from the public consultation.

Remuneration of **hybrid capital instruments** must comply with the following requirements:

- Overall remuneration must adequately factor in the characteristics of the instrument chosen, built-in incentives for exit (such as step-up and redemption clauses) and an appropriate benchmark interest rate.
- The minimum remuneration of hybrid capital instruments until they are converted into equity-like instruments must be at least equal to the base rate (1-year IBOR or equivalent) and a premium as set out in the Temporary Framework.
- Conversion of hybrid instruments into equity must be conducted at 5% or more below Theoretical Ex-Rights Price.
- After conversion into equity, a step-up mechanism must be included in order to incentivise buy-back of the capital. If, two years after conversion, the State still owns equity resulting from its Covid-19 intervention, the State shall receive an additional share of ownership of at least 10% of the remaining participation. As with equity instruments, the Commission may accept alternative step-up mechanisms if they have a similar overall effect/impact.
- Additional step-up or payback clauses may be included, provided that they encourage an early end to the State's recapitalisation support.

As the nature of hybrid instruments varies significantly, the Commission does not provide guidance for all types of instruments. But it does

provide that they must follow the same basic principles, with remuneration reflecting the relevant risk.

Governance and prevention of undue distortions of competition

The Temporary Framework sets out a number of specific conditions that must be met in order to prevent undue distortions of competition. In particular, a beneficiary must not engage in aggressive commercial expansion financed by State aid or take excessive risks and is prohibited from:

- advertising the fact that it received a Covid-19 recapitalisation measure;
- using State aid to cross-subsidise economic activities of integrated undertakings that were already in economic difficulties on 31 December 2019;
- making dividend payments, making non-mandatory coupon payments, or buying back shares other than in relation to the State;
- certain M&A – where at least 75% of the recapitalisation measures have not been redeemed, the beneficiary cannot acquire a stake of more than 10% in competitors or companies with upstream or downstream operations, unless the beneficiary is an SME or where the acquisition is necessary to maintain the beneficiary's viability; and
- paying bonuses to management or other variable or comparable remuneration elements (or, where at least 75% of the recapitalisation measures have not been redeemed, paying management more than the fixed part of their remuneration on 31 December 2019).

Where the beneficiary of a recapitalisation measure above EUR250m is an undertaking with significant market power, Member States must propose additional measures to preserve effective competition in those markets. Importantly, such measures may include structural or behavioural commitments as

foreseen in the Commission's [guidance](#) on remedies acceptable in a merger control context.

Exit strategy and reporting obligations

The amended Temporary Framework requires that beneficiaries other than SMEs receiving recapitalisation of more than 25% of equity demonstrate a credible exit strategy for the participation of the Member State (except where the State's intervention is reduced below 25% within 12 months from the date of granting the aid). This strategy must lay out the beneficiary's plan on continuation of its activities and the use of the invested funds, including a repayment schedule, and the measures that the beneficiary and the State will take to abide by the repayment schedule.

Beneficiaries will have to periodically report progress to the Member State, which in turn must report annually to the Commission. Beneficiaries other than SMEs must also periodically publish information on the use of the aid received. In particular, this must include information on how their use of aid supports activities in line with EU objectives and national obligations linked to green and digital transformation, including the EU objective of climate neutrality by 2050.

Finally, if six years after the recapitalisation the State's intervention has not been reduced below 15% of equity, a restructuring plan in accordance with the [Rescue and Restructuring Guidelines](#) will have to be notified to the Commission for approval.

Subordinated loans

The amended Temporary Framework provides that subordinated debt can be an appropriate means to support undertakings and that it is a less distortive instrument than equity or hybrid capital. A measure in the form of subordinated debt must comply with the existing requirements set out in the Temporary Framework in relation to aid in the form of subsidised interest rates for loans. However, as subordinated loans increase the ability of companies to take on senior debt in a way similar to capital support, an additional credit risk mark-up (plus 200 bps for large enterprises and 150 bps for SMEs) and a further

limitation as to the amount compared to senior debt will apply. If subordinated debt goes beyond the following ceilings, it will have to be assessed in line with the conditions for Covid-19 recapitalisation measures described above:

- i. two thirds of the annual wage bill of the beneficiary for large enterprises and the annual wage bill of the beneficiary for SMEs; and
- ii. 8.4% of the beneficiary's total turnover in 2019 for large enterprise and 12.5% of the beneficiary's total turnover in 2019 for SMEs.

Comment

This amendment to the Temporary Framework was sent to the Member States for consultation on 9 April 2020. The fact that it has taken until 8 May to publish the final version indicates that the initial version included some contentious points for Member States which took some time to resolve. Indeed the Commission, reportedly in response to pushback from certain Member States, has softened its stance on a number of points compared to the draft. In relation to eligibility and entry conditions, for example, the Commission has included a broader definition of common interest reasons that can justify intervention. It has lengthened the period before step-up mechanisms incentivising exit must kick in. And prohibitions on M&A activities have been relaxed – the Commission has now allowed acquisitions of interests up to 10%, as well as lifting the prohibition once 75% of the recapitalisation measures have been redeemed.

A further interesting inclusion in this amendment to the Temporary Framework relates to environmental and digital transition conditions. The Commission explicitly notes that it welcomes Member States taking climate and digital objectives into account when designing national support measures and recalls Member States' responsibility to ensure that measures do not hinder the achievement of these objectives. However, it stops short of taking a formal position or imposing any concrete requirements in this respect, other than the obligation on large undertakings to report on how aid received is being used to further EU objectives and national

obligations linked to green and digital transformation. This may give rise to some interesting questions as to the level playing field between Member States. It is already clear that Member States are taking different approaches to this issue with, for instance, France attaching certain environmental obligations to its State aid to Air France. Other Member States, such as Germany, have so far not done the same in respect of their aid to national airlines. It will be interesting to see how this develops.

An issue that has been raised more generally in relation to the Temporary Framework relates to

the requirement that aid is not granted to undertakings that were already in difficulty on 31 December 2019. The definition of 'undertakings in difficulty' refers to the [General Block Exemption Regulation](#) and includes undertakings whose accumulated losses are greater than half of their share capital. This definition in practice means that undertakings backed by venture capital or private equity are often ineligible for aid due to the way they are funded. Despite industry bodies reportedly having raised this matter with the Commission, this matter has not been resolved as part of the present amendment to the Temporary Framework.

Overall, the Commission has approved over EUR1.9 trillion of aid under the Temporary Framework so far, in almost 150 separate decisions. More measures are being approved on a daily basis. We are closely tracking these – for more information see our regularly updated [overview](#) of the decisions adopted by the Commission – and will communicate any further amendments/extensions to the Temporary Framework as the situation develops.

Please get in touch with your usual antitrust contact if you would like to discuss any of these issues further.

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