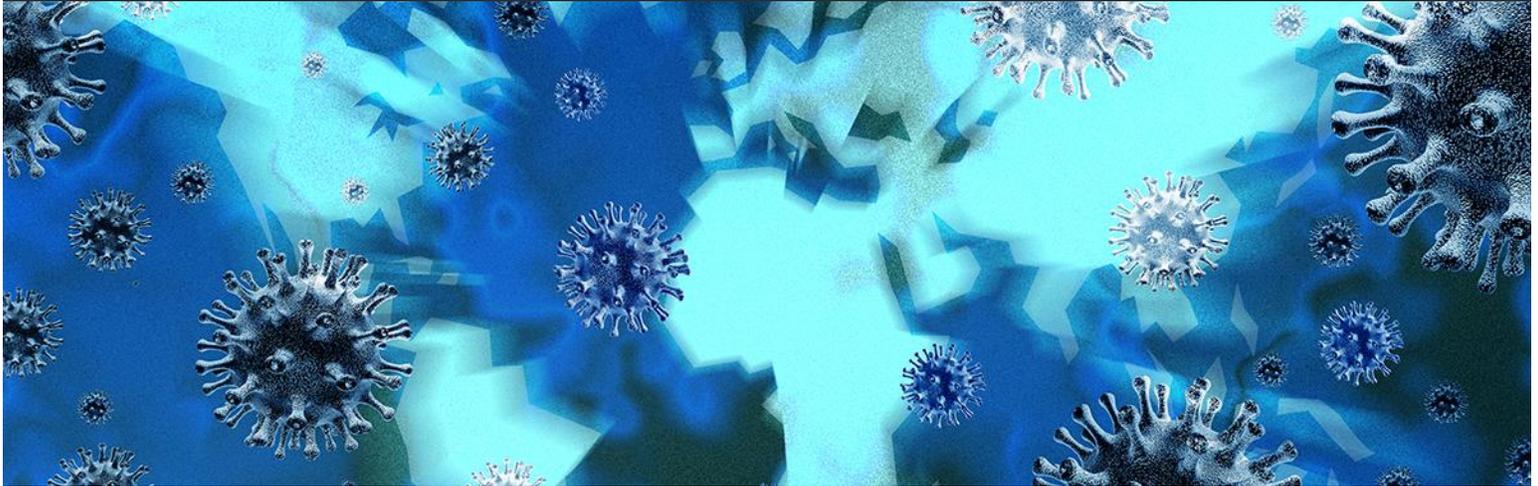


Alert | Health Emergency Preparedness Task Force: Coronavirus Disease 2019 – Focus on Italy



May 2020

EU State Aid: Public Recapitalization and Subordinated Debt to Tackle Effects of COVID-19

On May 8, 2020, the European Commission (the Commission) issued a second amendment to the “*Temporary Framework for State Aid measures to support the economy in the current COVID-19 outbreak*”, for the purpose of allowing Member States to provide **recapitalizations aid in favor of non-financial companies in need**.

Since the adoption – on March 13, 2020 – of the Communication “*Coordinated economic response to the COVID-19 outbreak*”, the Commission has demonstrated its intention to address the shock caused by the health emergency to the global and Union’s economies through a coordinated economic response of Member States and EU institutions.

Against this backdrop, the State Aid Temporary Framework (the Temporary Framework), adopted on March 19, 2020, sat alongside the State aid tools already available to face the collateral effects of the current crisis, thus granting Member States the possibility to provide, on the basis of Article 107(3)(b) TFEU, direct grants, selective tax advantages, state guarantees for loans, subsidized public loans, and short-term export credit insurance. Following the same strategy, the first amendment to the Temporary Framework, issued on April 3, 2020, enabled Member States, *inter alia*, to allow for targeted measures to save jobs and support those sectors and companies mostly affected by COVID-19 (for a more analytic overview on the provisions of the Temporary Framework and its first amendment please refer to GT Newsletter “[EU at the Time of COVID-19](#)”, dated May 5, 2020).

The adoption of the second amendment complements the types of measures already covered by the Temporary Framework and expands the aid tools available for States with a view to authorize targeted public interventions in the form of recapitalization aid to non-financial companies in need. The second amendment was published on May 13, 2020, and will remain in force until December 31, 2020, save for the provisions on recapitalization which will be effective until July 1, 2021.

Preliminary Considerations: A New Effective Tool or Solely a Residual Remedy?

By means of the second amendment, the Commission enables Member States to provide **public support in the form of equity or hybrid capital instruments** to undertakings facing financial difficulties due to the COVID-19 outbreak, provided that “***no other appropriate solution can be found***” and, in any case, “***subject to stringent conditions***” with a view to discourage the spread of distortive effects for competition between undertakings.

The Commission also emphasizes that **recapitalization measures should only be considered as residual remedies**, as there may be more suitable tools existing at EU level to support companies in difficulty. The Commission makes reference, in particular, to the possibility for Member States to acquire strategic companies under fair market terms and prices, to make full use of national investment screening mechanisms or to exercise, where existing, the governmental “**golden powers**”.

Recapitalization Schemes and the Proportionality Test

Recapitalization schemes provided by the Commission aim at ensuring that the disruption of the economy does not result in the unnecessary exit of undertakings that were viable before the COVID-19 outbreak from the market. They may be particularly useful for companies that are not able to sustain more debt and for which the liquidity support provided by the State is not sufficient to ensure their long-term viability.

In detail, the Commission allows Member States to provide “*COVID-19 recapitalization measures*” to both large undertakings and SMEs by using:

1. **equity instruments**, namely the issuance of new common or preferred shares, and/or
2. **hybrid capital instruments**, like profit participation rights, silent participations, and convertible secured or unsecured bonds.

State intervention may take the form of any variation or combination of equity injections and/or hybrid capital, provided that they are the least distortive to competition.

To this purpose, the second amendment **establishes precise eligibility and entry conditions** to be fulfilled by applying the recapitalization measures, consisting of:

- the necessity of the aid, without which the beneficiary would go out of business or would face serious difficulties to maintain its operations;
- the existence of a common interest to intervene. This may relate, *inter alia*, to avoiding social hardship and market failure due to significant loss of employment, the exit from the market of an innovative company or a systemically important company or the risk of disruption to an important service;
- non-availability on the markets of financing at affordable terms and inadequacy of horizontal measures provided by the Member State to cover liquidity needs;

- non-applicability to companies “in difficulty” as of December 31, 2019 within the meaning of Article 2(18) of Regulation (EU) no. 651/2014 (“*General Block Exemption Regulation*”).

States shall grant COVID-19 recapitalization measures only following a **written request** by the prospective beneficiary undertakings. A separate notification to the Commission of individual aid is required only with regard to aid schemes exceeding a threshold of €250 million.

In any case, in order to ensure **proportionality of the aid**, the Commission establishes that “*the amount of the COVID-19 recapitalization 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, i.e. the situation on 31 December 2019*”. However, no specific thresholds in this regard have been specified.

Remuneration Mechanisms for the Public Investment

The Member State, which shall receive **appropriate remuneration for the investment**, is asked to put in place a mechanism to gradually incentivize redemption of COVID-19 recapitalization measures, which should be redeemed as soon as the economy stabilizes. In this regard, the Commission provides for **two remuneration schemes**, to be applied respectively regarding equity instruments and hybrid capital instruments.

Any recapitalization measure granted in the form of equity instruments shall be related to a “**step-up mechanism**” increasing the remuneration of the State, aimed at incentivizing the beneficiary to buy back the State capital injections. This increase in remuneration, which may take, for example, the form of additional shares granted to the State, shall correspond to a **minimum of 10% increase in the remuneration**. The step-up mechanism shall be activated (i) four years after the equity injection if the State has not sold at least 40% of its equity participation resulting from the equity injection, and (ii) six years after the equity injection, if the State has not sold in full its equity participation. If the beneficiary is not a publicly listed company, Member States may decide to implement each of the two steps one year later.

Regarding hybrid capital instruments, the Temporary Framework sets specific values of remuneration different for SMEs and large enterprises for each of the eight years following the recapitalization.

The Commission may accept alternative remuneration 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.

Exit Strategy of the State from the Participation Resulting from the Recapitalization

Beneficiaries other than SMEs that have received a COVID-19 recapitalization of more than 25% of equity must demonstrate a **credible exit strategy** for the participation of the Member State, save for the case in which 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 should be prepared and submitted to the Member State within **12 months** following the granting of the aid and must be endorsed by the State.

If within six years following the COVID-19 recapitalization the State’s intervention has not been reduced below 15% of beneficiary’s equity, a restructuring plan for the beneficiary must be notified to the Commission.

Governance and Prevention of Undue Distortions of Competition

The Commission establishes certain conditions and sets some restrictions regarding governance of undertakings in order to limit the potential distortive effects on competition and to encourage the beneficiaries and their owners to buy out the shares owned by the State as soon as the economy will be stabilized.

Firstly, as long as the COVID-19 recapitalization measures have not been fully redeemed, **beneficiaries cannot make dividend payments, nor buy back shares**, other than in relation to the State.

Furthermore, as long as at least 75% of the COVID-19 recapitalization measures have not been redeemed:

- beneficiaries other than SMEs are in principle prevented from acquiring a more than 10% stake in competitors or other operators in the same line of business;
- the remuneration of each member of the beneficiaries' management must not go beyond the fixed part of his/her remuneration on December 31, 2019, and must not include any bonus or other variable or comparable payment.

Subordinated Debt

The Commission allows Member States to grant subordinated loans, provided the amount of subordinated debt shall not exceed the following thresholds:

- two-thirds of the annual wage bill of the beneficiary and
- 8.4% of the beneficiary's total turnover in 2019 (12.5% of the beneficiary's turnover for SMEs).

The loans must be granted at reduced interest rates for a maximum of six years.

Takeaways

The scope of the Commission's intervention is to mitigate the socio-economic impact of the COVID-19 outbreak by establishing a proper framework to be applied across a wide range of industrial sectors, in line with EU State aid rules. The adoption of this strategy responds to the flexibility needs of Member States, to which the Commission granted certain room for *manoeuvre* in assessing the compliance with the new State aid framework. This is the case, for example, of the power granted to States to evaluate the necessity of the aid as well as to assess the existence of a common interest to intervene in relation to such circumstances in which the "*risk of disruption to an important service, or similar situations*" could justify a State's intervention in situations even where there is no market failure.

However, the flexibility provided for Member States does not ensure that supporting measures will actually be addressed to the undertakings and sectors mostly affected by the crisis. Only those Member States having a budgetary ability to provide State aid will make recourse to these measures of public support, by deciding autonomously which company and industry aid. This threat has been recognized by the Commission Vice-President Margrethe Vestager, who urged the need 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 help their industry and the EU's competitiveness as a whole*". According to Commissioner Vestager, the existence of significant differences among the levels of aid granted by various Member States may cause distortion in "*the bloc's single market*" as it may hamper the common level playing field. For instance, she evoked a scenario where a company first receives aid from a given Member

State and then uses the liquidity received in order to acquire shares in companies from other Member State that received less or no aid.

Additionally, during the last two months, the Commission has approved 107 State aid measures, for an overall amount of €1.9 trillion in State aid. In particular, from March 12 to May 15, 2020, 103 measures were granted under the Temporary Framework while the remaining ones were allowed pursuant to Article 107(3)(b) TFEU, namely in the form of “*aid to make good the damage caused by natural disasters or exceptional occurrences*”.

This data may demonstrate that the need for liquidity is pushing a number of Member States to support and take advantage of the measures provided by the Temporary Framework, with the effect of obliging the Commission to accelerate the in-depth investigations generally needed before approving an aid plan.

** This GT Alert is limited to non-U.S. matters and law.*

For more information and updates on the developing COVID-19 situation, visit [GT's Health Emergency Preparedness Task Force: Coronavirus Disease 2019](#).

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