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Inside Story: Croatia

This month's Inside Story is brought to you by Nigel Davies (nigel.davies@wynriver.com), Wyn River Limited, London, UK

Croatia's new balance sheet correction process and other regional operational restructuring developments.

Croatia joined the European Union as its newest member on 1 July to much fanfare. Joining the European Union promotes among other things a level playing field in trade and customs, investor protection, social rights and employment mobility. However, as readers are aware, there is no automatic harmonisation of insolvency and restructuring law or practice country by country and interesting local concepts emerge which can offer some useful data and ideas to neighbours.

Croatia recognised that several companies are now over-indebted, including a number of large companies, and have little or no prospect of repaying all bank loans within a reasonable time frame. The Croatia National Bank's Governor, Boris Vujčić, recently presented in London the CNB estimate that Non Performing corporate loans in Croatia may have been be as high as 25% when they enterered the EU. Other neighbouring countries face similar or even worse scenarios.

This is a common problem across the world and has given rise to the phrase of "zombie" companies. Zombie companies just about keep going as long as there is no trigger for new money and interest rates remain low, but seem to offer little in the way of growth or realistic remedies for creditors or shareholders alike. Zombies seem content to stumble on day to day without much direction, hoping for the discovery of a miracle cure.

To address this problem, Croatia adopted a new restructuring law in late 2012 to help companies with a viable future but too much debt to try to avoid insolvent liquidation, rather similar to the Company Voluntary Arrangement concept in England and Wales. Croatia's new restructuring law was designed to reduce the risk that by terminating potentially viable businesses through liquidation, potential upside value may be destroyed. Liquidation is still an effective tool for companies that have no future and as such are probably best closed down with the productive assets and resources sold and/or redeployed with proceeds passed over to creditors.

Over-indebted companies in Croatia now have the option to open formal debt forgiveness talks with all their creditors, including governmental, trade and bank creditors. Companies have to prepare forecasts which show how much profit and cash they can generate in the future, draft a restructuring

plan and demonstrate how much debt they are capable of servicing. This will show how much debt the banks and other creditors need to write off in order for corporate solvency to be restored. Companies that are over-indebted have 60 days to present a restructuring plan and companies that are insolvent have 21 days. A filing must be made with the Financial Agency, land registry and other relevant agencies. The Financial Agency publishes on its website that a filing has been made and invites creditors to submit claims within a defined period. An application can be made to freeze existing enforcement proceedings and prevent new proceedings from being started. Although the precise mechanics or experiences have not yet been fully published and/or proven, the general principle is that at least 25% of creditor claims must agree to the initial concept or else bankruptcy proceedings will follow. Various compromises of creditor claims can be made, including debt for equity conversions, but not in respect of employee claims. Creditor claims fall into three categories – financial institutions, public authority and state claims and other claims. A second round of creditor votes requires a simple majority of each category to be reached in at least two creditor categories or by a two thirds majority overall. In general, secured creditors can opt to separate the assets subject to their charge and pursue their own collection process. A Court hearing will be called to assess the voting results. A settlement committee is formed and will select a Settlement Trustee from the official list of bankruptcy trustees. The Settlement Trustee will monitor the conduct of the company during the settlement negotiations, will check the validity and content of the submitted restructuring plan, checks creditor claims and the implementation of the restructuring plan and settlement payments to agreed creditors.

In many respects this solution is attractive:

- it unlocks the stalemate position and encourages an objective discussion between borrowers and lenders, when often both the intra-creditor and debtor-creditor debates have been sub-optimal;
- future viability and debt service capacity is, ideally, discussed before a cash crisis is triggered, when management and advisers can be overwhelmed by many other urgent survival issues;
- a reset of debt levels will allow both company and bank management to apply their efforts elsewhere in the value chains of their respective businesses;
- to date there seems to be little negative stigma attached to filing for debt rescheduling, for example no immediate whole-scale loss of customers or suppliers;
- correcting the balance sheet provides an opening of opportunity for new money or new investors to support the future growth of the business, based on an appropriate risk/reward structure, something they would be reluctant to do if the company still faces technical insolvency.

However, speaking off the record, several regional and local Croatian banks and local advisers recently revealed some concerns about the process to date:

- some claim the procedure places little incentive or obligation on owners and managers to set themselves a challenging improvement target, although banks can of course vote against the proposals. The weaker the future “target” profitability, the bigger the haircuts the banks must

take. Challenging debtor-side proposals without access to all data and alternative scenarios is not always easy for third parties;

- the much debated debt for equity solution is available to banks in theory but still provokes mixed reactions by several regional Central Banks and State authorities. Local Central Banks set national policies for defining, setting provision levels and exit resolution of Non Performing Loans and these vary from country to country. The National Bank of Croatia is right to emphasise that banks are set up to be lenders not owners and that a dominant equity position will require results to be consolidated into the bank's financial results. Some global banks have developed specialist teams to manage and add value to their equity stakes but many regional banks do not. Some regional Central Banks do permit local banks to take on equity positions with certain conditions attached;
- then comes the Chapter 11 debate – is the management team that allowed their company to become over-indebted the right team to design and implement the changes needed to achieve a new prosperous future? The banks are also in the firing line for perhaps lending too much during the good times;
- current management often has undue influence on the Croatian settlement process, since until recent amendments to the law, debts owed to connected persons, including management and companies controlled by management, had a vote in the resettlement process. While the recent amendments have reduced this problem, they have not eliminated it;
- genuine turnaround skills are hard to find locally across South East Europe. Buying in experienced international professionals is relatively expensive but a good investment if considerable upside potential can be identified and unlocked.

There has also been some interesting momentum recently on this latter point across South East Europe with the introduction of the position of Chief Restructuring Officers ("CRO") to a few companies to lead balance sheet and operational improvements. My own regional advisory firm, Wyn River, has recently placed a CRO into a large agribusiness in Romania with further CRO projects both in Romania and Serbia pending at present. Sometimes a CRO appointment is combined with a Chief Operating Officer, who brings specific best practice revenue, cost and efficiency ideas based on years of relevant sector leadership, or a new or interim Chief Financial Officer, whose role is to enhance the effectiveness of the finance function for both internal and external reporting.

- What exactly is a Chief Restructuring Officer and how do other (interim) executive appointments work?
- How effective and balanced are the solutions offered by pre-insolvency restructuring solutions, whether in Court or out-of-Court?
- Is Insolvent Liquidation proving a cost-effective tool for creditors?
- How do you get the balance right between encouraging risk-taking by directors versus a more conservative management style that reduces the potential extent of creditor losses?
- What are the risks for CROs, COOs and CFOs given the often harsh sanctions for management failures imposed by local law?

We will review examples of effective solutions across South East Europe through a series of case studies which we plan to share with you in future editions of Eurofenix. By the date of the next INSOL Europe Eastern European conference in Prague on 11 April 2014, we hope to have enough material to present some useful conclusions on balance sheet and operational restructuring solutions across the region. If you have case studies you would like to share, please get in touch with me via nigel.davies@wynriver.com.

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