Pérez-Llorca

Special Information Briefing
COVID-19 (No. 17):

The recapitalisation of undertakings by Member States in the exceptional circumstances created by the COVID-19 outbreak

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On 8 May 2020, the second amendment to the Temporary Framework for State aid measures to support the economy in the context of the current COVID-19 outbreak (the **"Temporary Framework"**), approved by the European Commission's Communication of 19 March 2020, was published[1]. This new amendment establishes the criteria of European Union (**"EU"**) law on State aid, which will allow Member States to provide public support in the form of equity and/or hybrid capital instruments to undertakings facing financial difficulties due to the COVID-19 outbreak, i.e. to recapitalise companies that are facing difficulties due to COVID-19.

It is worth remembering that the Temporary Framework sets out the conditions of compatibility which the European Commission will, in principle, apply to all aid granted by Member States to support the economy in the context of the current COVID-19 outbreak, on the basis of Article 107(3)(b) of the Treaty on the Functioning of the EU (**"TFEU"**). Under Article 107(3)(b) of the TFEU, the European Commission may declare aid which is granted by a Member State to remedy a serious disturbance in its economy to be compatible with the internal market.

The main development contained in the second amendment of the Temporary Framework, published on 8 May 2020, is that it establishes the criteria that the European Commission will apply from now on to allow Member States to provide public support in the form of equity and/or hybrid capital instruments to companies facing financial difficulties due to the COVID-19 outbreak. These measures have been called "COVID-19 recapitalisation measures".

This legal briefing provides a general analysis of this new regulation.

1. Objective of the new regulation

The amendment of the Temporary Framework aims at ensuring that the disruption of the economy does not result in the unnecessary exit from the market of undertakings that were viable before the COVID-19 outbreak. The European Commission considers that reduced equity for undertakings in markets with low demand and disrupted supply aggravates the risk of a serious economic downturn, which could potentially affect the whole EU economy for a long period of time. The Commission also considers that well-targeted public interventions providing equity and/or hybrid capital instruments to undertakings could reduce the risk for the EU economy of a significant number of insolvencies.

According to the Temporary Framework, the COVID-19 recapitalisation measures must not exceed the minimum needed to ensure the viability of the beneficiary, and should not go beyond restoring its capital structure to the one predating the COVID-19 outbreak (31 December 2019). In addition, large undertakings must report on how the aid received supports their activities in line with EU

[1] C(2020) 1863 final.

objectives and national obligations linked to the green and digital transformation, including the EU objective of climate neutrality by 2050.

It establishes the general principle that the COVID-19 recapitalisation measures should only be considered if no other appropriate solution can be found. Furthermore, such measures are subject to stringent conditions because they are highly distortive for competition between undertakings. The Temporary Framework regulates, in detail, (i) the State's entry, remuneration and exit from the undertakings concerned, (ii) the governance of recapitalised undertakings and (iii) other measures to limit distortions of competition.

2. Applicability of the recapitalisation measures

For the recapitalisation measures to be covered by the Temporary Framework, they must be granted before 1 July 2021.

COVID-19 recapitalisation measures can be granted for both large undertakings and small and medium-sized enterprises (**"SMEs"**).

3. Eligibility and entry conditions for the States

The COVID-19 recapitalisation measures must fulfil the following conditions:

a) Without the State intervention the beneficiary would go out of business or would face serious difficulties to maintain its operations. Such difficulties may be shown by the deterioration of, in particular, the beneficiary's debt to equity ratio or similar indicators;

b) It is in the common interest to intervene. This may relate to avoiding social hardship and 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;

c) The beneficiary is not able to find financing on the markets at affordable terms and the horizontal measures existing in the Member State concerned to cover liquidity needs are insufficient to ensure its viability; and

d) The beneficiary is not an undertaking that was already in difficulty on 31 December 2019, within the meaning of the General Block Exemption Regulation[2].

According to Article 2(18) of the General Block Exemption Regulation, an undertaking in difficulty is an undertaking in respect of which at least one of the following circumstances occurs:

a) in the case of a limited liability company, where more than half of its subscribed share capital has disappeared as a result of accumulated losses; this is the case when deduction of accumulated losses from reserves (and all other elements generally considered as part of the own funds of the company) leads to a negative cumulative amount that exceeds half of the subscribed share capital;

b) in the case of a company where at least some members have unlimited liability for the debt of the company, where more than half of its capital as shown in the company accounts has disappeared as a result of accumulated losses;

c) where the undertaking is subject to collective insolvency proceedings or fulfils the criteria under its domestic law for being placed in collective insolvency proceedings at the request of its creditors;

d) where the undertaking has received rescue aid and has not yet reimbursed the loan or terminated the guarantee, or has received restructuring aid and is still subject to a restructuring plan;

e) in the case of an undertaking that is not an SME, where, for the past two years:

1) the undertaking's book debt to equity ratio has been greater than 7,5 and

2) the undertaking's EBITDA interest coverage ratio has been below 1,0.

In order to adopt COVID-19 recapitalisation measures, a written request must be made by the prospective beneficiary undertakings. Member States must provide evidence of such a written request as part of the notification of the individual aid measure to the Commission.

The Temporary Framework applies to both COVID-19 recapitalisation schemes and individual aid measures. When approving a scheme, the Commission will request the separate notification of individual aid above the threshold of EUR 250 million. In relation to such notifications, the Commission will assess (i) whether existing financing in the market or horizontal measures to

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[2] Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty (the "**General Block Exemption Regulation**"). OJ L 187 of 26.6.2014, p. 1-78.

cover liquidity needs are insufficient to ensure the viability of the beneficiary; (ii) that the selected recapitalisation instruments and the conditions attached to them are appropriate to address the beneficiary's serious difficulties; (iii) that the aid is proportionate; and (iv) that the other conditions of the Temporary Framework are complied with.

4. Types of recapitalisation measures

The Commission recalls that the TFEU is neutral as regards public versus private ownership. Article 345 of the TFUE provides that Treaties shall in no way prejudice the rules in Member States governing the system of property ownership. The Commission also recalls that, if Member States purchase existing shares of undertakings at market price or invest *pari passu* with private shareholders, this normally does not constitute State aid. Similarly, if Member States decide to purchase newly issued shares and/or provide undertakings with other types of equity support or hybrid capital instruments on market terms, i.e. under conditions complying with the Market Economy Operator Principle, this also does not constitute State aid.

After clarifying these points, the Temporary Framework establishes that Member States can provide COVID-19 recapitalisation measures using two distinct sets of recapitalisation instruments:

a) equity instruments, in particular, the issuance of new common or preferred shares; and/or

b) instruments with an equity component (referred to as 'hybrid capital instruments'[3]), in particular profit participation rights, silent participations and convertible secured or unsecured bonds.

The State intervention can take the form of any variation of the above instruments, or a combination of equity and hybrid capital instruments. Member States may also underwrite the above instruments in the context of a market offering, under the condition that any resulting State intervention in a beneficiary meets the conditions set out in the Temporary Framework. The Member State must ensure that the selected recapitalisation instruments and the conditions attached thereto are appropriate to address the beneficiary's recapitalisation needs, while at the same time being the least distortive to competition.

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[3] Hybrid capital instruments are instruments that have characteristics of debt as well as of equity. For instance, convertible bonds are remunerated like bonds until they are converted into equity. The assessment of the overall remuneration of hybrid capital instruments thus depends on the one hand on their remuneration while they are debt-like instruments and on the other hand on the conditions for conversion into equity-like instruments.

5. Amount of the recapitalisation

No quantitative limits have been set, unlike with other measures provided for in the Temporary Framework. However, in order to ensure proportionality of the aid, the amount of the COVID-19 recapitalisation must not exceed the minimum needed to ensure the viability of the beneficiary, and should not go beyond restoring the capital structure of the beneficiary to the one predating the COVID-19 outbreak (31 December 2019). In assessing the proportionality of the aid, State aid received or planned in the context of the COVID-19 outbreak will be taken into account.

6. Remuneration and exit of the State

A. General principles

The State shall receive appropriate remuneration for the investment. The closer the remuneration is to market terms, the lower the potential competition distortion caused by the State intervention.

The COVID-19 recapitalisation should be redeemed when the economy stabilises. The Commission considers it appropriate to give the beneficiary sufficient time to redeem the recapitalisation. The Member State must put a mechanism in place to gradually incentivise redemption.

The remuneration of the COVID-19 recapitalisation measure should be increased in order to converge with market prices to provide an incentive to the beneficiary and to the other shareholders to redeem the State recapitalisation measure and to minimise the risk of distortions of competition.

B. Remuneration of equity instruments

A capital injection by the State, or an 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 not a publicly listed company, an estimate of its market value should be established by an independent expert.

Any recapitalisation measure shall include a step-up mechanism increasing the remuneration of the State, to incentivise the beneficiary to buy back the State capital injections. This increase in remuneration can take the form of additional shares granted to the State[4] or other mechanisms, and should correspond to a minimum of 10% increase in the remuneration of the State (for the participation resulting from the State's COVID-19 equity injection that has not been repaid), for each of the step-up steps:

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[4] Additional shares can, for instance, be granted via the issuance of convertible bonds at the date of the recapitalisation, which will be converted into equity at the date of trigger of the step-up mechanism.

a) Four years after the COVID-19 equity injection, if the State has not sold at least 40 percent of its equity participation resulting from the COVID-19 equity injection, the step-up mechanism will be activated.

b) Six years after the COVID-19 equity injection, if the State has not sold in full its equity participation resulting from the State's COVID-19 equity injection, the step-up mechanism will again be activated[5].

If the beneficiary is not a publicly listed company, Member States may decide to implement each of the two steps one year later, i.e. five years and seven years after the granting of the COVID-19 equity injection, respectively.

The Commission may accept alternative mechanisms, provided they overall lead to a similar outcome with regard to the incentive effects on the exit of the State and a similar overall impact on the State's remuneration.

The beneficiary should have, at any time, the possibility to buy back the equity stake that the State has acquired. To ensure that the State receives appropriate remuneration for the investment, the buy-back price should be the higher amount of: (i) the nominal investment by the State increased by an annual interest remuneration 200 basis points higher than presented in the table below[6] or (ii) the market price at the moment of the buy-back.

As an alternative, the State may sell at any time its equity stake at market prices to purchasers other than the beneficiary. Such a sale requires, in principle, an open and non-discriminatory consultation of potential purchasers or a sale on the stock exchange. The State may give existing shareholders priority rights to buy at the price resulting from the public consultation.

C. Remuneration of hybrid capital instruments

The overall remuneration of hybrid capital instruments must adequately factor in the following elements:

a) the characteristics of the instrument chosen, including its level of subordination, risk and all modalities of payment;

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[5] For instance, if the step-up takes the form of the grant to the State of additional shares. If the State's participation in a beneficiary is 40% as a result of its capital injection, and if the State does not sell its participation before the requested date, the State's participation should increase by at least 0.1x40%=4% to reach 44% four years after the COVID-19 equity injection, and to reach 48% six years after COVID-19 equity injection, resulting in a corresponding dilution of the stakes of other shareholders.

[6] The 200 bps increase does not apply in year 8 and onwards.

b) built-in incentives for exit (such as step-up and redemption clauses); and

c) 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[7]), plus the premium as set out below.

Remuneration of hybrid capital instruments: 1-year IBOR +

	1st year	2nd and 3rd year	4th and 5th year	6th and 7th year	8th year and after
SMEs	225 bps	325 bps	450 bps	600 bps	800 bps
Large enterprises	250 bps	350 bps	500 bps	700 bps	950 bps

The conversion of hybrid capital instruments into equity shall be conducted at 5 percent or more below TERP (Theoretical Ex-Rights Price) at the time of the conversion.

After conversion into equity, a step-up mechanism must be included to increase the remuneration of the State, to incentivise the beneficiaries to buy back the State capital injections. If the equity resulting from the State's COVID-19 intervention is still owned by the State two years after the conversion into equity, the State shall receive an additional share of ownership of the beneficiary in addition to its remaining participation resulting from the State's conversion of the COVID-19 hybrid capital instruments. This additional share of ownership shall be at a minimum 10 percent of the remaining participation resulting from the conversion. The Commission may accept alternative step-up mechanisms provided they have the same incentive effect and a similar overall impact on the State's remuneration.

7. Governance and prevention of undue distortions of competition

In order to prevent undue distortions of competition, beneficiaries must not engage in aggressive commercial expansion financed by State aid and beneficiaries must not take excessive risks. As a

[7] Base rates calculated in accordance with the Communication from the Commission on the revision of the method for setting the reference and discount rates (OJ C 14, 19.01.2008, p.6.), published on the website of DG Competition at https://ec.europa.eu/competition/state_aid/legislation/reference_rates.html

general principle, the smaller the equity stake of the Member State and the higher the remuneration, the less there is a need for safeguards.

If the beneficiary of a COVID-19 recapitalisation measure above EUR 250 million is an undertaking with significant market power on at least one of the relevant markets in which it operates, Member States must propose additional measures to preserve effective competition in those markets.

Beneficiaries receiving COVID-19 recapitalisation measures are prohibited from advertising it for commercial purposes.

As long as at least 75% of the COVID-19 recapitalisation measures have not been redeemed, beneficiaries other than SMEs shall be prevented from acquiring a more than 10% stake in competitors or other operators in the same line of business, including upstream and downstream operations, although there are some exceptions.

State aid shall not be used to cross-subsidise economic activities of integrated undertakings that were already in economic difficulties on 31 December 2019. A clear account separation shall be put in place in integrated companies to ensure that the recapitalisation measure does not benefit those activities.

As long as the COVID-19 recapitalisation measures have not been fully redeemed, beneficiaries cannot make dividend payments, nor non-mandatory coupon payments, nor buy back shares, other than in relation to the State.

As long as at least 75% of the COVID-19 recapitalisation measures has not been redeemed, the remuneration of each member of the beneficiaries' management must not go beyond the fixed part of his/her remuneration on 31 December 2019. For persons becoming members of the management on or after the recapitalisation, the applicable limit is the lowest fixed remuneration of any of the members of the management on 31 December 2019. Under no circumstances shall bonuses, other variable or comparable remuneration elements be paid.

8. Exit strategy of the State and reporting obligations

Beneficiaries other than SMEs that have received a COVID-19 recapitalisation of more than 25% of equity at the moment of intervention must demonstrate a credible exit strategy for the participation of the Member State, 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 exit strategy shall lay out:

a) the plan of the beneficiary on the continuation of its activity and the use of the funds invested by the State, including a payment schedule of the remuneration and of the

redemption of the State investment (together, 'the repayment schedule') and

b) the measures that the beneficiary and the State will take to abide by the repayment schedule.

The exit strategy should be prepared and submitted to the Member State within 12 months after aid is granted and must to be endorsed by the Member State.

Beneficiaries must also report to the Member State on the progress in the implementation of the repayment schedule within 12 months of the schedule's presentation, and thereafter periodically every 12 months.

As long as the COVID-19 recapitalisation measures has not been fully redeemed, beneficiaries of a COVID-19 recapitalisation, other than SMEs, shall, within 12 months from the date of the granting of the aid (and thereafter periodically every 12 months), publish information on the use of the aid received. In particular, this should include information on how their use of the aid received supports their activities in line with EU objectives and national obligations linked to the green and digital transformation, including the EU objective of climate neutrality by 2050.

Member States should report to the Commission annually on the implementation of repayment schedules.

If, six years after the COVID-19 recapitalisation, the State's intervention has not been reduced below 15% of beneficiary's equity, a restructuring plan must be notified to the Commission for approval. The Commission will assess whether the actions contemplated in the restructuring plan ensure the beneficiary's viability, also with a view of EU objectives and national obligations linked to the green and digital transformation. If the beneficiary is not a publicly listed company, or is an SME, the Member State may decide to notify a restructuring plan only if the State's intervention has not been reduced below the level of 15 percent of equity seven years after the COVID-19 recapitalisation.

The information contained in this Information Briefing is of a general nature and does not constitute legal advice. This document was prepared on 9 May 2020 and Pérez-Llorca does not undertake any commitment whatsoever to update or review its content.