CLEARY GOTTLIEB

ALERT MEMORANDUM

The European Commission Relaxes State Aid Rules for COVID-19-related Recapitalizations

May 11, 2020

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

BRUSSELS

François-Charles Laprévote
+32 22872184
fclaprevote@cgsh.com

ROME

Giulio Cesare Rizza
+39 06 6952 2237
crizza@cgsh.com

PARIS

Victoria Blanc
+33 1 40 74 69 87
vblanc@cgsh.com

On May 8, 2020, the Commission published an important new communication aimed at relaxing State aid rules for COVID-19-related equity injections by States into non-financial companies.[1] While previous initiatives aimed at relaxing State aid rules (in particular the so-called "Temporary Framework", or "TF", adopted on March 19, 2020) [2] were focused on maintaining companies' access to liquidity, this new communication recognizes that the economic effects of COVID-19 will also endanger their solvency and thus require more structural (and potentially competition-distortive) measures such as equity or hybrid capital injections or subordinated loans (*i.e.*, debt instruments that are subordinated to ordinary senior creditors in case of insolvency proceedings).

[1] *See* Communication from the Commission, "Amendment to the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak", C(2020) 3156 final available here https://ec.europa.eu/competition/state_aid/what_is_new/sa_covid19_2nd_amendment_temporary_framework_en.pdf.

[2] *See* "State Aid Temporary Framework to Support the Economy in the Context of the COVID-19 outbreak" available here https://www.clearygottlieb.com/news-and-insights/publication-listing/state-aid-temporary-framework-to-support-the-economy-in-the-context-of-the-covid-19-outbreak. The TF initially allowed Member States to implement aid in four different forms: (i) direct grants, repayable advances and tax advantages, (ii) loan guarantees, (iii) subsidized loans, and (iv) short term export credit insurance. The TF was first amended on April 3, 2020 to clarify a number of provisions and enable additional types of aid measures for activities aimed at combating the COVID-19 outbreak, as well as selective measures in the form of tax and social security deferrals or wage subsidies for the sectors or regions most hit by the crisis. *See* "Amendment to the State Aid Temporary Framework to Support the Economy in the Context of the COVID-19 Outbreak" available here https://www.clearygottlieb.com/news-and-insights/publication-listing/amendment-to-the-state-aid-temporary-framework. The TF and its first amendment were published, respectively, in the OJ C 91I/1 and the OJ C 112I/1.

The Commission's new communication takes the form of an amendment to the TF (the "Second Amendment"). Like the TF itself, it is based on Article 107(3)(b) TFEU, which allows the Commission to clear aid granted to "*remedy a serious disturbance in the economy of a Member State*". In addition to provisions on subordinated loans and recapitalizations, the Second Amendment also clarifies certain provisions on the aid measures covered in the initial TF. The Second Amendment only applies to aid to the "*real economy*" (*i.e.*, non-financial undertakings),[3] and for companies that were not in financial difficulties as of December 31, 2019.[4]

1. Key principles

The Second Amendment sets forth a number of key principles regarding State recapitalizations:

— In light of their distortive effect on competition, they "*should only be considered if no other appropriate solution can be found*" and are subject to "*stringent conditions*"; the Commission however clarifies that these conditions may be less stringent if the support is granted at EU (as opposed to national) level – and actually calls for such EU level support to be established;

— State recapitalizations may not exceed the minimum needed to ensure the viability of the beneficiary, and must be limited to restoring its capital structure to the level predating the COVID-19 outbreak;

— States are encouraged to prefer subordinated loans, as a first-line and less distortive form of support (*see* below);

— The Commission will require large companies to report on the use of the aid received and its alignment with the EU's green objectives and digital transformation;

— Member States may design national measures in line with additional policy objectives, such as further enabling the green and digital transformation of their economies; and

— The Commission recalls that some equity injections and purchases may not constitute State aid if the State acts as a market economy operator (*e.g.*, by purchasing stakes or subscribing to new shares on market terms).

2. Subordinated loans

Subordinated debt is a less distortive instrument than equity or hybrid capital, given that it cannot be converted into equity when the company is a going concern. Although the State assumes less risk, such subordinated debt increases the beneficiary's ability to take on senior debt in a manner similar to capital support. The Second Amendment allows States to provide subordinated loans subject to the State receiving a higher remuneration and subject to further limitations as to the amount, compared with the limitations applying to aid in the form of senior subsidized loans:[5]

— If the subordinated loan remains below 2/3 (100% for SMEs) of the company's 2019 wage bill or 8.4% of its 2019 turnover (12.5% for SMEs), it must only be subject to the (limited) conditions laid out in Section 3.3. of the TF regarding senior subsidized loans. If the subordinated loan exceeds these two ceilings, it must be considered as a recapitalization and subject to more stringent conditions (*see* below).

[3] As part of the clarifications brought to the initial TF, the Second Amendment provides that aid to credit and financial institutions is not to be assessed under the TF except for "*(i) indirect advantages to credit or financial institutions channeling aid in the form of loans or guarantees under sections 3.1 to 3.3 pursuant to the safeguards of section 3.4, and (ii) aid under section 3.10 provided the scheme is not targeting exclusively employees from the financial sector.*"

[4] Companies in financial difficulties as of December 31, 2019 may still receive aid subject to the more stringent conditions of the Commission's Guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty, OJ 2014, C 249/1 (the "Rescue and Restructuring Guidelines").

[5] *See* Second Amendment, paras. 29 and 32.

— The loan's base rate must be subject to a 200 bps premium (150 bps for SMEs) on top of the minimal remuneration provided in the TF for senior loans.

— The subordinated loan may be cumulated with other subsidized loans or guarantees allowed under Sections 3.2. and 3.3. of the TF, provided their total amount remains below the ceilings provided for in the TF.[6]

3. Recapitalization measures: eligibility criteria

The Second Amendment allows Member States to implement recapitalization measures until June 30, 2021 (as opposed to December 31, 2020[7]), through (i) **equity instruments**, in particular the issuance of new common or preferred shares, and/or (ii) **hybrid capital instruments**, in particular profit participation rights, silent participations or convertible bonds. Member States may also underwrite these instruments in the context of a market offering.

All these measures are subject to the Commission's prior clearance, either of the recapitalization scheme (if the measure is open to several companies) or of the individual recapitalization measure (if the measure is only provided to one company). In addition, individual aid granted under a scheme requires a separate notification if it exceeds € 250 million.

In order to benefit from the recapitalization, the beneficiary must make a written request for the State's intervention and fulfil the following conditions:[8]

— Without the State intervention, its viability would be at risk or it "*would face serious difficulties to maintain its operations*";

— It is in the common interest to intervene (*e.g.*, because the aid prevents social hardship or a market failure "*due to significant loss of employment, the exit of an innovative company, the exit of a systemically important company, the risk of disruption to an important service, or similar situations duly substantiated by the Member State concerned*");[9]

— No other financing solution is available on the markets at affordable terms and liquidity measures are insufficient; and

— The beneficiary was not in financial difficulty before the COVID-19 outbreak (*i.e.*, before December 31, 2019).[10]

4. Recapitalization measures: remuneration and exit of the State

By way of general principle, the Second Amendment provides that the State must receive "*appropriate*" remuneration for the risks it assumes, and provide for step-up or other mechanisms aimed at incentivizing the beneficiary to redeem the aid as soon as possible when the economy stabilizes.

4.1. Remuneration of equity instruments

If the beneficiary is a publicly listed company, the capital injection must be conducted at a price that does not exceed the average share price over the 15 days preceding the request for the capital injection. If the beneficiary is not a listed company, its market value must be estimated by an independent expert or by other appropriate means.

The State must provide for a step-up mechanism increasing the remuneration of the State, to incentivise the beneficiary to buy back the State capital injections.[11] For example, additional shares may be granted to the State, corresponding to a minimum 10%

[6] Twice the beneficiary's 2019 wage bill or 25% of its 2019 turnover.

[7] Which is the final date before which the other forms of aid envisaged in the TF must be granted.

[8] *See* Second Amendment, para. 49.

[9] *See* Second Amendment, para. 49(b).

[10] Recapitalization measures may not cross-subsidise other activities of integrated undertakings that were in financial difficulty before the COVID-19 outbreak. Beneficiaries will thus be required to set up clear account separation to demonstrate that the aid does not benefit those activities: *See* Second Amendment, para 76.

[11] *Id.*, para. 61.

increase on the State's remaining stake for each of the following steps:

— Four years after the State capital injection (or five years if the beneficiary is not a listed company), if the State has not sold at least 40% of its COVID-19 related equity stake; and

— Six years after the State capital injection (or seven years if the beneficiary is not a listed company), if the State has not sold its entire COVID-19 related stake.[12]

The beneficiary should be able to buy back the shares owned by the State at any time. The buy-back price should be the higher of (i) the market price at the moment of the buy-back, or (ii) the nominal State's investment increased by an annual interest remuneration ranging from 425 bps to 1,150 bps depending on the company's size and the redemption date. As an alternative, any purchaser other than the beneficiary can buy the State's equity interest at market prices at any time, provided, in principle, that the sale is completed on the stock exchange, or after an open and non-discriminatory consultation of potential purchasers.

4.2. Remuneration of hybrid capital instruments

The overall remuneration of hybrid capital instruments must take into account, in particular, the level of subordination, the instrument's risk and all terms of payment, incentives for exit, such as step-up and redemption clauses, as well as an appropriate benchmark interest rate. The remuneration of hybrid capital instruments must at least equal the 1-year IBOR plus a premium ranging from 225 bps to 950 bps, depending on the company's size and the redemption date. The conversion of hybrid capital instruments into equity must be conducted at 5% or more below TERP (Theoretical Ex-Rights Price) at the time of the conversion.

In the same vein as equity instruments, hybrid capital injections must include a step-up mechanism after conversion into equity to increase the remuneration of the State. If two years after the conversion into equity the State has not sold its stake, it must receive an additional share of at least 10% of its remaining participation.[13]

5. Recapitalizations: governance and additional conditions

The Second Amendment also lays down a number of safeguards on the governance of the recapitalized undertakings and to avoid undue distortions of competition. In particular:

— The beneficiary may not "*engage in aggressive commercial expansion financed by State aid*" or "*take excessive risks*".

— If the beneficiary of a recapitalization measure of more than € 250 million has "*significant market power*" on a relevant market, the State must propose measures aimed at preserving effective competition in those markets, such as structural (*e.g.*, divestitures) or behavioural commitments similar to those provided for in merger control proceedings.

— Before the redemption of at least 75% of the State stake, non-SME beneficiaries are prevented from acquiring more than 10% of the shares of competitors. The Commission considers purchases below this threshold to be unproblematic since no particular shareholders rights are associated with smaller stakes. This prohibition in principle also applies to acquisitions of stakes in companies downstream or upstream of the beneficiary's business but the Commission may allow transactions that are necessary for the beneficiary's viability (*e.g.*, where access to an input supplied by another company is essential for the beneficiary's activity).

— Until the State's equity has been fully redeemed, beneficiaries are forbidden to distribute dividends or non-mandatory coupon payments other than those that may be owed to the State.

[12] The Commission may accept alternative mechanisms providing for similar exit incentives.

[13] The Commission may accept alternative mechanisms providing for similar exit incentives.

— As long as at least 75% of the COVID-19 recapitalization has not been repaid, the remuneration of each of the members of the beneficiaries' management must not exceed the fixed part of his/her remuneration as of December 31, 2019, and cannot include bonuses or variable remunerations. For new management members, the cap is set at the lowest fixed remuneration of any management member as of December 31, 2019.

6. Recapitalizations: exit strategy of the State and reporting obligations

Within 12 months of the State's intervention, non-SME beneficiaries of a recapitalization accounting for more than 25% of their equity must submit (and the State must endorse) a credible exit strategy for the participation of the Member State, unless the State's shareholding has already been reduced below 25% by that time. The exit plan must include the beneficiary's strategy with regard to the continuation of its business and the use of the State funds, as well as a repayment or redemption schedule for the State's stake. The beneficiary must report to the State on progress on this exit plan every 12 months, and the Member State must likewise report to the Commission on an annual basis.

In addition, until the recapitalization has been fully redeemed, non-SME beneficiaries must annually publish information on the use of the aid, in particular on how such use takes into account EU objectives and national obligations related to the green and digital transformation, including the EU's objective of climate neutrality by 2050.

Where the State's participation is not reduced below 15% of the company's equity within six years of the COVID-19 recapitalization (seven years if the beneficiary is not a listed company, or is an SME), a restructuring plan must be notified to the Commission for approval.[14]

[14] In accordance with the 2014 Rescue and Restructuring Guidelines (*see* note 4 above).

Conclusions

The Second Amendment considerably expands the tools available to Member States in the current COVID-19 crisis by allowing structural measures such as recapitalizations. The Commission acknowledges the possible distortive effects of such interventions on competition and its communication thus contains novel pleas for alternative, less distortive solutions such as subordinated loans or coordinated interventions at EU level.

Overall, however, the conditions set out in the communication have been significantly softened in comparison with its first informal draft sent out for consultation to Member States. They also appear generally less stringent than the conditions that typically apply to State aid in the form of recapitalizations of companies in difficulties in non-crisis times as set out in the Commission's 2014 Rescue and Restructuring Guidelines. In particular, the Commission will not require restructuring plans prior to granting its clearance, a major difference with its pre-COVID practice, and even with its practice during the 2008 financial crisis.

It remains to be seen whether the Commission will require harsher conditionality through the "*exit*" or "*repayment*" plans to be submitted, or through the commitments to be provided when the beneficiary has significant market power, or through the – at this stage very generic – references to novel objectives of green and digital transformation. The future decision-making practice of the Commission on individual schemes or recapitalizations going forward will shed some light on these issues.

…

CLEARY GOTTLIEB