

## European Commission sets State aid framework for public recapitalizations and subordinated debt

### Background

On 19 March 2020 (amended on 3 April 2020), the European Commission (“**Commission**”) adopted a “**Temporary Framework**” for State aid measures that identifies the scope of far-reaching rescue measures Member States implement for companies (please see also our news of [06.04.2020](#) and [16.03.2020](#)). It sets the conditions pursuant to which the following measures are compatible with Community law: (i) direct grants, tax advantages, repayable advances with a nominal value of up to EUR 800.000; (ii) state guarantees; (iii) subsidized rates for loans; (iii) short term export credit insurances; (v) support for coronavirus-related R&D, products and facilities; (vi) deferral of tax payments/suspensions of social security; and (vii) wage subsidies for employees.

To-date, the Commission has approved an estimated EUR 1.9 trillion in State aid to the EU economy, and issued more than 100 respective decisions on that basis. Nevertheless, it became clear that the losses many companies have incurred by the far-reaching lock downs reflecting negatively on their equity and adversely affecting their ability to borrow from financial institutions. Following consultations and controversial discussions with Member States, the Commission accepted that, as a last resort, Member State can provide well-targeted equity and/or hybrid capital instruments to companies in order to reduce the risk of multiple insolvencies, provided that clear conditions apply. It encourages Member States to take the green transformation and the digital transition – key objectives under Commission President Ursula von der Leyen – into account when designing such support measures.

On 8 May 2020, the Commission therefore adopted the second amendment of the Temporary Framework (“**Amendment**”) that identifies the scope for public recapitalization schemes and individual recapitalization measures for non-financial companies, and introduces the possibility for Member States to grant subordinated debts. The Amendment further provides certain clarifications as to the existing aid instruments, and to the monitoring and final provisions. Subordinated debt are now accepted as an appropriate means to support undertakings in Corona-caused distress as long as they comply with – modified – conditions applicable for subsidized interest loans. Member States are now expected to finalize their national schemes that have to be notified to, and approved by, the Commission before the measures can be implemented (in Germany, it concerns the *Wirtschaftsstabilisierungsfondsgesetz*).

## **Beneficiaries of recapitalization measures**

A company must satisfy the following cumulative conditions: (i) without state intervention the beneficiary (SMEs or large company) would go out of business or face serious difficulties to maintain operations; (ii) there is a common interest to intervene, e.g., because of social hardship or market failure, the exit of an innovative or systemically important company, the risk of disruption of an important service etc.; (iii) no possibility for the beneficiary to find financing on the markets at affordable terms, and no existent horizontal measure to cover liquidity needs is available; and (iv) the beneficiary was not already in difficulty on 31 December 2019.

## **Types of recapitalization measures**

Member States can provide equity instruments (e.g. the issuance of new common or preferred shares) and/or hybrid capital instruments (e.g. profit participation rights, silent participations, and convertible secured/unsecured bonds).

## **Recapitalization amount**

The amount of recapitalization aid must be limited to ensuring the viability, and it should not go beyond restoring the capital structure of the beneficiary as of 31 December 2019 (pre-Corona pandemic situation). State aid received or planned in the context of the Corona outbreak will be taken into account.

## **Remuneration of equity**

The Member State shall receive appropriate remuneration for the investment, and there must be incentives to redeem when economy stabilizes.

A public capital injection or equivalent intervention shall be conducted at a price that does not exceed the average share price of the beneficiary over the 15 days preceding the request for the capital injection. If the beneficiary is a private company, an estimate of its market value should be established by an independent expert or other proportionate means. Any recapitalization measure must include a step-up mechanism that increases the remuneration in order to incentivize the beneficiary to buy back the State capital injections. This increase in remuneration can take the form of additional shares (e.g. through the issuance of convertible bonds) granted to the State or other mechanisms. It should correspond to a minimum of 10% increase in the remuneration of the State (for the participation resulting from the State's equity injection that has not been repaid), for each of the step-up steps:

(i) Four years after the COVID-19 equity injection, if the State has not sold at least 40% of its equity participation in a public company resulting from the equity injection, the step-up mechanism will be activated. (ii) Six years after the COVID-19 equity injection, if the

State has not sold fully its equity participation resulting from the Corona equity injection, the step-up mechanism will be activated again. For private companies, Member States may decide to implement each of the two steps one year later, i.e. five years and seven years after granting of the COVID-19 equity injection, respectively. The Commission may accept alternative, but similarly incentivizing, mechanisms.

At any time, the beneficiary should be able to buy back the State’s stake. The buy-back price should be the higher amount of (i) the nominal investment by the Member State increased by an annual interest remuneration basis points 200 basis points higher than presented in the table below; or (ii) the market price at the moment of the buy-back. Alternatively, the Member State may sell at any time its stake at market prices to purchasers other than the beneficiary in which case an open and non-discriminatory consultation of potential purchasers, or a sale on the stock exchange is required. Existing shareholders may enjoy priority rights.

**Remuneration of hybrid capital instruments**

The remuneration must adequately consider (i) the level of subordination, risk and all modalities of payment that constitute the characteristics of the chosen instrument; (ii) built-in incentives for exit; and (iii) an appropriate benchmark interest rate. The minimum remuneration of hybrid capital instruments until they are converted into equity-like instruments shall be at least equal to the base rate (1 year IBOR or equivalent as published by the Commission), plus the premium as set below:

Recipient	1 <sup>st</sup> year	2 <sup>nd</sup> and 3 <sup>rd</sup> year	4 <sup>th</sup> and 5 <sup>th</sup> year	6 <sup>th</sup> and 7 <sup>th</sup> year	8 <sup>th</sup> year
SME	225 bps	325 bps	450 bps	600 bps	800 bps
Large enterprise	250 bps	350 bps	500 bps	700 bps	950 bps

The conversion of hybrid capital instruments into equity shall be conducted at 5% or more below TERP (Theoretical Ex-Rights Price) at the time of the conversion. A step-up mechanism must be included to increase the remuneration of the Member State in order to incentivize the beneficiaries to buy back the State capital injections. In that respect, the Commission demands that where a Member State owns the equity two years after conversion, the State shall receive a minimum of 10% of the remaining participation that has been converted from the hybrid capital instruments – Member States may choose equally incentivizing step-up mechanisms as well as pricing formulae that include additional step-up or payback clauses.

## **Governance of the (partly) privatized beneficiary**

Due to the potential of competition distortions by these forms of state intervention, the Commission demands certain governance-related restrictions:

- Generally, beneficiaries must not aggressively expand or take excessive risks.
- Where the recapitalization measure is above EUR 250 million, and the beneficiary has significant market power on a relevant market, Member States must propose additional measures to preserve effective competition on such a market, e.g. by proposing structural remedies (divestitures) or behavioral obligations.
- Beneficiaries are prohibited from advertising the recapitalization for commercial purposes.
- As long as at least 75% of the recapitalization measures have not been redeemed, beneficiaries other than SMEs must not, in principle, acquire a stake of 10% or more in competitors or of upstream and downstream businesses.
- Beneficiaries must not cross-subsidize economic activities that were already in economic difficulties on 31 December 2019 (i.e. pre-Corona pandemic) – a clear account separation shall be put in place.
- As long as the recapitalization measures have not been fully redeemed, beneficiaries cannot make dividend payments, non-mandatory coupon payments nor buy back shares other than in relation to the State.
- As long as at least 75% of the State's equity has not been redeemed, the remuneration of each member of the beneficiaries' management must not go beyond the fixed part of the remuneration on 31 December 2019. Bonuses, other variable or comparable remuneration elements must not be paid.

## **Exit strategy/reporting obligation**

Companies other than SMEs where the State owns more than 25% of equity must demonstrate a credible exit strategy for the State participation, unless the State's intervention is reduced below the level of 25% of equity within 12 months from the date of the granting of the aid. The beneficiaries should report the exit strategy to the Member States within 12 months after the aid is granted, and the Member State needs to report vis-à-vis the Commission.

For the duration of the recapitalization, beneficiaries other than SMEs shall publish annually information on the use of the aid, in particular to what extent it was used in line with the digital and green transformation objectives.

The Member State should report to the Commission annually on the implementation of the repayment schedule and compliance with the governance conditions. Where the beneficiary received a recapitalization exceeding EUR 250 million, the report shall include information on the proportionality of the aid.

Member States must submit a restructuring plan if the State's participation in publicly listed companies has not been reduced below 15% within six years after the recapitalization, and in private companies/SMEs within seven years.

### **Applicability**

The Commission applies this Amendment from 19 March 2020 (i.e. the adoption of the Temporary Framework); unlike other aid under the Temporary Framework that only applies until 31 December 2020, the recapitalization exemption will be applied until 1 July 2021.

**Any questions? Please contact:** [Dr Jens Peter Schmidt](#) , [Dr Gerald Reger](#), [Dr Michael Brellochs](#) or [Sarah Blazek](#)

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