

Business Advice Series Part Seven: Ten typical mistakes investors make in Hungary

How to deal with a partnership gone bad

In the last installment we described a thoroughly typical example of how the local management of a company can deliberately put a foreign partner at a disadvantage to the point where he foreign partner has to send a troubleshooter to Hungary to evaluate the suspected bad state of affairs. Although the full extent of the damage is not yet known, breaches of duty by the CEO - who in our example is also a partner - have already made such an impact that cooperation no longer makes sense or is even unacceptable. Now the real dispute begins.

At the beginning of such a dispute a clear decision must be made whether the partner really wants to take the whole affair to its conclusion. If there is no longer an economic interest in the investment or - in very rare cases - the problematic CEO takes over the stake at a very favourable price, it is wise to withdraw from the investment fast.

But the reality is often different: there is normally at least a strategic interest, large sums of money have been invested and in the end the reputations of your own firm and its management are at stake. Nobody likes to be cheated.

Drastic measures

It is often the case that laughably small sums of money are offered by the suspect CEO to buy the share. Whoever wants to keep his stake in such a situation should decide immediately and be prepared to take drastic measures.

The key to protecting your interests lies in the carrying out of a thorough forensic-orientated due diligence check. This means an internal business check with its focus on looking for bookkeeping irregularities. The foreign partner should force such an examination on the the local CEO using all allowable means. It is helpful if there are still good contacts within the company.

Colleagues still loyal to the foreign partner will lead you to the aspects of the company which are most incriminating. They often know best the complicated web of interests and relationships in the business.

The results of this check are often the best ammunition to use for making a claim for damages, voting out of office the CEO or pressing criminal charges. Of course the CEO and partner has no interest in such a check.

Using the evidence

This point is the very latest at which you will become painfully conscious of the mistakes made in the formation of the company or in the purchase of your share (see parts 1 and 2) in the business. If you have the required majority you can dismiss the CEO immediately. If on the other hand the CEO is the majority shareholder it will be difficult.

At this point it is helpful if there is at least enough initial evidence of fraud, betrayal of confidence or embezzlement, etc., so that by means of the criminal law the CEO can be forced to open up "his" firm.

Things are sometimes made more difficult when at the year-end closure the auditors give their blessing to the mismanagement rather than (according to instructions) uncovering serious abuses. If the auditor now supports the foreign investor in

accordance with his duty, he risks being held legally liable - he should have uncovered the deficiencies earlier. Therefore, the auditors who should protect the partner from this kind of loss are often not on the side they should be.

In addition, the corrupt CEO will not just limit himself to the use of legal means to obstruct the due diligence check - he will threaten to use his wide range of contacts including those in politically important positions. But this is usually mere bluster - of course everyone in Hungary knows everyone else, making bluffing of this kind commonplace.

The due diligence check often reveals an alarming situation. As a rule it is difficult to prove definitively the malicious intention of the CEO on every point. But this is not necessarily a disaster. Information collected can help to confront the CEO with massive claims for damages.

Moreover, insofar as there are items which have not gone through the books, tax laws can be broken. In orderly book keeping the results of the company and also the basis of calculating various taxes (corporate tax, local taxes, etc.) would have been different and probably higher.

These facts often indirectly constitute tax evasion - a charge which no CEO cares to face. He naturally knows that he is legally liable even with his own private wealth for every careless business transaction.

After this procedure the CEO should suddenly lose enthusiasm for his involvement in the business. Suddenly he will want to sell his share to you. But at this point you should also pay heed - find out why next week.

The 'Business Advice Series' points out the recurrent pitfalls of doing business in Hungary and gives advice aimed at making your business more successful.