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**BENEFITING FROM THE OWNER'S BANKRUPTCY: WHEN RELATIONSHIP  
DISSOLUTION IS USEFUL**

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**Abstract**

The paper aims to demonstrate that some former affiliates may benefit from their foreign owner's bankruptcies. It includes two cases from Estonia: Klementi and Regio. Both enterprises actually gained twice: when they were acquired by foreign owners and when after the owners' bankruptcy, they became locally-owned again.

## Introduction

Due to their “mortality”, in the long-term, all relationships should end (Pressey and Mathews 2003). Still, much of the research involving firms in long-term business relationships has concentrated on their formation and maintenance, while comparatively little is known yet about the ending (Alajoutsijärvi, Möller and Tähtinen 2000; Pettersen 2002; Ping 1999; Stuart 1997). Moreover, the existing literature is largely based on the concepts of personal or consumer relationship termination (Giller and Matear 2001). Thus, there is a need for additional knowledge in the area of the consequences of the ending of other relationship types.

It has been shown that the stronger is the level of commitment to a relationship, the less probably the partners will voluntarily dissolve it (Morgan and Hunt 1994; Pettersen 2002). However, sometimes, even the generally strong relationships between foreign owners and their affiliates do not last. For example, a relationship might end due to the owner’s bankruptcy. The consequences of this particular type of relationship ending have not received much attention in the previous literature. In some papers (for example, Hennart, Roehl and Zeng 2002 and Thomson and McNamara 2001) it is only stated that after an owner’s bankruptcy, its affiliate was sold, but no details are given whether and if, then how the subsidiary gained or lost from this in the longer term.

In some papers, the possibility that foreign owners might eventually withdraw is evaluated as a potential threat to the foreign-owned enterprises and the host country, in general (Blomström and Kokko 1996; Jungnickel and Koopmann 1997). The success of a relationship is quite often mistakenly measured by its longevity (the longer, the better) while dissolved partnerships are interpreted as failures (Gomes-Casseres 1998; Havila and Wilkinson 2002). This is especially the case when the relationship ends before the partners reach their initial goals (Bleeke and Ernst 1992; Koza and Lewin 2000; Larimo 2002). In reality, the opposite may be true.

The paper aims to demonstrate that a foreign owner's bankruptcy might be sometimes beneficial for its former affiliates. (It is assumed that they are not closed down completely: this would be undoubtedly harmful). It begins with a literature review and a methodology section. Then, the evidence from two cases from Estonia — Klementi and Regio — is introduced. After that, the results are discussed and some managerial implications drawn. The paper ends with several suggestions for the future research.

### **Literature review**

Cross-border collaborations are increasing in number, diversity and strategic significance (Reuer 2000). They are formed for several reasons: acquiring information, learning better management techniques, sharing R&D costs and risks, obtaining access to complementary technology, patents or territories, competing, maintaining a strong market position, facilitating international or domestic expansion, gaining presence in a new market, conforming to foreign or domestic government policy, reaching economies of scale, lowering production costs, developing new products and increasing productivity (for an overview, see Deeds and Rothaermel 2003; Lin and Chen 2002 and Yudaeva et al. 2003). Yet, relationships do not last forever. Some of them end and some are put into end (Tähtinen and Halinen-Kaila 2000).

Relationships can be continuous, terminal (they continue unwillingly) and episodic — created for a specific purpose or a time period (Halinen and Tähtinen 2002). Relationship ending can be planned and unplanned, friendly and unfriendly (Serapio and Cascio 1996). It is possible that both partners agree to it (voluntary ending), one of them refuses to agree (unilateral involuntary dissolution) and a relationship just fades away (Pressey and Mathews 2003). The type of relationship ending might depend on the relationship type. In continuous relationships, the breakdown comes unexpectedly from the parties' point of view. The ending can be chosen (one or both actors make a decision to terminate the relationship), forced

(caused by a change or an event in the broader network in which the relationship is embedded) or natural (the need for business exchange has gradually diminished). Terminal relationships continue until the circumstances permit the desired ending. The ending of an episodic relationship is predetermined, although it may break up before the agreed time (Halinen and Tähtinen 2002). Foreign direct investments could be characterized as continuous, but sometimes they may be forced (a hostile takeover) or even episodic (the investor decides to buy a company for the purpose of closing it down and servicing the market through its other affiliates). A foreign owner's bankruptcy, on the other hand, is almost certainly unplanned from the owner's viewpoint. Thus, if after the bankruptcy, the firm and its affiliates are sold to different buyers, this type of relationship ending could be classified as forced and unfriendly or, if its subsidiary desires it, unilateral.

In the literature, the number of relationship ending phases varies. Sutton (1987) developed a model of organizational death that had a sequence of six interpretation shifts. Peng and Shenkar (2002) indicated four stages of dissolution. Ping and Dwyer (1992) stated that relationship ending proceeds through two phases that are further divided into seven stages. Tähtinen (2001, 2002) brought out six phases. Tähtinen and Halinen-Kaila (1997) and Halinen and Tähtinen (2002) distinguished between seven stages. Some authors state that the dissolved relationship could be re-activated at any point in the future (Tähtinen 2001), although it may be more difficult in the last stages of its ending (Peng and Shenkar 2002). After a foreign owner's bankruptcy, the re-activation should be relatively unlikely, especially if the parent company or some of its former affiliates are closed down.

The consequences of relationship ending depend on the usefulness of the relationship. Retaining unnecessary relationships may sometimes cost even more than terminating them (Dwyer, Schurr and Oh 1987). Thus, if a relationship does not provide sufficient return to the company, its dissolution can be beneficial. On the other hand, if the relationship is useful, its

ending can be harmful (Alajoutsijärvi, Möller and Tähtinen 2000) and cause the loss of both money and time, as the parties may have to negotiate contract disengagement, proprietary rights, copyrights and final invoices (Halinen and Tähtinen 2002). They may be also forced to write down some machinery and equipment or even re-design their factories (Harrison 2001). In the case of a foreign owner's bankruptcy, the costs could be especially high, as the affiliate is often quite deeply integrated into the parent company network.

The ending of a particular relationship may affect several other network relationships, both internal and external. The ex-partners have to create and strengthen their links with other social systems, customers, clients and other organizations (Pettersen 2002; Sutton 1987). What happens after a foreign owner's bankruptcy should depend on how the relationship ends. For example, if its manager or a small local enterprise acquires it, the affiliate might have a hard start: it might have to improve its image, develop its own trademark and/or build up new distribution channels. On the other hand, if the subsidiary is taken over by a large and internationally well-known owner, it might benefit from gaining access to its network, acquiring the right to use the new parent corporation's trademarks, improving its image and further developing some relationships with its previous buyers and suppliers.

Even if relationship ending is unwanted, the company can learn from it to manage other relationships and potential ending processes better (Tähtinen 2002). At best, the lesson learned will help the firm manage other relationships and potential ending processes (Halinen and Tähtinen 2002). On the other hand, even a previous successful relationship does not necessarily mean that the next one will also succeed (Peng and Shenkar 2002).

From the above, it can be concluded that an affiliate does not necessarily have to lose from its foreign owner's bankruptcy. The result (a gain or loss) should depend on the way the relationship ends (for example, to whom the subsidiary is sold), the affiliate's ability to keep its former relationships with buyers and suppliers and its capability to learn from the situation

and create new relationships. To illustrate these points, two examples from Estonia are provided.

### **Methodology**

Case studies — histories of past or current phenomena, drawn from multiple sources of evidence (Leonard-Barton 1990) — have been an essential form of research in social sciences and management (Chetty 1996). This method is useful for transcending the boundaries of the investigated cases, combining previously developed theories with new empirically derived insights and investigating a contemporary phenomenon within its real-life context. While case studies cannot be regarded to offer statistically representative results, their advantage is depth and comprehensiveness. This method is preferred when the research focuses on relatively contemporary events and the researcher has little control over the processes under investigation. Further, they allow doing descriptive, explanatory or causal research, answering “how” and “why” questions, tracing events and processes (Easton 1995; Eisenhardt 1989; Hartley 1994; Miles and Huberman 1994; Tsoukas 1989; Yin 1994). Consequently, this approach was chosen for understanding how former foreign-owned enterprises were affected by their owner’s bankruptcy and why they managed to increase their gains after that.

The main criterion in selecting the two case companies was the possibility to get the necessary data. As Klementi and Regio are relatively well-known in Estonia and Klementi has been listed at the Tallinn Stock Exchange since 1996, there are several articles about them in local business papers. Their homepages, annual reports and other public materials were also of assistance for verifying the data and gaining additional information.

The small number of cases might be a limitation: it limits the ability to generalize from the conclusions (Voss, Tsikristis and Frolich 2002) and there is a larger risk of misjudging a single event and exaggerating easily available data (Leonard-Barton 1990). Still, it is possible

to generalize even from one case (Stuart et al. 2002). Moreover, as this subject is still clearly under-researched, these two cases, despite being relatively short, should be helpful for giving at least some useful managerial and research implications.

### **Case descriptions**

**Case 1.** Klementi, a designer, manufacturer and retailer of women's garments, was founded in 1944 as a state-owned company. In 1994, it was privatized. In 1999, P.T.A. Group (Finland) acquired 43 per cent of Klementi. A year later, its share grew to 69% and in 2001, 79%. The firm gained from having a foreign owner. It received capital and became able to invest in machinery, open its first five shops in Tallinn, build a logistics centre that was responsible for the whole P.T.A. Group's raw material, and in 2000, establish a subsidiary in Lithuania (its first affiliate in Finland was founded in 1998: before the foreign investment). Moreover, Klementi obtained the right to sell its garments in Finland under the owner's trademark Piretta. By 2002, the company had 20 shops in Estonia, Latvia and Lithuania. It also became one of P.T.A. Group's main subcontractors: 30 per cent of the parent's garments were sewn in Klementi and sold to the parent firm at market prices. On April 21<sup>st</sup> 2002, bankruptcy of P.T.A. Group OY was declared. That had a significant negative effect on the activities of its Estonian affiliate. In 2002, Klementi's net loss was 2.0 million EUR (the turnover was 8.5 and exports 4.7 million) while a year earlier, it predicted a turnover of 12.8 and a profit of 0.7 million EUR for 2002. The company had to take large loans from two Estonian banks. During the following year, it fired 200 employees out of 650.

Still, the bankruptcy of P.T.A. Group was not totally negative for the Estonian firm. On July 12<sup>th</sup> 2002, an Estonian venture capital company Alta Capital and its co-investors acquired P.T.A. Group OY's shareholding in Klementi. As a part of the transaction, the latter bought several P.T.A. Group's internationally recognized trademarks (PTA, MasterCoat, Piretta,

Avenue, Clubline and Mallimari), some stock reserves and machinery. Due to acquiring trademarks and customer relationships, Klementi became able to considerably increase its export to several Nordic countries, pay more attention to design (it employed some Finnish designers that previously worked at the parent company) and reduce the share of subcontracting. Previously, Klementi sold its garments through P.T.A; after the deal, it started to export directly. 200 shops in Scandinavia began selling its products. The firm's main markets were Estonia (where it was the third largest producer), Sweden, Finland, Lithuania and Latvia, but it also exported to Canada, Norway, Austria and Germany. Moreover, Klementi established two new subsidiaries: one in Sweden and the other in Latvia. In 2003, the company organized a share issue to involve 1 million EUR of additional capital. Although in 2003, the firm still lost 1.4 million EUR, in 2004, it hopes to make a profit. It considers opening an affiliate in Norway in the near future and plans to reach a 30 million EUR turnover by 2007.

**Case 2.** Regio was founded in December 1990 by four members of the Jagomägi family. In 1993, all its employees — in total, 27 people — became its owners. Five years later, another investor, the Baltics Small Equity Fund (owned by EBRD and the Baltic-American Enterprise Fund), was involved. In the early years, Regio's main business activity was map publishing. Later, it also became active in production of spatial data and geographical information systems. In the beginning of 2000, it started developing mobile positioning solutions with Ericsson, the world leader in this type of services, and EMT, the largest mobile and telecommunication services provider in Estonia. In May that year, it introduced a positioning service of rescue calls, Rescue Board. This evoked some interest toward the firm from abroad. Regio decided to internationalize and for that, involve a strategic investor. In September 2000, the company merged with Done OY (Digital Open Network Environment), a Finnish provider of e-business solutions in both network and wireless environment. Done OY had about 1000 employees, of which about 300 were located in the United States, Great Britain, Sweden, Slo-

vakia and Hungary. Regio's shareholders received 3.5 per cent ownership of Done's share capital, but they were not allowed to sell 70 per cent of their shares before one year. The value of the stock was at that time around 4 million EUR. In 2000, Regio's turnover was about 1.5 million EUR and it had 48 employees.

At first, the relationship was successful. The new owners eased Regio's access to larger customers, financed its growth and enabled it to hire additional employees. Done OY also agreed to sell the firm's mobile location-based applications. Moreover, they helped it to cooperate with Ericsson, as the latter usually did not deal with companies with less than 100 employees. In September 2001, Ericsson started to sell Regio's software via its global network. This increased the credibility of the firm and gave it a competitive advantage. In 2001, the company's turnover was about 2 million EUR. Its number of employees increased to 65.

In October, 2001 Done was divided into Done Solutions and Reach-U. As a result of the transaction, Done Solutions started to deal with logistics and software solutions while Reach-U began to offer mobile solutions. Regio went into the ownership of the latter. In the end of 2001, the IT sector crisis reached Finland. In February 2002, Reach-U went bankrupt. The value of Done's stock dropped over 10 times.

In March 2002, Teet Jagomägi, an ex-owner of Regio, re-purchased the firm (later, he involved his local partners again). The negotiations took about a month. The liquidators finally agreed to sell the company as it was a knowledge capital firm and its main asset — employees — threatened to leave if Regio would be sold to another buyer against their will. Jagomägi did not agree to reveal the price but he claimed that taking into account that the stock of the technology sector had dropped up to 10 times and the stock of Done even more than that, he managed to repurchase the firm for less than he had sold it. The ex-owners of Regio retained their shares of Done.

In general, Regio benefited from its transactions with Done. It acquired the rights to use the software that Reach-U Solutions had developed. In the last 18 months, the latter together with Done had invested about 0.4 million EUR into its development. The software was critical for continuing Regio's co-operation with Ericsson, the firm's main foreign partner. The company also became the owner of two relatively well-known trademarks — Reach-U and Mginе Technologies. As a result, it did not lose any important customers because of the owner's bankruptcy (but it had to make some efforts to retain them). In addition, the firm gained very valuable understanding of the processes in the foreign mobile service market. Thus, Regio started to offer its services to Croatia, Spain, China, Thailand, Slovakia and several other countries.

### **Discussion and managerial implications**

From the case study data, it becomes evident that a foreign owner's bankruptcy might considerably harm its former affiliate, but sometimes, the latter may even benefit from it (see Table 1). The result seems to depend on the characteristics of the previous and the new owner and the affiliate (both before and after the acquisition), the relationship between them and some outside actors and factors.

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Insert Table 1

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The results indicate that the two case companies, Klementi and Regio, managed to benefit from the relatively short period of foreign ownership. The gains could be divided into two categories: the period itself and the aftermath.

- When the firms were acquired by their foreign owners, they received capital and became able to expand their (international) activities. Moreover, the companies

gained the right to use their owners' trademarks, increased their credibility and got access to the parent corporation's (marketing) networks. Through that, they became able to find new customers. Regio also managed to grow considerably.

- When the foreign owners went bankrupt, it was, at first, harmful (in terms of financial losses and, in the case of Klementi, a reduced number of employees) but in the long term, beneficial. The firms regained their decision-making freedom. Moreover, they managed to retain the necessary network relationships with their customers and create some new ones. The companies also acquired the right to use their former owners' trademarks. In addition, both enterprises managed to get some know-how. Moreover, Klementi acquired some machinery and stock reserves while Regio obtained the former owner's software.

Based on the conclusions from the two cases, Figure 1 was drawn. It shows that a company should gain from foreign ownership in terms of capital, know-how and market access. When the foreign owner goes bankrupt, it should lose. It may even find itself in a considerably worse position than before involving a foreign investor, but not necessarily. On the other hand, after being acquired by a new owner, it may gain and move to a better position, compared to the period when it was initially foreign-owned.

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Insert Figure 1

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Although each particular case is at least slightly different from another, some assessed failures may later turn out to be successes (and the other way round) and the gains and losses do not have to be so dramatic, some managerial advice could be given. It is hard to foresee whether and if, then when a foreign owner goes bankrupt and which consequences it will bring for its affiliates. Still, although they should be negative at least in the short run, it is

wrong to avoid involving foreign investors at any cost. When there is a need for them, they should be involved, but they should be chosen very carefully (for example, they should be able to bring the necessary resources and capabilities to the relationship). Moreover, the subsidiaries should try to learn as much as possible from the foreign owners and their other affiliates and try to build up strong relationships with companies not belonging to the owner's network. If the owner goes bankrupt, they should retain useful relationships and be active in establishing new ones. When acquired by a new owner, the learning and relationship-building process should continue.

### **Conclusions and recommendations for the future research**

Foreign direct investments are generally long-term. Still, sometimes the relationship between the parent company and its affiliates ends, for example, when the former goes bankrupt. The paper demonstrated that the owner's bankruptcy may affect its subsidiaries very strongly, and the impact may be both negative (at least, in the short run) and positive (if ever, then in the long run). Which effect prevails, should depend on the characteristics of the former and the new foreign owner, their affiliates, the relationships between them and the general business environment.

The two case companies, Klementi and Regio, mostly benefited from the bankruptcies of their owners. They gained from the initial foreign investment — acquired capital, became able to use the owners' trademarks, obtained access to their contacts and quickened their international growth. Moreover, although the bankruptcy itself resulted in some financial and other losses, these firms managed to gain in the long run: to acquire the former owners' know-how, additional trademarks, maintain some critical (customer) relationships, create some new ones and, as a result, further speed up their internationalization.

Although many other enterprises might find themselves in a very different situation from the ones just described, their managers could learn something from it. They should not avoid involving foreign investors at any cost. If they are involved, the affiliates should try to be active in obtaining the necessary know-how, contacts and resources from the parent corporation's network. If the owners go bankrupt, they should try to learn from the situation as much as possible, retain critical relationships and create some new ones, if necessary.

This paper covered only some issues of this under-researched area. Several aspects still need attention. For example, more data from Estonia and other countries could be gathered (both via surveys and interviews) to study the subject further. This might help to understand, which factors mostly impact the consequences of a foreign owner's bankruptcy for the affiliates, how often they benefit from it and how often they lose.

Moreover, the roles of different actors and factors should be examined further: for instance, whether the extent of the subsidiary's involvement in the parent company and surrounding network quickens or hinders this process, whether the ending of short-time foreign direct investments has different consequences than the bankruptcy of a long-time foreign owner and whether the parties' size, nationality, managerial style or previous international experience matter.

This additional knowledge might be useful for managers in making forecasts about the consequences of the foreign owner's bankruptcy. The results of these predictions, in turn, should help them decide what to do in a specific situation and which foreign investors to involve.

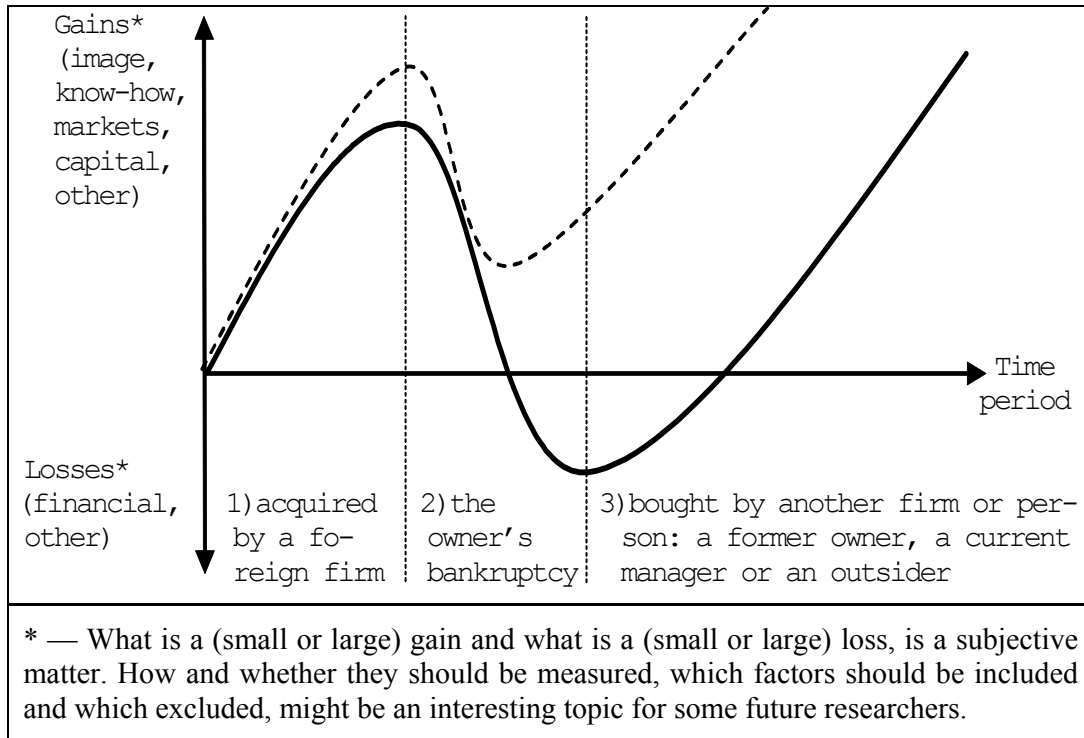
**Table 1**

The consequences of foreign ownership and a foreign owner's bankruptcy for its former affiliate

	<b>Klementi</b>	<b>Regio</b>
Gains from finding a foreign owner	Capital inflow, necessary for investing in machinery, opening new shops and establishing foreign subsidiaries; acquiring the right to use the owner's trademark Piretta; the possibility to subcontract for the parent.	Capital inflow, necessary for (international) growth; easier access to larger customers; the possibility to use the owner's sales contacts; increased credibility, turnover and the number of employees.
Losses from the owner's bankruptcy	A large net loss instead of a predicted profit; the necessity to lay off a third of employees.	A loss for the firm's former owners (in terms of Done' stock); the efforts to retain former customers.
Gains from the owner's bankruptcy	Acquiring the former owner's trademarks (PTA, MasterCoat, Piretta, Avenue, Clubline and Mallimari), some stock reserves, machinery, know-how (design) and customer relationships; an increased ability to export directly and open affiliates, not just subcontract.	Acquiring the former owner's software, critical for continuing cooperation with its foreign partners; obtaining two trademarks — Reach-U and Mginе Technologies; a very valuable understanding of the foreign mobile service market; an increased ability to internationalize.

**Figure 1**

Hypothetical gains and losses from foreign ownership and a foreign owner's bankruptcy for its former subsidiary



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