COVID-19: PRESSURE POINTS: EUROPEAN COMMISSION ISSUES STATE AID RULES FOR COVID-19 STATE RECAPITALISATIONS AND SUBORDINATED DEBT (EUROPE)

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Legal Briefings

On 8 May 2020 the European Commission adopted the second amendment to its Temporary Framework on the application of the EU State aid rules in light of the COVID-19 outbreak. The amendment extends the Temporary Framework to cover State recapitalisations of companies in the form of *equity and hybrid capital instruments*, subject to conditions with respect to the State's entry, remuneration and exit, and governance and other requirements to limit potential competitive distortions. It also introduces the possibility for States to use *subsidised subordinated debt* to address companies' liquidity issues, in addition to subsidised senior debt (which was already covered).

The EU State aid rules essentially regulate interventions by EU Member States in their national economies (including the UK during the current Brexit transition period[1]) that provide selective economic / financial advantages i.e. they benefit specific companies or certain groups of companies. Where a measure involves State aid, it cannot in principle be implemented unless it is notified by the State concerned and approved as "compatible with the internal market" by the European Commission. This so-called "standstill obligation" is subject to the application of various "block exemptions" which cover certain specific types of aid measures.

The Temporary Framework does not provide a further block exemption from the requirement to notify and obtain Commission approval. It does, however, set out guidelines in relation to certain types of aid measures, which if followed, the Commission would consider as compatible with the internal market and would be able to approve relatively quickly upon notification.

Prior to this amendment the Temporary Framework already allowed Member States to adopt wide-ranging support measures broadly applicable across economic sectors and including direct grants, State guarantees and subsidised senior debt, but mostly for amounts that were relatively limited per company (the existing Temporary Framework is covered in our earlier posts available here and here).

The extension of the Temporary Framework now to cover State recapitalisations represents a significant evolution of the approach, towards more targeted interventions of greater magnitude in favour of individual systemic companies. It is assumed that these kinds of measures are inherently more distortive of competition and they are consequently subject to greater scrutiny, which is reflected in stricter requirements as follows:

- *Eligibility and entry conditions* – State recapitalisations can only be granted in circumstances where the beneficiary would otherwise go out of business or at least face serious difficulties to maintain operations, and provided no other appropriate solution is available in terms of affordable private financing or the relevant State's existing horizontal aid schemes. It must also be demonstrated how the intervention would be in the "common interest", for example, to avoid social hardship and market failure due to significant loss of employment, the exit of an innovative or systematically important company, or the risk of disruption to an important service. Finally, and as with the other COVID-19 aid measures covered by the Temporary Framework, companies will only be eligible where they were not already a "firm in difficulty" within the meaning of the EU State aid rules, before January 2020, but face difficulties thereafter as a result of the COVID-19 outbreak.

- *Amount of the recapitalisation* – State recapitalisations must not exceed the minimum required to ensure the viability of the beneficiary and should not go beyond restoring the capital structure to that predating the COVID-19 outbreak. In terms of pricing for the capital injection, this in principle should not be in excess of the average share price of the beneficiary over the 15 days preceding the request for the injection, while in the case of unlisted companies, an estimate of market value should be established by an independent expert or by other proportionate means.

- *Remuneration and exit* – The remuneration for State recapitalisations should be as close as possible to market terms and increased over time in order to provide incentives for the beneficiary to redeem the recapitalisation and look for alternative capital when market conditions permit. The amended Temporary Framework therefore requires that State recapitalisations include a "step-up" mechanism that increases their remuneration if sufficient levels of the State's equity participation have not been relinquished by certain time milestones, these in principle being 40% of the State's equity by 4 years and the full amount of the State's equity by 6 years following the injection for listed companies and by milestones of 5 and 7 years for unlisted companies.

Beneficiaries and the relevant Member State must in principle also agree upon an exit strategy following the recapitalisation which is subject to annual reporting (along with reporting on compliance with the other requirements set out below). If the State's intervention has not been reduced below 15% of the beneficiary's equity within 6 years after the recapitalisation for listed companies, 7 years for unlisted companies, a restructuring plan must be prepared and submitted to the Commission for approval.

- *Acquisition ban and additional requirements for companies with significant market power to limit distortions of competition* – To reduce distortions of competition arising from the State aid, beneficiaries in principle are prohibited from acquiring a stake of more than 10% in competitors or operators in the same line of business, including both operators upstream and downstream, unless the acquisition is necessary to maintain the beneficiary's viability. This acquisition ban applies so long as at least 75% of the State recapitalisation remains in place, providing a further incentive for the beneficiary to begin redeeming the State's equity expeditiously.

Additional requirements to reduce competitive distortions apply in the case of significant capital injections in support of beneficiaries that have "significant market power" in a market on which they operate. Where the capital injection in such undertakings exceeds €250 million, Member States must impose measures to preserve effective competition in these markets, including potential structural remedies such as divestments or behavioural commitments in line with those proposed to address competition concerns in the context of merger control proceedings.

- *Dividends, buy-backs, management remuneration and reporting* – As long as the State recapitalisation has not been fully redeemed, beneficiary companies are not allowed to pay dividends or buy-back shares, other than in relation to the State. Furthermore, until 75% of the State recapitalisation has been redeemed, strict limitations on the remuneration of senior management must be adhered to, including a ban on bonuses or comparable remuneration elements.

> Finally, as long as the State recapitalisation has not been fully redeemed, the beneficiary will be required to publish annually information on the use of the State aid, and in particular, larger enterprises will have to explain how the aid is used to support their activities in line with EU and national requirements in connection with green and digital transformation (including the EU objective of climate neutrality by 2050). In this regard, while the Commission is not requiring that such environmental and digital transformation objectives are imposed formally as conditions for State recapitalisations (which would be questionable from an EU State aid law perspective) it is certainly encouraging States to impose such requirements of their own accord.

In addition to State recapitalisations, the amended Temporary Framework also introduces the possibility for States to support undertakings facing liquidity difficulties by providing subordinated debt on favourable terms. These measures must fulfil all of the requirements set out in the existing Temporary Framework with respect to subsidised senior debt, as well as additional requirements in view of their greater distortive effect (as they increase the ability of companies to take on more senior debt in a way similar to capital support). In particular, subordinated debt aid measures must be remunerated with an additional credit risk mark-up and are restricted in their amount to two thirds of the beneficiary's annual wage bill and 8.4% of 2019 turnover in the case of large enterprises. Where the subordinated debt exceeds these ceilings, the measure is assessed in light of the more stringent rules for State recapitalisations.

While the above requirements for State recapitalisations appear onerous, they are in fact a good deal less stringent than the requirements under the normally applicable rules for State bailouts, namely the rules with respect to rescue and restructuring aid for undertakings in difficulty (for reasons not connected to the COVID-19 outbreak) under the Commission's existing rescue and restructuring guidelines. In particular, and contrary to the normally applicable rules, there is no general requirement for a restructuring plan setting out far-reaching measures to restore the beneficiary to long-term viability, nor for a significant level of "own contribution" i.e. a contribution from the own resources of the beneficiary, its shareholders / creditors etc., nor for the significant structural and behavioural measures typically imposed in a rescue and restructuring case (except in the case of significant capital injections in support of beneficiaries with significant market power).

It remains to be seen how much States will make use of these new possibilities to support companies under the amended Temporary Framework and there will evidently be disparities in the financial capacities of different States to make significant capital injections in their national systemic companies. These amendments however, have been subject to prolonged consultation and discussions between the Commission and Member States and therefore it seems likely that at least some States will be resorting to such measures going forward. The guidelines also serve as a starting point for regulating possible recapitalisation measures using EU level funds, which are currently under discussion between the Commission and Member States as a means of filling possible gaps at the national level.

State recapitalisation measures should also be seen in the context of concerns at the European level in relation to the potential for takeovers of strategic companies (currently in a weakened state due to the COVID-19 outbreak) by third-country supported purchasers. It remains to be seen how these kinds of considerations will influence States' decision-making when it comes to making use of the recapitalisation aid measures provided for under the amended Temporary Framework.

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1. Although the UK is no longer an EU Member State, the EU State aid rules continue to apply during the current Brexit transition period and will essentially remain applicable to all aid granted before the end of the transition period

More on COVID-19

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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