

Espirito Santo controlled management: a flash in the pan?

Martine Gerber writes a sequel to last year's contribution as the case moves forward, and explains the details of the claw-back mechanism



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It took decades for the Espirito Santo family to build a multinational financial group that was worth about €8 billion and whose fortune was swept away in just a year.

Espirito Santo's financial collapse is one of the worst 21st century banking failures, which has left thousands of creditors stranded and pushed many trustees to find their way through the tangle of cross-funding within the group. Many entities, from the Bank of Portugal to public prosecutors, are currently investigating the causes of the group's failure and the stakes of being condemned for fraudulent practices or the misuse of company assets are quite high. Unfortunately, Espirito Santo's Luxembourg holding companies have played an important role in the group's financial disaster. The controlled management procedures initiated by the Luxembourg entities in 2014 did not prevent their bankruptcy but even paved the way for their inevitable demise.

Unsuccessful use of controlled management to rescue Luxembourg holding companies

Controlled management¹ did not succeed in avoiding the initiation of bankruptcy proceedings for Espirito Santo's Luxembourg holding companies.

Although the Luxembourg Court initially accepted some of the holding companies' petitions for controlled management, the court appointed expert, further to examining the companies' financial standing and whether

they were already under cessation of payments, apparently and unequivocally deemed their applications impossible.²

Consequently, the initiation of the controlled management procedure does not prevent a business entity or the court from initiating bankruptcy proceedings if the following two cumulative conditions are met: the inability to pay one's creditors and the inability to raise credit. If, under such circumstances, the company's directors fail to file bankruptcy proceedings, they may be held liable.³

As for ESI, ESFIL, ESFG and ESC the bankruptcy conditions were fulfilled, the court rejected their controlled management application and bankruptcy proceedings were opened within one week.

For Rio Forte a first judgment rejected the controlled management application on 17 October 2014, whereas bankruptcy was declared on 8 December 2014. As more than one month elapsed between the two decisions, it is possible to suppose that the directors and shareholders of Rio Forte were reluctant to file a petition for bankruptcy and have tried by all possible means to find an alternative.

Once the various Luxembourg Espirito Santo entities were declared bankrupt, several trustees were appointed. The Luxembourg District Court appointed different trustees for ESFIL and ESFG, then for ESI, ESC and Rio Forte, whose mission was to realise the assets of the bankrupt companies and to pay off their debts to the largest extent possible.

The trustees attempted to provide information and cooperate by means of a common website that was created on this occasion (www.espiritosantoinsoleucencies.lu). The way the court has handled these bankruptcies may raise some questions and concerns. As a matter of fact, the court appointed an expert who investigated the financial standing of ESI, ESC and Rio Forte and upon the acceptance of their controlled management petition he was also appointed as their trustee. Rather than opting for a time saving and effortless choice, if the court had appointed a new trustee, perhaps matters could have been investigated differently.

In addition, despite the creditors' various informal requests, within 15 days as of the declaration of bankruptcy the court did not appoint a creditors' committee composed of three members chosen amongst the debtor's main unsecured creditors in order to assist the trustee and monitor the bankruptcy operations. The creditors' committee carries out a purely advisory role. Moreover, so far the trustees have only communicated through their website and still have not organised a sort of general assembly of creditors with a Q&A session as it was done for the Madoff cases. The trustees are obviously trying to understand the numerous facets of these highly complicated cases; however, modern justice in Luxembourg is certainly not being reflected by this sort of behaviour.

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To claw-back or not to claw-back?

The courageous trustee of ESFG filed two lawsuits with the Lisbon Administrative Court on 30 November 2014, which challenged, among others, the creation of Novo Banco and the resolution measure applied to BES by the Bank of Portugal. Obviously, in Portugal the separation of bad debts was the stumbling block of the BES restructuring which saved the unsecured creditors with cash in the bank and purely applied the principle “too big to fail”. Nevertheless, for creditors of the Luxembourg entities the separation of bad debts implies the loss of assets and more problems in challenging operations during the claw-back period.⁴

In principle the claw-back period (*période suspecte*) is fixed, at the judge’s sole discretion, six months plus ten days before the date of the judgment declaring the bankruptcy. Further to the trustee’s requests and the pressure put on by the creditors, by means of a second judgment, the court changed the beginning of the claw-back period to January 2014 for ESFIL, ESFG and ESI.

It will be interesting to observe whether the trustees of the Espirito Santo case will avail themselves of their right to declare null and void certain preferential transfers or fraudulent conveyances that a debtor could have made to a creditor during the claw-back period. In this regard, some transactions must be declared null and void, if they were undertaken during the claw-back period. Upon the trustee’s request other transactions may be declared null and void by the commercial court, if enough evidence is brought forth to prove that the persons receiving payment from the debtor or entering into a transaction with the debtor had known of the suspension of payments. In the case at hand, this might be what likely happened as quite often the intermediaries worked for BES. Finally, there is a general principle

that all acts or payments made to defraud the creditors will be declared null and void, regardless of the date when they were made.

At the time being, in Luxembourg, the creditors are primarily focused on the claw-back actions that have not yet been launched by the trustees. It is not possible to determine when they will be launched as trustees are not bound by any time-limits imposed by law. For Rio Forte, the claw-back actions might be the sole means to recover assets spread in various entities of the group. The trustees should, however, be cautious and fully evaluate the final consequences of setting aside some particular transactions due to the domino effect that could be triggered by the claw-back actions along with international private law provisions.

Claim declaration: the creditors’ Gordian Knot

The most peculiar aspects of the Espirito Santo case consist in the fact that (i) the vast majority of creditors are unsecured creditors and that (ii) many distressed investors have brought forth several assignments of claims, whose original claim could not always be proved valid due to the systematic lack of supporting documentation.

The bankruptcy judgment instructs creditors to file and prove their claims within a short determined period, in principle 20 days. The judgment also fixes a closing date for the verification of claims and a date for a hearing when the submitted claims will be examined by the court.

Creditors shall file and evidence their claims at the Clerk’s office of the Commercial Court. In practice, creditors are allowed to declare their claims until the closure of the claims verification process. In the bankruptcy judgments of ESI and Rio Forte, the trustees postponed the closing date of the claims verification process twice. Finally, given the numerous claims, the fact that creditors are not based in Luxembourg and the multiplicity

of assignments, the trustees fixed the time-limit to 30 September 2015. However, this date is not a foreclosure date.

The trustees shall thereafter send a notice to the creditors communicating the date fixed by the court to discuss their claim. In principle, all claims may be disputed in a sole judgment. If the latter is impossible, the court pronounces the disjunction, i.e. separates the disputes, in order to examine those which could be pleaded. The court, through the trustees, can set a new date to proceed to a second claims verification process.

At this stage, it is impossible to predict the outcome of the case.⁵ Assignors should file a new claim with the assignment attached thereto and be prepared to be challenged. Therefore, the closure of the Espirito Santo bankruptcy proceedings might still take several years.

In the meantime, the International Monetary Fund reported that the Espirito Santo case raises a number of questions about regulatory and supervisory arrangements and banking group structures in the European Union. It highlights the fact that, contrary to the United States, the regulation and supervision of banking groups in the European Union does not have a dual focus on both banks and their holding companies. Even on the basis of consolidated accounts, the financial problems of the three BES holding companies fell through the cracks and were not detected at an early stage. Therefore, the IMF proposes to introduce the direct regulation of ultimate bank holding companies.

Unfortunately, the episodes of Espirito Santo’s financial saga might still be numerous and we will do our best to update you on its complicated evolution in the near future! ■

Footnotes:

- 1 Governed by the Grand Ducal Decree dated May 24, 1935 see *Eurofenix Autumn 2014*
- 2 It is not possible to assess the content of the expert’s report as it is never communicated to third parties.
- 3 For an application see *Tribunal d’Arrondissement de Luxembourg*, case 192/05, 18/02/2005.
- 4 The Wall Street Journal Europe.
- 5 Country Report June 2015



THE SEPARATION OF BAD DEBTS IMPLIES THE LOSS OF ASSETS AND MORE PROBLEMS IN CHALLENGING OPERATIONS DURING THE CLAW-BACK PERIOD

