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# **Transfer of experiential and innovative teaching methods for business education**

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Transfer of Innovation

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# **PKM DUDA S.A.**

## Teaching notes

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**CURRENCY HEDGING STRATEGIES AND INVESTOR RELATIONS IN TIMES  
OF CRISIS -  
THE SLAUGHTER OF PKM DUDA S.A.**

**A. Summary of the case**

The PKM Duda S.A. Group was one of the three largest capital groups in the meat industry on the Polish market in 2008. On 16<sup>th</sup> February 2009 PKM Duda S.A., a company listed on the Warsaw Stock Exchange, published a current report on the influence of foreign exchange risk hedging transactions on the financial results of the capital group. In the report the company stated that as a means of hedging against the currency flows forecast for 2009 and 2010 it used asymmetric option strategies, and the estimated negative impact of the valuation of all uncleared foreign currency contracts on the financial results of the company in 2008 amounted to 29.3 million PLN (over 70% of the company's net profits achieved in 2007). As a result, within two days of the report's publication the company's market valuation had decreased by nearly 50%.

On the 1<sup>st</sup> of December 2008 the company's CEO Maciej Duda, in an interview with a 'Puls Biznesu' [Business Pulse] journalist, claimed that his company did not and does not use currency options. The outrage of investors at the situation was enormous. Ever since it was first listed on the Warsaw Stock Exchange PKM Duda had been highly valued by capital market players in respect of the competence of the management board and their adopted strategies of corporate development. The Polish Financial Supervision Authority launched a preliminary investigation into the possible violation of disclosure obligations by PKM Duda. The hedging instruments used by PKM Duda included forward contracts and option strategies. In order to lower the initial cost connected with buying foreign currency 'put' options PKM Duda sold currency 'call' options to banks. Because of the asymmetric character of these transactions (a greater volume of 'call' options than 'put' options) the group took a speculative position on the foreign exchange market, thus exposing itself to the risk of a rapid depreciation of the PLN.

The impact of currency derivative transactions on the company's financial situation soon became apparent. Directly, the currency derivative instruments incurred substantial liabilities and a financial loss (the negative valuation of derivatives as at 31.12.2008 amounted to 79.4 million PLN, of which 34.2 million lowered the company's financial result for 2008).

Indirectly, the problems connected with option trading had an impact on how the company and the capital group were perceived by financial institutions. Invoking contractual clauses, one by one the banks started to terminate the contracts they had with the company.

### **B. Teaching objectives and target audience**

This case is appropriate for undergraduate, executive level and MBA courses relating to international corporate finance, foreign exchange rate risk management, corporate hedging strategies, investor relations in public companies, capital market regulations or business ethics.

The case is quite popular in the classroom as it presents a situation in which investors (many of whom were small individual investors) had been misled by a public announcement from the Chief Executive and suffered severe financial losses. The case also provokes a lively exchange of opinions among participants due to the fact that it presents two very contrasting views of the company PKM Duda - for many years a widely known and well respected public company and then a company that made some bad financial decisions and misled investors.

### **C. Teaching approach and strategy**

This case study may be used as part of a broader programme to explore corporate finance with a special focus on public companies. It is preferable for the study to be used in smaller groups to foster open discussion among the lecturer and the participants. The study provides a basis for an evaluation and analysis of the CEO's behaviour and the company's decisions.

The study can form the basis of two 90-minute blocks. However, if only selected assignment questions are used then a 90-minute block is sufficient.

A video of an interview (appr. 5 minutes long) with CEO Maciej Duda conducted on 18<sup>th</sup> February 2009 by the station TVN CNBC (in Polish) can be used as a supplement to show how the CEO explained the losses on option contracts (this is available at: [http://www.tvncnbc.pl/4572450,35515,0,1,0,tlumaczenie-dudy,tvn\\_cnbc.html](http://www.tvncnbc.pl/4572450,35515,0,1,0,tlumaczenie-dudy,tvn_cnbc.html)).

### **D. Assignment questions**

#### **1. How successful had the PKM Duda group been during the period 2002-2008?**

When evaluating the activities of the PKM Duda group during the period 2002-2008 the students ought to take into consideration the following facts:

- At the end of 2008 the PKM Duda group was the third largest capital group in the meat industry on the Polish market, preceded only by Animex (Smithfield Foods) and Sokołów (the Finnish 'HK Ruokatalo' and Danish 'Danish Crown' groups).

- The group successfully implemented a strategy of vertical integration in the sector under the motto 'From the field to the table,' gaining control over the whole value chain in the industry: from the processes of production (livestock breeding, livestock purchasing, slaughtering, beef and pork cutting, cured meat production) to the sales processes (wholesale distribution of meat and cured meat products). On 5<sup>th</sup> February 2009 the company received a special award on the occasion of the 5<sup>th</sup> anniversary Ranking of Meat Producing Plants.
- At the beginning of 2009 the PKM Duda group was the largest in respect of the scope of its operations regarding those capital groups operating in the meat sector whose main entities (parent companies) were listed on the Warsaw Stock Exchange (see appendix 1 to the case study text).
- Since the debut of its shares on the Warsaw Stock Exchange in 2002 PKM Duda S.A. had been dynamically expanding the scope of its operations. The group's net sales revenue in 2008 amounted to 1,463 million PLN, eight times higher than the group's revenue in 2002. At the end of 2008 the assets of the capital group reached 1,079 million PLN and were nine times higher than at the end of 2002. The operating income increased in 2008 to the level of 28.4 million PLN in comparison to 6.9 million PLN in 2002. The level of employment in the group reached an all-time high of over 2,500 people at the end of 2008 [Students can also analyse the other financial data included in appendix 2 of the case study].
- In a ranking published in 2008 by the Rzeczpospolita newspaper PKM Duda S.A., as a company (on the basis of stand-alone financial data for 2007), was 213<sup>th</sup> on the 'List of 2000' largest companies in Poland. Also, it was in 18<sup>th</sup> place in the category of companies with the most dynamic increase in its level of employment in 2007.
- In January 2009 in the Forbes Diamonds 2009 ranking the company was included in the group of firms which in the years 2005-2007 had the most dynamic increase in their value.
- Ever since it was first listed on the Warsaw Stock Exchange PKM Duda had been highly valued by capital market players in respect of the competence of the management board and their adopted strategies of corporate development. The favourable attitude of the market towards the company was manifested in the numerous awards that it received. In the 2003 edition of the 'Stock Market Company of the Year' ranking it had a respectable 11<sup>th</sup> position. In the following year it came 4<sup>th</sup>, and in 2006 the company was in 2<sup>nd</sup> place. On 21<sup>st</sup> October 2008, shortly before the

publication of the report on the company's hedging transactions, PKM Duda was one of the winners of the Premium Brand 2008 Independent Reputation Ranking of Listed Companies.

- In November 2006 CEO Maciej Duda was awarded the title of 'Entrepreneur of the Year' in a prestigious competition organised by Ernst & Young under the patronage of, among others, the Harvard Business Review.

**2. How would you evaluate the attitude of the CEO Maciej Duda and of the company as regards informing investors about option trading? In particular, how would you evaluate the legitimacy of the information the CEO of the company communicated on 1<sup>st</sup> December 2008 (“the company did not deal in option contracts”) and on 17<sup>th</sup> February 2009 (“the company did not deal in speculative options”)?**

With this question students usually engage in a lively discussion. Students can consider the following points:

- On 1<sup>st</sup> December 2008 the company's CEO Maciej Duda, in an interview with a 'Puls Biznesu' [Business Pulse] journalist, claimed that his company had not and did not use currency options [students can consider the fact that the interview had not been reviewed by the CEO]. 77 days later, on 16<sup>th</sup> February 2009, a current report was released which revealed that as a means of hedging against the currency flows forecast for 2009 and 2010, apart from forward contracts, the company had used asymmetric option strategies, and the estimated negative impact of the valuation of all uncleared foreign currency contracts on the financial result for the company in 2008 amounted to 29.3 million PLN.
- Inadequate information at an early enough stage regarding the losses suffered in option trading in a way contradicts the words of the CEO, who in October 2008, in connection with the Premium Brand 2008 award he received said, “...*We take great care that investors receive full and accurate information regarding the company's operations and financial situation. We have used this approach ever since going public and have built our relations with investors on the foundation of partnership and trust*” (full text in the case study).
- Even after the publication of the current report which revealed that the company engaged in asymmetric 1:2 option strategies, the CEO still maintained that the company did not do speculative option trading (press report of 17<sup>th</sup> February 2009). As

it was, the asymmetric nature of the option strategy (a greater size of options sold than options bought) meant that the company exposed itself to the risk of unlimited losses as a portion of the 'call' options sold were not covered by the company's export revenues.

Ultimately, students ought to conclude that both the statements were false. The company did deal in option contracts and some of them (options not covered by export revenues) were speculative because they carried unlimited risk.

### **3. Is the negative valuation of uncleared currency derivative contracts (as at 31.12.2008) significant from the perspective of cash flow?**

Students should consider the following points:

- In a situation where the nominal value (size) of hedging instruments is adjusted to the amount of foreign currency receivables, the possible negative valuation of hedging transactions on the balance sheet data does not affect a company's net financial result because it is offset by the positive valuation of currency receivables.
- In a situation where the instruments hedge the forecast export revenues, even though a negative valuation of hedging transactions is not covered by a positive valuation of the hedged position on the balance sheet data (currency receivables do not exist, the export transaction is only planned), the financial loss is only visible in the accounts (paper loss).
- From a financial point of view, the cash flow result when hedging transactions are closed is significant (important).
- If the size of the hedging instrument is covered by the amount of the hedged position (export revenues), the cash flow gains and losses from each position offset one another (the losses on hedging instruments are offset by an increase in the PLN valuation of export revenues).
- If a currency derivative is not covered by export revenues (the amount of the forecast export revenues was lower than the size of the hedging instrument, or the forecast export revenues were not realised) then the settlement amount exercised affects both the financial result and the net cash flow of a company (as the instrument is speculative); such a situation occurred in the case of PKM Duda because of the asymmetric option strategy.

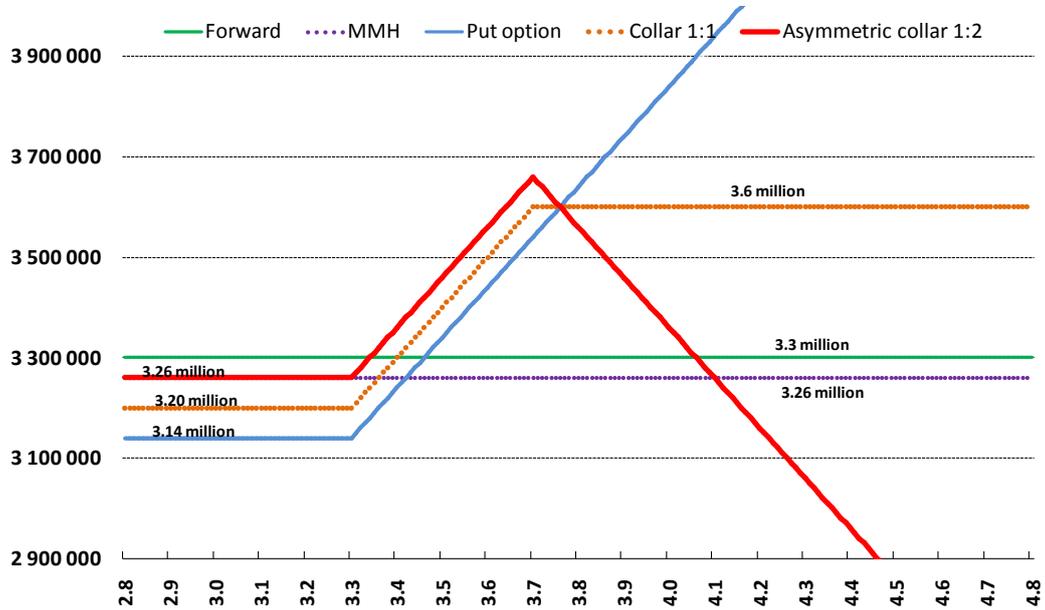
- 4. Conduct a financial analysis of a hedging strategy for an export contract worth 1 million EUR signed on 19.08.2008, from which revenues are expected after six months. Present the value of export revenues in PLN graphically in a range of exchange rates from 2.8 to 4.8 PLN/EUR if they have been hedged by means of:**
- a. asymmetric collar (1 long 'put':2 short 'call'; as well as 1:4),**
  - b. tunnel without asymmetry (1:1),**
  - c. 'put' option,**
  - d. forward contract,**
  - e. money market hedge (MMH).**

**Can an asymmetric collar be considered to be a hedging strategy?  
Use the financial data in Appendix 4 of the case study.**

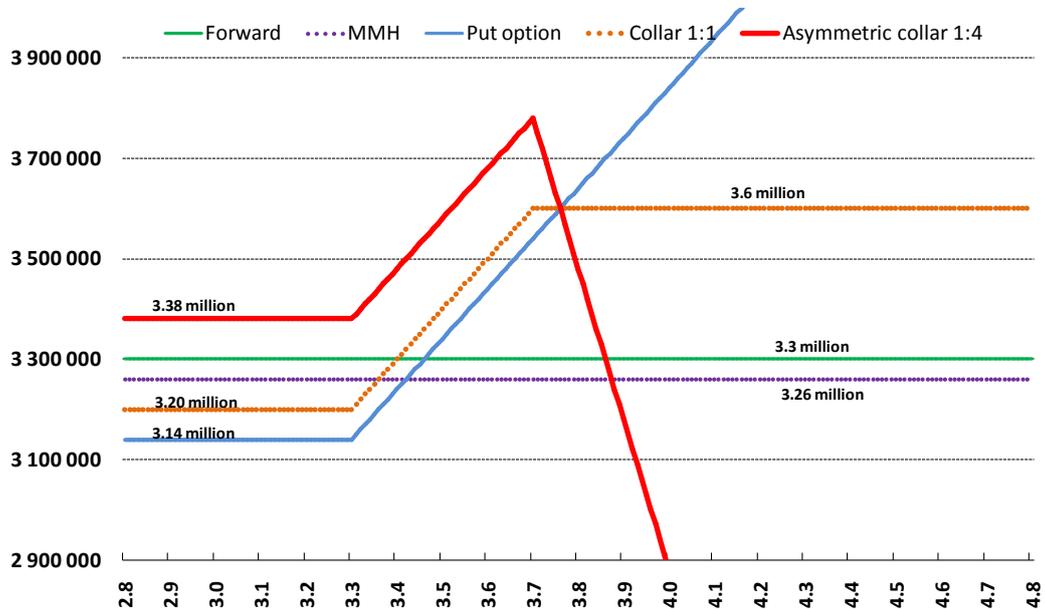
When introducing this question the instructor ought to emphasise that the purpose of hedging for a Polish exporter is to ensure that the revenues in PLN will be independent of the exchange rates of foreign currencies.

Results of hedging strategies:

**Figure 1 and 2: PLN-valuation of hedged export revenues within the range of future spot exchange rates 2.8-4.8 PLN/EUR (in PLN)**



Source: own calculations.



Source: own calculations.

Additional information:

- a. Asymmetric collar (1 long 'put': 2 short 'call'; as well as 1:4)

In the case of an asymmetric collar (1:2; 1:4 – a larger size in the ‘call’ option written than the ‘put’ option purchased by the company) the exporting company is taking a speculative position in the currency market, exposing itself to the risk of PLN depreciation. Thus the exporter totally modifies its risk profile. Polish exporters before 2008 were keen to take the risk as most market analysts were predicting a further PLN appreciation (the PLN had been appreciating steadily since 2004 – see appendix 5 of the case study). In the case of a larger asymmetry the PLN-valuation of export revenues decreases more sharply with any depreciation of the PLN.

**b. Collar without asymmetry (1:1),**

This strategy involves buying a ‘put’ option and selling a ‘call’ option (the same maturity, higher exercise price for the call option).

The strategy hedges export revenues within a range of 3.2-3.6 million PLN.

**c. ‘Put’ option**

This strategy involves buying a ‘put’ option. It requires an initial outlay of 0.16 million PLN (option premium).

The strategy is very flexible as the company has a right and not an obligation – it may choose not to exercise the option in 6 months’ time. It hedges export revenues at a minimum level of 3.14 million PLN.

**d. Forward**

In practice this is the most popular hedging instrument due to its simplicity. It usually does not involve initial outlays (for clients with a shorter track record banks sometimes require some type of safety deposit which is returnable).

The strategy fixes export revenues at 3.3 million PLN (there is an obligation to exchange 1 million EUR for 3.3 million PLN in 6 months).

**e. Money market hedge (MMH)**

This is also called a synthetic forward. It does not involve initial outlays.

The strategy fixes export revenues at approximately 3.26 million PLN.

Additional calculations for MMH (assumption: the interest rate margin charged by the bank at a level of 1.5 percentage points - as compared to the interbank interest rate).

Beginning of the period (t=19.08.2008-Tuesday)		End of the period (t=23.02.2009-Monday)	
Transaction	Cash flow	Transaction	Cash flow
1. EUR-loan for 188 days (interest rate 6.657% p.a. =	+966,403.62EUR	1. Settlement of PLN-deposit 3,179,467.92PLN *(1+4.94%*(188/365))	+3,260,367.52PLN

5.157%+1.5%) 1 million EUR/(1+6.657%*(188/360))			
2. Spot sale of EUR for PLN at 3.29 PLN/EUR	-966,403.62EUR +3,179,467.92PLN	2. Export inflows in EUR	+1,000,00.00EUR
3. PLN-deposit for 188 days (interest rate 4.94% p.a.)	-3,179,467.92PLN	3. EUR-loan repayment (capital and interest) 966,403.62EUR *(1+6.657%*(188/360))	-1,000,000.00EUR
<b>Sum</b>	<b>0</b>	<b>-</b>	<b>+3,260,367.52PLN</b>

Source: own calculations.

The instructor should emphasise that MMH is a natural hedge of export revenues denominated in EUR (it involves incurring loans denominated in EUR).

**5. Did the company violate the regulations which public companies on the Polish capital market are obliged to observe by not relaying information about its option trading immediately after buying the option contracts? What are the obligations of a public company as regards informing capital market investors about its operations and what are the possible sanctions for a company which does not observe them?**

First of all, the instructor ought to discuss the legislation pertaining to the disclosure obligations of Polish public companies. The instructor and the students should discuss the most important regulations relating to disclosure obligations, which are presented below:

- The disclosure obligations of a public company are regulated by the 'Act on public offers, and the conditions governing the introduction of financial instruments to organised trading and public companies' (Public Offer of Financial Instruments Act) and the 'Regulation of the Minister of Finance on current and periodic information to be published by issuers of securities' (Regulation). An issuer of securities approved for trading on a regulated market is obliged to disclose; simultaneously to the Polish Financial Supervision Authority, the Warsaw Stock Exchange and to the general public (through the ESPI system and the corporate website); the following information:

- 1) confidential information (insider information),
- 2) current and periodic information.

Confidential and current information must be disclosed by a public company immediately after an event or after becoming aware of an event, but no later than within 24 hours.

According to Article 154 of the 'Trading in Financial Instruments Act' confidential information is the kind of information which has not been disclosed to the public and

which, if it was disclosed, could significantly influence the price of any financial instruments (a rational investor test); and the information must be defined in a precise way (i.e. it must indicate circumstances or events which have occurred or which may reasonably be expected to occur, and its character must make it possible to adequately assess the potential impact of those circumstances or events on the price of financial instruments).

According to the Regulation, a Quarterly Report should contain information which in the issuer's opinion is significant for evaluating their financial situation and financial results, plus any changes to either, as well as information which is significant in evaluating the capability of the issuer to fulfil their obligations. The report should also indicate factors which in the issuer's opinion may affect their performance, at least over the forthcoming quarter of the year.

- The Polish Financial Supervision Authority (KNF) can launch a preliminary investigation into the possible violation of disclosure obligations by a public company. When a violation of disclosure obligations by a public company is suspected, the Office of the Polish Financial Supervision Authority instigates administrative proceedings which may end in imposing sanctions. According to Article 96 of the 'Public Offer of Financial Instruments Act', if an issuer does not fulfil their disclosure obligations or does so inadequately, the KNF may decide to exclude, for a specified or unspecified period of time, their securities from the regulated market; or impose a financial penalty of up to 1 million PLN, taking into account the financial situation of the company; or apply both sanctions simultaneously. In the case of a flagrant violation of obligations, the KNF may impose a financial penalty of up to 100,000 PLN on any person who at the time was on the management board of a public company.

At this point the instructor can ask the students for their opinions as regards the violations of disclosure obligations by PKM Duda (in particular, whether the information about the written currency options [short position] should be considered confidential information and as such should have been disclosed). Next, the instructor can present the opinion of the Polish Financial Supervision Authority ('A list of sanctions imposed by the Financial Supervision Authority'):

- On 28.09.2009 the Polish Financial Supervision Authority unanimously decided to impose a financial penalty of 70,000 PLN on PKM Duda for violating disclosure obligations by not revealing within the legally required period confidential

information about their involvement in currency derivative transactions which carried unlimited risk and thus could have a significant influence on their financial results (violation of Article 56 of the 'Public Offer of Financial Instruments Act'). In setting the penalty the KNF took into account the company's precarious financial situation.

(decision from KNF session no. 87 on 28<sup>th</sup> September 2009)

**6. Did CEO Maciej Duda violate Polish capital market regulations by stating publicly on 1<sup>st</sup> December 2008 that the company did not and does not deal in option contracts?**

To begin with the instructor ought to discuss with the students the notion of capital market manipulation and the relevant legislation (in particular the sanctions for manipulation):

- According to Article 39 of the 'Trading in Financial Instruments Act', manipulation is defined, among others, as:
  - 1) placing orders or transactions resulting in an unnatural or artificial fixing of the prices of financial instruments;
  - 2) buying or selling financial instruments at the close of trading, which may be misleading to investors;
  - 3) obtaining material benefits from the influence of opinions relating to financial instruments, expressed in the mass media on an occasional or regular basis, on the price of the financial instruments held if an existing conflict of interest has not been publicly disclosed;
  - 4) disseminating through the mass media, including the Internet or in any other manner, false or inaccurate information or rumours which are or may be misleading in relation to financial instruments (so called information manipulation):
    - a) by a journalist – if they acted without due professional care, or if they obtained direct or indirect material or personal benefit for themselves or for another person by disseminating such information, even if they acted with due professional care,
    - b) by another person – if they were aware, or if acting with due diligence they could have found out, such information to be false or misleading.
- Administrative sanctions for manipulation: according to Article 172 of the 'Trading in Financial Instruments Act' the KNF can decide to impose a financial penalty of up to

200,000 PLN or a financial penalty of up to ten times the material benefit obtained, or both, on any person who engages in manipulation as defined in points 3 and 4b.

- Criminal sanctions: according to Article 183 of the 'Trading in Financial Instruments Act' a person who engages in manipulation other than defined in points 3 and 4b is liable to a fine of up to 5 million PLN or imprisonment from 3 months to 5 years, or both penalties together. A person who engages in collusion with another person for the purposes of market manipulation is liable to a financial penalty of up to 2 million PLN.

Next the instructor can ask the students to evaluate the actions of CEO Maciej Duda in the light of the above regulations (did the CEO perpetrate manipulation?). Then the instructor can present the opinion of the Polish Financial Supervision Authority ('A list of sanctions imposed by the Financial Supervision Authority, according to the type of infringement'):

- On 16.09.2009 the KNF imposed a fine of 200,000 PLN on the CEO of PKM Duda S.A. for information manipulation consisting of misleading investors through a publicly expressed false assurance that the company did not deal in speculative derivatives trading and that the derivatives held in its portfolio were for hedging purposes and did not threaten the company's financial results (violation of Article 39 of the 'Trading in Financial Instruments Act').

The instructor can stress that:

- 200,000 PLN is the highest fine ever imposed by the KNF on a natural person for information manipulation;
- up to September 2009 only four people (including Maciej Duda) had been punished by the KNF for information manipulation.

Students should also arrive at the conclusion that, irrespective of any law-breaking, the actions of the company's CEO was reprehensible from the point of view of business ethics.

**7. Who is responsible for the options problem in Poland – entrepreneurs or banks? (see appendix 5 of the case study) Was the fact that the banks offered option instruments to companies in the form of asymmetric strategies (with a larger short position for entrepreneurs) a breach of the principles of fair trade? Do the complaints made by companies to the Polish Financial Supervision Authority, about being intentionally misled by banks which offered them instruments and transaction volumes which were unsuitable for their needs, seem justified?**

This question usually engages students in a lively discussion as there is no “model answer” to it (students may have opposing views).

When analysing this question the following aspects should be taken into account:

- One of the fundamental principles of economic life is 'the freedom of contract' within the boundaries of the law (companies and banks entered into option contracts the conditions of which were accepted by both parties).
- Banks as institutions of public trust ought to pay special attention to giving precise information to clients about the products they offer, and in particular they ought to ensure that the client is adequately informed about any potential risk factors connected with a given contract.
- Unlike natural persons, corporate clients (especially larger entities such as listed companies) are professional customers who may be expected to be familiar with the nature of different financial instruments (large companies employ financial directors who ought to possess the relevant knowledge and be able to analyse financial contracts); so the complaints made by companies about the banks not adjusting such products according to their needs seem unfounded.
- As the Polish Financial Supervision Authority indicated (appendix 7 of the case study) before 2009, as a matter of course, banks required companies to sign declarations confirming that they were aware of the risks resulting from the contracts, as well as declarations which confirmed that it was the company's independent decision to enter into a contract connected with a given financial instrument (regarding banks' lack of guidance and independent decision making by companies).
- A bank is responsible for the correct credit rating of a customer. The potential risks connected with option contracts (short position) ought to be taken into account when assessing the overall credit risk and treated as using up the credit limit by the customer. The bank should react early to any changes in the valuation of option contracts and renegotiate with the customer the conditions of the contract if the credit rating is lower. If banks had renegotiated the contracts and closed the clients' short option positions in September 2008 (on September 15<sup>th</sup> 2008 Lehman Brothers filed for bankruptcy and the world financial markets descend into chaos; so the probability of investors abandoning emerging markets and of the depreciation of the currencies of those countries increased) or in October 2008 (the currencies of Central and Eastern European countries begin to rapidly depreciate) rather than several months later (in February 2009 the exchange rate of the PLN had already reached a record low), the

losses of companies and the problems which banks had because of insolvent clients would have been less serious.

- It cannot be excluded that in individual cases some companies were indeed inadequately informed about the nature of and the risks involved in derivatives trading (the responsibility for this may lie with individual bank employees).
- Before the beginning of the financial crisis in 2008 bank employees who were responsible for selling financial products such as currency options were remunerated in a large part in the form of commission (they received commission related to the quantity and value of the financial instruments they sold to customers); therefore this type of commission-based remuneration could have been one of the causes of the substantial involvement of Polish companies in derivatives.
- The losses of companies with short option positions turned out to be a significant problem for the banks (banks were unable to receive their profits from such transactions with companies as the clients were insolvent). The involvement of local banks in option contracts in many cases consisted in buying a currency option from a customer and then selling it to a foreign bank (at a higher premium) – in the hope that any potential losses from the contract with the foreign bank will be offset by profits from the contract with the local company.
- It seems that banks did not conduct stress tests on their clients (they did not take into account extreme scenarios in the currency markets or analyse the possible effects on option contracts) – this could have been the result of an opinion which was common among currency analysts in mid-2008 that the appreciation of the PLN was likely to continue into the future.
- An assessment of responsibility can only be conducted on a case by case basis, i.e. for each individual contract, after analysing the provisions of the contract as well as the procedures and the circumstances in which it was signed (one cannot generalise).

#### **8. Would an earlier implementation of the MiFID directive in Poland (before 2008) have helped prevent the 'option problem'?**

For a discussion of the MiFID directive see appendix 6 of the case study. When answering this question see also appendix 7 of the case study.

When analysing this question the following aspects should be taken into account:

- An analysis carried out by the Polish Financial Supervision Authority (“The main findings of an analysis of companies' involvement in currency derivatives,”

11.03.2009) revealed that some banks applied the principles included in the MiFID directive even before it was implemented in Polish legislation.

- MiFiD harmonises the procedures used by financial institutions and imposes uniform requirements regarding contracts with customers – thus it regulates the financial services market.
- It can be assumed that if a suitability assessment of financial instruments was obligatory, in many cases the banks' assessments would have been negative, and some companies would have decided against short position in option contracts.
- However, as the Polish Financial Supervision Authority indicated (appendix 7 of the case study), before 2009 it was standard procedure for banks, to legally protect their interests, to require that customers sign declarations confirming that they were aware of the risks resulting from the contracts, as well as declarations which confirmed that it was the company's independent decision to enter into a given financial instrument contract (regarding banks' lack of guidance and independent decision-making by companies). Even so, a large number of companies became involved in writing option contracts with banks.

**9. What are the possible methods/procedures of settling a dispute with a bank regarding derivatives contracts? What attempts to solve the 'option problem' were undertaken in Poland?**

When analysing this question the following methods/procedures/aspects should be taken into account:

- Negotiations between the company and the bank – closing short option positions, changing the expiration dates of options (adjusted to the timing of currency receivables) and restructuring the liabilities incurred through option trading (providing relief from some liabilities and/or converting them into company shares and/or changing them into long-term liabilities paid off in instalments) – used by such listed companies as PKM Duda and Ropczyce.
- Settling the dispute in court – a company invokes an error as the reason for the invalidity of a civil contract (Civil Code) – a strategy employed by the listed company Apator.
- Using the Court of Arbitration of the Polish Financial Supervision Authority (on 11<sup>th</sup> February 2009 the KNF changed the regulations regarding its Court of Arbitration and created a mediation centre for option contract disputes).

- Using the Court of Arbitration at the Polish Banking Association.
- Because of the considerable scale of the 'option problem' in the whole of the economy, the problem attracted the attention of politicians:
  - The minister of finance created a hotline which companies could use to report any losses they suffered in derivative transactions;
  - The co-ruling party PSL (Polish People's Party) along with two opposition parties, PiS (Law and Justice) and SLD (Democratic Left Alliance), prepared draft legislation relating to the 'currency option problem';
  - The draft legislation stipulated, among other things, a suspension in the execution of option contracts and a suspension of liability enforcement until an out-of-court or a court settlement is reached;
  - The most far-reaching proposal in the PSL draft was a clause stipulating that if a company is willing to renegotiate a contract and no agreement with the bank is reached within four months, either in the form of an out-of-court settlement or a decision by a Court of Arbitration, the company has the right to withdraw from the contract (the contract becomes invalid);
  - The Polish Financial Supervision Authority, the National Bank of Poland and the Ministry of Finance raised numerous significant objections to the drafts (e.g. a breach in the principle of the security of civil law transactions), and the Parliamentary Public Accounts Committee rejected three pieces of draft legislation submitted by MPs after their first reading.

**In order to answer the questions below students need a more advanced knowledge of Polish economic law (commercial company law, capital market law). This section should be discussed with students who have an appropriate level of knowledge in the area of economic law. It is advisable that during the class students have access to the texts of the relevant legislation: the Civil Code, the Trading in Financial Instruments Act, the Commercial Company Code and the Penal Code. Alternatively, when discussing the following questions the instructor can indicate or summarise the law and ask for an interpretation in the particular legal situations (as in the case of questions 5 and 6).**

**The following questions may be omitted, as they will not affect an analysis of the other points.**

**10. Can the members of PKM Duda's management board be held legally responsible by the company for the financial losses on option contracts? On which legal regulations can the company base its civil suit against the management board when demanding compensation for material losses?**

The students should give an affirmative answer to the question and indicate the following legislation as the basis for the company's civil suit:

- Commercial Company Code – according to Article 483 (Civil liability), a member of the board, a member of the supervisory board and a liquidator
  - is accountable to the company for any damage done through any action or omission which is contrary to the law or to the company's charter, unless not at fault;
  - should perform their duties with due care and diligence appropriate for the professional nature of their activity.

**11. Which legal regulations in the areas of capital market law and commercial company law could become the basis for the Association of Individual Investors notifying the Public Prosecutor's Office of an offence committed by the management board of PKM Duda S.A.?**

The students should indicate the following legislation as the basis for the notification of an offence:

- Commercial Company Code – according to Article 585 (Criminal liability), a person who as a member of the board, supervisory board, audit committee or as a liquidator acts to the company's detriment is liable to imprisonment of up to 5 years and a fine.
- The Public Offer of Financial Instruments Act (Chapter 9 Criminal liability) – according to Article 100, a person who, being responsible for current and periodic information, disseminates false or withholds true information which significantly influences the content of the information is liable to a financial penalty of up to 5 million PLN or imprisonment of between 6 months and 5 years, or both.
- Penal Code
  - According to Article 286 § 1 a person who, in order to obtain material benefits, leads another person to the inexpedient management of their own or another person's property by misinforming them or by exploiting an error or an inability to properly understand any actions undertaken is liable to imprisonment of between 6 months and 8 years.

- According 296 § 1 a person who, being obliged to deal with matters concerning the property or business of a natural person, legal entity or an organisational unit without legal personality, causes substantial material damage by abusing the powers granted to them or by failing to fulfil their obligations is liable to imprisonment of between 3 months and 5 years.
  - § 2. If a perpetrator of the offence specified in § 1 acts in order to obtain material benefits, they are liable to imprisonment of between 6 months and 8 years.
  - § 3. If a perpetrator of the offence specified in § 1 or 2 causes extensive degrees of material damage, they are liable to imprisonment of between 1 and 10 years.
  - § 4. If a perpetrator of the offence specified in § 1 or 3 acts unintentionally, they are only liable to imprisonment of up to 3 years.
  - § 5. A person is not liable to punishment if before the initiation of criminal proceedings they voluntarily repair the damage they have caused in its entirety.

#### **E. Additional readings or references**

1. „Podstawowe wnioski z analizy zaangażowania przedsiębiorstw w walutowe instrumenty pochodne” [The main findings of an analysis of companies' involvement in currency derivatives], 11.03.2009, Polish Financial Supervision Authority.
2. „Komunikat KNF z dnia 17 grudnia 2008 r. w sprawie wpływu walutowych instrumentów pochodnych na banki i spółki publiczne” [Communication of the Polish Financial Supervision Authority of 17<sup>th</sup> December 2008 on the influence of derivative instruments on banks and public companies], 17<sup>th</sup> December 2008, Polish Financial Supervision Authority.
3. „Stanowisko UKNF w sprawie dobrych praktyk w zakresie walutowych transakcji pochodnych - podstawowe zagadnienia opracowane na podstawie wniosków z analizy nadzorczej” [The position of the Office of the Polish Financial Supervision Authority on good practice in currency derivative transactions – key issues based on the findings of a supervisory review], 4<sup>th</sup> June 2009, Polish Financial Supervision Authority.
4. „Opcje obniżyły zyski o setki milionów złotych” [Options lowered profits by hundreds of millions of zlotys], Michał Śliwiński, Aleksandra Kurowska, 2<sup>nd</sup> June 2009, <http://www.parkiet.com/artykul/816692.html>

5. Opcje walutowe: trudny problem ministra gospodarki [Currency options: a difficult problem for the Minister of the Economy], Marek Wierzbowski, 24<sup>th</sup> December 2008, <http://www.ekonomia24.pl/artykul/706249,238890-Opcje-walutowe--trudny--problem-ministra-gospodarki--.html>
6. Ustawa o ofercie publicznej i warunkach wprowadzania instrumentów finansowych do zorganizowanego systemu obrotu oraz o spółkach publicznych [Act on public offers, and the conditions governing the introduction of financial instruments to organised trading and public companies].
7. Ustawa o obrocie instrumentami finansowymi [Act on trading in financial instruments].
8. Kodeks spółek handlowych [Commercial Company Code].
9. Rozporządzenie Ministra Finansów w sprawie informacji bieżących i okresowych przekazywanych przez emitentów papierów wartościowych [Regulation of the Minister of Finance on the current and periodic information published by issuers of securities].
10. Kodeks cywilny [Civil Code].
11. Kodeks karny [Penal Code].
12. „Wykaz kar nałożonych przez Komisję Nadzoru Finansowego” [A list of sanctions imposed by the Financial Supervision Authority], [www.knf.gov.pl](http://www.knf.gov.pl).

#### **F. Some additional information about the outcome of the case and follow-up facts**

Despite initial failures in the negotiations, PKM Duda eventually reached an agreement with the banks. On the last day of the period of protection from creditors (24.07.2009) the company signed a debt settlement agreement on the basis of which the banks agreed to restructure the company's debt of 301.2 million PLN, of which 88 million PLN were liabilities incurred by derivatives trading. The banks agreed to exchange part of the debt for company shares – this conversion into equity applying to 155.2 million PLN of the company's debt. Thus PKM Duda became the first company in Poland to have successfully completed a reorganisation procedure (signing an agreement with creditors). A restructuring process ('Duda 2012') was implemented, the aim of which was to improve efficiency and reduce costs, as well as selling selected assets. Whereas in 2009 the company had a net loss in the amount of 307.8 million PLN (the results of losses on option contracts), in 2010 it made a net profit of 32.1 million PLN.