EU Expands Temporary Framework For State Aid to Allow Recapitalization

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On May 8, the European Commission (EC) approved new measures under the Temporary Framework for State Aid, which allow Member States to purchase equity and subordinated debt from non financial companies. The EC will allow recapitalization measures through June 30, 2021, a time period six months longer than other measures under the Temporary Framework.

The European Commission adopted the Temporary Framework for State aid on March 19. The initial framework allows Member States to provide direct grants, selective tax advantages, and advance payments to companies, in addition to allowing public guarantees on loans and subsidized public loans to companies.

The EC adopted the first amendment to the framework on April 3. The first amendment allows Member States to grant aid for coronavirus-related research; or provide support for construction of testing facilities or production of supplies related to the COVID-19 outbreak. Member States can provide targeted support to companies through tax or social security contribution deferrals and wage subsidies.

The second amendment allows Member States to provide public support to companies in the form of equity or hybrid capital instruments. Recapitalization can be in the form of equity or hybrid capital instruments. This includes new common or preferred shares, profit participation rights, silent participations, and convertible secured or unsecured bonds.

Under the Treaty on the Functioning of the European Union (TFEU), Member States that take equity stakes in strategic companies by buying existing shares at market price, or invest pari passu with private shareholders, are not considered to have provided State aid.

The EC established a set of conditions for the use of recapitalization measures related to appropriateness, remuneration, exit strategy, governance, and cross-subsidization or acquisition of competitors.

Appropriateness

Recapitalization should only be used if there is no other appropriate solution and should only be used to ensure the viability of the company. In order to be eligible for recapitalization aid, a beneficiary must not be able to find affordable financing on the market. Aid should not go beyond restoring the company's pre-COVID-19 capital structure, and companies that were considered in difficulty as of December 31, 2019, are not eligible.

Remuneration

Member States must be sufficiently remunerated for the risks assumed through recapitalization.

Equity Instruments

For equity instruments, the price paid by the Member State cannot exceed the average share price of the beneficiary over the 15 days prior to the request for assistance. If the company is not publicly traded, the price will be based on an estimate of the market value established by an independent expert.

Recapitalization measures should include a step-up mechanism to increase the remuneration of the State to incentivize a beneficiary to buy back the State's equity investment. The step-up mechanism can be in the form of additional shares or other mechanisms. The step-up mechanism will be activated if the State has not sold at least 40% of its participation after four years for publicly-listed companies or five years for private companies. If the State has not sold its participation in full after six years for publicly-listed companies or seven years for private companies, the step-up mechanism will be activated again. The step-up mechanism will increase the State's share by at least 10%. For example, if the State's stake is 40% after four years, the participation will increase by at least 4 percentage points. Hybrid capital instruments converted to equity will also be subject to the step-up mechanism.

Hybrid Capital Instruments

Remuneration for hybrid capital instruments must take into account the level of subordination, risk, payment modalities, incentives to exit, and an appropriate benchmark interest rate. Hybrid capital instruments must pay a minimum of the 1-year interbank offered rate (IBOR) plus the rate from the following table:

Recipient Type	Year 1	Years 2-3	Years 4-5	Years 6-7	Year 8 and after
Small and medium-sized enterprises	225 bps	325 bps	450 bps	600 bps	800 bps
Large Companies	250 bps	350 bps	500 bps	700 bps	900 bps

Hybrid capital instruments can be converted to equity.

Governance

Companies are banned from share buybacks and dividends for as long as the Member State has an equity share. In addition, companies must adhere to a strict limitation on management compensation, including a ban on bonus payments, as long as 75% of the recapitalization is outstanding. Companies are also banned from t

Member states will be required to report the identity of the beneficiaries of recapitalization measures within three months. The EC encourages but does not require Member States to incorporate a focus on green or digital transformation in recapitalization measures. However, large companies will be required to annually report on how the aid is used, specifically related to the EU objectives of green and digital transformation.

Preventing Distortion of Competition

If recapitalization of a single beneficiary with significant market power exceeds EUR 250 million, the Member State will be required to take additional action to preserve competition in the market. In addition, large companies receiving recapitalization support are not permitted to acquire more than a 10% stake in competitors, companies in the same line of business, or upstream and downstream suppliers, as long the State retains at least 75% of its stake.

Exit Strategy

A Member State can sell its equity stake at market prices to buyers other than the beneficiary at any time after the initial investment.

Large companies that receive recapitalization equal to at least a 25% equity stake must develop and submit an exit plan for the participation of the State unless the State's stake is reduced to less than 25% after one year. The exit plans must include a planned payment schedule for the remuneration and the redemption of State investment. Beneficiaries are required to submit plans within 12 months of receiving aid, and the Member State is required to approve the plan.

If the Member State's stake is 15% or greater after six years for a publicly-listed company or seven years for all other companies, the EC will require a restructuring plan for the beneficiary.

Subordinated Debt

The second measure in the amended Temporary Framework allows Member States to buy subordinated debt. In such cases, the State's position is subordinated to that of ordinary senior creditors in insolvency proceedings. Subordinated debt provided to companies above the established limits for aid to a beneficiary will be subject to the conditions for recapitalization. For large companies, aid in excess of two-thirds of the annual wage bill or 8.4% of the total turnover in 2019 will be subject to the recapitalization conditions. For small and medium-sized enterprises, the limit is either the full annual wage bill or 12.5% of the total turnover in 2019. Subordinated debt cannot be converted to equity while a company is a going concern.

The following table provides a summary of the measures of the Temporary Framework for State Aid, which was adopted on March 19 and amended on April 3 and May 8.

Date	Included Measures
March 19	1. Direct grants, selective tax advantages and advance payments up to EUR 800,000 2. State guarantees for loans taken by companies from banks 3. Subsidized public loans with favorable interest rates to companies 4. Safeguards for banks that channel State aid to the real economy 5. Short-time export credit insurance
April 3	1. Support for COVID-19 related research and development 2. Support for the construction and upscaling of testing facilities 3. Support for the production of products relevant to the COVID-19 outbreak 4. Targeted support in the form of deferral of tax payments or social security contributions 5. Targeted support in the form of wage subsidies for employees 6. Expands the provisions in the initial temporary framework, allowing companies to receive up to EUR 800,000 in aid through zero-interest loans, 100% guarantees
May 8	1. Recapitalization of nonfinancial companies through equity and hybrid equity instruments 2. Support to companies through subordinated debt at favorable terms