

**NOTES ON THE DEFAULT CRISIS OF BANCO ESPÍRITO SANTO AND  
GRUPO ESPÍRITO SANTO**  
**Material Facts, and Strategies to Claim Compensation for Investors**

Westworth & Partners

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**1. Introduction**

This note has been prepared with the purpose of providing preliminary information on the facts regarding the default and material bankruptcy of Banco Espírito Santo (BES) and of a number of companies in Grupo Espírito Santo (GES), as well as an analysis of the legal possibilities for the investors in these bank and companies (shareholders and owners of debt titles, such as bonds and commercial paper) to claim compensation for the damages incurred as a result of those facts.

This is not a legal opinion, and its scope is only of providing Westworth & Partners' clients some general ideas and guidelines regarding their rights under the applicable legal framework. It cannot be construed in any other way than as a preliminary informal analysis, subject to being altered, amended, or changed in the course of a thorough and extensive study by Westworth & Partners while preparing the indemnity claims for its clients.

At the present moment, we are working on the definition of each category of investment instruments related to GES and BES, in order to establish the applicable legal and contractual framework, and jurisdiction (as many of these debt instruments were issued by companies with registered offices in Luxembourg or Switzerland).

In the next paragraphs you will see that the legal stance of BES' shareholders is already clear, but the same does not happen yet with regard to holders of debt instruments.

BES's shareholders have apparently lost all capital invested in the shares, given that, from the information which has been made public, BES's assets are insufficient to pay for its liabilities. Therefore, in the end of the insolvency proceedings, most likely there will be no money to refund the shareholders.

In what concerns the owners of debt instruments: there are some doubts yet about the type of liability that the New Bank is going to acknowledge and accept, and about the allowances which are being set aside, by the New Bank, to face certain types of liabilities, most of them regarding bonds and debt instruments which have been bought by non qualified investors in the retail agencies of Banco Espírito Santo.

Therefore, this preliminary note will focus mainly on the legal solutions available to BES' shareholders, to whom, at the present date, and for the reasons above indicated and better described below, is easier to prepare the guidelines for a compensation claim. We will provide some insights into the situation of certain types of debt owners, but we will enlarge this note in the near future with information concerning that specific point, when we have the answers to a number of questions regarding this group.

## **2. Relevant Facts**

In May / June, BES carried out a share capital increase in the amount of 1.045 M€ which was fully paid-up, with the demand exceeding the offer. The official prospectus of the share capital increase contained several mentions regarding irregularities in GES, and an overall picture of a severe financial situation of Espírito Santo Financial Group (ESFG) the holding company of BES. At the same time, by determination of the Bank of Portugal (the Portuguese Central Bank), this holding company set aside an allowance of 700M€ in order to face damages incurred by clients who had bought debt titles of GES companies.

In July 3 the Bank of Portugal issued a statement affirming that *“the solvability of BES is solid, having been significantly reinforced with the capital increase. The Bank of Portugal has been adopting a number of supervisory measures which consist of specific*

*instructions to ESFG and BES to avoid risks of contagion to the non financial branch of GES”*

In July 10, ESFG announced the suspension of trade of its shares and debt instruments in Lisbon and in Luxembourg (where its registered domicile is located), due to material difficulties in course of its major shareholder Espírito Santo International – ESI (another company also with registered offices in Luxembourg).

It also became public that ESI was considering filing for bankruptcy in Luxembourg, as well as Rioforte, its mother company (a major holding company in Espírito Santo Group, also with registered offices in Luxembourg), and that Banque Privée Espírito Santo (the Swiss based private banking of GES) is failing to repay its clients upon the maturity of some of the products which it has commercialised.

BES issued a statement that day, informing that all losses in which it might incur by exposure to the GES companies were covered by its capital ratio (alleging that it had € 2,1M above the minimum mandatory ratio, and an exposure of €1,18M to GES). This statement was confirmed by the Bank of Portugal.

In 14 July the board of directors of BES was replaced by a group of people appointed by the Bank of Portugal. Vítor Bento - a senior economist which had been director of the company in charge of the Portuguese system of electronic payments (SIBS) - replaced Ricardo Salgado as CEO.

In 18 July, Rioforte filed a request for controlled management (pre bankruptcy procedure) with the Luxembourg authorities and ESFG is out of the PSI20 (the Portuguese Public Stock Market).

In July 23 the Luxembourg courts approved the request for a controlled management of ESI.

In July 24 ESFG filed a request for controlled management with the Luxembourg authorities.

In July 29, the Bank of Portugal issued a statement reinstating that BES’ solvability was assured.

Luxembourg authorities accept the request for a controlled management of ESFG (the holding company which owned 20,1% of BES) and Rioforte.

In July 30 the Bank of Portugal announces that BES incurred in losses of €3.577,3M, most of which, as the Bank of Portugal will later explain on a statement of August 3, were incurred in the second quarter of 2014.

In August 1 BES shares are suspended in the Portuguese Stock Market.

In August 3, the Bank of Portugal issued a statement informing the public that a resolute measure had been enforced on BES, with the following contents and consequences: a new bank (called “New Bank”) is incorporated and authorised to operate in the banking system. All assets, deposits and credits of BES are transferred to the New Bank. The former BES keeps its name, as well as all liabilities indicated in a list that contained all “toxic” products, namely all credits regarding GEC companies. This list can be updated and changed from time to time, by discretion of the Bank of Portugal. Senior BES debt is transferred to the New Bank while other debt remains in BES.

### **3. Shareholders**

Shareholders are the front line of investors who automatically incurred in heavy losses as a consequence of the resolute measure decreed by the Bank of Portugal.

Actually, by direct effect of the decision to create the New Bank to where all BES valuable assets have been transferred, and revoking BES banking license, leaving it with all liabilities and exposure to the debt of GES companies, BES shareholders have virtually lost all money invested in purchasing the shares.

The effect of revoking the banking license is that BES will now enter into winding-up proceedings, where all its assets will be sold in order to pay creditors, and all its credits will be claimed.

The effect of this is that the shareholders cannot bear any serious hopes of having any return on their shares. According with the accounts which have been made public, BES assets are far insufficient to pay for its debts.

However, as we will briefly analyse below, many of BES shareholders - namely those who have bought shares in the capital increase in June, and those who have acquired

them later, in the course of June and July, while the Bank of Portugal was issuing public announcements to the market stating that BES' solvability was assured – may have the possibility of being indemnified by other entities apart from the BES' bankrupt assets.

#### **4. Owners of debt instruments in BES and GES**

This is a large group, with many differences according to each specific type of debt instrument.

Investors owning senior debt instruments have seen their credits assigned to the New Bank, which means that, according to the statements of the Bank of Portugal, will be paid upon the maturity of the titles.

However, junior debt remained with BES, hence investors which own these instruments will have to claim their credits to the bankrupt assets.

There are still, however, some doubts in this regard. The New Bank already stated that it may set aside an allowance to pay credits of holders of instruments of debt issued by GES entities, whenever such payment proves determinant to maintain a relationship of trust with the clients, in conditions to be later defined by the board of directors of the New Bank.

One thing looks certain though: there will be a fundamental distinction between qualified and non qualified investors. Any kind of protection that may be established by the New Bank will only, in principle, apply to non qualified investors.

#### **5. Possible claims**

##### **A. Shareholders**

###### **1. General Guidelines for an indemnity claim**

As mentioned above, BES shareholders are the group which losses are already determined: loss of the capital invested in the shares; and no special mechanism of compensation is designed to refund them. Their only resource is to claim their credits in the bankruptcy proceedings, but BES has far more debts than assets, and,

as its banking license has been revoked, there are no hopes that its activity may in the future generate any cash flow to pay shareholders.

There is the remote possibility that the New Bank is sold for more than the 4.9M€ which have been spent to capitalise it. If that should happen, the surplus would be transferred to BES bankruptcy assets and shareholders might be entitled to a part of it, after all BES creditors were duly paid.

Therefore, the only meaningful option for BES' shareholders to obtain compensation is judicially, claiming for responsibility from third parties for the damages they incurred.

Here we identify four possible targets for a claim for compensation:

- i. BES board of directors: naturally, for as the Bank of Portugal expressly acknowledged, there was a fraudulent scheme to finance the non financial entities of Grupo Espírito Santo, which eventually led to the decapitalization of the bank.

The board of directors knew, or should have known about this fraudulent scheme which ruined the bank. And knowingly, they took the decision of increasing BES share capital, advising the public in general, and worst of all, their retail clients, with whom the bank had a privileged relation of trust, to purchase shares.

- ii. BES's external auditors, KPMG: they had, or should have had disclosed the information to assess the dimension of BES' exposure to GES' debt. That would have led them to refuse approving BES statements and accounts. That would have prevented the capital increase. Eventually, that would have had prevented the losses incurred by BES in the second quarter of 2014.

- iii. The Bank of Portugal: the responsibility of the Bank of Portugal for allowing BES to incur in such monstrous losses as 3.577M€ is patent in its own statements, most notably that of August 3, 2014, where the Governor of the Bank of Portugal acknowledged that almost all of the 3.577 M€ were incurred by the bank in the second quarter of 2014. Amazingly, in the same statement, the Governor also informs that the Bank of Portugal was watching BES closely ever since 2013 when, as a result of an exceptional audit, it

realised that BES was being used to fraudulently finance companies of GES. The Bank of Portugal may incur into severe liability for the following facts:

- a. Failing to disclose relevant information which it apparently had since 2013, and which if known could have prevented many people from purchasing shares in a bank which administration was in fact using the bank's capital to finance non profitable entities in its group;
- b. It failed to adopt measures to prevent BES board of directors to refrain from incurring in further liabilities. As a result of that, according to the information made public by the Bank of Portugal (same statement of August 3), directors incurred in losses of approximately 1.5M€ in the months of June/July.
- c. The bank disclosed false information which led some investors to purchase BES' shares as late as July, when it issued statements, more than once, affirming that the bank's solvability was assured. No one would have bought shares if they only suspected that in the next day they would be left owning a bank without any assets or a banking license.

This acts, and omissions, may have been adequate cause to the decision of the investors to purchase BES' shares and may also be a direct and adequate cause to most of the losses incurred by those shareholders. If we can prove so - and there are reasons to believe that we might – it will be possible to obtain compensation from the Portuguese State for some of the losses incurred by the shareholders. As a matter of fact, at the present moment, from the shareholders' standpoint we believe that a claim against the Bank of Portugal is the best possible way to obtain due compensation.

- iv. Finally, the Portuguese Securities Market Commission (CMVM) – they had access to most information evidencing that BES was selling much of GES' debt to his clients, through investment funds which periodically disclose all relevant information to the CMVM. However, they allowed the increase of share capital in June. It is a fact that the prospectus contained much of the disclosures which evidenced the exposure of BES to GES, but that doesn't exonerate CMVM from its liabilities in this process. If only, it just increases them, because knowing all that exposure and the consequences thereof, the capital increase should not have been allowed, as there were serious



evidences of mismanagement of the bank. CMVM must had not only prevented the capital increase but also suspended trading of BES shares before it did.

CMVM approval of the share capital increase, as well as its omissions in not suspending trading of BES shares in the last days of July may be a direct and adequate cause to damages incurred by the shareholders, and as such, this is a claim to consider.

## 2. General Costs of an Indemnity Claim

The costs of filing an indemnity claim will be variable according to the amount claimed. They will vary furthermore by decision to file one or multiple claims.

In some cases, the decision if the amount invested may or not justify filing an indemnity claim can be a difficult one for the investor.

From our side, we will be available to appreciate each particular case in order to give an accurate estimate of costs and fees involved.

## **B. Owners of Debt Instruments**

It is early to analyse the options for these investors, for no one knows yet about the damages they will incur.

As above mentioned, there are several types of debt instrument and each category must be treated separately, because in many cases, different legal frameworks are applicable.

In what concerns BES debt instruments, a distinction has been made between senior and junior debt. Senior debt has been assigned to the New Bank, and the Bank of Portugal already stated that the New Bank will refund the holders of these instruments upon their maturity date. However, junior debt remained in BES, and will be paid only after the refund of all BES' creditors (with the exception of shareholders, who are paid last).

In what concerns debt instruments issued by companies belonging to GES, we are working closely with our partners in Luxembourg and Switzerland, analysing the

particular instruments owned by our clients and the chances of obtaining compensation with the local regulatory entities and courts.

There is, however, a liability of BES for having sold GES debt instruments to its retail clients, knowing that the companies which issued them were insolvent. That liability may be claimed in BES, but it also may be claimed to the New Bank, which is currently studying setting aside allowances to compensate BES clients who have bought GES debt instruments. The New Bank expressly stated that if it decides to pay such compensations, that will not mean acceptance of any liability, but merely the wish to keep the trust of its clients.

Either way, we are waiting for further disclosure of relevant information in this regard, and will produce extra information in the near future.

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