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Kordarna - the first large case of reorganization
under the new insolvency act

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Declaration of Authorship

Hereby I declare that I worked out this thesis independently, using only the listed resources and literature.

Prague, January 11, 2011

.....
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Abstract

The long awaited insolvency act in force - Act 182/2006 Coll., changed the whole insolvency process by enabling new solutions to handle corporate insolvency issues. Among the most revolutionary features is the facilitation of a reorganization process. The thesis focuses on legal and economic aspects of the reorganization framework and compares it with the possibility solution of bankruptcy liquidation. The thesis analyzes the reorganizations of company called Kordarna, a.s. and also three subsidiary firms belonging to the KORD Group companies, which have been the first major test of the reorganization framework under the current Czech Insolvency Act.

After the analysis of the procedural steps throughout the insolvency proceedings, the thesis arrives at a conclusion that given the circumstances, the chosen reorganization procedure was the best possible solution to Kordarna's insolvency for all classes of creditors and also other involved stakeholders. Moreover, the slow pace of the process is also discussed in detail. An important conclusion is reached in the field of bankruptcy estate valuation, where the thesis claims that the values of bankruptcy estates valuations were unrealistically high, because the adverse impact of the current extraordinary asset market conditions was never fully considered.

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Keywords	Czech Insolvency Code, Reorganization, Bankruptcy liquidation, Bankruptcy costs, Kordárna, Bankruptcy estate valuation
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Abstrakt

Dlouho očekávaný zákon č. 182/2006 Sb. o úpadku a způsobech jeho řešení (insolvenční zákon) změnil mnoho aspektů insolvenčních řízení umožněním nových forem řešení úpadku. Mezi nejpřevratnější změny patří bezesporu zavedení možnosti reorganizace podniku. Tato diplomová práce se zabývá kombinací právních a ekonomických aspektů reorganizačního řešení a srovnává je s řešením konkurzním. Práce analyzuje reorganizace společností Kordárna, a.s. a tří dalších dceřiných společností skupiny KORD, které jsou prvním opravdu velkým testem reorganizačního řešení na základě současného insolvenčního zákona.

Po analýze jednotlivých reorganizačních kroků docházíme k závěru, že zvolené reorganizační řešení je za daných podmínek nejlepším možným řešením úpadku a to jak pro všechny skupiny věřitelů, tak pro ostatní zainteresované osoby. Dále práce mimo jiné rozebírá relativní zdlouhavost celého procesu. Důležitého závěru bylo dosaženo v oblasti oceňování konkurzní podstaty, kde práce dochází k závěru, že tyto valuační jsou nadhodnoceny, protože neberou v potaz současné mimořádné podmínky na trzích aktiv.

Klasifikace JEL

G32, G33, G34

Klíčová slova

Insolvenční zákon, Reorganizace, Konkurz, Kordárna, Náklady insolvenčního řízení, Ocenění konkurzní podstaty

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Introduction

The topic of bankruptcy has become more relevant than ever before, especially now given the recent times of economic crisis. Many firms are being hit by the huge fall in the demand of their products and services. Together with an overly aggressive capital structure many are forced into financial distress, which leads to insolvency in an increasing number of cases.

The long awaited insolvency act in force - Act 182/2006 Coll., changed the whole insolvency process by enabling new solutions to handle corporate insolvency issues. Among the most revolutionary features is the facilitation of a reorganization process. The reorganization option, as an analogy of Chapter 11 in the United States bankruptcy law, brings a possibility to go through the whole insolvency process, ending up with a healthy going concern.

In the thesis provides an economic analysis of the first big case of reorganization as a solution to bankruptcy under the new Czech insolvency code - the case of Kordarna, a technical fabrics producer from Southern Moravia. This company with pre-insolvency revenues of more than CZK 3 bn., is a typical example of a victim of an economic downturn, having financed its expansion with too much debt. On the case of Kordarna we try to assess and illustrate the economic functionality of the particular rules and provisions of the relatively untested reorganization legislation.

The thesis consists of two parts – the general one and the specific one. The first - general one - analyzes and describes the Czech Insolvency Code that is currently in force from an economic standpoint. It is not intended to serve as a compact guide to insolvency or reorganization, since it does not deal with all the details of complex legal rules, which regulate an insolvency proceeding. It is more intended to serve as a framework for an economic analysis of an insolvency proceeding, which is performed in the second - specific part of this thesis. Particular topics in the first part are chosen to cover the main provisions influencing behavior of all the parties involved in the corporate insolvency proceeding accomplished by reorganization. All the above is combined with economic theories and hands-on observations from the

financial practice. Furthermore, the first part provides an economic discussion of the decision-making between the bankruptcy liquidation and reorganization solution.

The second - specific part tries to sum up all important aspects of the particular Kordarna insolvency proceeding; starting with brief description of an economic situation that lead all the KORD Group companies to insolvency, over the reorganization allowance to the final successful approval of the reorganization plan. The thesis pays a special attention to the steps of the creditors, the trustee, the lawyers and the consulting specialists who enabled a relatively smooth course of the reorganization.

The second part also seeks to provide an analysis of success rate of the proceeding from various standpoints of the involved stakeholders by testing of the hypothesis that the reorganization was the best solution to minimize the loss given default figure. Moreover, the paper focuses on practical features of the case, such as the legal instruments used, the direct and indirect reorganization costs, the length of the process etc., which could actually serve as a test of the suitability of legal provisions for potential future reorganization cases.

General part - reorganization

1. Insolvency – legal definition and financial logic

The current insolvency law in force Act 182/2006 Coll., on insolvency and its resolution, as amended, hereafter the “**Insolvency Code or IC**” defines insolvency in §3 as follows¹:

(1) The debtor is in insolvency if it has:

- a) more than 1 creditor and
- b) monetary payables that are more than 30 days overdue and
- c) it is not able to pay off these payables (inability to pay debts as they fall due).

The concept in clause 1c), is further in detail defined in clause 2: The debtor is assumed to be unable to pay off debts if it either stopped paying off a sufficient portion of its monetary payables or it is not possible to achieve enforcement of at least one of the claims due by a judicial execution or the debtor is not fulfilling its obligations for more than 3 months after maturity².

The other way a company becomes insolvent is pursuant to § 3 (3) the overindebtedness. “A debtor is overindebted if it has more than one creditor and a sum of its liabilities exceed a value of its assets.” But an important definition follows: “If one could reasonably assume ongoing operations of a debtor, this should be taken into account in valuation of debtor’s assets. This means that we do not take into account book values of assets but a net present value that these assets are able to generate over to infinity. It probably puts the court, as a decider about legitimacy of a petition, in front of a difficult task.

The two described ways of determining insolvency - default on payables due or overindebtedness are in English literature called with concise names: cash flow insolvency and balance sheet insolvency.

¹ Czech Insolvency Code §3

² The fourth possible causation of bankruptcy could be achieved only during an insolvency proceeding that has already been launched. If the debtor does not submit all lists demanded by § 104. These include list of all the assets including the receivables and its debtors, list of all the payables outstanding with a list of creditors furthermore a list of its employees and any other documents proving insolvency or impending insolvency.

1.1. Bankruptcy costs

From times of Modigliani and Miller who in 1958 proved the irrelevance of corporate capital structure in their non-realistic no-taxes and no-bankruptcy world, many capital structure theories emerged. In 1968 Stiglitz has proved that the Modigliani-Miller's irrelevance theorem is valid even with an assumption of bankruptcy but only as long as there are no associated transaction costs. Since then a majority of optimal capital structure theories based on realistic assumptions do assume some level of bankruptcy costs³. The next section seeks to breakdown possible costs resulting from an insolvency proceeding. Bankruptcy literature distinguishes between direct and indirect costs.

1.1.1. Direct costs

Direct costs category includes all legal, advisory, consulting and other administrative fees connected with the whole process from the filing of a petition throughout the whole proceeding until its end; some sources also include the management time spent on the administration of the insolvency⁴. These costs have a big advantage for academic research purposes as they are clearly measurable and thus comparable among different bankruptcy cases and also between different solution choices⁵. This assumes that these costs are approved and reported transparently, which is however not the case under the Insolvency Code. The trustee's and the committee costs should be approved and therefore reported in a transparent way but this does not apply to the debtor's costs. In case of Kordarna we are lucky that some of the debtor's costs are reported as an attachment of the reorganization plan.

³ Kraus and Liezenberger (1973), Fama and Miller (1972) or Milne (1975)

⁴ Like Warner (1977); There are also papers such as Weiss (1990) (mentioned below), which do categorize the management time cost into indirect costs as they interpret these as an unused opportunity due to occupation of management with insolvency administration.

⁵ On empirical research of bankruptcy cost see Altman (1984), Frank and Torous(1989), Warner (1977) or Branch (2002), for a detailed overview of the literature investigating magnitude of the direct costs see chapter 6.3 of the specific part, where you can also find a comparison with direct costs in case of Kordarna.

1.1.2. Indirect costs⁶

Indirect costs are more problematic to measure. They comprise⁷:

a) Decline of sales

A magnitude of this effect would largely depend on the type of business and on a particular firm. The plunge of revenues could have few reasons. Low credibility of a debtor as a business transaction counterparty will be among the first that comes to mind. Transactions where debtor acts as the supplier should not be a problem as the new claims have the highest priority. More problematic is a big uncertainty of further development. Imagine an automotive supplier company producing intermediate goods used in car production. The automaker's clear choice is to simply change the supplier, even in the case when the debtor runs its business operations without a change in the insolvency, because the automaker cannot afford to risk that the insolvency might potentially lead to a bankruptcy liquidation which in turn would result in the semi-product not being available to him.

b) Increased operational costs

There are many effects of a decreased creditworthiness of a troubled firm that make the operations more expensive. The company could for example lose some of its key employees or have to handle employee retention costs to prevent an unwanted attrition⁸.

Moreover, a cost of capital of a distressed firm increases. Both fundamental forms of capital, debt and equity become more risky so the premium required by an investor for an investment into these on the market will be higher. In extreme cases the situation leads to credit rationing which could be interpreted as infinite cost of capital level. The insolvency law tries to prevent this by establishing a special institute of "DIP financing".

Among other significant costs, Weiss (1990) mentions a reduction in competitiveness of the firm where management focus is diverted from the usual business activities to bankruptcy proceedings instead.

⁶ Branch (2002) provides an exhaustive overview of indirect costs empirical research

⁷ Broggi, Santella (2003) or Weiss (1990)

⁸ Weiss (1990)

These costs, both direct and indirect, are an inherent part of loss given default (LGD), which together with a probability of default occurrence is one of the determinants of pricing of financing on capital markets. One of main goals of insolvency code is to protect the interests of the involved parties by minimizing this LGD figure. All professionals and legislators involved in the creation process of the new amendments to the Insolvency Code or the judges setting precedents to future insolvency cases should be aware of the high degree of responsibility placed upon them. By changing the legislation they also affect the LGD rates, which in turn impact the models setting the interest rates of various debt providers and thus also change the setting the economic potential of the whole economy⁹. So we do not have to exaggerate to assert that insolvency law changes have a significant macroeconomic impact.

⁹ Branch (2002)

2. Finding a solution to insolvency

The most important part of the proceedings – the decision-making process determining the way the whole process will pursue - is governed by § 148 and § 149 of the Insolvency Code. This chapter is dedicated to a brief description of the optional solutions given by the law to solve insolvency followed by a detailed discussion of the legal framework, which sets the rules about roles of all the involved parties and their rights and duties in the process. Last but not least special attention is paid to the incentives of the particular parties, their possible actions and the overall consequences. I want to present this in a kind of a different way than the existing publications. I want to concentrate on such provisions of the Insolvency Code that have proven to have a real and substantial economic impact.

The approach I have chosen to describe the above is somewhat unconventional compared to the approach used by authors of existing publications. My intention is to concentrate on those provisions of the Insolvency Code which have been proven to have a real and substantial economic impact.

In order to perform a detailed comparison of methods of solution to insolvency, it is necessary to define both of them carefully not only in the legislative framework but also in the context given by their practical usage. For a corporate debtor there are basically two possibilities: bankruptcy liquidation or reorganization.

Brief definitions of bankruptcy liquidation and reorganization according to Insolvency Code follow:

1) Bankruptcy liquidation

“Bankruptcy liquidation is a way of solution to insolvency that consists in a pro rata satisfaction of claims of creditors from monetization (liquidation sale) of a bankruptcy estate”¹⁰.

2) Reorganization

Reorganization is legislatively defined by § 316 of the Insolvency Code: “Under reorganization we ordinarily understand a gradual satisfaction of creditors’ claims by

¹⁰ Insolvency Code §244

keeping business operations of a debtor running, provided by measures leading to a recovery of debtors finance according to a reorganization plan that was previously approved by an insolvency court¹¹.

The reason why the exact definitions of bankruptcy and reorganization are crucial for the discussion is that in existing literature the concepts of understanding bankruptcy and reorganization differ and these different understandings simply change the logic of the whole discussion and decision-making.

Richter (2008) defines these as follows¹²: “It is generally known that insolvency proceeding solved by bankruptcy liquidation has one goal, monetization of the assets and satisfaction of the creditors’ claims. On the other hand reorganization (in the sense of Chapter 11) has a goal of settling the creditors from earnings out of ongoing business operations of the debtor. In reorganization assets are not sold by pieces for their liquidation value, but (above all) the debtor’s capital structure is changed.” He later also points out that these definitions are in a matter-of-fact improper because there are plenty of bankruptcy liquidation solutions which have not ended by liquidation and a piecemeal sale of debtors business¹³. These cases exist and they are not uncommon. However if we say that bankruptcy could possibly end by not selling debtor’s business by pieces, we also have to dissect the definition of reorganization. According to § 341 (1b) the core of a particular reorganization process could also be a piecemeal sale of all the debtor’s assets. Baird and Rasmussen (2002) point out that the practical usage of reorganization concept in the United States (Chapter 11) recently deviated from its original purpose. They prove on empirical data that the original definition of law of corporate reorganizations as “a way to preserve a firms going-concern value” based on a fact that “Specialized assets in a firm are worth more in that form than anywhere else” is mistaken¹⁴.

For the purposes of this chapter, when talking about the decision between reorganization and bankruptcy, we could just adhere to the narrow definitions and then discuss an influence of the special cases of either form.

¹¹ Insolvency Code § 316 section 1

¹² Richter (2008) - Chapter 9.2, pages 342 - 343

¹³ Richter (2008) – Chapter 9.2 page 343

¹⁴ Baird, Rasmussen (2002): The End of Bankruptcy

§ 148 and § 149 rule the timing of a judicial decision about the way of solving the insolvency. The two decisions that need to be made, meaning the declaration of insolvency and the decision about the way of solving it, do not need but could be bound together. We talk all the time about two possible solutions but both ways are not available for all bankrupt companies. § 316 (4) sets two thresholds that define a company eligible for reorganization. First one is a revenue threshold of 100 mil. CZK and the other is a bottom limit of 100 employees. When either one of these thresholds is exceeded the company qualifies for reorganization. Richter (2008) calls these threshold requirements a “quantitative reorganization doorway”¹⁵.

If none of the aforementioned conditions is met, the Insolvency Code gives pursuant to § 316 (5) another chance to smaller businesses. Richter accents the substance of the threshold rules by pointing out that “it is really a doorway, not a wall”.¹⁶ Reorganization of a debtor that “does not fit” the doorway (is too small for it) is plausible too. The only “way around the quantitative reorganization doorway” leads through a pre-negotiated reorganization¹⁷. This requires smaller businesses willing to solve insolvency by reorganization to submit an already approved reorganization plan together with petition filing or latest within 15 days after the declaration of insolvency.

When a debtor meets the requirements to qualify for reorganization but a reorganization plan has not been submitted together with the filing of an insolvency petition, the court will due to a provision of § 149 decide about the way of solving the insolvency in a separate ruling that has to be given in a period of three months after the declaration of insolvency. The court then also has to wait for the meeting of creditors, which is called (organized) together with the declaration of insolvency.

According to § 137 (1) the creditors’ meeting is scheduled by the court to be not later than within the next 2 months following the declaration of the insolvency. The procedural period is binding the involved parties to act promptly and limits the total duration of the proceeding from the filing of the insolvency petition to the ruling about the solution to a maximum of 107 days. By the voluntary petition this period

¹⁵ Richter (2008), Section 9.2.3.1 Page 351

¹⁶ Richter (2008) Section 9.2.3.1 Page 353

¹⁷ Also called Prepackaged reorganization (Prepack) – definition by Horne, Wachowicz (2008) Page 634: „a device employed to avoid the legal delays inherent in Chapter 11 reorganization.”; more on the Czech legal rules about Prepacks in Richter (2008) Section 9.4.2.2 Page 384

consists of maximum of 15 days¹⁸ to declare the insolvency itself and other 3 months given to the court to decide after the declaration of insolvency¹⁹. Speeding up of the whole process is extremely crucial foremost when reorganization is intended. The status quo of the declared insolvency without a solution in a form of a reorganization plan confirmed does not benefit anyone. In such a vacuum the indirect costs accrue and the value is being destroyed²⁰. In an extreme case it could easily happen that a debtor with a reasonable going-concern value and also a will to pursue the way of reorganization ends up in bankruptcy liquidation because after few months in insolvency there is simply nothing left to reorganize. And that all just because all the future potential is eaten up by accrued indirect and direct bankruptcy costs²¹. The scarce reorganization data from the Czech insolvency practice were gathered and analyzed by Richter (2010). Review of his findings about duration of proceedings compared with the case of Kordarna could be found in the second part of the thesis.

In the situation described in the first section of § 149 the court waits with the decision for any outcome from the creditors' meeting. § 150 gives creditors a right to pass a resolution about the way of solving the insolvency in a creditors' meeting. If the right to pass this resolution is not used by the creditors, the insolvency court is the next to decide about the solution on its own.

Rules for adoption of a resolution on the official creditors' meeting are governed by § 151. The first clause of this section sets a special quorum needed for approval, there are two possibilities how the resolution is adopted:

¹⁸ §134

¹⁹ IC § 149 (1)

²⁰ Cheng and McDonald (1996)

²¹ For example of insolvency case where the indirect costs accrual forced a company to cease operations see Cutler, Summers (1988) ; An econometric research of duration and outcome of Chapter 11 proceedings was performed by Li (1999), his findings unsurprisingly prove the prepackaged reorganizations to last shorter. Moreover he claims that the probability of successful emergence of a debtor from Chapter 11 increase with time spend in insolvency until a breaking point of 21 months then the probability rapidly declines towards zero. These findings are more or less consistent with previous research on the same topic. The inverted U shape probability curve of emerging from reorganization procedure also resulted from an empirical research of Giammarino, (1989) or White, (1989). This result is also consistent with theoretical reasoning that assumes a negligible chance of emerging from reorganization in the early stages due to procedural requirements that need to be completed and a diminishing chance of reorganization success after reaching of the critical proceeding length due to the decline of trust of the creditors and trade partners in the "happy end".

a) when at least one half of all present secured creditors vote in favor of the resolution and at least one half of all present unsecured creditors (all counting based on the size of their claims)

b) or when at least 90% of all creditors vote for it.

These rules for forming the approving majority prevent passing a solution detrimental for any of the groups. But on the other hand it prevents an unfounded obstruction from a creditor that does not possess more than 50 % of the votes in secured or unsecured creditors' group.

Further steps following the creditors' meeting are described in §152. Unless there are any procedural shortcomings as ineligibility of proposed solution for the particular debtor or a contradiction with already approved reorganization plan, the court has to decide about the insolvency solution according to the resolution adopted on the creditors' meeting.

These are briefly the main legal rules directly regulating the process of choosing the way how the insolvency should be solved. To sum it up all the responsibility and decision making burden lies on the creditors themselves because even though it is the court who decides it is strictly bound by the decision of the creditors as far as they act in accordance with all the regulating guidelines.

The allocation of competences described in the last paragraphs from the strict point of view of legislation should now be reviewed from the standpoint of economic logic. Let's look back to what we have written in the chapter about what actually is the insolvency. One of the causes of insolvency is the overindebtedness which is defined as a state when the value of assets falls below the value of liabilities. And thus the residual claim of shareholders is in insolvency worthless²². This in other words means that they no longer possess the general rights to govern and manage the corporation. The natural outcome of such a situation is passing of all these rights to creditors as they are the "next in line" as holders of fixed claims. Or even better interpretation: as the debtor either has no liquid assets to pay the payables due or it is

²² Fridson, Alvarez (2002) Page 312; This statement is a big simplification of a complicated law problematic of shareholders rights in insolvency. The discussion of this goes beyond the scope of the thesis; for more on this discussion see Richter (2008) pages 394-395

over-indebted the creditors now become the residual claimants and thus they are by virtue of their direct interest the ones to manage the company.²³

2.1.Special cases

In the previous paragraphs we discussed reorganization and bankruptcy liquidation concepts in their narrow meanings. This short section has a purpose to reconcile for inexhaustive definitions of the two concepts.

Piecemeal sale under reorganization

Piecemeal sale is according to § 341 one of the legitimate ways of pursuing reorganization. The main difference compared to a classical bankruptcy liquidation is that the sale is carried out by the creditors and management themselves not by the trustee. This has a big advantage of a direct overlook of creditors over the sale process. As Richter (2008) predicted in his book²⁴ and examples from current reorganization experience prove, a relatively common way is a minor sale of non-core business assets of the debtor and keeping the assets needed to continue operations²⁵. The assets for sale could be sold either already before the approval of a reorganization plan to obtain a liquidity to ensure the financing of operations or the sale of the assets is based in the plan itself and proceeds are used for the payout of creditors. This modification of an original purpose of reorganization framework could also be observed in the United States as documented by Baird and Rasmussen, who comment on the situation:” Many larger corporations file for reorganization, but they are no longer using it to rescue a firm from an imminent failure. Many use Chapter 11 merely to sell their assets and divide up the proceeds.”

Reorganization performed under bankruptcy liquidation legislation

This vice versa concept exploits the simplicity of bankruptcy liquidation in comparison with reorganization to sell a firm as a going concern. Disadvantage of this is that without pre-negotiating with all the business partners the sale and

²³ For the reason why residual claimant should possess the voting rights see Choper, Coffee, Gilson(1995) : Cases and Materials on Corporations 33

²⁴ Richter (2008) Chapter 9.4.4.2 Page 397

²⁵ As an example could serve among others a case of Kordarna a.s and other KORD Group companies: Slovokord, Slovensky Hodvab, Kordservice SK. For more examples see the dataset of Richter concerning reorganizations in 2008 and 2009 available at: <http://ies.fsv.cuni.cz/sci/publication/show/id/4127/cz>

continuity of the operations could fail on their misunderstanding or disbelief in the proceeding success. This could be amplified by the fact that creditors actually have a very limited control over the structuring of the sale process as it is controlled by the insolvency trustee²⁶. The customers and clients of the debtor could then as a precaution start searching for the product elsewhere and therefore the sales related risks are high. On the other hand these are outweighed by lower direct costs as a majority of priority administrative claims arising in reorganization does not burden the process.

²⁶ Although the general way how the assets will be sold could be pursuant to §286 (2) chosen only with an approval of the creditors' committee

3. Economic rationality of decision between bankruptcy liquidation and reorganization

In this chapter I want to concentrate mainly on quantitative economic indicators. When is it rational to save an insolvent company by carrying on its operations and on the other hand when should the operations be stopped without delay and the company sent into liquidation? The following discussion seeks to give a sufficient answer to this question, being primarily based on financial figures and ratios. We will also disregard any externalities or wealth effect on any other involved parties other than current bankruptcy estate claimants – the creditors²⁷.

When we try to define general rules about the feasibility and worthiness of keeping the company running we assume that the company was forced into insolvency by losing money on its operations²⁸. So at the beginning of this discussion we could simplify the problem on a detailed analysis of company profitability and its determinants.

Overall profitability measured by net income or better in relative terms by return on equity (ROE) shows how much profit the company is able to generate per one unit of investment of its shareholders. NI denotes net income and Eq value of equity.

$$ROE_t = \frac{NI_t}{Eq_{t-1}}$$

This overall profitability could be decomposed by a leverage formula into operating profitability and financing profitability. The decomposition is extremely useful for our purpose of analysis of the going-concern value. Through this process we are able to identify a particular problem of a company, see whether there is a potential for improvement and consequently decide what the best solution to the insolvency is.

Leverage formula²⁹:

$$1: \quad ROE_t = ROIC_t + FLV_{t-1} \times SPR_{t-1}$$

²⁷ Without the loss of generality we can assume there is nothing left for the shareholders as the company is already insolvent; in case of the reorganization shareholders are assumed to form a special creditors' class .

²⁸ We neglect special cases of falling into bankruptcy due to some extraordinary event.

²⁹ Novak, J. – Company valuation lecture notes, Koller, Goedhardt, Wessels (2005)

First part of the equation represents an operating profitability. It is measured by return on invested capital, which could also be replaced by (is equal to) return on assets (ROA). The other addend represents financial profitability and it is a product of financial leverage (FLV) and spread (SPR).

Let us first discuss the second addend as it is in the case of insolvency a much more important element.

Financial leverage measures the magnitude of company's liabilities in proportion to its equity; it could also be interpreted as an intensity of debt financing³⁰. It is defined as:

$$FLV = \frac{ND}{Eq}$$

ND stands for net debt, which is defined as liabilities minus financial assets.

Empirically, financial leverage varies across industries, depending on their operating risk³¹. There are many companies including Kordarna that simply increased their leverage too much, resulting in their inability to handle a downturn of their revenues.

Spread (SPR) is a difference between operating profitability (ROIC) and after-tax interest rate paid on net debt (IR). It captures the "per unit benefit" of debt financing, as debt is used to obtain additional assets that generate the ROIC³². If spread is positive, increasing leverage directly benefits the company.

$$SPR_t = ROIC_t - IR_t$$

...where $IR_t = IE_t \times \frac{(1-TR)}{ND_{t-1}}$

And where IR stands for interest rate, IE is interest expense and TR denotes a marginal tax rate.

³⁰ Novak, J. - Company valuation lecture notes, Koller, Goedhardt, Wessels (2005)

³¹ For reference of varying financial leverage among industry sectors see updated statistics by Damodaran at: http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/dbtfund.htm; Early research on financial leverage ratios see also Schwartz and Aronson, 1967; and Scott, 1972

³² Novak, J. - Company valuation lecture notes, Koller, Goedhardt, Wessels (2005)

In good years $ROIC > IR$, so spread is positive and it pays off to increase leverage, although in bad years with falling revenues and margins, the ROIC goes down and spread becomes negative. The increased leverage used in previous years to expand could then be a weakness that starts to throttle the business. As you will see in the second part of the thesis this is exactly the case of Kordarna.

The basic idea of many of the valuation approaches is to separate operations from financing. It is based on an idea that solely operations are a unique concept of the particular business unlike the financing policy which could be easily changed or replicated. In evaluating the feasibility of reorganization we need the same concept, to help us to better understand which companies have fallen into insolvency because their business model did not give them a real chance to generate a profit needed to finance the operations and which are the companies that went bankrupt just because of an inappropriate financing policy.

Let us now illustrate in the financial framework, which we just introduced, when the reorganization³³ should be pursued. Let us define a “value of operations” as a difference between going-concern based value and liquidation value³⁴. This value of operations could be also understood as an equivalent of goodwill. A simple view that reorganization should be pursued when this value of operations is positive appears to be a bit too general. The two main “going-concern concept” - based valuation techniques³⁵ discount the value created by the business in the future. When a company goes bankrupt what happens is that the residual claim of former shareholders is canceled and the only claims left are the originally fixed ones. Consequently the reorganization plan changes the capital structure. The chapter dealing with the reorganization plan describes features of various techniques applied to achieve goals of the plan. Here it shall suffice to ascertain that there are techniques that lead to a new equity-only capital structure of the debtor. Assuming this, we arrive to a zero or even negative net debt, which results in a non-positive FLV and thus the second addend in the leverage formula (equation (1)) is negative or equal to zero. So at the end of the day the only factor that matters for a bankrupt company is

³³ Meaning reorganization in our narrow definition from section 2 of this thesis.

³⁴ Going concern value and liquidation value see Hitchner (2006)

³⁵ Discounted Cash Flow method and Economic Value Added see e.g. Koller, Goedhardt, Wessels (2005)

the operational profitability. Even though the operating profit was negative before bankruptcy, if there are ways to get it back to black numbers it could be worth to reorganize. A successful bankruptcy procedure should provide a filtering mechanism that should give a chance to viable companies to reorganize and inefficient firms to be liquidated. As Tucker and Moore (1999) or Classens and Klapper (2006) claim “this allows valuable resources to move to their highest value use”. Although Wang (2006) points out that “the characteristics and accessibility of these two general procedures (reorganization and bankruptcy liquidation)³⁶ vary dramatically from country to country.

³⁶ Author’s note

4. Reorganization

Since the whole thesis should concentrate on the concept of reorganization as a solution to insolvency, the next chapter describes the process, from the moment when reorganization is approved by the court as the method of resolution of insolvency. It then goes through the most important issues in the reorganization plan including a description of the bankruptcy liquidation alternative, which has in every reorganization case a direct influence on the features of a particular process.

4.1. Reorganization plan

Reorganization plan is a crucial document in the reorganization process. It is characterized by § 338 of the Insolvency Code and its content is defined in § 340. The plan determines the roles of all the persons affected by virtue of an approved reorganization and proposes the measures pursuing a recovery of operations of the debtor and settlement of relationships between debtor and creditors.

The debtor has a priority right to submit a plan. What is the logic that makes a debtor the one who should submit the plan first? The debtor himself is definitely the one who has the best information about the business, he should know about the potential space for improvement of operations and is probably capable to predict whether the changes proposed in the plan could save the company. The problem about a debtor submitting a plan could be its motivation to spend time with such a complex work, when the stake of the shareholders is most probably wiped out. But if we take a debtor as a separate institution not fully governed by its shareholders any more, then the incentives of the management itself are probably sufficiently apposite because all the employees including management want to keep their jobs. So the debtor's first turn is from this point of view a logical step. A deadline for submission of a plan is initially 120 days and it could be extended by the court by no more than another 120. The creators of the new Insolvency Code tried to find a balance between speeding up of the whole process and giving an author a sufficient time to prepare a plan.

The reorganization plan is an official document and its content is strictly regulated by the code. Pursuant to § 340 the plan always has to include the following:

- a) Division of creditors into classes³⁷, connected with treatment of their claims
- b) Specification of the way of reorganization³⁸
- c) Measures that have to be taken to fulfill the plan (especially the specification of persons enabled to dispose of the property of the estate.
- d) Indication whether the operations of the debtor will continue or a specification of the part that will keep on running
- e) List of persons that will participate on financing of the implementation of the plan
- f) Assessment of influence of the plan on employment in the debtors company
- g) Specifications of payables of the debtor after the fulfillment of the reorganization

Even though reorganization is regulated by many rules which have the purpose to protect the rights of all involved groups, the provision of § 338 (3) generally says that reorganization described in a plan may divert from the rules set in the clauses of the Insolvency Code concerning the settlements of the claims, handling of the estate or the payables outstanding at the end of reorganization. Zelenka (2008) in his commented edition of the Insolvency Code interprets this as following: “When measures presented in a plan are (voluntarily) approved by creditors it could in the three fore mentioned fields anyhow differ from practices based on the Insolvency Code.”

4.2.Classes of creditors

According to §337, for the purpose of estimation of the extent of satisfaction of claims and voting on the approval of the reorganization plan, creditors are divided into classes. These classes are formed based on the rule that in each particular class there should be creditors with the same legal rights and the same economic interests. This division into groups is always specified in the reorganization plan. The provision of § 337 defines which creditors must always form a separate class:

³⁷ More about this in next section of the thesis (4.2.1)

³⁸ More on the possible ways of reorganization in section 4.4.1

4.2.1. Secured creditors

§ 337 (2) states that a separate group is formed by a) each single secured creditor – the logic of this seems straightforward because every secured creditor has to have a right not to approve a reorganization plan if he has doubts that the extent of satisfaction of his secured claim is going to be diminished by the plan. An explanation by Richter (2008) is that the claims of two secured creditors are so heterogeneous that they simply cannot be in one group. This according to him could have two reasons: either the claims are secured by a different asset or if they are secured by the same asset then they have to have a different seniority. This rule of having a separate group for each secured creditor could according to Richter be breached in case of a syndicated bank loan; in this case the claims of all the creditors are of the same seniority so they have to be placed into the same class.³⁹

When constituting classes of secured creditors and determining the amount of their claims we have to take into account provision of § 167 (2). According to this provision a claim of a secured creditor could be classified for a purpose of voting on an approval of a reorganization plan only in an extent in which it is covered by a value of security. In the situation when the value of security does not amount the value of the pertaining secured claim, the claim is divided into two parts. The first stays as a secured one and amounts exactly the value of the security, the other part – “the rest” is to be further regarded as a separate unsecured claim. If this happens the creditor has a right to vote on a reorganization plan twice, once as the only member of “its own” secured group and second time as one of members of unsecured creditors group.

This setting simply makes a reorganization plan unfeasible unless the satisfaction scheme does fully repay all the secured claims to the extent of the value of pertaining securities because every single secured creditor has a right to turn the plan down. The right of the court to replace the approval of this class with its own ruling is not applicable in this case, since the treatment of the class could then not be considered as fair⁴⁰.

³⁹ Kordarna was financed by a syndicated loan, to find more about handling of this claim in the reorganization plan see the second part of the thesis secured creditors section.

⁴⁰ The definition of fairness of the reorganization plan is defined in §349 (1)

4.2.2. Shareholders and members of a debtor

Another class is formed according to § 337 by creditors mentioned in § 335. Pursuant to this section, during reorganization the shareholders and members of a debtor are also taken as creditors. This rule does not apply if the debtor is bankrupt due to overindebtedness.

As the value of claims of all the shareholders is zero, the voting in this group is based on different criteria, the ownership shares, which the particular shareholders possessed prior to the insolvency. Another specificity of voting in this group is in the definition of quorum needed for the approval. It is defined as a majority of shareholders or members of the debtor but furthermore these voters have to represent more than two-thirds of the registered capital of the company⁴¹.

The Code does not assign nor forbid any other classes. From reorganization plans we can see that in almost all of them there is a class of unsecured creditors. Zelenka (2008) furthermore suggests a separate class of employees as their interest is not similar to any of the other creditors⁴².

4.3. Plan approval process

Last paragraphs were devoted to the division of creditors into classes for the purpose of voting on the reorganization plan. The voting can take place in a special creditors meeting, after the voting it is the insolvency court who at the end of the day decides about the approval of the plan. § 348 tells the court to approve the plan if the following is fulfilled:

- it is in accordance with the Code, it is approved by each of the groups (this condition has an exception – according to § 347, subsection 4 - a group whose rights are not affected by the plan is automatically taken as having accepted the plan),
- every creditor receives a settlement with a net present value at least the same as in the case of bankruptcy liquidation solution,
- post-insolvency creditors' claims and claims with the same priority are settled or will be settled immediately after the plan comes into force.

⁴¹ For reasoning of this quorum definition based on general corporate law - see Richter Page 392

⁴² Zelenka (2008) Page 496

If these conditions are met the court should approve the plan. Although these conditions are not necessarily needed for the approval, since a YES vote of some of the classes is not inevitably required. In the situation when at least one class of creditors, whose rights are affected by the plan, approves it, the approval of other classes could be replaced by a ruling of the insolvency court⁴³ (when all the other legal rule conditions are met and the plan was pursuant to § 348 (2) approved by at least one creditors' classes except the one of the shareholders). The purpose of this right given to court is to avoid unreasonable obstructions to a collective process from any of the creditors. The court could furthermore use this right only if the reorganization plan is concerning the affected class fair and it can assume that a pursuance of the reorganization plan will not lead to liquidation⁴⁴. Fairness of the plan is concerning the particular creditors' class fulfilled⁴⁵:

a) by secured creditors' classes: if the net present value of the payout is at least equal to the value of the pertaining security obtained in an expert's opinion valuation⁴⁶ and the creditor will be given a same or a similar security of the same order to his secured claims

b) by unsecured creditors' classes: if every creditor's payout is at least equal to a nominal value of its claim with interest or if none of the creditors with claims subordinated to this class creditors receives any payout. This basically means that any reorganization plan suggesting a zero payout for unsecured creditors could be considered fair to them if the shareholders receive no payment.

Now we take into account all legal rules governing the reorganization plan approval and we also consider the already mentioned § 348(1d), which allows the court to approve the plan only if every creditor gets a payout with a same or a higher net present value than he would have received in the bankruptcy liquidation scenario. This provision is also referred to as the best interest test⁴⁷. This parameter does not allow for reorganization when this should be financially less favorable for any of the creditors than the bankruptcy liquidation solution, unless the creditor does accept

⁴³ IC § 348 (2)

⁴⁴ IC § 348 (2)

⁴⁵ IC § 349 (1,2,4)

⁴⁶ IC § 349 (1)

⁴⁷ Zelenka claims that the main purpose of the best interest test is to avoid unreasonable obstructions from creditors.

this⁴⁸. (The replacement of a class approval could not be used if the reorganization based on the plan is not of the “best interest” of the creditor)

4.4.Pursuance of the plan

If a reorganization plan went successfully through the whole approval process, meaning the plan has at the end of the day been ratified by court, it then constitutes a binding document.⁴⁹ From the moment it comes into force it is binding on all the parties of the proceeding. If there should be any deviation from the steps in the plan, the plan needs to be changed.

4.4.1. Proposed solutions

The variety of measures that lead to revitalization of a bankrupt company are many and could be used in combination. § 341 provides us with a list of the most common ones. Structuring of this list is a bit chaotic and it deserves some kind of financial standpoint decomposition. In the list there are basically two concepts of who is going to be a new equity holder in the company⁵⁰.

- b) Sale of the whole bankruptcy estate or its part or a sale of debtor’s company
- c) Distribution of some (or all) of the assets to creditors or a transfer of these assets into an SPV owned by creditors

These are basically the two alternatives: the debtor’s assets are sold (b) to a strategic or financial investor or the creditors remain in seat after the reorganization (c). In addition to the above two concepts , there is also an option:

- d) merger of the debtor with another company but that could be classified just as a special form of sale⁵¹ (b). The aforementioned list also includes two different ways of obtaining new capital which could be freely combined with (c) and (d):

- e) issuing of a new equity or other type securities by the debtor

⁴⁸ Richter (2008) Page 410

⁴⁹ § 352 of the Insolvency Code

⁵⁰ The particular index letters correspond to the indexation of subsections from § 341

⁵¹ Whole debtor’s company or at least a part of it changes its owner no matter whether the payment is done through stock or cash

f) ensuring of a new financing of operations of a debtor's company (debt financing)

New stock issued could go to the hand of creditors or they could be issued to hands of a third party – an investor, so it could be a form of selling a part of a company. Financing by debt already during the insolvency proceeding is a common move to provide cash flow and prevent ceasing of operations⁵². Ensuring of a new debt financing when a plan comes into force should not be difficult if balance sheet of the company was cleaned up. The only problem could be a habit of many commercial banks, which hesitate to continue a business relationship with a firm when they “get burnt” on its exposure. In other words once the particular bank's loan receivables are discounted in the reorganization this bank will not grant any more financing to this company⁵³.

The following measure stems from the very fundament of the insolvency – the fact that the estate value simply does not suffice to satisfy all the fixed claims in full:

a) restructuring of creditors' claims, consisting in remission of some parts of the debt including a debt service or in deferring of payments

This measure is most common and appears in majority of reorganization plans; according to Richter (2010) 13 out of 20 reorganizations in 2008 and 2009 contained restructuring of creditors claims as one of implemented measures in the reorganization plan.

Usage of this measure depends on a reorganization plan funding. If creditors decide to finance the plan themselves they have to discount their claims to give the debtor a capital needed to maximally diminish the probability of falling into bankruptcy again. Thus the discount on claims of creditors is delimited downside by at least an NPV lost due to “only” rescheduling of the claims because it is highly improbable that a debtor could continue operating just with sourcing the cash from cost savings and better efficiency on operations. Upside bound on the discount (highest possible discount) on creditors' claims is again defined by the liquidation value of the assets.

In the other case when the company is sold, a situation with restructuring of creditors' claims is more complicated. The payout of creditors is based on the plan

⁵² There is a separate section of the thesis about DIP financing

⁵³ For more on credit rationing in markets with imperfect information see Stiglitz and Weiss (1981)

and the extent of satisfaction of claims depends on the ratio between the amount for which the company is sold and value of the claims. The final amount is based on a negotiation between the one who files the plan and an investor or between the creditors and an investor⁵⁴. The plan could be filed by a debtor, who has no strong motivation to anyhow increase the price. By contrast when it is one of the main creditors, who is the designer of the reorganization plan, he is certainly going to push the price up to gain the highest possible payout. Although this statement is rather questionable since the designer of the plan has to be a residual claimant and that does not come automatically. One of the reasons for that could be the fact that for instance a fully secured creditor is with 100 % secured payout indifferent about the price being paid. Moreover as Easterbrook (1990) claims it is extremely difficult to determine who the residual claimants are.

We have seen that the measures suggested in the Insolvency Code, when combined could be a cure for a majority of problems an insolvent company has and these measures should serve as a gateway to return to normal business operations. On top of these measures the Insolvency Code again allows a big portion of freedom in deciding about the actions proposed in the plan and does not limit it to the ones mentioned in the previous paragraphs. Kozák, Budín, Dodam and Pachtl (2008) claim that although the list of measures mentioned in § 341 is only demonstrative and does not by far specify all possible measures, the particular measures actually intended to be used in the reorganization have to be exactly described in detail, hence no general proclamations should be accepted by the court⁵⁵. Indeed apart from these measures that all should care about capital structure and financing matters of the debtor there have to be changes to operations of the company. Without any patching of loopholes that are present in the system the effect of the aforementioned actions implemented in isolation might be seen as no more than adding water into a leaky bucket.

⁵⁴ Problematic aspect of the statement that creditors could influence the price being paid through negotiation with investor is the right of a court to replace their no vote providing the conditions in §348 respectively §349 are fulfilled

⁵⁵ Kozák, Budín, Dodam and Pachtl (2008) Page 455

4.5. Bankruptcy liquidation legislation

Even though this thesis focuses primarily on reorganization, the legislative provisions governing the payout and claim satisfaction in bankruptcy liquidation directly affect many of the aspects in the process of reorganization. White (1989) labels liquidation as a "basic bankruptcy procedure" she based this on her claim that: "Even for firms that decide to reorganize rather than liquidate, the liquidation procedure sets the framework for bargaining over the reorganization". It starts with the voting of creditors about authorization of reorganization. The creditors consider whether they could earn more from reorganization than from a liquidation piecemeal sale. In addition the designer of a plan is facing a challenge to set up a plan with the clear bottom line - to overpass the payout rates probably given by bankruptcy liquidation scenario. If the plan does not meet this requirement it has a negligible chance to go through. So to be able to understand the substance of reorganization it is necessary to understand in detail the rules for payout of different groups of creditors.

4.5.1. Liquidation value

The first figure that determines the payout in liquidation sale is the value of assets. We are talking here about the liquidation value because we assume ceasing of all business operations and selling all assets piece by piece.

Liquidation value of a company is basically equal to the sum of values of assets on its balance sheet assuming ceasing of all operations and selling it piece by piece on the market⁵⁶. Normally in healthy companies this liquidation value is much lower than the "going concern" values determined by other valuation techniques⁵⁷. In cases when this statement is not true and the company's earnings are negative without any outlook of restructuring, the rational solution is to liquidate and really sell piece by piece. Liquidation value generally does not amount to the book value of assets as stated in company's financials even though the accounting rules aim is to get as close as possible to the market value of particular assets. Liquidation value is heavily diminished by discount which stems from low liquidity on specialized asset markets.

The size of such a discount could basically be derived from a structure of a particular balance sheet. Each asset category could be ranked based on a liquidity level. If we

⁵⁶ Pinto, Henry, Robinson, Stowe (2010) Chapter 1 Page 4

⁵⁷ Hitchner Page (2006) Page 821

want to put together such a ranking we will start with financial assets. The financial assets together with marketable securities could naturally be fully transferred to the insolvency estate and liquidated without any discount.

Next in a row are other current assets, which consist of receivables and inventory. Receivables could basically be cashed from the original business counter-side; The extended time needed for the enforcement process leading to the possible full recovery of the receivable can be seen as an obstacle. This represents a general trade-off between the execution cost and time related price risk⁵⁸. Another possibility is to sell the unenforceable receivables at a discount. Inventory liquidity depends largely on the particular type of business.

Fixed assets are the most illiquid items on a balance sheet. Discount on such items could be huge, high specificity of items like machinery or a low serviceability of factory halls adjusted for a particular type of production makes these assets highly illiquid. Marketability is even more diminished by non-existence of any organized markets for such specialized assets. Even tougher are the conditions for sale in a situation of the global economic crisis we have experienced in last two years. There is considerable unused production capacity and capital for expansion is extremely scarce. This state leads to low demand for inventory as well as lowered demand for any production facilities. The observation of lower liquidation values in times of an economic downturn are supported by research of Acharya, Bharath and Srinivasan (2005). Their research also proves that this phenomenon is even more pronounced among firms possessing assets with high industry specificity⁵⁹. Nevertheless as to my knowledge in case of the liquidation scenario simulation performed in expert's opinion of EQUITA Consulting⁶⁰ there is no direct downside adjustment of asset valuations due to an economic downturn, the only valuation modification is incorporated by adding an extra premium of 2 % to the discount rate for lower liquidity due to a recession⁶¹.

⁵⁸ More on this – see Fiedler(1998) or Jorion (2000) Chapter 14

⁵⁹ The discussion of this problematic concerning the case of Kordarna and other KORD Group companies can be found in the second part of this thesis Chapter 7.1.2

⁶⁰ Bankruptcy estate valuation - KSBR 39 INS 2464 / 2009 – B 103 -107

⁶¹ Bankruptcy estate valuation - KSBR 39 INS 2464 / 2009 – B 104, Page 2

(Time value of money and the NPV)

When we try to estimate the liquidation value of a company, we have to provide for a time value of money, this combined with the fact that in case of liquidation the sale of assets could take months to be accomplished. When comparing the payout in bankruptcy liquidation and the reorganization, the net present value of payouts needs to be compared. Likewise the best interest test based in provision of § 348 (1) also compares NPVs of the particular solutions.

We have just gone through the discounts which have to be applied because of lower market price in comparison with a book value of the estate. Another expense is normally applied on behalf of direct selling expenses as marketing, taxes, consultancy fees, expert's opinions fee; it could according to § 298 reach 4 % of the final value. Another 5% could be subtracted from the estimated gain of the assets sale as a maintenance cost. It includes all expenses of a trustee or a debtor which needed to be spent to prevent the loss of value of the estate, this cost item comprises security measures, repairing etc.

Estimation of liquidation value of the estate is only the first step on a way of getting to the final payoff amount for each of the creditors' groups. Before any of the (unsecured) pre-insolvency creditors gets paid, all claims emerged after the insolvency declarations have to be settled.

Provision § 296 states that these payables – “priority administrative payables” are first to be paid from the proceeds of the bankruptcy sale. In a potential situation when the gain of the sale does not even equal the amount needed to cover priority administrative payables the payout order among these is governed by § 305. First to be paid is the remuneration of an insolvency trustee and all his billed expenses. Next in a row are administrative priority payables enumerated in legislation § 168 and § 169. After these are paid out in full there are the DIP financing payables. § 305 (2), further determines the order in a situation of existence of secured creditors. Under these circumstances a secured creditor has a right to be paid directly from the proceeds acquired through the sale of pertaining collateral (secured asset) as soon as the secured claim is paid in full the resting amount could be used to pay out other claims in a designated order.

4.5.2. Priority administrative claims

I would like to spend more time addressing the topic of this claim class especially associated with the relationship bankruptcy liquidation vs. reorganization. These claims are actually the only cornerstone that could make a difference in determination of total payout to creditors and thus it could be a decisive factor in search for the right solution.

Labor related claims and labor market (in)flexibility

Labor related claims should definitely have the right to be prioritized because the creditors – here the employees - have almost no possibility to control the credibility of a debtor and thus to adjust their risk; Richter (2008) gives even better reasoning by pointing out the impossibility to diversify human capital as opposed to financial capital⁶². So the ranking of all labor related claims arisen in three years preceding the insolvency by § 169 as priority claims seems legitimate.

Labor market in the Czech Republic is commonly criticized for its relative inflexibility stemming from a low preference of part time jobs and high level of severance payments⁶³. This factor could play an infamous role in times of crisis when companies have to react as fast as possible on big variations in demand for their products. Without giving the firms an instrument to cut their expenditures in hard times, many are unnecessarily forced to insolvency⁶⁴.

The role of labor market inflexibility in determining which solution to chose in an insolvency proceeding is a bit paradoxical. The more inflexible the particular labor market is, the more it prefers reorganization to bankruptcy sale. Current legislation entails every employer an obligation to pay redundancy money equal to five⁶⁵ average monthly salaries, when a company wants to let its employee go immediately⁶⁶. The severance payments need to be paid even in a case when a

⁶² Richter (2008) Pages 174-175

⁶³ E.g. Industry and Transportation Federation of the Czech Republic (Svaz průmyslu a dopravy) included a requirement for labor market reform that would make it more flexible among top 10 priorities for 2010 - http://www.spcr.cz/files/Agenda_2010.pdf; for comparison with other CEE countries see Romih, Festic (2008)

⁶⁴ Kose, J., Lang, L.H.P., Netter, J. (1992)

⁶⁵ Three monthly salaries according to Labor Code 262/2002 Coll. §67 plus there is a two month notice period, so an employer has to let employee work for two more months and pay him a regular salary or to give him compensation for these two months; for our purpose of view from employees standpoint it makes no difference

⁶⁶ Labor Code 262/2002 Coll. §67

company is already in insolvency and the operations will be ceased because of bankruptcy liquidation⁶⁷. As we know these labor related claims have a priority over regular claims based in § 169. This extra cost makes reorganization preferable over bankruptcy liquidation. Interesting is the insight to a labor market inflexibility from the standpoint of a potentially distressed company acquirer. In the case of a reorganization a plan specifies an amount needed to pay out the creditors and thus to acquire the company. As mentioned above, the minimum amount needed to payout the creditors is set by a bankruptcy liquidation alternative scenario in which the amount to be paid to creditors is diminished by severance payments which are a part of administrative priority payables. Therefore the mandatory level of severance payments decreases the lower bound of a price range in case of a company sale in reorganization.

Insolvency trustee

Since an insolvency trustee is a manager who has a big influence on the success of the proceeding, his/her remuneration should be probably somehow based on his/her performance. When measuring how well he/she has performed and how he/she succeeded we should first understand and define his/her goal. Clearly a goal of a trustee should be to maximize the value for the creditors and other parties involved in the proceeding. The remuneration is governed by § 38 and an exact amount is set by a regulation 313/2007 differently for each solution to insolvency. Upon a liquidation sale the remuneration of a trustee is calculated as a relative part of an amount available for creditors' payout. This system of determination is a big step forward compared to an old insolvency Code, which assessed the remuneration to be set as a proportional part of an amount gathered by a liquidation of the estate. The latter (former law) version did not take into account the performance and actual payout for creditors directly; it is as if to a CEO is paid based solely on revenue rather than profitability⁶⁸. It is therefore important that the trustee considers expenses because they partly go out of his pocket. However, the current determination of trustee's remuneration might be also seen a bit problematic since there are post-insolvency costs beyond his/her sphere of influence, such as severance payments⁶⁹. Upon a

⁶⁷ Labor Code 262/2002 Coll. §52/b

⁶⁸ Regulation 476/1991 Coll. § 7/2

⁶⁹ Richter (2008), Page 160

reorganization the trustee's salary is based only on a pre-insolvency size of the company (measured by its annual turnover). Considering that he/she is able to manage his/her costs there could be a place for some motivation element in his remuneration.

Specific part – The case of Kordarna

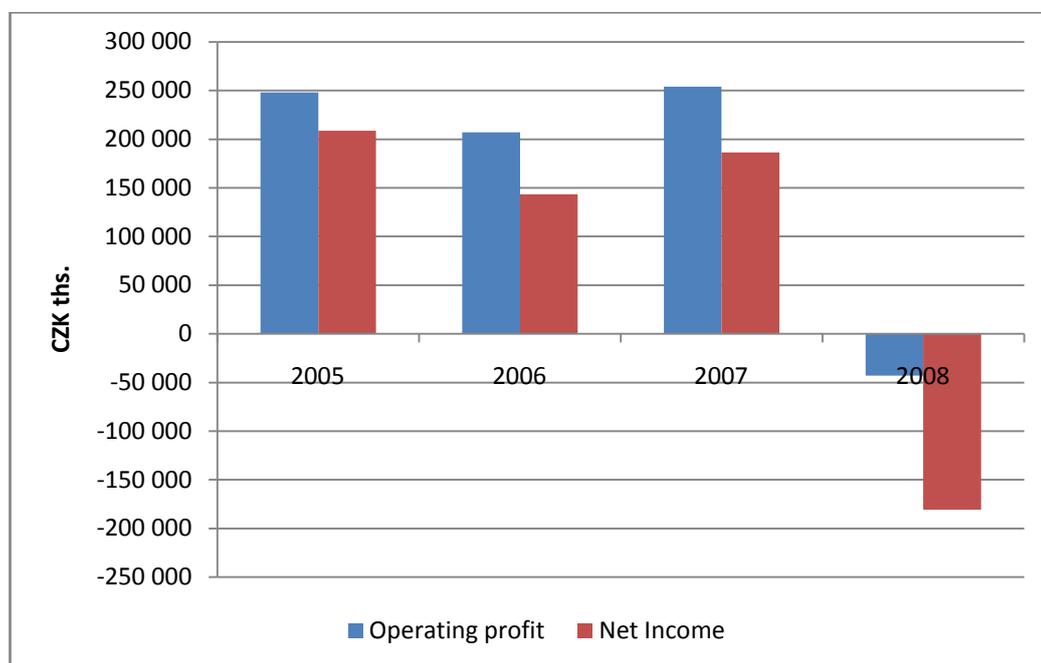
1. Kordarna Business Overview⁷⁰

Kordarna a.s. (hereafter Kordarna, the Company or the Debtor) was the leading European producer of technical fabrics for the rubber industry also called cords. Clients of the company include some European and global tyre production leaders. The products of the company are also used in conveyor belts production. In recent years Kordarna also entered a new market of geotextiles and geogrids used in the construction industry. Kordarna is a member of the KORD Group, which consists of companies linked by production of technical fabrics. The Group comprised Czech companies Kordarna a.s., Kordservice a.s., Kordtrade s.r.o. and Texiplast a.s. as well as Slovak companies Slovokord, Slovensky Hodvab and Kordservice SK.

1.1. Prepetition development

Kordarna started a big expansion project in 2007 with a construction of a new factory in Slovakia. The investment project financing was highly leveraged with a syndicated bank loan. Until 2007 the company performed well, which can be documented by its operating profit and net income figures.

Chart 1:



⁷⁰ Kordarna a.s. Annual report 2008 – www.justice.cz

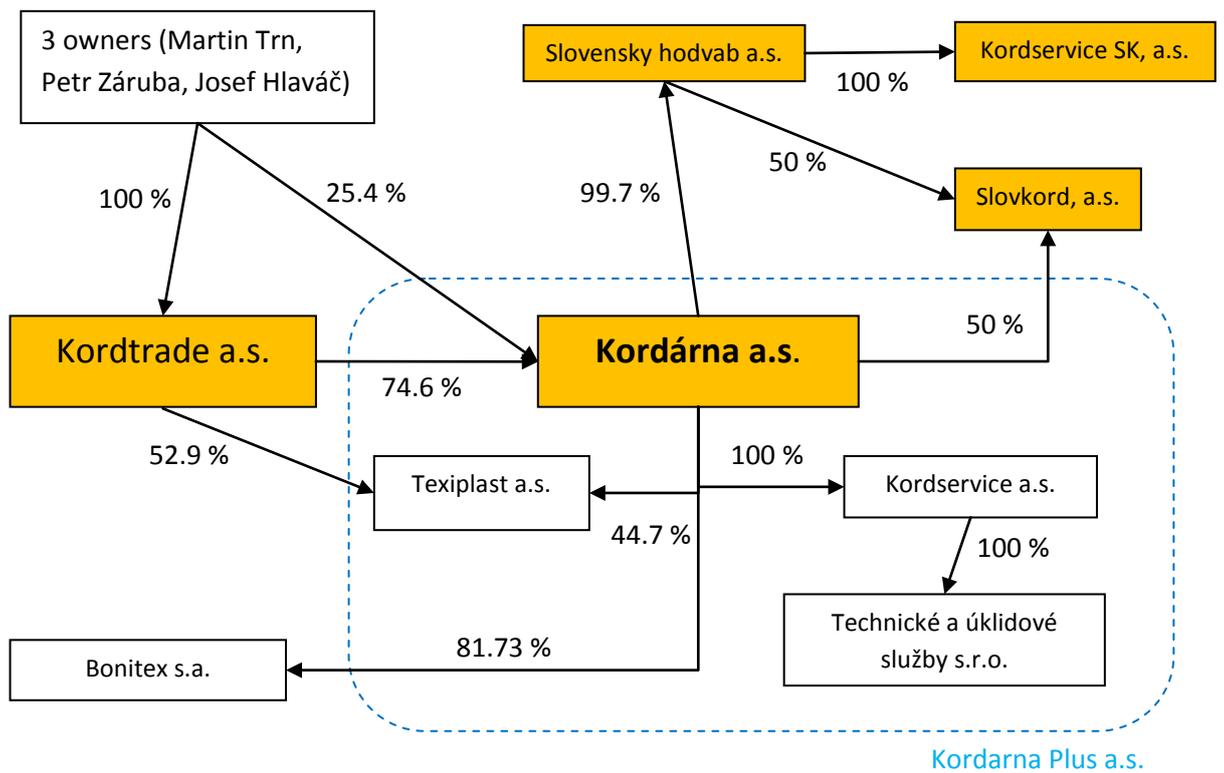
Kordarna's financial health, which was solid before, started deteriorating in 2008. Until the 2007 surpluses in the operating cash flow figures indicated enough strength to cover increased leverage burden. However, during the 2008, some of the main customers of Kordarna from automotive supplier industry were among the worst struck by the global economic crisis, which resulted in their decreased purchases. The market with cords is supplied by independent producers by 45 % while the remaining 55 % are generated by Tyre producers themselves. The tyre sales decreased by only 22 % during the 2007 and 2008, but the independent producers were naturally among the first ones cut by the big tyre companies supplies from. Resulting drop in sales by more than 50 % sent Kordarna into red numbers on both operating profit and net income too.

1.2. Petition filing

Kordarna a.s. filed a voluntary petition on 30.4.2009, in which it indicated the cash flow insolvency to be the primary reason. Already in the initial petition the Debtor had shown its intention to solve the insolvency by reorganization. It subsequently proves fulfillment of all the requirements to qualify for reorganization solution. The "Quantitative doorway" of more than 100 employees or more than CZK 100 mil. turnover has been passed without a problem with both criteria multiply exceeded (over 500 people employed and over CZK 2.7 bn. of turnover). The Debtor clearly stated in the petition that "it intended to solve the insolvency by the means of reorganization", and it also emphasized in the petition that the negotiations with the main financing creditors about particular solutions and measures have already started.

The petition further informed that Kordarna is a member of a group where three other companies are also insolvent and intend to file their own petitions shortly. Furthermore, these sister companies also planned to solve their insolvency with reorganization and Kordarna a.s. as a parent company suggests that it would be best for the court to coordinate the insolvency proceedings of all four group member companies.

Chart2: KORD Group Organization Scheme



Orange shaded companies are insolvent

2. Economic situation of Kordarna around the Insolvency filing⁷¹

2.1. Profit & loss statement view

The economy of the Company in the year 2009 can be divided into two periods: the first pre-insolvency period 1.1.2009 – 13.5.2009 and the later insolvency period – 13.5.2009 – 31.12.2009.

In the first months of 2009 the sales went down by more than 50 % compared on year-to-year basis. At the end of April 2009 the Company was not able to satisfy any more payables due and it filed a voluntary insolvency petition. In the pre-insolvency period Kordarna generated an operating profit of CZK – 6.0 mil. without extraordinary insolvency connected costs. Including these extra costs of legal and consulting services, severance payments and most importantly a one off adjusting item of CZK – 532.5 mil. for partial write-offs of intra-group loans to bankrupt Slovak KORD Group companies (Slovkord, a.s., Slovenský hodváb, a.s., Kordservice SK, a.s.) the operating profit figure reaches the amount of CZK – 547.8 mil.

During the insolvency period the average monthly sales have not diminished significantly compared to months in the pre-insolvency period. An average monthly figure of sales of own products and services reaches CZK 108.3 mil. before the insolvency and CZK 107.9 mil after the insolvency so there is no significant change in sales⁷². The above data is fully supported by the major customer-confirmed purchase volume agreements from June and July which covered the period until the end of 2009.

Also when we review cost of goods sold and subsequently value added figures there is no significant change between the two periods. In the pre-insolvency period average monthly value added on own products and services sales reach according to our own calculation CZK 18.9 mil. and the same figure after the insolvency reaches CZK 17.8 mil.

⁷¹ All financial figures in this section come from Attachment #20 of the reorganization plan (EBITDA reporting table) - KSBR 39 INS 2462 / 2009 – B 118 and Annual reports of Kordarna available at www.justice.cz

⁷² Own calculations using figures from EBITDA reporting table - Attachment #12 - KSBR 39 INS 2462 / 2009 – B 120

Monthly operating profit in the months following the insolvency until the end of the year reached CZK – 58.6 mil. (including an adjusting entry of CZK – 19.0 mil. for the writeoff of Russian customers' receivables) The operating profit figure also includes extra expenditures for the direct insolvency costs (law and consultancy fees) and redundancy payments.

The Company planned to improve sales figures by entering the Russian market, where the market growth should be much higher based on the forecasts. It started a negotiation with potential partners before the reorganization plan was filed. The upswing of the market in Czech Republic could not be awaited earlier than in 2011.

2.2.Cash flow statement view

Until the insolvency the debtor largely used selling of short term trade receivables before their maturity to finance its operations (known as factoring). When the financial situation deteriorated the suppliers gradually started to switch to pre-payments. The remaining factoring agreements were repudiated after the declaration of insolvency from the side of the financing banks, mainly due to the uncertainty whether these financial operations could be considered as “necessary for carrying on the business operations” by course of § 111 of the insolvency code. According to this provision, since the insolvency proceeding has began⁷³ the debtor has to avoid disposing of the insolvency estate if this should anyhow change the structure or usage of the estate or should the estate be diminished. The second clause of § 111 specifies exceptions from this rule applied on acts necessary to carry on the business operations within the scope of regular company management⁷⁴. The financing institutions' worries about the legitimacy of the operations stemmed from the third clause of § 111 which clearly nullifies all acts that are inconsistent with § 111.

Renegotiating with factoring companies was crucial for success of the whole proceeding. At the end of May the Company's cash balance was around zero. The outlook at this point of time has shown a negative EUR 2.6 bn. of cash balance without renegotiation of the factoring payments. So the Debtor filed a suggestion for

⁷³ In case of Kordarna disposing with the bankruptcy estate is limited already from time the insolvency petition was filed because it was a voluntary petition (filed by the debtor himself). For analysis of the difference with involuntary petition see Richter (2008) Section 4.5.4 Page 224

⁷⁴ Kozák, Budín, Dodam and Pachel (2008) in notes to § 111 do not mention any financing operations or working capital ensuring operations among the examples of exceptions considered to be necessary to continue business operations on page 142

a precaution in the matter on 29.5.2009⁷⁵. On the next day the debtor also supported this suggestion with facts about the former factoring agreements and an assurance that the new factoring agreements would have the same parameters pre-negotiated with the providing institutions⁷⁶. The court reacted quickly and on the next day it assumed in the answer a positive attitude by giving the financing providers a guarantee of a legitimacy of the agreements⁷⁷.

According to a representative of Ceska Sporitelna the matter of quickly restoring the factoring processes was essential for keeping the company in operation which in turn proved crucial for the success of the whole reorganization. From August until the end of the year the cash balance settled somewhere between EUR 1 - 2 mil. Approaching the end of the year the amount of cash available rose to reach more than the EUR 4 mil. mark and hence since July 2009 the company has become basically solvent and able to cover all newly emerging expenses.

⁷⁵ **KSBR 39 INS 2462 / 2009 – B 2**

⁷⁶ KSBR 39 INS 2462 / 2009 – B 3

⁷⁷ KSBR 39 INS 2462 / 2009 – B 4

3. Reorganization

On 10.6.2010 the Company officially filed an application for reorganization solution of the insolvency⁷⁸.

On the first creditors meeting on 23.6.2010 creditors have chosen the members of the creditors committee by vote. From the 3 members of the committee one represents Ceska Sportelna another EON and the third CSAD Hodonin. This implies that Ceska Sportelna, despite being a 100 % secured creditor and 94 % unsecured creditor, has a minority in this important body. The reorganization was allowed by the court on 7.8.2010 by a ruling⁷⁹ three days after the creditors' meeting approved the reorganization solution in its resolution⁸⁰.

A dominant measure in the reorganization process is a separation of core business assets, which are inevitable for further business operations, followed by their transfer them into an SPV. In the case of Kordarna, the SPV created with an intention to be sold to an investor as a going concern was called Kordarna Plus a.s. (hereafter Kordarna Plus). For it to become a successor of the Company and a full-fledged carrier of business operations Kordarna Plus had to acquire not only crucial assets but also the employment contracts of almost all employees, patents and trademarks etc. Technically Kordarna Plus was created as a subsidiary fully owned by Kordardna a.s., the registered capital was increased to CZK 602 mil. and it was fully paid by a nonmonetary investment of core business assets of the Company. The exact value of CZK 602 mil. was obtained through an expert appraisal of the particular assets⁸¹.

The biggest source of funds for the payout of creditors was intended to be gathered through the sale of 100 % shares of a new subsidiary company Kordarna Plus. The residual assets that were not transferred to the new Kordarna Plus remained in the Company to be sold later in a piecemeal sale. The valuation of these assets was estimated to an amount of CZK 28 mil.⁸².

⁷⁸ Can be found in Insolvency register under the number KsBR 39 INS 2462 / 2009 – B 10-15

⁷⁹ KsBR 39 INS 2462 / 2009 – B 20

⁸⁰ Creditor's meeting report KsBR 39 INS 2462 / 2009 – B 22

⁸¹ The full appraisal of Kordarna Plus - KsBR 39 INS 2462 / 2009 – B 121

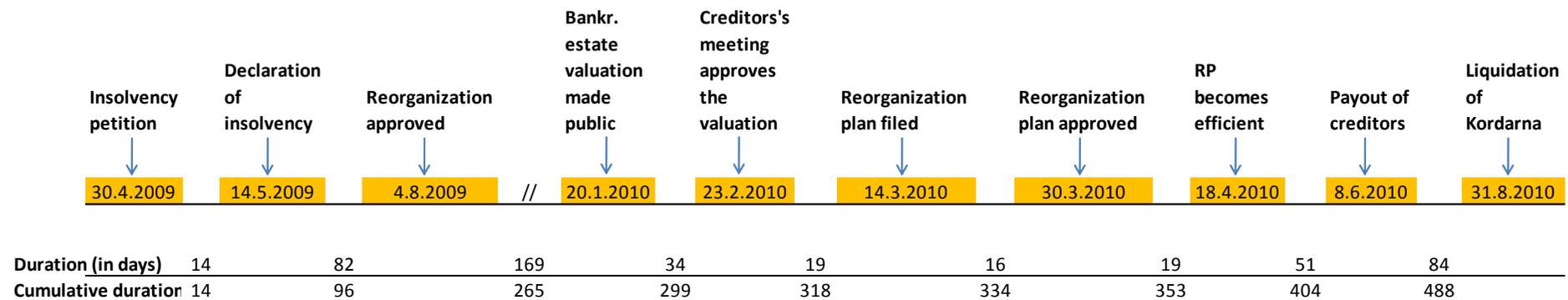
⁸² The valuation was first approved on the creditors' meeting and then also by the court in a ruling KsBR 39 INS 2462 / 2009 – B 113 on 25.2.2010

The valuations mentioned above show that an overwhelming majority of funds for the payout of creditors comes from the sale of Kordarna Plus, so it was extremely crucial for the creditors to make the sale successful.

3.1. Schedule

As we mentioned in the general part of the thesis minimizing the length of the insolvency proceeding is one of the most crucial aspects leading to an efficient solution of insolvency. Later in this section we will analyze why. Let us now have a look on actual duration of reorganization of Kordarna and compare it with statistics of other reorganizations published by Richter (2010) and empirical findings from other literature on reorganizations. In the graphical scheme, depicting the whole insolvency proceeding of Kordarna, we can see the time periods needed to advance from one step to the other⁸³; let us explore the most important ones.

Chart 3:



The insolvency proceeding started with the filing of the petition on 30.4.2009, it then took the court 14 days to declare insolvency. In a time of 82 days after the declaration, the consensus was found about the solution of the insolvency – the reorganization was approved on the meeting of creditors on 4.8.2009. According to Richter (2010) an average duration between declaration of insolvency and an approval of reorganization is 74 days. Altogether the proceeding from the day of filing of the petition until the final liquidation of Kordarna a.s. took 488 days (16 months). For

⁸³ Some dates in the scheme do not match with the ones published in the schedule in the reorganization plan, since the actual dates of occurrence of some of the events differed from the planned ones.

the creditors the most important period is probably the duration from the start of the proceeding until the payout accomplishment, which took 404 days (more than 13 months).

Another really important step in the reorganization process is the final decision about the winning bidder in the investor selection process (here in a form of an auction for purchase of the successor company), because from that moment an investor can start preliminary negotiations with the new trade partner and other involved institution and individuals, although the whole process can still collapse on unwillingness of creditors. In the case of Kordarna it took 252 days (8months and 7 days) to find an investor from the moment of declaration of insolvency. From all the steps in the entire reorganization process, the approval of the reorganization plan might be the most crucial. One of the reasons is the fact that the hope of creditors and most importantly business partners in a successful reorganization heavily increases after the approval is carried out. The creditors' meeting convened for the purpose of voting on the filed reorganization plan took place on 30.3.2010, which is eleven months after the declaration of insolvency. When we compare the duration of the proceeding with a proceeding duration statistics published by Richter (2010), this figure does not differ from the average. Richter states that the average time period from filing of the petition to the court decision on the reorganization plan is 11 months (median value 12,25 months).

Even though a company in insolvency is exempt from cash outflows on loan installments and many other expenditures, as long as it operates it still needs to settle its trade partners' post-insolvency receivables in time and this is where the other bankruptcy costs accrual also occurs. For a financial officer of a debtor to survive running in an insolvency regime for almost a year could be seen as a tough balancing act on the edge of a cliff of liquidation. Nonetheless the case of Kordarna is very specific one because of a rather stabilized financial situation of the Company already at the beginning of the insolvency proceeding⁸⁴.

When we look at the timeline the procedure that took the most time is the preparation of the reorganization plan. Reorganization solution was approved on 4.8.2010 and the plan was filed first on 14.3.2010 so the period in-between these two steps is 222 days (7months and 10 days) compared to Richter's average among reorganizations of 160 days.

Even though the financial situation of Kordarna after restoring of factoring was not critical, all the involved professionals who I had a chance to interview agreed on the fact that the long

⁸⁴ Financial situation of Kordarna before and after declaration of insolvency and details about financing matters of Kordarna in insolvency was further discussed in the section 2.2.

duration of insolvency proceeding was injuring the market and thus also economic situation of the company. PWC representatives added that it took an extreme effort to keep sales figures above a the break-even level, especially after the ceasing of purchases from the number one cords customer. The decrease of sales resulting from a loss of such a big customer was offset by penetration onto Russian and Turkish markets.

The experience of Czech reorganizations is yet too short to provide an in-depth statistical analysis of its duration so let us also review the findings from foreign data samples. Empirical research of Acharya, Bharath and Srinivasan (2005) proved that firms spend more time in bankruptcy during periods of industry distress, 2.16 years as compared to 1.37 years in times of no industry distress. Denis and Rogers (2007) found that “firms spend less time in Chapter 11 the smaller they are and the better their pre-filing industry-adjusted operating performance”. The same researchers also claim a relevant finding for our case that if the debtor is acquired by a new investor during the time being in Chapter 11 then the only significant determinant of length spent in the insolvency is the firm’s size. Moreover we can claim that the relatively good operating performance of Kordarna after insolvency declaration, made the emergence from a reorganization quicker since such a dependence is among the most significant conclusions of research of Denis and Rogers (2007).

3.2.Sale process

To maximize the potential price and thus to maximize the value for creditors and also to ascertain maximal transparency the sale of Kordarna Plus was decided to be carried out through an auction⁸⁵. An investor selection procedure was according to the report from creditors' meeting⁸⁶ announced on 23.9.2009 and the requirements on investors were made public. Potential investors had to demonstrate the willingness to really participate in the process and the ability to settle the final price by consigning a guaranty of EUR 1 million. This amount had to be submitted until 18.11.2009.

The auction was lead by a consulting firm PriceWaterhouseCoopers (PWC), which according to their report addressed more than 300 potential investors. Creditor's committee approved a company CEFEUS CAPITAL as a winning bidder because they fulfilled all the requirements and offered a highest bid. The final price offered for 100 % of shares of Kordarna Plus by CEFEUS CAPITAL has been CZK 795 600 000. Nevertheless, this amount was adjustable; because of the ongoing business operation of the company the final amount paid depended on the current amount of working capital the new company has had on its balance sheet at the moment of sale. According to the contract the price could have been adjusted up without any limitation but downside it could have been lowered by mostly CZK 125 mil. from the originally determined price. If the value of working capital had diminished by more than CZK 125 mil., the investor could according to the reorganization plan have canceled the whole transaction. The whole Due Diligence process was carried out before the submission of the reorganization plan and before signing of the share purchase agreement, which had a clear advantage of an increased certainty of a successful transaction. So the conditions precedent for the investor were minimized to an extent of approving of the reorganization plan.

According to the court, the auction process was carried out transparently and it really succeeded in maximizing the value for creditors. There was not a single legitimate objection against the sale procedure from any of the proceeding participants. The

⁸⁵ Here the term "auction" does not denote a public auction by course of Public Auctions Act 26/2000 Coll., but a general term for a sale structured as an auction within the meaning of Mergers and acquisitions terminology.

⁸⁶ Creditors meeting report including the sale process details - KSBR 39 INS 2462 / 2009 – B 125

only protest was from a representative of SPV Invest s.r.o., which tried to step back into the auction as a bidder after it had been once rejected because of a failure to fulfill the requirement of depositing a EUR 1 mil. collateral. During the meeting, which took place on March 31, 2010, an attorney representing this company informed the court that the company together with its financing bank was prepared to pay more than a winning price. The court stated clearly however, that the sale process has been closed already and therefore the reasons for disqualifying SPV Invest from the tender for Kordarna Plus were legitimate. This has been proven by a documented correspondence between PWC and SPV Investment⁸⁷.

The winning price for Kordarna Plus was later adjusted in accordance with the share purchase agreement⁸⁸. The day specified in the contract, when the decisive value of working capital should be read was the day just before the reorganization plan became effective on 16.4.2010. An assessment of the working capital value was performed by an independent auditor and the assessed values included the working capital of Kordarna Plus a.s., KORDSERVICE a.s. and Technické a úklidové služby s.r.o. The following table⁸⁹ shows the values from the official auditor's report.

Table 1: Price adjustment - Working capital change (All figures are in CZK ths.)

		31.10.2009	16.4.2010	Change
+	Inventories	258 609	244 560	-14 049
+	Short Term Receivables	243 696	224 979	-18 717
+	Short Term Financial Assets	1 419	19 611	18 192
-	Short Term Payables	63 317	64 310	993
-	Short Term Bank Loans	25 855	12 669	-13 186
=	Working capital	414 552	412 171	-2 381

A notification about the progress in fulfilling of reorganization from 2.6.2010 gives comments concerning the change of working capital⁹⁰. Here we present the most important comments combined with other facts known from the economic development that could have affected the working capital level. The inventories diminished by more than CZK 14 mil., which was caused by a planned temporary

⁸⁷ The documents are attached to the creditors meeting report - KSBR 39 INS 2462 / 2009 – B 125

⁸⁸ Share purchase agreement – attachment #4 of the reorganization plan - KSBR 39 INS 2462 / 2009 – B120

⁸⁹ Values are obtained from the report of BDO Audit, s.r.o. , which is attached to The report of the Debtor on fulfilling of the reorganization plan - KSBR 39 INS 2462 / 2009 – B 132

⁹⁰ The report of the Debtor on fulfilling of the reorganization plan - KSBR 39 INS 2462 / 2009 – B 132

ceasing of production at the end of 2009. It has been done in order to reduce the level of invested capital stuck in excessive levels of inventories and thus to improve the cash cycle efficiency. The short term receivables declined by CZK 18.7 mil., the decline could be interpreted by a relative seasonal drop in sales during the winter months. The other reason for lower level of receivables is an increased usage of factoring, in which the receivables are sold for cash. Short term financial assets on the other hand increased by more than CZK 18 mil., which is partly inflicted by the aforementioned increase in receivables factoring sales and it is a good sign of improving the financial health of Kordarna Plus. The level of payables has not changed during the 5.5 months period. This is a result of the fact that almost all supplies were paid in advance.

The resulting change in working capital is a negative CZK 2 381 000 so the price for an ownership share of Kordarna Plus had to be slightly diminished from original CZK 795 600 000 to final CZK 793 218 000. The payouts of all creditors have been consequently diminished.

3.3.Liquidation of Kordarna a.s.

After the transfer of selected assets to Kordarna Plus there were still some assets left in Kordarna. These were intended to be sold and the whole entity was to be liquidated. There would also emerge some costs connected with the liquidation such as administrative fees or a remuneration of a liquidator. The remaining financial resources after subtracting these costs were primarily designated to be used to cover the remaining administrative priority payables while the rest will be distributed to creditors based on the proportion of secured and unsecured assets. The reorganization plan assumed and ordered the insolvency trustee to perform all the steps needed to liquidate and consequently erase the company from Commercial register within 30 days after the decisive conversion of assets into cash⁹¹.

⁹¹ Reorganization plan, Section 8.1.5 - KSBR 39 INS 2462 / 2009 – B 118

3.4. Settlement of the claims

In this section of the thesis we describe the way the final payout of all the creditors was determined, going into detail on factors that influence the payout of the different classes of creditors⁹². Class number one is formed by the only secured creditor – Ceska Sportelna with a total secured claim of CZK 3 459 531 607. The class number two is formed by all the unsecured creditors, whose combined claims amount together CZK 3 651 779 668. According to the plan the third class is formed by conditional bank creditors, who filed their claims in the total amount of CZK 980 621 666 (more on this special class in the next paragraphs). The last class (number four) is formed by shareholders who as stated in the general part of the thesis also have to form their separate group.

When the payout of creditors is defined there are two main variables that influence the particular amounts paid out: The first variable is the amount obtained from the sale of Kordarna Plus and the remaining assets and the second variable is the ratio setting the distribution of these funds among the groups of creditors. Let us start with the first one.

The amount designated to be paid out to the creditors consist of the final amount gained through the sale of shares of Kordarna Plus and the money gained through the sale of remaining assets. The payout figures derived below correspond to the price paid for Kordarna Plus of CZK 795.6 mil. because in the time of preparation of the plan the adjustment of this price as described above was not known yet. When reviewing the determination of the recipient of the money gained from the particular sale, let us start with the remaining assets where the system is rather simple. Remaining assets are sold in a piecemeal sale for the price that should not deviate much from the liquidation value appraisal. The whole bankruptcy estate liquidation value was CZK 519 042 000; determination of this value is presented in the bankruptcy liquidation scenario in the next chapter (number 4) in detail. From this value the remaining assets (the assets not transferred to Kordarna Plus) amount to CZK 34 938 342. Turning all these assets into cash could take more than a year but this fact is already taken into account in the valuation. When determining which creditor gets what, the situation is simplified by the fact that there is only one secured

⁹² The formation of creditor's classes is specified in section 7.1.2. of the reorganization plan - KSBR 39 INS 2462 / 2009 – B 118.

creditor and the value of the collateral is not even closely reaching the value of the pertaining claims. So the division of the proceeds from the sale of remaining assets follows these rules: if the secured assets could be sold separately, proceeds simply fall to secured creditors payout. If the secured assets could not be separated from the unsecured ones to be sold alone, they are sold together and the proceeds are divided according to the ratio between liquidation values of secured and unsecured assets. In our case there are both types of these asset settings, among the remaining assets we have clearly separable assets like painting art pieces but also residential real estate with inseparable secured and unsecured parts. The payouts from remaining assets assumed by the reorganization plan are derived from another valuation, which assesses the market value of these on 30.9.2009 on 28 873 000 CZK. At the end of the day the sum of all the individual components gives us the following division of this amount: approx. CZK 13 380 454 goes to secured creditors and the remaining CZK 15 492 545 falls to the total unsecured creditors payout.

The part of the bankruptcy estate assigned to be transferred to Kordarna Plus was appraised to CZK 484 103 657 which is more than 93 % of the total value of the estate. From this we can already see that success of the reorganization depended on the sale of Kordarna Plus because the expectation was that the final price will substantially overpass the liquidation value as there is a potential of further cash flow generation. The winning bid set the price to CZK 795 600 000 (before the final adjustments, which have been made first after the plan became effective). To find out again the distribution of the proceeds to the particular groups of creditors we have to know the ratio between liquidation values of secured and unsecured assets transferred onto the balance sheet of Kordarna Plus. Based on the expert's opinion report, from the total bankruptcy estate value of Kordarna Plus equal to CZK 484 mil., there is CZK 312 mil. subject to a security lien and while the remaining CZK 172 mil. thus pertains to the unsecured part of the estate. Hence the ratio between secured and unsecured assets at Kordarna Plus is 64.45 : 35.55. When we apply this ratio to the amount obtained through the sale we get the payout amounts assigned to secured and unsecured creditors. This calculation principle is nonetheless case-specific and cannot be generally applied to many similarly designed reorganizations. The applicability of this formula is restrained to cases where the liquidation value of the secured asset is lower than the value of the pertaining secured claim. If it is not

the case then the proceeds are distributed between secured and unsecured creditors based on the ratio of nominal values of their claims. This is induced by the fact that the proceeds from a sale of secured asset fully satisfy the claim of a secured creditor and the rest goes then to the pool for settlement of the unsecured ones. It is interesting to remind the reader that in the previous Czech Insolvency Code (Zákon o konkurzu a vyrovnání or ZKV) settlement of a secured creditor was not limited by 100 % of a secured asset liquidation value as it is now⁹³, but the limit was set to only 70% of the liquidation value⁹⁴.

Let us spend more time on thinking about the fairness of the distribution of a gain from the sale of a part of the company as a going concern. In case of bankruptcy liquidation it is all clear that the payoffs should match the liquidation values no matter whether the limit on settlement of secured creditors from monetization of secured assets is 70 % or 100 %. In reorganization through a sale of a running business unit the value paid by an investor corresponds to a future cash flow generation ability of the company. This cash flow is generated by an aggregate indivisible unit and we cannot say how big is a contribution of the particular secured or unsecured assets to any dollar of cash flow generated. The division of proceeds between the payouts based on the value of the fixed claims is though the only imaginable method as can be inductively proved by replicating the sale and payout by using a debt-equity swap first and then a standard sale of a company. In the debt-equity swap new shares are also issued according to the value of previous creditor's claims. The problem could arise in such a reorganization layout that we have seen also in case of Kordarna. The layout can be characterized by these features: 1) there is one package of assets designated to be sold as a going concern and thus we can assume that the valuation and also the price paid is based on a discounted cash flow method; 2) the other part of assets is sold in a piecemeal sale for the liquidation value. Here if you are a creditor you have a clear incentive to move a highest possible portion of your (secured vs. unsecured) assets to the viable part (equivalent to Kordarna Plus). If we assume that an average gain obtained in a "going concern" sale of one dollar of liquidation value is more than one dollar⁹⁵, the creditor who has

⁹³ IC § 167 (2)

⁹⁴ ZKV § 28 (4)

⁹⁵ Such an assumption could be made because otherwise such a "going concern" sale would not make sense

the security lien on the transferred asset could benefit from a transfer to the “going concern” part even though adding of this has not increased the price paid for the aggregate. At the top of this the probability of such a conflict of interest of creditors is increased by the fact that there is simply no clear cut between assets that should enter a new SPV and the ones that should be subject to liquidation.

Coming back to our data about settlements in our particular case, such a transfer that we have mentioned in the previous paragraph would bring approximately CZK 0.64 more per CZK 1 transferred⁹⁶ without an increase of the price for Kordarna Plus.

In our original reorganization scenario the already mentioned ratio of liquidation values of 64.45 % : 35.55 % (secured : unsecured) at Kordarna Plus gives us the approximate settlements of CZK 512.8 mil. for secured and CZK 282.8 mil. for unsecured creditors. To sum it up the total payout of a secured creditor is in accordance with the reorganization plan and is estimated to reach $(512.8 + 13.3 + 0.031^{97}) = \text{CZK } 526.2 \text{ mil}$

The total unsecured creditors' class payout was assessed to be $(282.8 + 15.5) = \text{CZK } 298.3 \text{ mil}$.

⁹⁶ This figure is marginal and it would slightly decrease with every other CZK transferred, but in general this example could serve as a sufficient illustration. The 0,64 CZK figure was obtained through a calculation $(795\,600\,000 - 484\,103\,658) / 484\,103\,658 = (\text{price of sale of Kordarna Plus} - \text{liquidation value of Kordarna Plus}) / \text{liquidation value of Kordarna Plus}$

⁹⁷ The minor gain of 31 130 CZK comes from a sale of real estate plot, which was fully secured and it was sold already before the filing of the plan

3.5. Value of the claims

3.5.1. Secured claims

According to a list of creditor's receivables⁹⁸, Kordarna a.s., had only one secured creditor - Ceska Sportelna, which filed a secured receivable in a total value of CZK 3 459 531 606. Although this is not the whole truth, it is correct from the technical perspective of the insolvency proceeding. In reality however, the loan, related to this claim, taken by Kordarna was provided by a syndicate of six banks where Ceska Sportelna acted as an arranging agent⁹⁹. A structure of this receivable is somewhat complicated because CS was a major loan financing provider for all members of the KORD Group. Since almost all of them went bankrupt and the loan agreements included guaranties and cross securities among the companies the Kordarna insolvency proceedings had to deal with the newly emerged receivables of secured creditors of Slovord, Slovensky Hodvab and Kordtrade SK. Even though this may be considered a mere technicality, it is important to illustrate the individual constituents of the claim and how they differ.

a) Loan contract from 18.10.2006 documents a receivable of in an extent of CZK 1 212 004 306, which on the bankruptcy date forms 35.03 % of the total secured claim of CS.

b) Cross security for payables of the three Slovak members of the KORD Group. Slovord a.s., Slovensky Hodvab, KORDSERVICE SK total amount reached CZK 1 629 091 654, which represents 47.09 % of CS claim.

c) Paralell Debt Agreement, which gave creditors of SLOVKORD a right to settle their claims from assets of Kordarna a.s. (again a form of cross-security). Amount of this claim is CZK 618 435 646, which translates to 17.88 % of CS claim.

In the previous section we reviewed the payout amount designated to be paid out to secured creditors. Ceska Sportelna is the only secured creditor which receives the whole amount of CZK 526.1 mil. This gives us a payout satisfaction rate of 15.21 % (based on the ratio 3 459 531 606 / 526 187 039).

⁹⁸ List of creditors KSBR 39 INS 2462 / 2009 – B 118

⁹⁹ More on the syndicated loan in conditional claim class description

3.5.2. Unsecured claims

Aside from filing its secured claim, Ceska Sporitelna as the biggest creditor also filed an unsecured one in the amount of CZK 1 826 015 247. This is by no means the final acknowledged value of the CS unsecured claim. The next lines show the rules and calculations needed to derive the final value of the claim. The secured claim mentioned in the previous section under the letter a) is a secured one and thus settled to the extent of 15.21 % (184 343 151 CZK). Therefore, according to § 167 the rest of the claim becomes a general unsecured one. Hence subtracting (1 212 004 306 - 184 343 151), yields CZK 1 027 661 155.

Another part of the unsecured claim is constituted by the yet unsecured part of the again undersecured claim under the letter b) derived as $(1\,629\,091\,654 - 247\,781\,206) = \text{CZK } 1\,381\,310\,448$.

The last constituent of the total unsecured claim of CS is formed by an originally unsecured claim filed by CS, but only above the value of the originally filed secured claim due to the cross – security with the Slovak members of the Kord Group (secured claim b) because these two filed claims actually represent the same receivable of Ceska Sporitelna. Hence the difference between these two claims $(1\,826\,015\,247 - 1\,629\,091\,654) = \text{CZK } 196\,923\,593$ should also be added to the total value of the CS unsecured claim. The above 3 parts added together $(1\,027\,661\,155 + 1\,381\,310\,448 + 196\,923\,593)$ form the total unsecured claim of Ceska Sporitelna in an amount of CZK 2 605 895 196.¹⁰⁰

The only other distinctive claim beside the one that we just gave detail on is a conditional unsecured claim of ABN AMRO BANK. The receivable also comes from the parallel debt agreement mentioned in the secured claims description under the letter c). After a subtraction of the previous settlement the remaining part becomes an unsecured unconditional claim of ABN AMRO BANK. The other part stems from a receivable of ABN AMRO from a debit of Kordarna a.s. on a checking account. So all together the unsecured claim of ABN AMRO is CZK 763 025 288.

The total value of the unsecured claims classified into a class number two after the verification procedure becomes CZK 3 651 779 668. As stated above the amount to

¹⁰⁰ This value could differ from the final claim value because the calculations deriving this assume the estimated payouts from security which could at the end of the day in reality differ.

be paid out to unsecured creditors reached CZK 298 350 399, which implies a payout ratio of 8.17 %.

3.6.Secured claim interest accrual

When a secured claim is bearing interest, in a reorganization according to a provision of § 171 (1) this interest starts to accrue again on the day following the day of decision about the solution of the insolvency. The interest rate applied is the same the loan contract specified before the insolvency. The interest payments are pursuant to § 171 (4) due monthly. In the case of Kordarna the Debtor asked the CS as a secured creditor on 26.8.2009 for a different payment schedule, which consisted of a postponed maturity of these payments beyond the reorganization plan approval. CS accepted the new payment schedule by a letter from 10.9.2009. According to professionals involved in the case, this act contributed substantially to the success of the reorganization.

4. Bankruptcy liquidation scenario

In order to tell whether the pursued reorganization solution is beneficial for the creditors we have to have some benchmark to be able to compare the actual payouts. In this section of the thesis we present the estimated payouts to the particular creditor classes based on the expert's opinion valuation.

4.1. Bankruptcy estate valuation

The whole bankruptcy estate value on the day when the insolvency was declared - 13.5.2009, was according to the EQUITA Consulting appraisal CZK 519 042 000. The valuator stated in the document that he had taken into consideration the fact that the situation in the particular industry was bad due to continuous impact of the global economic crisis. The situation at the time had lead to an increase of unused production capacities, with a potentially substantial impact on the demand for assets from the estate. The final value of bankruptcy estate was according to the valuator 558 545 000 CZK of which 62.98 % (CZK 351 785 000) beloned to secured assets while the remaining 37.02 % (CZK 206 761 000) to the unsecured assets.

4.2. Net proceeds of sale estimation

In order to get from the above figure to the net proceeds figure we have to subtract two items: the maintenance costs and the direct costs of sale. These costs differ among particular asset categories. Chapter 3.2.1 of the expert's opinion gives us tables of estimates of these in the form of percentage of the liquidation value¹⁰¹. The final estimated value of net proceeds is CZK 519 042 000. So implicitly the average sum of the two cost items reaches 7.07 %¹⁰².

4.3. Bankruptcy liquidation costs

In the description of the bankruptcy liquidation scenario we follow the methodology used in valuations of EQUITA Consulting, which separates these costs from the maintenance and direct sale costs. Bankruptcy liquidation costs comprise administrative priority claims as mainly:

- Insolvency Trustee's remuneration
- Labor related claims (severance payments)
- Expert's remuneration

¹⁰² Maximum limit based on § 298 is 9 % (=4 % + 5 %)

- All other claims emerging after insolvency declaration

These costs are further processed, each separately for the secured and the unsecured creditors because they differ as the secured creditors are paid directly from proceeds of sale of secured assets¹⁰³.

By secured creditors the only priority payable that needs to be settled from the net proceeds of sale is the remuneration of the insolvency trustee. Here it accounts for 2 % of the final payout amount, which in this case makes CZK 6.5 mil. Thus we arrive at an estimated payout for the secured creditor of CZK 317.7 mil in case of bankruptcy liquidation.

In the case of unsecured claims there are more priority payables that need to be settled before the payout, all of which are summarized in the following table (figures are in CZK millions)¹⁰⁴:

Table 2:

	Net proceeds	194.8
-	Trustee's remuneration	8.9
-	Severance payments	68.4
-	Other labor related claims	4.0
-	Production cancelation costs	3.2
-	Other	6.2
=	Unsecured creditors' payout	104.1

When we review the costs we clearly see that the highest amount is formed by severance payments. This corresponds to the effect we mentioned in the general part of the thesis about a substantial cost burden stemming from a relative inflexibility of the labor market, when liquidating a company. In our case the CZK 68.4 mil. have diminished the final payout by approx. 68 %.

After subtraction of all the costs the final amount designated for payout of unsecured creditors is CZK 104 081 000.

¹⁰³ IC § 167 (1)

¹⁰⁴ Section 3.2.2.7. of KSBR 39 INS 2462 / 2009 – B 103

4.4.Particular settlement rates

The payout rates for the bankruptcy liquidation scenario presented in the reorganization plan¹⁰⁵ are according to author's opinion wrongly calculated. The reorganization plan compares the payout rates obtained in the reorganization with the ones estimated in bankruptcy liquidation. The author of the plan has just taken relative (percentage) numbers from the expert's opinion and compared them with an actual payout. Nonetheless this was done without noticing that the denominators defined by values of filed claims significantly differ by the numbers derived in section 3.2.4 of the expert's valuation¹⁰⁶. This inconsistency is caused by the fact that when the expert's opinion was made and published the final value of claims was not known. The value of payout ratio presented in the reorganization plan corresponds to the value of unsecured claims of CZK 2 110.3 mil. although the actual reorganization payout ratio already counts with CZK 3 651.8 mil. So the presented rate of 1.98 % should according to our calculation be replaced by 2.85 %. Even though the liquidation payout estimates were in absolute numbers diminished by almost one third the damage made by potentially distorted creditors' decisions should be negligible because the payout in reorganization is even after the correction much higher.

The bankruptcy liquidation payout ratio for secured creditor is correct and reaches 11.21 %.

4.4.1. Administrative priority claims

Even though the company became technically insolvent it was still able to continue satisfying all claims from its ongoing operations. This stemmed from the fact that the cash flow generation was stabilized to cover all operating cash flow requirements. Furthermore, the financing cash flow was non-negative as the installments from loans did not need to be paid in insolvency and the interest payment pertaining to the secured payable was waived by the secured creditor.

The continual covering of payables from operations needed to be solved in a moment when a major part of the company transferred to Kordarna Plus. To prevent discontinuity in satisfying of all priority claims the company signed an agreement

¹⁰⁵ Reorganization plan, Section 8.1.3 - KSBR 39 INS 2462 / 2009 – B 118

¹⁰⁶ Section 3.2.4 of KSBR 39 INS 2462 / 2009 – B 103

with Kordarna Plus about transferring all the administrative priority claims pertaining to the transferred part of the company¹⁰⁷.

¹⁰⁷ Attachments of the reorganization plan – attachment #7 - KSBR 39 INS 2462 / 2009 – B 120

4.5.Reorganization plan approval

The creditors' meeting convened for the purpose of voting on the filed reorganization plan took place on 30.3.2010, which is eleven months after the declaration of insolvency.

4.5.1. Classes of creditors

For the purpose of voting on a reorganization plan approval the creditors were placed into classes gathering creditors with the same economic interest.

Class 1 – The only secured creditor – Ceska Sporitelna a.s.

Class 2 – Unsecured creditors

The reorganization plan placed all the unsecured creditors into one class. We can argue whether all of them had the same economic interest.

Class 3 – Conditional unsecured creditors

Claims of creditors placed in class number three come from a syndicated investment loan provided by a syndicate of six banks where Ceska Sporitelna acted as an arranging agent. CS filed the whole amount of this claim itself (including the amounts pertaining to other five members of the syndicate) so the conditional payables in this class represent the same identical claim. This principle is applied in order to prevent a denial of the claims of other banks because of some potentially unforeseeable affirmation issues. The fact that the claims are filed as conditional means that their acknowledgement depends on fulfilling of a condition. This condition was specified in the claim application form as follows: “existence of these claims is conditioned by the fact that the participation of CS in this insolvency proceeding is terminated differently than by termination of the whole proceeding for example according to § 184 of the Insolvency Code¹⁰⁸.” This condition is there because the filed claim represents the receivable identical to the one filed by Ceska Sporitelna. The total amount of receivables in this group is CZK 980 621 666, but as the condition has not been met until the plan was filed, it assumes a zero settlement for this group. Neither was the condition met before the creditors meeting so the court decided that this group was not allowed to vote on the plan¹⁰⁹. The court also

¹⁰⁸ § 184 deals with the situation when a creditor voluntarily withdraws its claim submission.

¹⁰⁹ Creditors meeting report - KsBR 39 INS 2462 / 2009 – B 125

stated that the Reorganization plan is fair in terms of §348 (2) and § 349 (2) of the Insolvency Code concerning the treatment of this group.

Table 3: Conditional claims

Conditional Claims	Value in CZK	%
Komercni Banka	231 382 640	23,60%
ABN AMRO Bank	231 382 640	23,60%
Raiffeisen Bank	220 364 419	22,47%
Calyon	165 273 315	16,85%
OTP Banka	132 218 652	13,48%
Sum	980 621 666	100,00%

Class 4 – Shareholders

According to § 335 one of the creditor’s classes is formed by shareholders and members of the debtor. The value of their claim is zero because this claim is subordinate relative to all the other claims. This means it could be settled as long as all the other claims are settled in full, which is not the case in this insolvency proceeding.

An interesting aspect here is the real value of shares. Even though a possession of the shares of the company does not give any longer a real chance for any payout it does not automatically mean that the value of the shares is zero. There could still be other nonmonetary rights, which could have some kind of value. An example of such a right could be a right to vote on a general meeting and thus to retain a certain amount of management control within. The quotation from the reorganization plan states that: “at the moment the plan becomes effective the function of the general meeting is not restored; since then it is still the insolvency trustee who possesses the competences of the general meeting”. A confirmation of zero value of the shares is implied by a reorganization plan assumption of liquidation of the company and trustee’s possession of all the general meeting competences until liquidation¹¹⁰.

¹¹⁰ Reorganization plan, Section 8.1.5 - KSBR 39 INS 2462 / 2009 – B 118

4.5.2. Voting on the reorganization plan

The next paragraph comments on the results of the voting as they are presented in the report from the creditors' meeting¹¹¹. The only member of the first group – CS voted for an approval. From 93 members of the second group 27 were present and with the exception of one minor trade creditor (China Shenma Group) who abstained from the voting, all the others voted for the approval. The third group members were not present and would not be allowed to vote anyway. Finally the fourth group formed by the shareholders was represented only by one of the four creditors (shareholders) – KORDTRADE, s.r.o., with an ownership share of 74,6 % and this creditor also supported the plan in its vote. The quorum needed for an approval in this group was defined by two rules both within § 347 (2). The first rule required that shareholders representing 2/3 of the ownership share must vote for the plan while the second rule stipulated that a majority of shareholders, defined not by the amount of their claims, but rather by the number of creditors must vote for the plan. While the first rule was satisfied without a problem, the second rule was not, as only 1 out of 4 appeared at the meeting and voted. Nevertheless the court concluded that the conditions of § 348 (2) and § 349 (3) were satisfied and therefore the plan concerning this group could be considered fair. The court proves its conviction for fair handling of this group by the fact that even in the bankruptcy liquidation scenario, there is no real chance that this group would get a single penny of payout¹¹². The court claims that all the groups 1 and 2 voted for the plan and the approval of the groups 3 and 4 is replaced by a ruling approval of the court, apart from that there are no other impediments. Based on these facts the insolvency court officially approved the reorganization plan on 1.4.2010¹¹³.

¹¹¹ Creditors meeting report - KSBR 39 INS 2462 / 2009 – B 125

¹¹² The claims in the group 4 are subordinate to the other so it means that unless the unsecured creditors are paid out in full the shareholders could not be given anything.

¹¹³ Resolution of the court about the approval of the reorganization plan - KSBR 39 INS 2462 / 2009 – B 126

5. After the approval

Generally speaking from the moment when the reorganization plan becomes effective it is again the debtor who is entitled to dispose of the estate, unless the reorganization plan states otherwise. As mentioned before, it is still the trustee who is entitled to dispose of the estate according to the plan. This ruling is not surprising because Kordarna a.s. is in the time of the plan taking effect only a shell sheltering assets designated to be liquidated. From the moment of efficiency of the plan the function of the general meeting is also restored, unless the plan claims differently. The plan also states that all the rights and function of the general meeting still remains in hands of an insolvency trustee.

6. Direct insolvency costs

We have discussed direct insolvency costs in the general part in chapter 1.2, at this point it will be interesting to further explore some of the factual figures reflecting these costs in case of Kordarna and compare them with existing literature findings. There is no rule in the Insolvency Code obliging a debtor to report on the expenditures connected with insolvency, but in the case of Kordarna we are lucky to get to this information because it is concealed in the monthly EBITDA reporting table attached to the reorganization plan¹¹⁴.

6.1. Direct costs before and during the insolvency

We see from the table that the company considers costs reported already in January 2010 (four months before the insolvency was declared) to be connected with insolvency and reorganization procedure. When we do not include one-off receivable write-offs the expenditures before the official commencing of the insolvency procedure reached CZK 9.2 mil.; the amount comprises severance payments of CZK 2.6 mil and legal and consulting fees CZK 6.6 mil. After 13.5.2009 (declaration of insolvency) the pace of cost accrual naturally increased. Even without the fee for the insolvency trustee the average monthly expenditures level (including severance payments and legal & consulting fees) in the period following the insolvency reached CZK 3.9 mil. compared to CZK 2.0 mil. in the months prior to the insolvency. The EBITDA reporting table was created at the end of 2009 but it also includes forecast figures for January and February and together with the information estimating the cost in the period after the plan approval the only figures we do not possess are the ones for the month of March. When we add up all the extraordinary costs for the whole year 2009 the result is CZK 38.2 mil. Together with estimated CZK 2.925 mil for the trustee's fee¹¹⁵ we arrive at the final insolvency proceeding costs of CZK 41.125 mil. In order to evaluate an impact that such extraordinary expenditures could have on the company we compared these with the normal operating costs of Kordarna. In the year 2009 when the production level was lower than in previous years, the costs of goods sold reached more than CZK 1 bn. and together with personal costs the operating costs reached CZK 1.224 bn. Hence the extraordinary costs make only 3.36 % of the operating costs in 2009. We can therefore assume that

¹¹⁴ Attachment #12 - KSBR 39 INS 2462 / 2009 – B 120

¹¹⁵ Own estimation: reorganization allowed at the end of June and a monthly salary in a company with more than 6.5 months x (CZK 415 ths. fee + CZK 35 ths. trustee's expenditures)

the direct insolvency costs could not significantly endanger the continuation of the production.

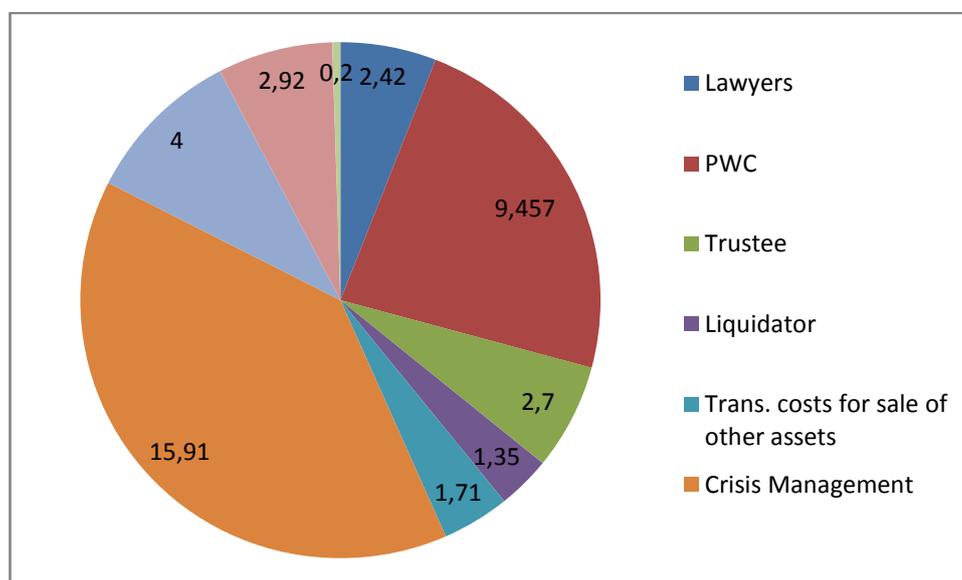
6.2. Direct costs after the reorganization plan approval

These costs are estimated in the reorganization plan for the period from the moment the plan becomes effective (end of March 2010) until the proposed final settlement of all insolvency issues. The plan estimates the liquidation of Kordarna a.s. and the remaining assets (in June 2011) to be the last step to finalize the implementation of the plan and thus also fulfills the satisfaction of all claims resulting from the plan.

The estimated amount needed to cover all the costs is CZK 40.7 mil. The biggest portion of the costs is formed by a remuneration of key crisis managers. The remuneration including the bonuses for successful reorganization amounts to CZK 15.9 mil. for the 15 months following the reorganization plan approval.

Chart 4:

The breakdown of the costs after the approval of RP (the amounts are in CZK mil.)



The total costs connected with reorganization are approximately CZK 88.7 mil.

6.3. Comparison of bankruptcy costs magnitude

To be able to compare the bankruptcy costs magnitude in case of Kordarna with some empirical studies we have to choose comparable relative figures. Most of the studies on bankruptcy costs use the following three denominators:

1. Market value of equity measured at the end of the last fiscal year prior to insolvency - This measure is rather inapplicable for us since Kordarna was never publicly traded and thus we do not possess a market value figure. The only possibility is to approximate it by the value obtained in the going concern valuation or even the final price paid in the reorganization sale of Kordarna Plus.

2. Book value of assets – Most existing empirical studies on bankruptcy costs use a relation to total assets at the end of the fiscal year prior to insolvency as a measure of magnitude of bankruptcy costs. The studies published by Weiss (1990) gives result of 2.8 %, McMillan (1991) using the same approach came up with an average value of 5.4 %. Other studies maintaining the same approach concentrated on a subsample of prepackaged bankruptcies, Betker's (1995) result for prepacks is 2.85 % and Tashijan (1996) compared the costs of pre-insolvency voted plans and post-insolvency voted plans arriving at 1.65 % and 2.31 % of the book value of assets respectively.

3. Liquidation value – There are reasons why the pre-bankruptcy figures are not the best comparables for the magnitude of bankruptcy costs¹¹⁶. Therefore Betker (1995) used liquidation value of assets as the base for costs comparison. His results claim direct costs to be 6.3 % in the case of ordinary Chapter 11 reorganizations and 3.23 % in the prepackaged reorganizations.

In order to compare our figures we have to incorporate exactly the same constituents of the direct costs as did the authors of the existing studies. The included cost categories are: all professional fees (mainly legal and consulting), Trustee's fee, independent experts' fees, eventually also asset sales costs and taxes. On the other hand the severance payments and the write-offs of assets are not included, even though they are well measurable and in case of Kordarna also precisely reported, they are not directly linked with insolvency. Concerning the time interval used we

¹¹⁶ McMillan (1991) claims that "pre-restructuring assets may be a poor measure of firm value. Firms often take large asset write-downs during the course of a debt restructuring".

have added all costs accrued from the beginning of 2009 until the estimated end of the proceeding (June 2011).¹¹⁷

Using the adjusted comparable methodology the direct insolvency costs amount to CZK 64.125 mil. Relatively this figure accounts for 1.97 % of the total assets, which in context of empirical observations places Kordarna costs towards the prepackaged reorganizations values of magnitude. The relatively low costs could be explained by a relative smoothness of the whole proceeding and cooperation of all involved stakeholders. Compared to the liquidation value of the bankruptcy estate, the costs reach 11.48 %, which is significantly higher than results of the existing studies. Comparison with the amount obtained through the sale of Kordarna for CZK 795 mil. the costs reach 8.06 %¹¹⁸.

From the author's point of view the most suitable base variable for comparison of direct bankruptcy costs is the total creditors' payout, since this figure really tells you about efficiency of the insolvency process by measuring how many cents on the dollar of payout are eaten up by direct costs. In the case of Kordarna the direct costs made 7.78 % of the total payout of CZK 824 504 130.

¹¹⁷ June 2011 is the planned date for the end of the liquidation of Kordarna a.s., the implementation of the reorganization plan itself should according to attachment #11 of the plan be finished already at the end of 2010. (KSBR 39 INS 2462 / 2009 – B 120)

¹¹⁸ Comparison of this figure with the results using pre-bankruptcy market value of equity is rather problematic. As the pre-insolvency market value and the post insolvency one could largely differ.

7. Other KORD Group companies

KORD Group companies were not just companies that were owned by the same owner, they were interconnected as members of a single supply chain. The financial transfers within the group were not limited just to regular trade relations, as we can see from the financials published in annual reports there were also intra-group loans used to stabilize the cash flow situation in the particular companies¹¹⁹. This interconnection could also be documented by reviewing a table of creditors of all four reorganized companies, because these loans were not paid off before the insolvency¹²⁰.

In the rest of this chapter we will focus on the insolvency proceeding of other KORD Group companies, though in much more concise way. The following text presents issues that either have a close linkage to Kordarna or they could be interesting in relation to some aspects of the reorganization process.

Slovak KORD Group companies reorganization

The business activities of Slovak members of KORD Group were an inevitable part of one KORD Group supply chain before the insolvency, so it was extremely crucial for the success of reorganization that all companies are enabled to restore production providing an investor acquires all assets essential to restore the business. Even though the Slovak KORD Group companies were regular entities founded and existing in accordance with law of Slovak Republic and they all have their principal office at Senica, Slovakia, they were all allowed to be subject to an insolvency proceeding in the Czech Republic. This fact is enabled pursuant to preamble 13 of the European Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings since the center of main interest (COMI) of all Slovak KORD Group companies is in Velká nad Veličkou in the Czech Republic¹²¹. Hence the court in Brno in Czech Republic could according to article 3, section 1 of the same regulation commence the “main” insolvency proceeding¹²².

¹¹⁹ Annual report 2008

¹²⁰ Table of intra-group payables

¹²¹ Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings

¹²² When the “main” insolvency proceeding has been commenced all other proceedings in any other member state become “subsidiary” proceedings pursuant to articles 3 and 27 of Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings on insolvency proceedings.

7.1.Slovkord

Slovkord a.s. was founded as a subsidiary company of Slovensky Hodvab and Kordarna. In 1999 the company was fully integrated with the production structure of the group and started polyester technical fibers production. On 1.1.2005 Slovkord took over the granulate manufacturing, which is the main raw semi-finished product for technical fibers production. In 2007 the group management decided to invest into a huge project that should have increased the capacity of granulate and fibers manufacturing. At the beginning of 2008 the company also took over a production of polyester textile fibers from its mother company Slovensky Hodvab. However, the production expansion project could not be finished because of economic problems; as a result of deteriorating cash flow all core business operations were ceased in May 2009. In 2010 the company only serves as a supplier of supportive business services for other KORD group companies¹²³.

The development in the group resulted in inability to pay off debts and the company filed a voluntary petition, subsequently it was declared insolvent on 13.5.2010¹²⁴. As in the case of other group members Slovkord has also chosen to apply for reorganization solution. The basic idea of the reorganization is similar to the one used in other KORD Group companies a takeover of core business operations by a third party investor, which would restart production, reestablish trade partner's confidence and might also finish the core investment projects started before the insolvency.

As a result of the similarity of procedural matters we will concentrate solely on the core factors and figures and on some aspects that differ from the other group members' reorganization procedures or the ones that are interesting from an academic standpoint.

7.1.1. Reorganization

To be able to coordinate the structuring of the reorganization Slovkord has chosen the following means of reorganization. Core business assets are transferred to an SPV called Slovkord Plus (hereafter SLK Plus) and this company is then sold in a tender to a highest possible bid. The sale was initially structured as a separate auction for seven detached assets packages, which comprised assets of all three Slovak

¹²³ Reorganization plan of Slovkord - KSBR 39 INS 2464 / 2009 – B 127

¹²⁴ Declaration of insolvency - KSBR 39 INS 2464 / 2009 – A 12

KORD Group companies (Slovkord, Slovensky Hodvab and Kordservice SK). The auction took two rounds and according to the report it proved a low investor interest. In all the separate auctions (except for minor package #5¹²⁵) the winning bid was placed by firms belonging to the JET Investment Holding (Santini Capital and Cefeus Capital). This fact together with complex linkages among the assets (charging liens) complicating the division of assets into the packages lead Slovokord to change the structuring. In order to simplify and speed up the process JET Investment offered a new structuring under three successor companies Slovokord Plus (SLK Plus), KORDSERVICE SK Plus (KSSK Plus) and Slovensky Hodvab Plus (SH Plus). On top of the operational assets these entities included also intangible assets, inventory, short-term and long-term payables and receivables, employee contracts and trade contracts; all properties set up to maximally facilitate carrying on or restoring production and trade activities. The items that were not added included intra-group receivables that emerged before the declaration of insolvency, irrecoverable receivables (receivables more than four years overdue or related to bankrupt companies), pre-insolvency payables, assets that were subject to adversary ownership claims. The total book value of assets included in the entities had reached an amount of EUR 115.7 mil.

7.1.2. Bankruptcy estate valuation issue

According to the report the final winning bid from Santini Capital reached EUR 3 172 000 (CZK 81 425 240)¹²⁶. When we compare this amount with the expert's valuation of the estate in the bankruptcy liquidation scenario we come to a surprising finding. The valuation of a Slovak independent valuator assessed the value of the estate to EUR 6 827 286¹²⁷. This is more than twice the amount obtained in the auction plus the proceeds from the sale of remaining assets. So this seems we have here an issue, which could have various causations.

Hypothesis 1: The reorganization was not the best solution option, since the bankruptcy liquidation scenario might have given a higher payout

¹²⁵ The package #5 represented a sewage water treatment plant and a highest bid for this was placed by TOMA a.s.

¹²⁶ Creditor's meeting report - KSBR 39 INS 2464 / 2009 – B 131

¹²⁷ Attachment #13 - - KSBR 39 INS 2464 / 2009 – B 127

Hypothesis 2: The sale (auction) was not performed efficiently and thus there was a chance to obtain higher value for creditors.

Hypothesis 3: The liquidation value of the estate assessed by the expert's opinion is too high and does not correspond to real market situation.

We can observe exactly the same setting of payouts and valuations in the case of Slovensky Hodvab. We are going to analyze the issue on the SlovKord figures, but the results obtained can be then referred to Slovensky Hodvab as well.

Before we anyhow analyze the issue, to have more complete information on the problematic let us present the payouts for particular creditors assumed by the reorganization plan and estimated in case of the bankruptcy liquidation.

The money for payouts in the reorganization come in large extent from the amount obtained through the sale of SLK Plus. The payouts of particular creditors' classes were based on the proportions of secured and unsecured assets in the estate. According to the expert's assessment from the total liquidation value of the estate of EUR 6 827 286 (CZK 175 256 432) secured part equates to EUR 6 420 438, which accounts for more than 94 % of the estate. The remaining EUR 406 848 pertains to the value of unsecured assets. The reorganization plan suggested CZK 65 064 209 for secured creditor, which is 1.88 % of its submitted claim amount and CZK 4 108 596 for unsecured creditors, which makes not more than 0.099% of their nominal claims. The bankruptcy scenario assumes some level of priority payables so the sum of payouts of secured and unsecured creditors is lower than the liquidation value of the estate. According to the official bankruptcy liquidation scenario, secured creditors payout would reach EUR 6 562 751¹²⁸, however there would be nothing left for the unsecured ones. There. Therefore Ceska Sporitelna as a secured creditor received a mere payout which was 2.5 times lower than in case of bankruptcy liquidation. The table summarizes the payouts (all values are in CZK ths.).

¹²⁸ Bankruptcy estate valuation - KSBR 39 INS 2464 / 2009 – B 103 -107

Table 4: Slovokord payout scenarios

Submitted claims and payouts	Submitted	Reorganization payout		BL payout	
Class 1 – secured	3 466 375 182	1.877%	65 064 209	4.86%	168 465 834
Class 2 – unsecured	4 150 096 551	0.099%	4 108 596	0.00%	0
Class 3 - conditional unsecured	876 497 437	0.000%	0	0.00%	0

At this point we return to the core of the issue. Here is a summary of facts related to the problematic:

- 1) The independent valuation of bankruptcy estate gave a higher value than the amount paid by the highest bid in the auction
- 2) Ceska Sporitelna accepted a payout 2.5 times lower than it would have received (according to the bankruptcy estate valuation) in bankruptcy liquidation

Let us assume for a while that successively each of the hypotheses is valid. For the validity of the hypothesis #1 (H1) speak the independent expert's opinion. If we assume that the values in the opinion are correct it implies the sum of payouts to be 2.43 times higher than the one actually paid out in the reorganization. Ceska Sporitelna as a secured creditor would also have received a much higher payout. If we now look at the process of the approval of the reorganization and the actual parameters of reorganization within the reorganization plan we see that CS as a 100 % secured and 67 % unsecured creditor could clearly in any of the voting stages convert the reorganization into bankruptcy liquidation. Moreover in the voting on the reorganization plan the possible vote of CS against the plan could not have been revoked by the court because the best interest test does favor the liquidation scenario¹²⁹.

Hypothesis #2 assumes a failure of structuring of the reorganization sale process leading to a lower price paid and thus a lower payout for creditors. A weak point of this hypothesis is revealed when we review the time sequence of the particular operations. The whole auction was finished before the voting on the plan occurred

¹²⁹For more information on reorganization plan approval process and the best-interest test see general part of the thesis section 4.2

and the outcome of the auction sale was incorporated in the reorganization plan¹³⁰. Hence again the secured creditor had a chance to reject the reorganization plan with an already known lower payout. So we arrive to the claim that if any of the first two hypotheses is valid then CS has had some other reason to vote for lower payout reorganization, otherwise the board members of CS would have acted against the fiduciary duty pursuant to § 194 (5) of the Act 513/1991 Coll., Commercial Code. Theoretically one of the reasons could be the one we describe in detail in the next section and it stems from future expectations of a potential business involvement in the ongoing business. However, this is rather improbable due to a lack of interest in continuing the business relationship, which was already shown in declining of providing a DIP financing.

The third hypothesis assumes the expert's valuation not to be realistic in a sense that it is exaggerated compared to the real possible amount of proceeds that would potentially be obtained in case of bankruptcy liquidation. As we know Ceska Sporitelna voted for the reorganization solution despite the higher public bankruptcy estate valuation done by the expert. Assuming the previous two facts and a rationality of CS decision-making we then have only one more conflict of facts to challenge. Ceska Sporitelna has approved (together with other creditors) the expert's valuation of the bankruptcy estate in the meeting of creditors on 23.2.2010.¹³¹ Why has it approved the valuation? Let us review what implications has the official valuation figure – the liquidation value of the estate on the insolvency proceeding, since these are not negligible. As we know from the general part section 4.1.1.1 pursuant to § 167 a claim of a secured creditor could be classified for a purpose of voting on an approval of a reorganization plan only in the extent in which it is covered by a value of security. So basically the valuation simply raises the value of the secured claim, which is senior compared to all other claims; this can then result in transfer of proceeds from general unsecured to secured creditors compared to the situation when the estate is valued properly (lower). Moreover the best interest test rule might be likened to a creditor being given a put option with a strike price set to

¹³⁰ Description of the auction in the reorganization plan KSBR 39 INS 2464 / 2009 – B 127 -section 8.3.3.

¹³¹ Creditors meeting report- KSBR 39 INS 2464 / 2009 – B 110

the level of the estate valuation¹³². And thus even though the creditor thinks that the valuation might be too high it has a clear motivation to approve it anyway. Unlike in case of the other two hypotheses, in this one we have not found any objection against its validity. We have not provided a rigorous numeric proof of the validity but at least we could assume, when we take into account the output of our analysis of creditors' incentives, the third hypothesis to be the most probable. This conclusion was then also validated by the representative of CS, who confirmed that the steps of CS in the proceeding were supported by the same conviction about the two possible scenarios.

To figure out whether this exaggeration is a unique phenomenon or rather a more common occurrence let us briefly review an existing literature. Campello and Giambona (2010) provided an interesting twist of a corporate finance “dogma” of a higher debt capacity of firms with higher portion of tangible assets¹³³. By measuring supply and demand for different types of tangible assets (e.g., machines, land, and buildings) they reached a conclusion that the tangible fixed assets are commonly illiquid and less redeployable. As we already mentioned in the general part the research of Acharya, Bharath and Srinivasan (2005) proves that the illiquidity in asset sales is significantly higher in the times of economic crisis and among firms possessing assets with high industry specificity¹³⁴. Their claim is supported by Altman, Brady, Resti, and Sironi (2003) who conclude that “aggregate bankruptcy recovery rates are negatively related to aggregate default rates”¹³⁵. To support the doubts about the reasonability of the value obtained in the expert's opinion we have to focus also on the particular valuation report¹³⁶. The structure of assets, on the day of declaration of insolvency is remarkable. From EUR 100.5 mil. of book value of total assets EUR 97.1 mil is the value of fixed assets, by which the marketability is as we described highly questionable¹³⁷. Another important fact not incorporated in the estate valuation is the extremely high level of interconnection of the assets among the

¹³² For readers not familiar with a concept of options and other financial derivatives see Hull (2006) Page 7

¹³³ See e.g. Friedman (1982) - Page 103 or Vance (2005) , E., Raising Capital - page 42

¹³⁴ Acharya, Bharath and Srinivasan (2005) found that “when the defaulting firm's industry is in distress, its instruments recover about 11.11 cents less on a dollar compared to when the industry is healthy, this effect is statistically significant at 1% confidence level.

¹³⁵ For the similar findings see also Thorburn (2000) or Pulvino (1998)

¹³⁶ Expert's opinion including all valuations - KSB 39 INS 2464 / 2009 – B 104 - 108

¹³⁷ KSB 39 INS 2464 / 2009 – B 105, Page 18

particular KORD Group companies. There are many examples of factory halls rented for the production by another company and thus equipped by their fixed assets or many buildings built on plots of another company. This fact would have made the piecemeal sale of many of the assets impossible unless the sale was somehow coordinated with all other KORD Group companies. According to a representative of CS when making a decision between reorganization and bankruptcy liquidation this also was a substantial factor against the piecemeal sale liquidation. According to author's knowledge this particular factor was not taken into account in the bankruptcy estate valuation.

7.1.3. Plan approval and creditors' objections

After the creditors' meeting approving the reorganization plan, which took place on 10.5.2010, the insolvency court received two complaints about procedural steps in the reorganization. The first one was filed by one of the unsecured creditors, who complained about the content of the report from the creditors meeting¹³⁸. The complainer wondered about the fact that the report does not include any reference about the discussion concerning the finishing of the production expansion project, which was interrupted in the course of the construction process because of the insolvency. According to the complaint a representative of the debtor together with an investor's representative expressed an intention to finish the construction project, but they also warned that this intention is not guaranteed by the reorganization plan nor is it contractually based in any other official document. The creditor claims in the petition that this important fact could have changed the opinion of many creditors about the plan.

If we generalize this particular issue and take a look on the reorganization from the point of view of creditors we have to admit that many of them are trade creditors and they are thus somehow interested in carrying on of the business relationship. Both suppliers and customers have an incentive to support the reorganization solution because of continuing trade relationship. The same aspect should also be taken into account by a bank, which in case of bankruptcy liquidation also loses a potential client. This "indirect" motivation factors lead us to a general preference of reorganization compared to the narrow quantitative view presented in the general part of the thesis. This preference could lead to a special situation, in which these

¹³⁸ Creditors petition - KSBR 39 INS 2464 / 2009 – B 134

creditors would prefer reorganization over liquidation even though a result of the best interest test is not going their way.

Coming back to the particular case of Slovokord and the issue of the intention to finish the construction project leads us to a suggestion. According to §343 (4) of the insolvency code and § 25 (1) regulation n. 311/2007 Coll., the two crucial documents - the reorganization plan and the reorganization plan report have to include a description of an assumed impact of the reorganization on all stakeholders such as employees, state administration (through taxes) or creditors, but there is no obligation to incorporate details about the intention to offer the trade creditors a continuation of a business relationship. Such information could generally be and in the case of Slovokord surely is a most important factor when deciding about the approval of the plan. The relative importance of such information is furthermore increased by the large discount of the creditor's claims assumed by the plan.

The other complaint, which includes also a request to the court to stop the reorganization plan approval procedure, is written on behalf of five unsecured creditors¹³⁹. These creditors claim that there was an investor, whose name they do not specify, offering about EUR 40 mil. in the tender for the Slovak part of the KORD Group. This investor was according to the complaint also able to guarantee the finishing of the construction project. The creditors also accuse Ceska Sporitelna of pursuing a dishonest intention when it accepted much lower settlement than in a bankruptcy liquidation scenario. This accusation is supported by a speculation that the investor plans financing of the acquisition together with CS and that is why CS accepts such a low payout.

The subject of the creditors' complaints was already discussed in previous paragraphs. The debtor strongly rejects an existence of an investor that withstood all the auction conditions and offered a higher amount than the winning bidder. Furthermore the debtor claims that the condition forcing a potential investor to finish the construction project would have harmed the main target of reorganization – the maximization of the payout of creditors. Last but not least the accusation of CS is also impugned by a statement that there is no sign of further cooperation of any JET Investment company and Ceska Sporitelna. This is now confirmed as the financing is

¹³⁹ Creditor's petition from JNS Elektrotechnika, s.r.o. - KSBR 39 INS 2464 / 2009 – B 135

currently provided by UniCredit. The creditors committee also reacted to the objections, in an official statement¹⁴⁰ it expresses an acceptance of affirmations of the debtor. Finally the court rejects all the objections either due to procedural errors¹⁴¹ or due to unsubstantiation of the objections¹⁴².

7.1.4. DIP financing (post-insolvency financing)

Slovkord did not use any DIP financing until the end of February 2010. To be able to cover payables due in the consecutive period it opened a line of credit by signing a contract with Santini Capital (the buyer of SLK Plus) at the beginning of April 2010. The same contract with Santini Capital was signed also with other two insolvent Slovak KORD Group companies. From the loan agreement attached to the reorganization plan we can find out the following features. The loan is structured as a revolving credit with a maximum possible use of credit of EUR 480 000. The arranged interest rate is floating EURIBOR plus 300 bps. So in case of full use of the financing the gain of Santini Capital on the interest paid would be according to our calculations about EUR 14 500 (CZK 374 ths.)¹⁴³.

7.2.Slovensky Hodvab

Historically Slovensky Hodvab was a traditional manufacturer of granulate, various chemical fibers and plastic bottles. After the takeover by Kordarna in 2005 a restructuring of production activities in the whole group followed, almost the whole production was transferred to other Slovak KORD Group companies. Since Slovensky Hodvab has served as a landlord of the group while it was still solvent, it has owned, managed and rented real estate for all Slovak members of the group. It has also owned a plant for plastic bottles recycling, which was rented to and run by KORDSERVICE SK. Economic problems in the group forced Slovensky Hodvab to file insolvency petition on the same day as other group members.

¹⁴⁰ KsBR 39 INS 2464 / 2009 – B 146

¹⁴¹ KsBR 39 INS 2464 / 2009 – B 144

¹⁴² KsBR 39 INS 2464 / 2009 – B 145

¹⁴³ We used EURIBOR rate for 11.11.2010 of 1.05 % sourced from www.euribor-rates.eu

Reorganization was structured in a similar way and as we already know the auction for the core assets was coordinated for all three Slovak KORD group companies as it is described in detail in previous part about Slovokord.

7.2.1. Payout rates

Also in case of Slovensky Hodvab the payout of the secured creditor was not higher than the ones estimated by an expert in bankruptcy estate valuation. The following table shows the payouts (all figures are in CZK)

Table 5: Slovensky Hodvab payout scenarios

Submitted claims and payouts		RP payout		BL payout	
Class 1 – secured	3 464 720 483	0.143%	4 937 573	1.01%	35 049 112
Class 2 – unsecured	3 612 222 334	0.099%	3 593 800	0.06%	2 120 375
Class 3 - conditional unsecured	353 993 776	0.000%	0	0.00%	0

7.2.2. Disposal of the estate

From the day the plan becomes effective until 31.8.2010 it is the company Slovensky Hodvab and particularly its board who possesses all the rights to dispose of the estate. The competences are limited only to the legal acts and operations that do not have a substantial impact on the estate; otherwise the board needs an approval of the creditor's committee.

7.2.3. Administrative priority payables

As we know Slovensky Hodvab intended to transfer all the core assets and thus also all the production and trade activities to a successor company called Slovensky Hodvab Plus. Nonetheless the original company remained active for the following few months with a purpose to sell all the remaining assets and to be properly liquidated. SLH Plus originated as a subsidiary company fully owned by Slovensky Hodvab and was then sold to an Investor. If we compare the situation with a normal acquisition in which the whole entity is acquired, we are bound to run into issues that need to be addressed and legally handled. One of these issues stems from the fact that there were continuing business operations before the transaction that produced trade payables that needed to be paid. To handle this issue Slovensky Hodvab and the successor company SLH Plus signed an agreement about the settlement of administrative priority payables. In this agreement SLH Plus committed itself to

paying the payables of Slovensky Hodvab that were related to the transferred part of the company. Such an agreement had to be signed and attached to the reorganization plan, in order for the plan to fulfill the rule § 348 (1) stating that the administrative priority payables have to be settled immediately when the plan becomes effective to allow the court to approve the plan.

Conclusion

The thesis analyzed the reorganization of Kordarna, which has been the first major test of the reorganization framework under the current Czech Insolvency Act. The thesis consists of two parts, the first – general part describes and analyzes the reorganization legislation and provides a discussion of a decision-making process between the choices of handling the bankruptcy: reorganization and bankruptcy liquidation. The second – specific part is focused on the particular proceeding of Kordarna and partially on the reorganizations of the other three KORD Group companies. The thesis concentrates on a combination of economic and legal aspects of the process and it offers the following important conclusions.

One of the most troubling issues uncovered by the case is the considerable length of time needed for the reorganization proceeding. It took 11 months from the declaration of insolvency until the approval of the reorganization plan. Considering the fact that the reorganization process was otherwise relatively smooth with no obstructions and additional procedural legal actions, the period of 11 months is deemed by many of the professionals on the edge of feasibility. The case of Kordarna was in many aspects a special one. The most important of these aspects was the ability of the company to “self-finance” its operations during its insolvency, which was enabled by reestablishing the factoring and the ability to acquire new customers to offset the loss of others. The positive operating cash flow throughout the reorganization process has prevented the accrual of administrative priority claims, which could have otherwise endangered the success of the reorganization. The extended duration of the process could be considered a weak point as it can lead to a lower general applicability of the concept to other insolvent yet viable companies, with inability to achieve a positive operating cash flow throughout their insolvency. However, the case of Kordarna has shown that even if the proceeding is the lengthy one the reorganization could still be successful.

Another part of the thesis concentrates on the bankruptcy costs. It shows that the direct costs using the existing literature methodology by Kordarna have reached CZK 64.1 mil., which accounts for 1.97 % of the pre-insolvency total assets. Compared to the research using the U.S. reorganization data, Kordarna bankruptcy costs rank at

the lower end of the scale of relative figures. Moreover, compared to the total creditors' payout of CZK 824.5 mil. the direct costs reached 7.78 %.

Reorganization of the Slovak KORD group companies has shown practical applicability of cross border insolvency proceeding onto a complex reorganization of a concern of four companies, out of which three are foreign.

In the case of Slovokord and Slovensky Hodvab an extraordinary situation emerged in which the payout of the secured creditor assumed by the reorganization plan was lower than the payout assumed in the bankruptcy liquidation scenario. The thesis concludes that all the actions of the affected creditor show an overvaluation of the bankruptcy estate, which was later supported by opinions collected from the interviewed subject matter experts. Furthermore, thesis provides analysis related to the official approval of the bankruptcy estate valuation report and reaches conclusion that the secured creditor has no incentive to reject (not to approve) the unrealistically overvalued figure. The uncovered phenomenon of overvaluing the bankruptcy estate could be caused by static assumptions of the valuation not taking into account the lowered demand for assets during the time of an overall economic downturn.

In closing, the reorganization of Kordarna and other Kord Group companies was successful from the standpoint of all involved stakeholders. The creditors received substantially more than they would likely have in the case of bankruptcy liquidation. The debtor was able to maintain business operations on the level needed to retain the majority of the big customers and with the new investor it successfully pursued the reorganization plan. Currently the successor companies plan to finish the expansion projects, started were started prior to the insolvency. The case has clearly shown an excellent example of a correct usage of the reorganization process as a solution to insolvency of an otherwise viable business.

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Table 5: Slovensky Hodvab payout scenarios

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Master Thesis Proposal



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Notes: The proposal should be 2-3 pages long. Save it as "yoursurname_proposal.doc" and send it to both mejstrik@fsv.cuni.cz and tomas.havranek@ies-prague.org. Subject of the e-mail must be: "JEM001: Thesis Proposal Yoursurname".

Proposed Topic:

Kordarna - the first large case of reorganization (under the new insolvency act)

Topic Characteristics:

Especially now in the times of economic crisis, the topic of bankruptcy becomes more relevant than ever before. Many firms are being hit by the huge fall in demand for their products and services. Together with a too aggressive capital structure many are forced into financial distress and insolvency leading in most cases to bankruptcy.

In the past almost all the bankruptcies have been solved by ceasing the operations of the firm, selling all the assets and distributing the proceeds to the creditors. This method might have been the easiest and the fastest way to settle the creditors' claims, but in many cases it is not the most efficient one.

The long awaited insolvency act in force from 1.1.2008 changed the whole insolvency process by enabling new solutions of corporate bankruptcy. One of the most revolutionary features is the facilitation of a reorganization process. Reorganization as a solution of bankruptcy is a common phenomenon in mature free market economies with developed institutional law settings.

The restructuring option, as an analogy for Chapter 11 in the United States bankruptcy law, brings a possibility to go through the whole bankruptcy process ending up with a healthy going concern. Application of such a solution could make all the creditors or at least some of them better off without hurting the others but there is a cornerstone needed for the approval of a reorganization plan and that is cooperation of the involved stakeholders - mainly creditors. This cooperation is not always achievable because of the different standpoints stemming from different seniority of the claims.

In the thesis we seek to perform an economic analysis of a first big case of a reorganization as a solution of bankruptcy under a new insolvency act in the Czech Republic - the case of Kordarna group a technical fabrics producer from Southern Moravia. This company with pre-insolvency revenues of more than 3 bn CZK, is a typical example of a victim of an economic downturn, having financed its expansion with too much debt. Even though the reorganization process is far from finished, the economic functionality of the new law could already be assessed because the reorganization plan has been successfully approved by the creditors in the beginning of April 2010. We try to identify what was the special feature of Kordarna that enabled the reorganization process?

A precedent of Kordarna as a first possible successful reorganization process could have

Hypotheses:

1. Hypothesis #1: The new insolvency act facilitates reorganization and thus helps to minimize the loss given default figure (LGD).
2. Hypothesis #2: The found solution is the best possible choice for all the creditors (secured and unsecured).
3. Hypothesis #3: The new law settings for the insolvency settlement in case of Kordarna are a win – win situation for all sides of the process (creditors, debtor, employees, state) compared to the old insolvency law conditions.
4. Research question #1: Why did informal restructuring not work? (given that afterwards the reorganization plan was approved by hundred percent of creditors)
5. Research question #2: What made old equity holders accept zero pay-out?

Methodology:

The newly established insolvency register enables us to work with almost complete information about the whole process of the insolvency proceedings. It also provides us with all the sources for quantitative analysis including all the interim financials. The main purpose is to provide an economic analysis of the insolvency decision making framework based on different company valuation models outcome as discounted cash flow or residual income (economic value added).

Outline:

1. Introduction
2. Insolvency law
3. Reorganization
4. Kordarna
 - a. The pre-insolvency period
 - b. The insolvency and reorganization solution
 - c. The outcome of the game, evaluation from different standpoints of particular players
5. Conclusion

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