



LITIGATION AND DISPUTE RESOLUTION

DEBT RECOVERY FUNDS

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Law 69/2017, which governs Debt Recovery Funds (“DRF”), was published on 11 August 2017 and came into force on the following day. The aim of DRFs is to mitigate the losses incurred (only) by non-qualified investors who acquire financial instruments representing the debt of entities that are insolvent or in a difficult financial situation, when the instruments have been mis-sold by credit institutions subject to resolution actions, or by other entities in a group or control relationship with the entity that is insolvent or in financial difficulty.

This mechanism was created in the wake of the conclusions appearing in the Parliamentary Commission of Inquiry Report on the management of Banco Espírito Santo (“BES”) and the Espírito Santo Group (“GES”). Furthermore, the mechanism has the more or less self-confessed objective of being a solution for non-qualified investors in commercial papers issued by GES companies and acquired from the network of branches of the banks BES, BEST- Banco Eletrónico de Serviço Total, SA (“BEST”) and Banco Espírito Santo dos Açores, SA (“BAC”). However, it is a mechanism that could make it possible to create other funds intended to compensate investors in other institutions, as long as the remaining legal requirements are met.

In the immediate future, this solution makes it possible to provide compensation for part of the losses suffered by customers of GES who, according to the available information, invested around €434 million in commercial paper issued by Espírito Santo International, S.A. (“ESI”) and by Rio Forte Investments S.A. (“Rio Forte”), and who, following the collapse of BES/GES in 2014 lost their investments.

The previous mechanisms to protect non-qualified investors were insufficient, because only small investors were protected by the Investor Compensation System. In turn, this system did not cover investors who acquired debt securities sold at branches of BES, BEST and BAC in the form of commercial paper.

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WHAT ARE DEBT RECOVERY FUNDS?

DRFs are closed funds with autonomous assets and without legal personality. Their sole purpose is to acquire debt owed to non-qualified investors arising from or related to the subscription of debt securities issued by entities which, on the date of the sale in question, were insolvent or in a difficult financial situation. The goal of these funds is to make it possible to recover those debts and to mitigate the losses suffered by the customers to whom the money is owed.

In practice, DRFs acquire the debts that are in the situation described in the law and then proceed to recover them, in order to obtain the compensation awarded by the courts or under out-of-court settlements.

Like other funds – such as venture capital funds and investment funds – DRFs are managed by managing bodies and all their assets are entrusted to a depositary. The following may be DRF managing bodies: (i) DRF management companies, a new form of a company incorporated in the form of a public limited company (*sociedade anónima*) and with a minimum share capital of €125,000; (ii) specific credit institutions (banks, savings banks, the central agricultural credit bank, mutual agricultural credit banks or financial credit institutions); or (iii) securitisation fund management companies. The functions of the management body include managing the assets of the DRF and administering the fund itself.

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WHAT ARE THE ADVANTAGES FOR INJURED INVESTORS WHO PARTICIPATE IN A DRF?

In practice, DRFs are a mechanism for advance payment of part of the investment made by the injured investors, thus a guarantee of (partial) reimbursement of their investment, without the need to go to court – which always has an uncertain outcome – and without additional costs. The injured investors may also benefit from centralised and professional management of the processes to recover the debts assigned to the fund. In theory, this makes it possible to recover the debt more easily and to be compensated for the amounts that exceed the amounts received with the assignment of the debts.

The tax rules that apply to these funds are also advantageous:

- The income of DRFs is exempt from corporate income tax provided the DRF is incorporated and operates in accordance with Portuguese legislation;
- The income distributed by the DRFs to their participants (the injured investors) is excluded from personal income tax on the amount that does not exceed the difference between the cost, proven by documentary evidence, of the debts assigned by the participants and the price received for the assignment of these debts.

WHO CAN PARTICIPATE IN A DRF? WHICH DEBTS/INJURED INVESTORS ARE COVERED?

To be acquired by a DRF, the debts must be (i) owed to non-qualified investors and (ii) arise from or be related to the subscription of debt securities (subject to Portuguese law or sold in Portugal).

Besides this, the new law establishes additional requirements for the debt in question to be covered by this solution:

- The financial instruments must be sold by credit institutions subject to resolution actions or by entities that are in a control or group relationship with such institutions;
- The issuer of the financial instruments must have been insolvent or in a difficult financial situation on the date of the sale in question;
- This situation of insolvency or of difficult financial circumstances must not appear in the documentation made available for the investors or, if it does, there will have to be proof of breach of the financial intermediation duties by the seller; and
- There must be evidence or other information that make it possible to conclude that the sellers of the financial instruments at issue may be held responsible for paying the debts in question. In other words, there must be evidence of misselling.



CLÁUDIO MELO - *Mirror With a Memory, 2000 (detail)*
Provas lambda 80 x 100 cm

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These funds are set up by following the process defined in the new law and they depend on the prior authorisation of the CMVM (the Portuguese Securities Market Commission), which is granted within a maximum of 30 days of the date of receipt of the request.

HOW ARE DRFS SET UP?

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After obtaining the authorisation, the management body makes a subscription offer for a period of not less than six months, which is also supervised by the CMVM. This offer proposes the subscription of recovery units to the injured non-qualified investors. Upon subscription, the investors become participants with a share in the DRF in proportion to the amount they are owed by the resolved credit institution. The fund will thus be constituted if the offer is subscribed by at least half of its potential target investors, representing more than half of the total capital in the financial instruments covered by the offer. The fund then acquires from its subscribers (the injured investors) the debts they are owed by the credit institution subject to resolution.

This means that the assets of DRFs will be composed exclusively of debts acquired from the participants, the securities relating to these debts and bank deposits. Besides this, the assets of the DRF may also include other assets that come to it from the payment of debts, or which are necessary to maximise the such payments. However, in principle, and save for exceptional circumstances and upon prior authorisation of the CMVM, DRFs may not acquire any new debt in addition to the debts acquired at the time the fund was constituted.

WHAT IS THE DURATION OF DRFS?

DRFs have a maximum duration of 10 years, which may be extended on one or more occasions, for a period not exceeding their initial duration. To extend the duration, the participants must pass a resolution for this purpose at least six months before the end of the fund's term.

HOW DO DRFS OPERATE?

DRFs must operate so as to maximise the recovery of the debts acquired from participating investors in an efficient way. To achieve this, DRFs may take out the necessary financing from legally authorised entities.

DRF managing bodies are prohibited from engaging in the following operations:

- any operations capable of creating conflicts of interest or which are not functionally appropriate to pursuing in and out-of-court means to settle the debts transferred to the fund by the participants.
- granting credit, charging assets or providing guarantees on behalf of the DRF under management, except to obtain the financing strictly necessary to pursue the activity of the fund.
- accepting the provision of guarantees or the granting of credit by participants on behalf of the fund;
- other than in exceptional situations and upon prior authorisation of the CMVM, acquiring or holding any assets, financial instruments, or assets and rights other than the debts assigned by the participants at the time the fund is constituted, the securities relating to these debts and the bank deposits strictly necessary to manage the activity in question.

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FUNDAÇÃO
PLMJ

CARLOS PINTO COELHO

Carril, 1999 (detail)

Prova cromogénea

50 x 60 cm

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HOW IS THE INCOME OF DRFS DISTRIBUTED?

The income of DRFs is distributed in the terms defined in the documents that set up the fund. These documents establish the criteria, conditions and frequency of income distributions. However, distributions may only occur after the reimbursement in full of the financing taken out by the DRF to pursue its activity and the amount of the enforcement of the guarantees of the State, if they have been enforced.

WHEN DOES THE LIMITATION PERIOD ON THE DEBTS OF THE INJURED INVESTORS RUN OUT?

The law establishes that, for the purposes of the limitation period applicable to injured investors, the date on which the injured investor became aware of their right to the debt is the date of revocation of the operating licence of the credit institution subject to a resolution action or, if earlier, the date on which, in accordance with the applicable legal provisions, the powers to change the terms of the resolution action are extinguished.

HOW IS THE ACQUISITION OF THE DEBTS OWED TO THE INJURED INVESTORS PROCESSED?

To benefit from this solution, the injured investor will have to assign to the DRF in full all the debts owed to it that are in the situation described above. The injured investor may not assign only part of the debts eligible for this solution.

All the rights, claims and proceedings that result from the acquisition of debts, over the entities connected to the sale of the financial application are transferred to the DRF so that it can begin the necessary court proceedings and/or continue to litigate in its own name and receive any judicial or out-of-court compensation.

Besides the requirement that the debt assignment must be made in writing, the law also establishes that debts may only be assigned if:

- Their transferability is not subject to any legal or contractual restrictions;
- They are pecuniary in nature;
- They are not subject to a condition; and
- They have not been given in guarantee, or attached or seized by the courts.

As under the general debt assignment rules, the assignment of the debt by the injured investor to the DRF is not dependent on the acceptance or knowledge of the debtor. However, in contrast with the general rules on debt assignment, in this case notice of the assignment does not even have to be given to the debtor to take effect against it. The assignment takes effect at the time it becomes effective between the injured investor and the fund.

When crucial to obtaining financing, these funds may benefit from a personal guarantee of State.

With the assignment of the debt, the DRF has the same rights as those previously held by the injured investors, in exactly the same terms. However, the debtors may not raise any means of defence against the fund that relate to any defects in the assignment.

Importantly, the debt assignment may not be clawed back in favour of the insolvent estate, except if those seeking the claw-back prove that the parties acted in bad faith.

This new law raises some doubts, among others, its general and abstract nature, and the question of its retroactive application, above all, the question of the limitation period of the debts assigned.

FINANCING AND PERSONAL GUARANTEE OF THE STATE

For the DRFs to be able to acquire the debts owed to the injured investors, the DRFs may take out financing with entities legally authorised for this purpose.

The law establishes that, when crucial to obtaining financing, these funds may benefit from a personal guarantee of State, which is intended to provide assurance to the banks providing the financing of reimbursement of the credit and payment of any interest arising under the financing.

As an alternative to the DRFs obtaining financing, the State may provide the injured investors with a guarantee of payment of the debts owed to them, if that is necessary for the funds to comply with their legal and contractual obligations to the participants.

DO THE FUNDS HAVE TO PAY COURT FEES IN DEBT RECOVERY PROCEEDINGS?

The law exempts DRFs from payment of court fees in any actions that may be brought by the funds, or in which they intervene in some other way in the pursuit of their object: the recovery of debts that have been assigned by the injured investors.

SUPERVISION

The CMVM has powers of supervision over the DRFs, while the Bank of Portugal has powers of authorisation and prudential supervision of the management bodies.

FINAL NOTES

There are accusations that this new law is “tailor-made” for only some of the injured BES investors and leaves out other parties injured by BES (including qualified investors and immigrants) and investors in other financial institutions that have suffered losses. Furthermore, the new law creates yet another burden on taxpayers, because the Debt Recovery Funds will inevitably need a guarantee from the State to finance themselves. Nevertheless, this new law is essential to making it possible to compensate around 2000 non-qualified BES investors.

This new law raises some doubts from a legal point of view. Among others, it is general and abstract in nature – in other words, it may apply to other situations besides (some) injured BES investors. There is also the question of its retroactive application, specifically in terms of the question of the limitation period of the debts assigned.

It will also be interesting to carry out a more detailed analysis and to look at the activity of managing the Debt Recovery Funds. We now have yet another player in this market and this player has its own rules, which do not always coincide with the ones that apply to the other operators.

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The Lawyer European Awards, 2015-2012

 Portuguese Law Firm of the Year
Who's Who Legal, 2016, 2015, 2011-2006
Chambers European Excellence Awards, 2014, 2012, 2009

 Top 50 - Most Innovative Law Firm in Continental Europe
Financial Times - Innovative Lawyers Awards, 2014-2011