

## Hotly Anticipated Extension of EU State Aid Framework to Recapitalizations and Subordinated Debt

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### Key Points:

- EC extends the Temporary State Aid Framework to allow member states to provide recapitalizations to companies adversely affected by the COVID-19 crisis, including airlines, retailers and firms active in hospitality, leisure and transport.
- Governments can now more readily acquire equity in strategically important companies—such as those active in energy, aviation, critical technology, bioscience, pharmaceuticals, defence, transport and aerospace—to protect and support their critical contributions and stave off advances from foreign acquirers.
- Recapitalizations are subject to strict conditions, including as regards its necessity, the member state's remuneration, its exit from the investment and governance of the beneficiary company (including bans on management bonus payments, dividends and certain investments).
- If the member state's interest has not been reduced to within 15 percent of the beneficiary's equity within a set timeframe (six years for publicly listed companies and seven years for other companies), a restructuring plan for the beneficiary will have to be notified to the EC.
- Some private equity and venture capital-backed businesses may in practice be ineligible for recapitalization aid as they may be deemed to already have been "in difficulty" prior to COVID-19 purely as a result of their business or financing model. This is controversial and hotly contested by the industry.
- Should member states wish to provide subordinated debt in amounts exceeding certain specified ceilings (for example, as compared with senior debt, being one third for large enterprises and half for SMEs), the conditions for recapitalization measures will apply.

The European Commission (EC) has now (May 8, 2020) adopted its much anticipated second amendment (Amendment) to the State Aid Temporary Framework, setting out the conditions upon which member states can provide recapitalizations and subordinated debt to companies in need as a result of the ongoing COVID-19 crisis.<sup>1</sup>

### Contact Information

If you have any questions concerning this alert, please contact:

**Davina Garrod**

Partner

[davina.garrod@akingump.com](mailto:davina.garrod@akingump.com)

London

+44 20.7661.5480

**Alaric Green**

Counsel

[alaric.green@akingump.com](mailto:alaric.green@akingump.com)

London

+44 20.7012.9737

**Sebastian Casselbrant-Multala**

Associate

[Sebastian.Casselbrant-Multala@akingump.com](mailto:Sebastian.Casselbrant-Multala@akingump.com)

London

+44 20.7012.9697

The EC recognises that otherwise-viable businesses, temporarily subject to a liquidity crisis due to the COVID-19 outbreak, are facing longer-term solvency issues due to lock-downs and other emergency measures. These losses have decreased their equity, which has in turn stifled their ability to borrow on the markets.

The Amendment aims to ensure that the current disruption to the economy does not result in the unnecessary exit from the market of businesses that were viable before the COVID-19 outbreak. It also complements member states' ability to purchase shares of companies at market price or *pari passu* with private shareholders, which in principle falls outside the scope of European Union (EU) state aid rules. This is particularly relevant for governments wishing to acquire equity in strategically important companies—such as those active in energy, aviation, critical technology, bioscience, pharmaceuticals, defence, transport and aerospace—to ensure that their contributions to the economy are not compromised, and to help scupper acquisitions by potentially hostile foreign buyers, or those with questionable motives.

## Recapitalization Aid

The recapitalization rules cover measures using both equity instruments (in particular, the issuance of new common or preferred shares) and hybrid instruments with an equity component (in particular profit participation rights, silent participations and convertible secured or unsecured bonds).

While member states can notify either general recapitalization schemes or individual aid measures, the EC will request a separate notification of aid to a company above the threshold of €250 million for individual assessment.

### Eligibility for the aid

The beneficiary must meet the following requirements:

- Without the member 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.
- The beneficiary must not be able to find affordable financing on the markets, and the horizontal measures existing in the member state concerned to cover liquidity needs are insufficient to ensure its viability.
- The beneficiary must not already have been in difficulty on December 31, 2019 (within the meaning of the General Block Exemption Regulation (GBER)).

The decision for the Temporary Framework to rely on the GBER definition of an “undertaking in difficulty” has been rightly criticized by the global investment community as it could disqualify many private equity and venture capital-backed businesses from eligibility.<sup>2</sup> In that definition, two of the five circumstances under which a business is deemed to be “in difficulty” relate to where:

- More than half of the subscribed share capital of a limited liability company has disappeared as a result of accumulated losses.
- More than half of the capital of a company—in which at least some members have unlimited liability for the debt of the company—has disappeared as a result of accumulated losses.

Many start-ups, scale-ups and medium-sized businesses supported by private equity and venture capital will have met one or both of these conditions on December 31, 2019, purely as a result of, for instance, relying on equity that is treated as debt or having been in a loss-making growth-phase.

## Conditions to the aid

The Amendment sets a number of conditions to the aid, in order to avoid undue distortions to competition, including:

- **Conditions on the necessity, appropriateness and size of intervention:** The Amendment states that recapitalization aid should only be granted if:
  - No other appropriate solution is available.
  - It is in the common interest to intervene (for example, to avoid social hardship and market failure due to significant loss of employment, the exit of an innovative or a systemically important company, or the risk of disruption to an important service).
  - The aid is limited to enabling the viability of the company, and does not go beyond restoring the beneficiary's capital structure to before the COVID-19 outbreak (i.e., on December 31, 2019).
- **Conditions on the state's entry in the capital of companies and remuneration:** The state must be sufficiently remunerated for the risks it assumes. Beneficiaries must be incentivised to buy out the shares acquired by the member state, via a step-up mechanism that increases the remuneration due to the state (by a minimum of 10 percent each time) if its interest is not reduced over time. The beneficiary should have the possibility to buy back the equity stake at any time, at the higher of the market price, or based on an increasing return specified for each year of the investment in the Amendment.
- **Conditions regarding the exit of the state from the capital of the companies concerned:** The member state and the beneficiary must develop an exit strategy, in particular as regards large companies that have received significant recapitalization aid. If, six years after the COVID-19 recapitalization (or seven years for nonlisted companies), the member state's intervention has not been reduced below 15 percent of beneficiary's equity, a restructuring plan must be notified to the EC for approval.
- **Conditions regarding governance:** Until at least 75 percent of the recapitalization is redeemed, the Amendment imposes strict limits on the remuneration of the beneficiary's management, including a ban on bonus payments. Further, until the relevant member state has exited in full, beneficiaries are subject to bans on dividends and share buybacks. These conditions are intended to incentivize the beneficiaries and their owners to buy out the shares owned by the member state as soon as the economic situation allows. If the beneficiary of a recapitalization measure in excess of €250 million has significant market power on at least one of the relevant markets on which it operates, the member state must in addition propose measures to preserve effective competition in those markets (including structural or behavioural remedies).
- **Prohibition of cross-subsidisation and acquisitions:** The Amendment prohibits beneficiaries from using the aid to support economic activities of integrated

companies that were in economic difficulties prior to December 31, 2019. In addition, until at least 75 percent of the recapitalization is redeemed, the Amendment prevents non-small and medium-sized enterprises (SME) beneficiaries from acquiring a stake of more than 10 percent in competitors or other operators in the same line of business, including upstream and downstream operations (other than in exceptional circumstances, and then only once the EC has approved the acquisition).

Non-SME beneficiaries that have received a recapitalization of more than 25 percent of equity at the moment of the 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 percent of equity within 12 months from the date of the granting of the aid). This plan shall lay out (i) the beneficiary's plan for the continuation of its activity and the use of the funds invested by the member state, including a repayment schedule of both the member state's remuneration and redemption; and (ii) the measures that both the beneficiary and the member state shall take to abide by this repayment schedule. The exit plan should be prepared and submitted to the member state within 12 months after aid is granted, and must be endorsed by the member state.

### **Public transparency and reporting**

The amendment states that member states have to publish details of the identity of the companies that have received recapitalization aid, and the amount, within three months of the recapitalization. Non-SME beneficiaries have to publish information every 12 months on the use of the aid received, including in particular on how the use of the aid received supports the company's activities in line with EU objectives and national obligations linked to the green and digital transformation.

### **Aid in the Form of Subordinated Debt**

The Amendment also enables member states to support companies in financial difficulties by providing subordinated debt (meaning debt instruments that are subordinated to ordinary senior creditors in case of insolvency) on favorable terms. The EC's press release comments that such debt is a less "distortive" measure than equity interventions. However, the Amendment does specify minimum interest rates, noting that the provision of subordinated debt increases the ability of companies to take on senior debt in a manner similar to capital support.

Should member states wish to provide subordinated debt in amounts exceeding certain specified ceilings (for example, as compared with senior debt, being one third for large enterprises and half for SMEs), all the conditions for recapitalization measures set out above will apply.

### **Comment and Next Steps**

The EC's amended Temporary Framework is generally intended to be in place until the end of December 2020. However, because solvency issues may not materialize until the later stages of the COVID-19 crisis, the Temporary Framework will apply in respect of recapitalization measures until July 1, 2021. The EC will assess in advance whether one or both of these dates need to be extended.

The amendment expressly acknowledges that “additional EU level support and funds are necessary to make sure that this global symmetric crisis does not transform into an asymmetric shock to the detriment of member states with less possibility to support their economy and the EU’s competitiveness as a whole.” It further notes that the green transition and the digital transformation will play a central and priority role in ensuring a successful recovery.

During the negotiations of the draft Amendment, the Swedish government warned that placing tight restrictions on when member states must sell off their shares would simply create a deluge of shares and refinancing requirements in a few years’ time. It remains to be seen in practice whether this will be the case, but it is clear from the “exit” provisions in the Amendment that there appears to be no provision for member states to retain significant interests in businesses in the long term.

<sup>1</sup> See the EC’s press release here: [https://ec.europa.eu/commission/presscorner/detail/en/ip\\_20\\_838](https://ec.europa.eu/commission/presscorner/detail/en/ip_20_838). The full amendment, adopted on May 8, 2020, can be found here: [https://ec.europa.eu/competition/state\\_aid/what\\_is\\_new/sa\\_covid19\\_2nd\\_amendment\\_temporary\\_framework\\_en.pdf](https://ec.europa.eu/competition/state_aid/what_is_new/sa_covid19_2nd_amendment_temporary_framework_en.pdf).

<sup>2</sup> See Invest Europe’s ‘Letter to the European Commission on UIDs definition in a state aid context’ dated April 28, 2020, here: <https://www.investeurope.eu/media/3036/pae-invest-europe-letter-on-undertakings-in-difficulty.pdf>.

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