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State aid rules applicable to COVID-19 recapitalizations

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The first State aid measures authorized by the European Commission (Commission) following the COVID-19 outbreak were aimed at helping companies to cover their immediate liquidity needs, mainly through bank loans guaranteed by EU Member States.

The significant losses incurred by companies as a result of the lockdown will compel some of them to increase their capital in order to finance their operations, satisfy financial ratios to obtain financing from banks or issue bonds and/or to avoid entering into insolvency proceedings.

Some companies will ask Member States, their affiliated entities (State agencies) and/or local authorities (collectively referred to as the "State") to participate in their capital increase. Furthermore, outside of capital increases, States will acquire shareholdings in companies in financial difficulty.

If a State acquires shares at market price or invests *pari passu* with private shareholders, its investment does not qualify as State aid. For instance, in 2014, the Commission considered that the French State's acquisition of a 14% stake in PSA Peugeot Citroen did not amount to a State aid since a Chinese car manufacturer simultaneously invested the same amount of money under the same conditions.

However, if a State acquires existing shares, subscribes for new shares or other capital instruments at other than market conditions, it will need to comply with the requirements set forth by the Commission in the amendment of 8 May 2020 to the COVID-19 Temporary Framework adopted on 19 March 2020.

These requirements apply to both State aid schemes and individual aids that must be notified and cleared by the Commission before being implemented (individual aids must be notified if they depart from such approved schemes or exceed €250 million). Furthermore, equity investments may be subject to merger control clearances if they lead States to acquire exclusive or joint control over companies.

1. Key Principles aimed at Discouraging (Long-Term) State Intervention

The Commission considers that State recapitalization distorts competition much more than State guarantees for bank loans since (i) there is an immediate transfer of State financial resources; (ii) it necessarily benefits fewer companies; and (iii) States are "deep pocket" investors, which reassures investors, banks and clients in the long-term.

The Commission has therefore enacted very strict conditions aimed at discouraging companies from relying on State recapitalization or, alternatively, encouraging them to redeem State recapitalization measures as quickly as possible:

a) State recapitalization should be a last resort solution if no other option is available;

b) Recapitalization must not exceed the minimum needed to ensure the viability of companies and should not improve their financial ratios compared to the ones predating the COVID-19 crisis;

c) The State must receive remuneration that increases over time, in order to incentivize companies and their shareholders to redeem the State recapitalization measures as quickly as possible;

d) Companies cannot pay dividends (or buy back shares other than those of the State) as long as the State "COVID-19" recapitalization measures have not been fully redeemed;

e) Companies must not engage in aggressive commercial expansion and are prohibited from advertising the recapitalization measures for commercial purposes;

f) Companies are prohibited from acquiring a stake of more than 10% in competitors, suppliers or clients, which will prevent them from participating in potential market consolidations, as long as at least 75% of the State "COVID-19" recapitalization measures have not been redeemed (except in the case of SMEs or where the acquisition of a stake in operators upstream or downstream is necessary for ensuring the acquirer's viability);

g) Companies with significant market power (i.e., with market shares of at least 30%/40%, depending on the relevant markets) may benefit from State recapitalization measures above €250 million if they make structural or behavioral commitments which are sufficient to preserve effective competition, such as the divestment of subsidiaries or assets or the termination of long-term exclusivities[1]; and

h) Management can receive neither bonus (nor other variable remuneration elements), nor higher remuneration than the fixed part already in place as at 31 December 2019 (new comers will be capped to the lowest fixed remuneration of equivalent managers of the company), as long as at least 75% of the State "COVID-19" recapitalization measures have not been redeemed.

[1] In accordance with the Commission's notice on remedies acceptable under the EU Merger Regulation.

2. Eligibility

The recapitalization measures must fulfil the following conditions:

a) Without State intervention, companies would go bankrupt or face serious difficulties;

b) No financing is available on the market at affordable terms;

c) Companies were not already in difficulty on 31 December 2019;[2] and

d) The State intervention enables the avoidance of job losses and market failures (systematically important or innovative companies, risk of disruption in a sector, etc).

3. Recapitalization Measures

The recapitalization measures can take the form of newly-issued shares, convertible bonds or other hybrid capital instruments.

However, the Commission clearly states its preference for subordinated debt (i.e., subordinated to ordinary senior creditors) that cannot be converted into equity and, on this basis, distorts competition to a lesser degree.

The amount of recapitalization must not exceed the necessary minimum and should not improve companies' financial profile compared to the situation as at 31 December 2019. Nor can it be used to cross-subsidize group subsidiaries that were already in economic difficulties.

4. State Remuneration

The State must receive remuneration that is appropriate and increasing over time in order to incentivize companies and their shareholders to redeem the State recapitalization measures.

Equity

The price paid by the State for the shares shall not exceed companies' average share price over the 15 days preceding the request for the State intervention (for non-publicly listed companies, independent experts must establish companies' market value).

In the absence of payment of dividends, the remuneration can take the form of additional shares or convertible bonds granted to the State and not to other shareholders. The remuneration of the State must be increased by at least 10% at two points in time after the COVID-19 capital injection – i.e.

a) After four years for publicly listed companies, and five years for others, where the State has kept at least 60% of its shareholding resulting directly from the COVID-19 capital increase;

b) After six years for publicly listed companies, and seven years for others, where the State has not fully sold its "COVID-19 shareholding".

Furthermore, the State's shares must be "on sale" at any time to:

a) Recipient companies at the higher amount of (a) the market price or (b) the State's investment increased by growing annual interest rates set by the Commission in the amended Temporary Framework (based on 1-year IBOR; pt. 66);

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[2] The Rescue and Restructuring Guidelines apply to companies that were already in difficulty at that time.

b) Investors at market price, normally through an open and non-discriminatory process (with potential priority rights for existing shareholders).

Hybrid capital instruments

Their minimum remuneration must, until conversion, be at least equal to the base rate (1-year IBOR) plus the premiums set in the amended Temporary Framework (pt. 66).

The conversion into equity must be conducted at 5% or more below the 'theoretical ex-rights price' (TERP) and the State's remuneration must increase over time to incentivize stake holders to buy back the State's injections.

5. Exit Strategy and Reporting

Companies (except for SMEs) whose State "COVID-19 shareholding" exceeds 25% must provide a credible exit strategy, including a plan on the use of the State funds, a payment schedule for the State remuneration and a schedule for the redemption of the State investment. Information on the use of the State funds must be updated every 12 months.

Furthermore, a restructuring plan compliant with the Rescue and Restructuring Guidelines must be notified to the Commission where the State "COVID-19 shareholding" has not been reduced below 15% six years after the recapitalization as regards publicly listed companies and seven years, thereafter, as regards non-publicly listed companies or SMEs.

6. Embedding EU policy objectives related to green and digital transformation

The Commission tries to weave together in its amended COVID-19 Temporary Framework EU policy objectives in the area of green and digital transformation with EU State aid control.

The Commission encourages Member States to design national support measures reflecting objectives related to green and digital transformation. As long as aids have not been fully redeemed, companies (other than SMEs) have to periodically report on their use and compliance with their responsibilities linked to the green and digital transitions.

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