LEGAL ALERT

TEMPORARY FRAMEWORK FOR STATE AID IN THE CONTEXT OF COVID-19

EXPANSION TO EQUITY, HYBRID CAPITAL AND SUBORDINATED DEBT

INTRODUCTION

On 19/03/2020 and 04/04/2020, the EU Commission (COM) adopted and expanded the so-called Temporary Framework (TF) in which it significantly flexibilizes, in the current context, the EU State aid rules normally applying to liquidity aid. This flexibility and the internal allocation of the necessary resources enabled the COM to rapidly approve (so far more than 100) liquidity aid schemes notified by Member States[1] (MS), so that they could address immediate liquidity risks in their economies in a swift and effective way.

INITIAL VERSION AND FIRST AMENDMENT

The TF, as amended on 04/04/2020, covers the following **main liquidity aid measures**[2] described in more detail in the **table below**:

1 The TF is not self-executing. Unlike under block-exemption regulations, liquidity aid measures cannot be directly implemented just because they fulfil the criteria set out in the TF. Member States continue to require Commission approval before they can implement these measures.

2 The sections concerning *(i)* short-term export credit insurance (3.5.), *(ii)* aid for investments in research and development, testing and upscaling infrastructures and products relevant for the combat of COVID19 (3.6.−3.8.) and *(iii)* deferrals of tax and social security contributions and wage subsidies to avoid lay-offs (3.9., 3.10.) will not be addressed in this note.

- **"Easy fix – solutions"** (including **all possible types of aid**, *e.g.*, grants, tax or payment advantages, commission-less guarantees covering 100% of underlying loan, interest-free loans, subordinated debt, equity, etc.)**, not subject to any significant requirements, up to EUR 800k per undertaking** (EUR 120k for fishery and aquaculture; EUR 100k for primary agricultural production) (section 3.1.);

- **Subsidised guarantees on loans** subject to conditions relating to maximum duration of guarantee and loan, maximum guarantee coverage and loan amount and minimum guarantee premiums (section 3.2.);

- **Subsidised interest rates/loans** subject to conditions relating to maximum maturity, maximum loan amount and minimum interest rates (section 3.3.).

Apart from the "easy-fix solutions", the main liquidity aid measures foreseen under the TF concern **access to finance (debt)**, to be taken on until the end of 2020, and therefore measures to address **immediate and more limited liquidity needs**.

However, certain undertakings may face **greater and/or longer-term solvency issues**, namely those for which the lockdown measures resulted in a decrease or suspension of production and in a demand shock (*e.g.*, airlines). The resulting **losses reduce** their **equity and ability to take on additional finance**, thus increasing the risk of insolvency, which may disrupt supply chains and affect the whole of the EU economy for a longer period.

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As there may therefore be a **need for** MS to provide public support in the form of **equity**, **hybrid capital** instruments and/or other non-equity measures which increase the capacity to take on debt, such as **subordinated debt**, the COM proposed to include these measures in the TF. However, as these instruments are more valuable for recipients, tend to have a greater magnitude and are typically granted to fewer undertakings, they are, from the viewpoint of the COM, more distortive of competition than the other types of liquidity aid foreseen under the TF and therefore require qualified limitations and conditions. The resulting complexity of discussions between COM and MS is indicated by the fact that, although the consultation was initiated on 09/04/2020, it took until 08/05/2020 for the amendment to be adopted.

SUBORDINATED DEBT

In terms of value for the recipient, risk for the issuer and potentially distortive effects, **subordinated debt** is in the area between senior debt and hybrid capital instruments. The Commission therefore integrated this instrument in section 3.2. on subsidised interest rates/loans, but added a risk mark-up to the minimum interest rates (+ 200bps), reduced the maximum loan amounts (to ⅓ for large enterprises (LE) and ½ for SME) and determined that, if these amounts are exceeded, the compatibility of the measure will be assessed under the rules for equity and hybrid capital.

EQUITY AND HYBRID CAPITAL

The rules on the provision of **equity** (such as issuance of new common or preferred shares) **and hybrid capital** (such as profit participation rights, silent participations, convertible bonds) not covered by section 3.1. are set out in section 3.11.

The rules apply to both **schemes and individual aid measures**. However, even if granted based on a scheme already approved under section 3.11. TF, individual recapitalisations (recaps) of > EUR 250 million must (also) be notified to and approved by the COM.

As the TF in general, section 3.11. applies to **non-financial undertakings** (*i.e.*, to the real economy, excluding credit and financial institutions) **of any size** (SME and LE) that did not qualify as undertaking in difficulty on 31/12/2019. However, while other types of aid foreseen under the TF can be granted until 31/12/2020, section 3.11. foresees the **possibility to grant recaps until 30/06/2021**.

The **main criteria** are set out in more detail in the **table below**. Essentially, recaps:

- Must only be granted to undertakings that would otherwise exit business or face serious difficulties to maintain its operations (measures of last resort);

- Must not exceed the minimum needed to ensure the viability of the beneficiary and not go beyond restoring its capital structure on 31/12/2019;

- Must be subject to stringent conditions as regards the entry and exit by the state, the remuneration of the capital injected, the beneficiary's corporate governance and measures to limit undue distortions of competition; and

- Are recommended to be designed in a way that supports EU objectives and national obligations linked to green and digital transformation.

Several requirements, including on remuneration, corporate governance and limitation of undue distortions of competition, are **open to different interpretations**. It will likely take some COM decisions applying these rules until there is greater clarity in this regard.

Finally, as the TF in general, **section 3.11.** is **not exhaustive**. Alternative approaches, to the extent not already expressly permitted in section 3.11. itself, will be assessed by the COM directly based on Article 107(3)(b) TFEU.

Section	Measure	Dimension	Main conditions
3.1.	**“Easy fix”** **All measures, incl. grants, guarantees, loans, equity, hybrid capital**	Up to – EUR 100k in agriculture – EUR 120k in fishery and aquaculture – EUR 800k in all other sectors – Where activities in different sectors with different ceilings, separation of accounts or similar to ensure that each individual ceiling respected; in addition, the higher of the individual ceilings serves as overall ceiling	Essentially none (apart from some conditions concerning aid to undertakings active in agriculture or fishery and aquaculture)
3.2.	**Subsidised guarantees**	**Guarantee**: – Maximum duration of ≤ 6 years – If losses sustained proportionally and under same conditions by bank and state: coverage of ≤ 90% of loan principal outstanding at any time – If losses first attributed to state: guarantee coverage of ≤ 35%	**Guarantee**: – Commission: ≤ 25-200bps, depending on type of undertaking, guarantee coverage and year of term (rate progressive; flat premium also possible)
		Loan: – To finance investment and/or working capital needs – Maximum maturity of ≤ 6 years – Maturity beyond 31/12/2020: loan principal must not exceed higher of *(a)* 2 x 2019 annual wage bill, *(b)* 25% of 2019 turnover, *(c)* self-certified liquidity needs for 18 (SME) or 12 (LE) months following granting of loan – Maturity until 31/12/2020; loan principal can be higher, if duly justified and proportionate	**Loan**: – No specific requirements concerning remuneration – Section 3.4. requires safeguards ensuring that advantages involved in guarantee passed on, as far as possible, to final beneficiary (“Section 3.4. Requirements”)
3.3.	**Subsidised loans**	**Senior debt**: – Requirements identical to those for loans backed by state guarantee under section 3.2.	**Senior debt**: – Interest rate: (i) base rate (1y-IBOR or equivalent as published by Commission) + spread of ≤ 25-200bps, depending on type of undertaking and year of maturity (rate progressive; flat premium also possible) – Section 3.4. Requirements
		Subordinated debt: – Requirements identical except loan principal ceilings (in excess of which measure assessed per section 3.11. on recapitalization measures): *(a)* 1x (SME) or 2/3 (LE) of 2019 annual wage bill, or *(b)* 12.5% (SME) or 8.4% (LE) of 2019 turnover.	**Subordinated debt**: – Interest rate = minimum rates for senior debt + 150bps (SME) and 200bps (LE) – Section 3.4. Requirements

<table>
<tr><th colspan="3">Recapitalisation measures (section 3.11.)</th></tr>
<tr><td>Eligibility of beneficiary (B)</td><td colspan="2">– Without recap, B would exit business or face serious difficulties to maintain its operations, in light of deterioration of debt to equity ratio or similar indicators;
– It is in the duly substantiated common interest to intervene, e.g., avoidance of social hardship due to significant loss of employment, exit of innovative or systemically important company, risk of disruption to important service, or similar;
– B not able to finance itself on market at affordable terms and horizontal liquidity measures existing in MS insufficient to ensure its viability;
– B has submitted written request for the recap.</td></tr>
<tr><td>Proportionality</td><td colspan="2">– recap (+ other corona-aid received or planned) not to exceed minimum needed to ensure B’s viability nor go beyond restoring B’s capital structure on 31/12/2019;
– selected recap instrument and conditions attached thereto to be appropriate to address B’s recap needs and the least distortive to competition.</td></tr>
<tr><td rowspan="3">Remuneration</td><td>Equity</td><td>Hybrid capital</td></tr>
<tr><td>– Price paid by MS ≤ Ø share price over 15 days preceding request for recap (if B not listed, market value to be established by expert or other appropriate means);
– Step-up mechanism increases remuneration by ≥ 10% (e.g., additional shares): (i) 4y after recap if MS not sold ≥ 40% of equity injected; (ii) 6y after recap if MS not sold all equity injected (if B not listed, 5y/7y);
– B may buy back equity injected by MS at any time for the higher of: (i) nominal recap + annual interest of 1y IBOR + spread ≥ 425bps – 1150bps; and (ii) market price at buy-back;
– MS may sell equity injected at any time at market price to purchasers other than B, in principle via open and non-discriminatory consultation of interest or stock-exchange.</td><td>– Until conversion into equity, ≥ 1y IBOR + spread ≥ 225bps - 950bps, depending on type of undertaking and # of year of participation (progressive);
– Conversion into equity at ≥ 5% below TERP (Theoretical Ex-Rights Price) at conversion;
– After conversion, inclusion of step-up mechanism activated if equity resulting from the conversion still owned by MS 2y after conversion.</td></tr>
<tr><td colspan="2">– Alternative methodologies possible if ≥ incentive effect & MS remuneration</td></tr>
<tr><td>Governance & mitigation of competition distortions</td><td colspan="2">– Until recap not fully redeemed, B (i) prohibited from advertising recap for commercial purpose; (ii) prohibited from paying dividends and non-mandatory coupons and from buying back shares other than in relation to MS; (iii) to have clear account separation to any activities that were in difficulties on 31/12/2019;
– Until recap not redeemed by ≥ 75%, (i) B (LE) not to acquire ≥ 10% in competitors or others in same line of business, incl. up-/downstream, except if up/downstream operator, necessary for B’s viability and approved by COM; (ii) remuneration of each member of B management ≤ fixed part of remuneration on 31/12/2019; no bonuses, nor other variable or comparable remuneration.
– If recap > EUR 250m and B significant market power, MS to propose additional measures to preserve effective competition, in particular structural or behavioural commitments foreseen in COM’s Merger Remedies Notice.</td></tr>
<tr><td>Exit strategy</td><td colspan="2">– If B LE, recap > 25% of B’s equity at injection and not reduced to < 25% within 12 months, B to submit to MS for endorsement exit strategy for MS stake;
– B to report to MS, and MS to COM, yearly on implementation of repayment plan and compliance with rules on governance and mitigation of competition distortions
– If MS stake not reduced to < 15% of B’s equity within 6y (if B not listed: 7y) after recap, MS to notify restructuring plan to COM for approval;
– Until recap fully redeemed, B (LE) to annually publish info on how their use of the aid supports EU objectives linked to green and digital transformation.</td></tr>
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