

5-1993

## The Legal Framework for Private Sector Activity in the Czech Republic

Cheryl W. Gray

Follow this and additional works at: <https://scholarship.law.vanderbilt.edu/vjtl>



Part of the [Marketing Law Commons](#), and the [Property Law and Real Estate Commons](#)

---

### Recommended Citation

Cheryl W. Gray, The Legal Framework for Private Sector Activity in the Czech Republic, 26 *Vanderbilt Law Review* 271 (2021)

Available at: <https://scholarship.law.vanderbilt.edu/vjtl/vol26/iss2/3>

This Article is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Journal of Transnational Law by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact [mark.j.williams@vanderbilt.edu](mailto:mark.j.williams@vanderbilt.edu).

# The Legal Framework for Private Sector Activity in the Czech Republic

Cheryl W. Gray\*

## ABSTRACT

*In this Article, Dr. Gray discusses the evolving legal framework in the Czech Republic as the government there moves from a socialist to a private market economy. The author traces the major legal developments, including the Republic's establishment of significant private property rights and of a modern commercial code. The author finds that the Republic has made significant strides in developing a private market economy and in facilitating foreign investment. Dr. Gray concludes, however, that the new laws face significant challenges, including a weak and immature judicial system and problems with addressing business failures.*

## TABLE OF CONTENTS

I.	INTRODUCTION .....	272
II	RIGHTS TO REAL PROPERTY .....	273
	A. <i>Defining Basic Property Rights</i> .....	273
	B. <i>Eliminating the Monopoly of State Ownership</i> ..	275
	C. <i>Revising the Regulatory Framework</i> .....	279
III.	RIGHTS TO INTELLECTUAL PROPERTY .....	280
IV.	COMPANY LAW .....	283
	A. <i>Characteristics of a Joint Stock Company</i> .....	284
	B. <i>Characteristics of the Limited Liability Company</i> .	286
	C. <i>Characteristics of the Two Partnership Forms</i> ..	287
	D. <i>Setting Up a Company</i> .....	288

---

\* Senior Economist, Policy Research Department, World Bank; J.D./Ph.D. Harvard University. The author would like to thank Peter Ianachkov and JUDr Jaroslav Sodomka for their extensive help on submission and their insightful comments on an earlier draft. The author would also like to thank Messrs. Gerhardt Bubnik, Vladimir Fiser, Pavel Florian, Daniel Futej, Milos Kolacek, Ludvik Kopac, and the lawyers at the U.S. Federal Trade Commission and the Prague offices of Squire, Sanders & Dempsey and White & Case for their helpful assistance. The findings, interpretations, and conclusions are the author's own and should not be attributed to the World Bank, its Board of Directors, its management, or any of its member countries.

V.	FOREIGN INVESTMENT . . . . .	289
VI.	CONTRACTS . . . . .	291
	A. <i>Features of Socialist Contract Law</i> . . . . .	291
	B. <i>The Current Situation</i> . . . . .	292
VII.	BANKRUPTCY . . . . .	293
VIII.	COMPETITION LAW . . . . .	295
IX.	JUDICIAL INSTITUTIONS . . . . .	297
X.	CONCLUSION . . . . .	299

## I. INTRODUCTION

After its "velvet" revolution in late 1989, the Czech and Slovak Federal Republic (CSFR) moved steadily to create the conditions for the development of a private market economy. Not only did the CSFR free up the conditions for market entry of new private firms, but it also took innovative steps to privatize large parts of its state-owned industry. To thrive, this emerging private sector requires a clear legal framework that provides decentralized rules of the game and which serves several basic market functions:

- (1) defining the universe of property rights in the system;
- (2) establishing a framework for exchanging those rights;
- (3) setting the rules for the entry and exit of actors into and out of productive activities; and
- (4) ensuring that the overall market structure and the rules of market exchange promote competition.

Each of these functions typically involves numerous areas of law. In practice, most market economies define property rights via a wide array of laws regulating the ownership and use of real, personal, and intangible property, and shares in going concerns. Contract law governs the exchange of those rights. Company, foreign investment, and bankruptcy laws are among the subset of laws governing the entry and exit of actors into and out of productive activities. States tend to set forth general rules of market structure and competition in antimonopoly and unfair competition laws, and they may also announce more detailed laws and regulations for specific economic sectors.

This Article describes the evolving legal framework in the Czech Republic by using the above-described general classifications.<sup>1</sup> While the

---

1. This Article is part of a larger research project to study evolving legal frameworks in Eastern Europe. Similar studies have been completed on Poland, Romania, Bulgaria, Slovenia, and Hungary. This Article only briefly touches upon privatization and does not discuss at all certain other areas of law that are also important to the private sector, including banking, taxation, and labor law. Although a critical area of reform, privatiza-

Slovak Republic has created essentially the same legal framework as that of the Czech Republic, these two systems could diverge considerably in the coming months and years. The evolution of the Czech Republic's legal framework presents a unique case, for the former CSFR out of which it grew differed somewhat from its Central and Eastern European (CEE) neighbors, particularly Poland and Hungary, in that Czechoslovakia's socialist leaders more thoroughly abrogated the state's prewar legal system during their tenure. The effect of this abrogation is that there are fewer people in or out of the Czech government familiar with market-oriented legal principles and practices. On the other hand, the CSFR had the advantage of starting in 1989 with a relatively clean slate upon which to craft modern laws. In some areas, such as company, contract, and antimonopoly law, legal reforms in the Czech Republic are relatively well advanced and could serve to some degree as models for other reforming socialist economies. In other areas, including constitutional and real property law, legal reform is embroiled in political controversy and lags behind developments in some neighboring states. Moreover, the institutional capacity of the Czech Republic's judicial system appears to be relatively weak and ill prepared to cope with the skyrocketing demands emerging in the newly reformed system.

## II. RIGHTS TO REAL PROPERTY

Rights to real property are in a tremendous state of flux in the Czech Republic. As the Czechs struggle to redefine the basic legal framework of real property rights, the clash of competing claims of current tenants, former owners, and new would-be purchasers creates widespread uncertainty. Moreover, the land registry and regulatory institutions require major overhaul. A real estate market is just beginning to emerge and is still in disequilibrium.<sup>2</sup>

### A. *Defining Basic Property Rights*

The constitution of a state, although generally not a detailed legal document, sets the basic rules under which the state's economy and government will operate. The rules pertaining to property ownership rank

---

tion is a transitional issue, whereas this Article seeks to address the long-term legal structure. The other areas of law are omitted due both to space limitations and to likely coverage in other World Bank or external studies.

2. Extreme price variation is one indicator of this disequilibrium. For example, the rental price of refurbished commercial space in a top location in Prague in mid-1992 could reportedly vary from under \$100 to \$450 per square foot.

among the most important of such rules. In the past, socialist constitutions typically gave precedence to state or socialized ownership and severely restricted the domain of private activity. Constitutional reforms throughout the CEE region in the last two years have, among other things, attempted to level the playing field for public and private ownership by granting unhindered rights to private ownership of property and private entrepreneurial activity.

The CSFR adopted its first constitution in 1920.<sup>3</sup> The state then adopted a new constitution, based firmly on socialist principles, in 1948.<sup>4</sup> A second socialist constitution superseded the first socialist constitution in 1960<sup>5</sup> and was itself amended in 1968.<sup>6</sup> The CSFR failed to adopt a new constitution after the 1989 revolution, even though the Federal Assembly elected in June 1990 supposedly had the responsibility for doing so during its two-year term. Political disagreements over governmental structure and the distribution of powers among the republics and between levels of government stalled this process, and the Assembly could not proceed until basic questions on union or disunion were resolved. Numerous amendments were made, however, to the 1960 constitution to bring its provisions in line with the needs of a private market economy. The Constitutional Law on Fundamental Rights, adopted in January 1991,<sup>7</sup> granted all persons the right to own and inherit property and provided equal protection for all types of ownership rights.<sup>8</sup> This law provided for expropriation only "in the public interest," according to law and with compensation.<sup>9</sup> It further provided that "everyone has the right to freely choose their profession . . . [and] to undertake other economic activities."<sup>10</sup> Thus, the amendments to the old socialist constitution quickly removed the constitutional barriers to private ownership and private entrepreneurship. The new constitution for the Czech Republic, which was finally adopted on December 16, 1992, reinforced these same

---

3. Constitution of the Czechoslovak Republic of February 29, 1920, in *Sbirka Zakonu a Narizeni, 1918-1974*.

4. Constitution of June 9, 1948, in 1 AMOS JENKINS PEASLEE, *CONSTITUTIONS OF NATIONS* 605 (1956).

5. The Constitution of the Czechoslovak Socialist Republic of July 11, 1960, published in Prague by Orbis, 1967.

6. *Zakony o federativnim usporadani CSSR*, published in Prague by Orbis, 1972.

7. Constitutional Law on Fundamental Rights, in *Lidove Noviny*, January 16, 1991, translated in JPRS-EER-91-025-S, February 28, 1991.

8. *Id.* art. 11(1).

9. *Id.* art. 11(4). A similar provision existed in the previous constitution but was virtually irrelevant due to the prohibition on private ownership of property.

10. *Id.* art. 26(1).

principles by explicitly incorporating the constitutional law on Fundamental Rights.<sup>11</sup>

The primary legislation defining property rights in detail for the Czech Republic is the Civil Code,<sup>12</sup> the existing version of which dates from 1964. As typical of the civil codes of other CEE countries promulgated during the socialist period, this code originally established a hierarchy of rights among state, cooperative, personal, and private property. State property—the “highest” form—encompassed the major means of production and was accorded special legal status. Personal property included the family house up to a size of 120 square meters, and small items for personal use. Private property, the lowest in the hierarchy, referred to private ownership of means of production (in practice mostly real estate).

Although the 1964 Code continues in force, major amendments made at the beginning of 1992 abolished the socialist property hierarchy and equalized the legal status of state and private property. A thorough overhaul of the Civil Code is planned but will take several years to realize.

#### B. *Eliminating the Monopoly of State Ownership*

Unlike Poland and Yugoslavia, where a significant amount of real property remained in private hands, the state owned or controlled almost all real property in Czechoslovakia during the socialist period. Industrial enterprises and the real property they occupied were all under state ownership, as were most apartment buildings. Although the state never officially expropriated agricultural land during the socialist period, it did allocate rights of use and transfer to state farms and cooperatives. Single-family housing, a few apartment buildings, and the land on which these were built (including small adjacent yards) were the only kinds of real property that remained in private hands.

Changing the basic definition of property rights by expanding the scope for private property ownership is the first, and in some sense the

---

11. Constitution of the Czech Republic, unofficial translation, Czech News Agency (CTK), December 18, 1992.

12. When Czechoslovakia became an independent state after World War I, the Czech Republic continued to apply the Austrian Civil Code (*Buergurliches Gesetzbuch*) of 1811, which had previously been in force in the Czech Kingdom. Slovakia, in contrast, continued to rely on Hungarian law, which at the time had a commercial code (dating from 1876) but no unified civil code. In 1950 the existing law in both republics was replaced with a new civil code, which included certain socialist principles and included directives of state organs (including the plan) as part of the law. A new civil code and an economic code were adopted in 1964. George E. Glos, *The Legal System of Czechoslovakia*, 8 MODERN LEGAL SYSTEMS CYCLOPEDIA 840.3-8.40,40 (1992).

easiest, step in reforming real property rights. Actually implementing these changes, primarily through the elimination of the monopoly of state ownership, is proving more problematic because of the tremendous distributional implications. The process entails privatizing commercial property through restitution to previous owners or transfers to new purchasers, and developing an active rental market in property still held by the state.

The CSFR moved quickly after its 1989 revolution to reverse the nationalizations of the socialist era by returning both real property and businesses to former owners. Four laws have governed the restitution process in the Czech Republic and Slovakia. The first, the "small" restitution law,<sup>13</sup> applies to property (mostly apartment houses and small businesses) nationalized between 1955 and 1961 by two sets of government decrees that contravened existing law even at that time. The deadline for claims under this first law was April 1, 1991 and an estimated 70,000 properties are involved. Due to the illegal nature of the original takings, restitution under this law is primarily in kind.

The second, the "large" restitution law,<sup>14</sup> covers property (mostly companies, including any real property owned by them) nationalized from individuals<sup>15</sup> under prevailing law after the Communists seized power on February 25, 1948. This law applies to five to ten percent of all state property, significantly more than the first law. However, it does not cover most of the major nationalizations of large industrial enterprises undertaken by the interim government between 1945 and 1948. The deadline for claims under this second law was October 1, 1991. Restitution under this law is primarily financial (mostly in vouchers that can be invested in newly privatized companies or shares in the companies themselves) rather than in-kind. This reflects the fact that the Communist government never fulfilled the promise of compensation under the 1948 nationalization law. The first law made restitution claims available to emigrés, but the second law limited claims to resident citizens. Although many claims under these two laws have been settled, many disputes (often between restituted owners and existing tenants) are only now entering the courts.

The third restitution law concerns agricultural and forestry land.<sup>16</sup> This law returns use and transfer rights in such land to the legal own-

---

13. Law on the Alleviation of Some Property Injuries, Law No. 403/90.

14. Law on Extrajudicial Rehabilitation, Law No. 87/91, February 1991.

15. Property taken from political parties and churches was thus excluded from restitution.

16. Law on Land and Agricultural Cooperatives, Law No. 229/91, June 1991.

ers, provided they are resident citizens. Despite the fact that less than 500,000 Czech still engage in agriculture, this law potentially could apply to as many as 3.5 million titleholders. There is widespread concern that this restitution not disrupt agricultural production. The deadline for claims under this law was December 31, 1992.

Finally, a fourth law, adopted by the Parliament in April 1992, returns land confiscated after World War II to ethnic Germans and Hungarians, as long as they have remained in the country and regained their citizenship.

This patchy and complex legal framework has created many problems. First, the heavy reliance on restitution-in-kind (particularly in the first law) has led to many disputes, often between competing claimants or between former owners and current tenants. These disputes are now beginning to clog the court system. Second, the legal precedence given restitution over privatization has created uncertainty among potential investors and has complicated privatization, particularly in the case of small businesses and housing. Finally, the government has poorly coordinated these restitution statutes with other laws that restrict the ownership rights of new owners.<sup>17</sup>

Business or residential real property not returned in-kind to former owners is potentially available for sale to new owners. In the case of land and buildings utilized by state-owned enterprises, privatization of real property represents only one aspect of the larger task of privatizing the firms themselves. Privatization of state-owned firms is proceeding rapidly in the Czech Republic and in Slovakia, more rapidly than in any other CEE country. Two laws govern the privatization process. The first is the "small privatization" law,<sup>18</sup> pursuant to which local authorities have sold over 100,000 small enterprises (such as retail shops and restaurants) in the two republics via public auction. Most such sales have only involved machinery, furniture, or inventories. The existence or fear of competing restitution claims has impeded sales of real property rights. However, a purchaser does acquire the right to rent the premises for three to five years at a fixed rent, after which the rental contract is subject to renegotiation.

Restitution claims also affect the privatization of larger firms, and the real property where upon they sit, but to a somewhat lesser degree than

---

17. The most important of these involve housing. New private owners of apartment buildings are still subject to tight rent control and limitations on eviction, yet they must assume the costs of maintenance and repairs.

18. Law on the Transfer of State Property of Certain Businesses to Other Physical or Legal Persons, Law No. 427/90, October 1990.



smaller firms. Over 3000 large companies (over 2000 in the Czech Republic) were privatized during the first wave of the "large privatization"<sup>19</sup> effort in the two republics. A second wave of similar magnitude will follow in 1993. Privatization of the large firms is being accomplished through direct sale to individual purchasers, auction to the public in exchange for vouchers,<sup>20</sup> restitution to former owners,<sup>21</sup> or, in many cases, through some combination of the above.<sup>22</sup> Unlike small privatizations, the real estate owned by the firm is generally transferred along with its other assets.

While privatization of firms is proceeding quite rapidly, privatization of state-owned housing stalled in 1992. The most recent parliament failed in May 1992 to pass a law whereby houses and apartments not already returned to former owners<sup>23</sup> would be sold by local governments<sup>24</sup> to tenants. Parliamentary action floundered upon the issue of price: how to determine it, how to reflect subsidy values, who would provide credit, and at what rate of interest. The newly elected legislators are expected to take up the issue again in 1993.

---

19. Law on Conditions of Transfer of State Property to Other Persons, Law No. 92/91, February 1991.

20. Before the end of the February 1992 deadline, every CSFR citizen aged 18 or older was eligible to buy a book of coupons worth 1000 investment points for 1000 Kcs. Some 8.5 million citizens—about three-fourths of all adult citizens—purchased coupons. These coupons can be used to purchase shares in individual companies or can be invested in one of several competing investment funds.

21. In most cases, the property has been significantly altered since nationalization so that financial compensation will be provided to former owners rather than restitution-in-kind. Three percent of all privatization receipts are earmarked for a compensation fund for that purpose.

22. Approximately the same amount of assets is being sold through direct sale as is being sold via voucher auction. The Privatization Ministry selects the method among competing proposals submitted by the enterprise itself or outside parties. The Ministry employs several criteria for evaluating proposals, including not only price to be paid but also future plans for restructuring, labor use, and additional investment. Each proposal must include a plan for dealing with any restitution claims filed under the large restitution law.

23. An estimated one-fifth of state-owned housing has been returned to former owners under the first and second restitution laws, leaving four-fifths to be covered by a program of housing privatization. Tenants who happen to be living in formerly nationalized apartments will not benefit from these laws, for they will be unable to purchase their apartments at subsidized prices like other tenants.

24. The 1990 Law on Municipalities made local governments the clear owners of publicly owned apartment buildings.

### C. *Revising the Regulatory Framework*

The Czech Republic faces an array of regulations on real property that have survived from the socialist period but need rethinking as the economy evolves into a market-based system. Rent and tenancy regulations rank among the laws most distorted by socialism. Rent control has long kept housing rents artificially low, far out of line with rents prevalent in free-market economies and too low even to support basic upkeep and maintenance. Although the government doubled permissible rents in mid-1992,<sup>25</sup> they nevertheless remain extremely low. Rent control is combined with tight restrictions on eviction. A tenant cannot be evicted unless alternative, equivalent housing is found. Given the acute shortage of commercial space in Prague (caused in part by these rent and tenancy regulations that prevent housing from being converted to commercial space), a speculative market has arisen in which some private enterprises have bought up available space at very high prices. These enterprises sometimes pay tenants large sums to leave voluntarily or actually build alternative housing in other areas of the city to meet the eviction-alternative requirement. The shortage of space and resulting high prices make it difficult for small entrepreneurs to find affordable space in which to open new businesses.

Another critical challenge facing the Czech Republic is updating and modernizing the land registry. Not all transfers and encumbrances continued to be registered in the land registry during the socialist period, and thus land records for this period are not fully reliable. In particular, land records in many instances fail to reflect transfers to and among state entities.

The Czech Republic originally designed its land register on the Austrian model, while Slovakia patterned its system after the Hungarian model. Because entry in the register was decisive in gaining firm title under the old civil code, all transfers made until 1951 were duly recorded in this system. From 1951 (when the government adopted a new civil code) until 1964, the old *cadastre* continued to exist, but entry in the register no longer constituted proof of title; rather, the validity of a contract of real estate transfer hinged upon registration with the state notary. Records from the period from 1951 to 1964 are the most unreliable with regard to the accuracy of land transfer and ownership. In 1964, the date of adoption of the most recent civil code, the old *cadastre* books were closed and a new land register was opened. Under this code registration of real estate contracts with the state notary continued to be the

---

25. Rent of a two-room flat thus rose from 100 to 200 Kcs. (about \$7) per month.

determinative step in obtaining firm title. However, because the state notary had a duty to send all contracts for entry in the new register, this register is thought to reflect accurately real estate transfers and encumbrances after 1964.

Czechs rarely used real estate mortgages after 1949. As in other CEE countries, little need existed for mortgage financing during the socialist period. Housing costs were low, and foreclosure was not a viable option due to the near impossibility of eviction. Because both banks and businesses were state-owned, banks could readily garnish wages if needed to satisfy overdue payments. The government altogether omitted the concept of a mortgage (or pledge) from the civil code in 1964.<sup>26</sup>

These conditions are changing rapidly in the Czech Republic, and mortgage lending will need to develop as an independent and viable instrument of finance as the real estate market grows by means of restitution, privatization, and increased rental of state-owned space. This development will require the growth of market-oriented financial institutions, a reintroduction of concepts of collateral security into law and everyday practice, the eventual phase-out of heavily subsidized interest rates, and an easing of foreclosure (and thus presumably eviction) procedures to transform real estate collateral into a true instrument of security. A 1988 amendment to the civil code has reintroduced the concept of collateral in the form of a pledge on immovable property. The land record is supposed to serve as a central registry to inform third parties and determine priority. It will take time and experience, however, to transform this concept into a practical and widely used form of security.

### III. RIGHTS TO INTELLECTUAL PROPERTY

Intellectual property laws had little meaning in the domestic economies of the CEE countries during the socialist era. Pervasive state control over the economy meant that inventors and creators tended to work within the state apparatus. Inventors were given credit for their inventions in the form of lump sum cash awards, calculated generally as a percentage of the savings achieved by the design or a percentage of the net return on the investment. The socialist organization upon whose behalf or within whose contractual relation the invention was created obtained an "authorship certificate," which gave it the right to use the invention and apply for patent protection abroad. Because the rights to the invention remained essentially with the state apparatus, the Czech Re-

---

26. I am grateful to Jaroslav Sodomka for providing helpful information regarding the history of mortgage finance.

public has had little experience with the enforcement of private patents. This area will therefore present a major challenge to the Republic's new intellectual property regime.

The CSFR moved in the late 1980s and early 1990s to update its intellectual property legislation and adapt it to the needs of a market economy. A new trademark law was passed in 1988,<sup>27</sup> and the existing patent<sup>28</sup> and copyright<sup>29</sup> laws underwent major amendments in 1990. The 1990 amendments came on the heels of the United States-Czechoslovakia Trade Agreement,<sup>30</sup> which conditioned most-favored-nation status on changes in this area.<sup>31</sup> These amendments brought Czechoslovak legislation generally in line with international norms. In the patent area, for example, the amendments establish a twenty year term for patents (extended from fifteen years under the previous version), extend protection to products and processes in all areas of technology, limit the use of compulsory licenses, and make decisions of the patent office subject to judicial review. In the area of copyright, the amendments extend protection to computer programs and data bases, audiovisual works, and sound recordings.

On the international front, the former CSFR has long cooperated in international conventions, although the protections these conventions provide have generally been treated as a matter of domestic law. In the patent and trademark area, the former CSFR is a signatory to the Paris Convention for the Protection of Industrial Property (1883), the major international treaty covering the subject,<sup>32</sup> and to the most current text of

---

27. Trademark Law, Law No. 174 of November 8, 1988, in force since January 1, 1989. This law provides for registration with the Office of Inventions and Discoveries and grants an initial 10-year term of protection that can be extended indefinitely by 10-year periods.

28. Law on Discoveries, Inventions, Rationalization Proposals and Industrial Designs, Act No. 84/1972, as amended.

29. Law No. 35/1965.

30. Agreement on Trade Relations Between the Government of the United States of America and the Government of the Czechoslovak Federal Republic, April 12, 1990.

31. The Agreement confirms the commitments made in the Universal Copyright and Berne Conventions and specifically requires 50-year protection for computer programs and databases, audiovisual works, and sound recordings. See generally Universal Copyright Convention, *done*, Sept. 6, 1952, 6 U.S.T. 2731, T.I.A.S. No. 3324, 216 U.N.T.S. 132, *as last revised* July 24, 1971, 25 U.S.T. 1341, T.I.A.S. No. 7868; Berne Convention for the Protection of Literary and Artistic Works, Sept. 1986, *as revised* at Paris, July 24, 1971, \_\_\_\_\_ U.S.T. \_\_\_\_\_, T.I.A.S. No. \_\_\_\_\_, 3 WIPO & UNESCO, COPYRIGHT LAWS AND TREATIES OF THE WORLD, Berne Conv. (Item H) (1987) [hereinafter Berne Convention].

32. The two most important rights granted by the Paris Convention are national

the Madrid Agreement Concerning the International Registration of Marks (Stockholm, 1967).<sup>33</sup> In the copyright area, the former CSFR is a signatory to the Universal Copyright Convention and the Berne Convention (Paris texts of 1971), which protect literary, scientific, and artistic works.<sup>34</sup>

Some lawyers perceive uncertainties in the transition from the old to the new system, particularly with regard to rights previously conferred through authors' certificates. Do those certificates continue to confer rights? If so, who owns those rights, particularly in the case of newly privatized entities? Does usage by other parties prior to the 1990 amendments confer any rights? What happens if an invention was created and recognized, but never actually used? These are the types of transition questions that have yet to be resolved in the move to a new intellectual property regime.

Enforcement capacity poses a problem in all areas of intellectual prop-

---

treatment of foreigners and right of priority in registration. The right to national treatment obligates states to treat foreigners as they would their own nationals under their own laws. The right of priority gives the holder of a patent one year to file in other member countries without losing priority rights over other potential claimants to the invention. However, the criteria for patentability is still a question of domestic law. Thus, the Paris Convention would do little to protect patents without a Czechoslovak law that provided reliable substantive patent rights. *See Paris Convention for the Protection of Industrial Property, done Mar. 20, 1883, as last revised, July 14, 1967, 21 U.S.T. 1583, T.I.A.S. No. 6923, 828 U.N.T.S. 305.*

The Paris Convention also grants national treatment and right of priority to trademark owners. Right of priority lasts six months for trademarks, as opposed to one year for patents. The Paris Convention does, however, provide a bit more substantive protection for trademarks than for patents by automatically protecting well-known marks, apparently without requiring that the mark be registered in other member countries. *See id.*

33. The Madrid Agreement protects both trademarks and service marks by allowing members of signatory countries to register their trademarks with the International Bureau of the World Intellectual Property Organization (WIPO) in Geneva. The mark must first be registered in the state of origin, whose administration then applies for registration with WIPO. The effect of WIPO is to protect the trademark in all signatory countries. Upon notification of the registration of a trademark, national administrations may still be authorized by national law to declare that certain trademark protection cannot be granted in that territory. Thus, like the Paris Convention, the Madrid Agreement ultimately depends on domestic law in protecting substantive rights. *See generally Madrid Agreement Concerning the International Registration of Marks, Apr. 14, 1891, 828 U.N.T.S. 389.*

34. Under the Berne Convention, no formalities are required to protect a work in other member countries. Whereas protection in the country of origin may depend on registration, no central registration exists for international protection; upon creation, works are protected.

erty law. Although a registration procedure exists, it is often slow,<sup>35</sup> and how a holder of intellectual property rights can in practice protect these rights if another person infringes them is still uncertain and untested. Enforcement will emerge as a critical issue as the domestic private sector and foreign investment grow. Giving true meaning to these rights will require institutional strengthening in the registration agencies and the courts to ensure that infringements can be identified, halted, and appropriately punished.

#### IV. COMPANY LAW

The former CSFR adopted a new company law, the Commercial Code, on January 1, 1992. It is the most comprehensive and arguably the best such law to emerge in Central and Eastern Europe to date. The Code encompasses both company law and commercial contracts, replacing the Economic<sup>36</sup> and International Trade Codes<sup>37</sup> passed in 1963,<sup>38</sup> the Law on Joint Stock Companies of 1990,<sup>39</sup> and former laws on cooperatives.<sup>40</sup> It applies equally to domestic and foreign entrepreneurs, thereby replacing former legislation specifically tailored to foreign investment.<sup>41</sup> It also has a section devoted to unfair competition.

The company section of the Code<sup>42</sup> generally follows the German model and sets out four types of companies: the joint stock company, the limited liability company, the "comandite" company, and the unlimited liability company. A separate chapter covers cooperatives.

---

35. For example, it reportedly can take one year to register a trademark and eighteen months to have it published.

36. Economic Law Code No. 109/1964, as amended.

37. Law No. 101/1963 on legal relations in international trade.

38. The prewar commercial code was abolished in 1950 with the adoption of a new civil code. This code was in turn replaced in 1963 by three new codes on civil, economic, and international trade, which the government meant to stand as the full achievement of socialism. Of these, only the International Trade Code followed generally accepted Western contract ideas as found, for example, in the Hague Convention of 1964, the New York Convention on Prescription of 1973, and the Vienna Convention on Sales Contracts of 1980.

39. Law No. 104/1990 on joint stock companies. This law replaced the extremely outdated 1949 Joint Stock Companies Act (Law No. 243/1949) and introduced modern company forms (generally along German models) into the country's legal framework.

40. Law No. 162/1990 on agricultural cooperatives; Law No. 176/1990 on housing, consumer, manufacturing and other cooperatives.

41. Law No. 173/1988 on companies with foreign ownership participation, as amended in Law 112/1990.

42. Commercial Code, January 1, 1992 pt. II.

### A. *Characteristics of a Joint Stock Company*

The most formal type of company in the commercial code is the joint stock company, or *akciová společnost* (abbreviated as *akc. spol.* or *a.s.*). Such a company resembles the German AG (*Aktiengesellschaft*), the French S.A. (*société anonyme*), and the United States public corporation. This form is intended to be used by large firms, in which ownership is widespread and thus necessarily separated from management. The Code applies tighter regulations and more extensive reporting requirements to this company form, primarily to protect the public in public offerings and to give shareholders tools to oversee management. About 3000 joint stock companies had been registered by the end of 1991, most being either state-owned enterprises or foreign joint ventures.

The Code requires a minimum capital outlay of 1,000,000 Kcs. (approximately \$35,000) to set up a joint stock company. This capital requirement places the Czech Republic in the middle range for European countries but is very high by United States standards.<sup>43</sup> This level represents a tenfold increase from the 100,000 Kcs. required by the previous joint stock company law. Within one year existing firms had to either increase their capital to one million Kcs. minimum or change their form, a major burden for many firms.

Capital contributions can be either in money or in kind. The value of in-kind contributions must be supported by an expert assessment.<sup>44</sup> At least thirty percent of monetary contributions must be paid in before the first general shareholder meeting, with the remainder due within one year (or a shorter period if so provided in the company's statutes).<sup>45</sup> In addition to minimum capital, each company must maintain a reserve fund in readily realizable assets, initially ten percent of capital, to be supplemented each year by at least five percent of net profits up to twenty percent of capital.<sup>46</sup>

The law provides great flexibility in structuring ownership interests in

---

43. While substantial minimum capital requirements reassure potential creditors, they act as barriers to entry to new entrepreneurs. An alternative and much needed means to protect creditors would be to increase the availability and credibility of collateral through changes in laws, institutions, and attitudes. In such a way, a legal framework with more extensive property rights (i.e. contingent or collateral rights on moveable property) could replace distortionary direct controls (i.e. high minimum capital requirements).

44. Commercial Code, pt. II, § 165(2).

45. *Id.* § 177.

46. This reserve requirement appears to be quite high and should be reviewed to weigh its supposed benefits against the burden it imposes on the newly emerging private sector.

a firm, although it is likely to be some time before widespread use of elaborate share structures emerges in the Czech Republic. The Code allows for registered or bearer shares,<sup>47</sup> and a company may, with some limitations,<sup>48</sup> also issue employee shares with certain advantages. Up to one-half of a firm's equity may be in the form of preferred shares (i.e. with a dividend preference and with or without voting rights).<sup>49</sup> Interest-bearing shares which were permitted in the 1990 joint stock company law are not permitted under the Commercial Code.<sup>50</sup> The law also permits companies to issue debentures that are convertible into shares within a certain time period.<sup>51</sup>

Shares entitle the holder to dividends and a percentage of assets upon liquidation. Although a "one share, one vote" rule generally applies, company internal statutes may set a maximum number of votes per shareholder. Unlike in some other countries, however, it is not possible for a company to assign more than one vote per share.<sup>52</sup>

In line with the German model, the Code provides that each joint stock company must have both a board of directors<sup>53</sup> and a supervisory board. The board of directors must contain at least three members, which are elected by the general meeting of shareholders (or by the supervisory board if so stipulated in the company statutes).<sup>54</sup> The supervisory board, which oversees the board of directors, must also include at least three members. In companies with more than fifty employees, the employees have the right to elect one-third of the supervisory board's members (or up to one-half, if the company statutes so provide), again following the German model of codetermination, with the remainder elected at the general shareholders meeting.<sup>55</sup>

---

47. *Id.* ¶ 156.

48. The company may not give more than 5% of equity free of charge to employees, and employee shares may be transferred only among current or retired employees. *Id.* ¶ 158.

49. *Id.* ¶ 159.

50. *Id.* ¶ 159(2).

51. *Id.* ¶ 160.

52. In Poland, for example, certain shares can be given up to five votes. See Cheryl W. Gray et al., *The Legal Framework for Private Sector Development in a Transitional Economy: The Case of Poland*, 22 GA. J. INT'L & COMP. L. 283 (1992).

53. The board of directors in this model has somewhat more hands-on responsibility than the outside Board typical of United States corporations. It usually meets twice a month. The day-to-day running of the company is the responsibility of the general manager appointed by the board. In practice, the supervisory board is not as important, as is typical in Germany.

54. Commercial Code, pt. II, ¶ 194.

55. *Id.* ¶ 200.



Quorum and voting rules determine the power of individual shareholders to influence outcomes at the general meeting. Pursuant to the law, the presence of shareholders owning at least thirty percent of company equity constitutes a quorum,<sup>56</sup> and most decisions require a majority vote,<sup>57</sup> although either the quorum or the voting rule can be changed by company statute. The flexibility to change these rules, plus the ability to limit the maximum number of votes per shareholder, gives the company wide latitude to separate the power of corporate governance from shareholding status. This ability might prove useful, for example, in negotiations between a foreign investor and local investors or the government, if the domestic partner wants to maintain majority ownership but the foreigner requires veto power over major corporate decisions. In such a case, high quorum or supermajority voting rules (or both) can be adopted to give the minority shareholder effective veto power, or the voting power of the majority shareholder can be limited to equalize voting power per shareholder.

The activities of directors should in principle be limited not only by shareholder oversight, but also by laws on fiduciary responsibility, conflicts of interest, insider trading, and fraud. Yet legal principles such as these are underdeveloped in the Czech Republic, as in other CEE countries. Furthermore, the legal provisions that do exist are in practice difficult to enforce given the shortage of well-trained lawyers and judges and the difficulties of obtaining evidence (due in part to underdeveloped discovery rules). The weakness of the legal sanctions for misconduct makes corporate governance even more difficult in this setting than in mature market economies.

### B. *Characteristics of the Limited Liability Company*

The limited liability company, or *spolecnost s rucemin omezenym* (spol. s r.o. or s.r.o.), is less formal than the joint stock company. It resembles the German GmbH (*Gesellschaft mit beschränkter Haftung*), the French S.A.R.L. (*société à responsabilité limitée*), and to some extent the United States closely held corporation. Because this form offers the benefits of limited liability to all investors while minimizing regulatory and reporting requirements, it is preferred by most small and medium-

---

56. *Id.* ¶ 185(1). This is a rather low quorum requirement by international standards. Fifty percent is a more common rule.

57. *Id.* ¶ 186(1). Certain decisions, such as a change in company statutes, a change in rights attached to particular types of shares, an increase or reduction in equity, and dissolution of the company, require two-thirds majorities in all cases. *Id.* ¶ 186(2), 187(2).

sized entrepreneurs. The maximum number of participants is fifty.<sup>58</sup> Minimum capital is 100,000 Kcs. (approximately \$3500),<sup>59</sup> with at least 20,000 Kcs. from each participant<sup>60</sup> (at least 30 percent of which is paid in upon registration).<sup>61</sup> Because such a company is intended to be a vehicle for investment by a small group of investors who are acquainted with one another, one participant cannot transfer his shares except with the approval of the others.<sup>62</sup>

Rules on corporate governance and reporting requirements are much simpler than in the case of the joint stock company. Rather than a board of directors, a limited liability company is managed by one or more statutory representatives appointed at a general shareholder meeting from among the participants or other persons.<sup>63</sup> As with the joint stock company, rules regarding quorum requirement (generally one-half of all voting rights represented) and voting majority levels for general shareholder meetings (generally simple majority) are mandated by law but can be altered by company statute. A supervisory board is not required but can be set up if the company agreement so stipulates.<sup>64</sup>

### C. *Characteristics of the Two Partnership Forms*

The two partnership forms, the unlimited liability company and the *comandite* company, are analogous to general and limited partnerships in the United States. In the former entity, *verejna obchodni spolecnost* (ver. obch. spol. or v.o.s. or surname plus a spol. [& co.]), all partners have unlimited joint and several liability with regard to the partnership's obligations, and they share equally in company profits unless the company agreement stipulates otherwise. Participants choose a commercial director from among themselves, and all have full access to the books and records of the company. In the *comandite* company, *komanditini spolecnost* (kom. spol. or k.s.), one or more participants (the general partners) have unlimited liability and responsibility for management, while the liability of the others (the sleeping partners) is limited to their capital contribution. In other respects this form is similar to the unlimited liability company. Both forms of partnership possess an important

---

58. *Id.* ¶ 105(3).

59. *Id.* ¶ 108(1). Although lower than the minimum capital required for a joint stock company, this is still a relatively high minimum capital requirement.

60. *Id.* ¶ 109(1).

61. *Id.* ¶ 111.

62. *Id.* ¶ 115.

63. *Id.* ¶ 133.

64. *Id.* ¶ 137.

advantage over the joint stock and limited liability company forms: they are not subject to tax at the entity level under the new tax law in force as of January 1, 1993.<sup>65</sup>

#### D. *Setting up a Company*

Although the new Commercial Code establishes a modern and well-designed legal framework for the establishment of companies, the process of actually setting up a company in the Czech Republic can be very complicated indeed. The firm must prepare the company's founding contract and statutes<sup>66</sup> in the form of a notarial deed,<sup>67</sup> and apply for registration with the Commercial Registry.<sup>68</sup> The main bureaucratic complaint at the present time is not directed towards notaries or the Commercial Registry, although the latter, in particular, can be a bit cumbersome.<sup>69</sup> Rather, businesspeople and lawyers are now concerned with another law that came into force on January 1, 1992, the Law on the Pursuit of Trade Activities.<sup>70</sup> This law requires most companies<sup>71</sup> to obtain a business license before they can register with the Commercial Registry. Although in theory this law was designed to ensure professional competency in technical areas of work, it appears far more encompassing and restrictive than such a purpose would justify. For example,

---

65. Although it has long been the rule in the United States, this pass-through tax treatment, whereby partners are taxed but not the partnership itself, is an innovation in the CEE countries. During the socialist period, all partnerships were taxed as legal entities. Poland, which recently introduced a limited partnership form of company with pass-through tax treatment, is the only other CEE country so far to adopt this approach.

66. The latter is mandatory only in the case of the joint stock company.

67. Notaries in the CSFR are still public employees, but the profession will soon be privatized. Although the process of preparing the founding documents can take several weeks, lawyers report that most notaries do not interfere unnecessarily in the substance of the documents as they have been sometimes reported to do, for example, in Poland. See Gray et al., *supra* note 52. The Polish situation may change, however, due to the recent privatization of the profession.

68. There is a 3000 Kcs. (about \$100) filing fee for registration.

69. It generally requires a few days for the commercial register to review and register company documents. This is very different from the situation in Hungary, for example, where it can take six months to register a company. See Gray et al., *Legal Reform for Hungary's Private Sector*, 26 GEO. WASH. J. INT'L L. & ECON. (forthcoming Spring 1993).

70. Law on the Pursuit of Trade Securities, dated October 2, 1991; translation in JPRS-EER-92-012-S, January 30, 1992.

71. The law does not apply to certain enumerated professions, such as doctors, lawyers, or accountants, or to firms engaged in certain specialized areas such as banking, mining, energy, agriculture, railroads, telecommunications, pharmaceuticals, or broadcasting. Separate licenses are required, however, for many of these activities.

in many cases the law requires three years of apprenticeship before a license can be obtained. The annexes specify certain activities covered by the law, but even unspecified activities require general licenses. A separate application is reportedly needed for each business activity, and a fee of 1000 Kcs. is charged for each application. Local lawyers report that the law is already causing confusion and delay. Of course, the applicability of the law and licensing procedures is still being refined.

Furthermore, companies must fulfill other bureaucratic requirements before a business license will be issued. For example, a permit from the local council is needed to open a business office. To obtain this permit, the business must show that it has a lease and that the property has been zoned as commercial space. If the space is zoned as residential, the owner must apply for a change of use permit under the Construction Act before the lease will be approved by the local council. If the company is foreign, it must also present a notarized deed of incorporation from its home government with a certified translation in Czech and must furnish a notarized power of attorney for local proxy. If the company wants to appoint a foreign manager, it must obtain a residence permit<sup>72</sup> from the Ministry of Interior, which in turn requires a police statement showing a clean criminal record, a medical certificate indicating an absence of infectious diseases, and a signed and notarized lease agreement (and, in the case of a sublease, a certificate from the owner that the tenant has the right to sublease).

In sum, many bureaucratic hurdles to the opening of a business still exist. They must be satisfied in succession and, taken together, are extremely cumbersome and time-consuming. Czech authorities would be well advised to review the applicability of this law and related requirements and limit them to the extent possible, to reduce the barriers to entry for new private entrepreneurs.

## V. FOREIGN INVESTMENT

As noted above, the new Commercial Code applies to both foreign and domestic investors, and thus supplants the previous foreign investment

---

72. Legal uncertainty also exists with regard to the definition of resident under various laws, e.g., the foreign exchange act, the tax law, and the residence permit regulations—and how these laws interact. Under the first two, being a resident has serious potential consequences for a foreign manager; under the foreign exchange act, a resident is supposed to bring all foreign assets to the CSFR, while the tax law imposes worldwide income taxation on residents. Pursuant to the third law, however, the foreigner must obtain a residence permit to work in CSFR. As these laws are new, lawyers currently are grappling with how to deal with them.

law.<sup>73</sup> The CSFR is the only CEE country so far to have eliminated specialized foreign investment legislation from its legal framework altogether.<sup>74</sup> Accordingly, foreigners generally can invest freely without limitations on the size of holdings, the sphere of activity,<sup>75</sup> or the repatriation of profits and without prior approval from any government agency. Until the end of 1992, foreign investors received special tax incentives not available to domestic entrepreneurs, including lower income tax rates<sup>76</sup> and discretionary tax holidays.<sup>77</sup>

Most foreign investment is entering the Czech Republic as part of the privatization process, as foreign companies bid to purchase all or part of firms being privatized. The Republic attracted foreign investment commitments of more than five billion dollars from about 180 foreign firms through its first "wave" of privatization. Of this amount, United States companies had committed some \$1.4 billion as of mid-1992, and German companies some \$2.5 billion.<sup>78</sup> Although the basic legal framework for

---

73. Law No. 173/1988 on companies with foreign ownership participation, in the version of Law 112/1990. The 1990 amendments to this law had already significantly liberalized the environment for foreign investment, allowing up to 100% foreign ownership, providing guarantees against expropriation, and permitting repatriation of profits in hard currencies (but only subject to availability from the company's export earnings and after mandatory sale of 30% of foreign exchange earnings to the State Bank). All foreign investments under this law required the approval of the Minister of Finance. The law provided that disputes with other domestic firms were to be handled by a special judicial body called the State Arbitration, rather than by the regular court system.

74. The new code contains a short section (chapter II) specifically addressing "business activities of foreign persons." It applies only to businesses not incorporated under CSFR law; foreign-owned Czech firms do not fit within this classification. This section is very liberal, giving foreigners the same rights as domestic entrepreneurs to carry out business, allowing expropriation of property only "by law and in public interest which cannot be satisfied otherwise," and guaranteeing full and immediate compensation in such cases of expropriation. Commercial Code, January 1, 1992, pt. II, ch. II, ¶ 25.

75. A few sectors of strategic importance may be closed to foreign participation under separate legislation.

76. For 1992, the domestic tax rate was 55%. Joint ventures with over 30% foreign ownership were subject to a 40% rate if net income exceeds 200,000 Kcs., or 20% if net income was lower than that amount. Beginning January 1, 1993, both domestic and foreign entities are subject to the same rate of 45%.

77. Tax holidays of at least one year, and more often two to four years, were available to companies registered before the end of 1992 with a tax liability of less than 1,000,000 Kcs. in the particular calendar year. If the tax liability is greater than this amount, the grant of the holiday is discretionary. The amounts saved by the tax holiday are supposed to be reinvested in the business within two years. See *Legal and Taxation Consequences of Investing in Czechoslovakia*, in 2 CZECHOSLOVAK FIN. REV., No. 8, Apr. 15, 1992.

78. Press release of the CSFR Embassy, May 7, 1992.

such investment is generally clear, one unclear area of major concern to these companies remains the question of responsibility for environmental liabilities incurred in the past. The Czech authorities are trying to resolve this question by promising indemnification for existing environmental liabilities (within limits) that are unknowable at the time the venture is negotiated, but whether this action will suffice in practice remains unclear.

As in most other CEE countries, individual foreigners cannot own real property in the Czech Republic. This prohibition, contained in the foreign exchange law of the former CSFR, states that a foreign exchange expatriate may acquire ownership rights in real property "by inheritance, marriage, swap, or only when stipulated by a special act."<sup>79</sup> A one hundred percent foreign-owned Czech company, in contrast, can purchase immovable property.

## V. CONTRACTS

Freedom of contract is one of the most basic principles underlying a market economy. During the socialist period, this principle was relegated to a tiny sphere of private noncommercial transactions, while commercial transactions were governed by the central plan. Since 1990 legal reformers in the former CSFR have attempted to broaden the sphere for private commercial transactions and to put them on an equal footing with their public counterparts.

### A. *Features of Socialist Contract Law*

Czechoslovakia's socialist leaders abrogated the state's prewar legal system more completely and systematically than did many of their socialist neighbors. With regard to contract law, while the prewar contract regime survived to some extent in most CEE countries, Czechoslovakia fully replaced its prewar regime with laws reflecting socialist principles. The first step in this transformation occurred with the adoption of a new civil code in 1950. Although this code contained extensive socialist phraseology and gave directives of state organs the force of law, it nevertheless retained many traditional contract principles and types. This civil code was then replaced in the early 1960s by three laws that were intended to represent the full achievement of socialism. The Civil Code governed the limited (generally noncommercial) sphere open to private

---

79. Law on Foreign Currency Exchange, Law No. 528/1990, art. 25, dated November 28, 1990, translated in JPRS-EER-91-123-S, as amended by Law No. 228/1992, in force as of July 1, 1992.

sector transactions, the Economic Code of 1964 addressed contracts among legal entities, and the Code of International Business Transactions covered contractual relations between domestic and foreign parties (individuals or firms). Of the three codes, only the last followed principles of contract common to Western market economies.

The socialist system of commercial contracts completely subordinated contractual freedom to the needs of the central plan. The plan was adopted annually and possessed the force of law. Every other related law was drafted so as to assure the priority of the plan over individual contracts. There even existed a specific category of precontractual disputes in which the subject matter was not the fulfillment or breach of contract, but the very willingness of one of the parties to conclude a contract. Virtually the only way for a party not to conclude such a contract was to prove a lack of available production capacity. More generally, socialist ideology dominated contract law. Contracts that were consistent with the law but were considered inconsistent with the rules of socialist coexistence could be nullified.

### B. *The Current Situation*

Contract principles have been radically transformed in the Czech Republic during the past two years. Rules for commercial contracts are now contained in two sources, the Civil Code and the new Commercial Code. Lawmakers extensively amended the Civil Code in 1991 to place private property and private contracts on an equal footing with public ones and to reinstate traditional market-oriented principles of contract law. This law provides underlying general principles of contract, such as offer and acceptance, fraud, duress, mistake, and impossibility and is considered a broadly acceptable framework within which the practice of private contracting can grow. Although there are plans underway to adopt a new civil code, the process is likely to take several years.

The new Commercial Code provides specific legal rules governing various types of commercial contracts.<sup>80</sup> It addresses not only general contractual concerns, such as what constitutes fulfillment of a contract and remedies for breach, but also furnishes detailed regulations on many types of contracts. These include agreements on the purchase of goods, credit, license of industrial property, storage, contractual work, proxy, commission, inspection, transport, and commercial representation. The Code also covers agreements in the financial area, such as letters of credit, safety deposit, bank accounts, traveler's checks, and security inter-

---

80. Part Three of the Code deals with "Commercial Commitments."

ests. The law thus provides a detailed legal framework that fits into the mainstream of market-oriented commercial practice.

The task of drafting and adopting new codes is small compared to those of (1) building a court system capable of enforcing contracts in a reasonably speedy and consistent way and (2) teaching an entire society to think in market terms and to accept the notions of risk embedded in the principle of freedom of contract. It will take time to change attitudes and to build the knowledge, experience, and interpretations necessary to create adequate certainty for the market to function efficiently.

## VII. BANKRUPTCY

Because of the absence of a clear conflicts of interest among various claimants (including shareholders, workers, or creditors) in the socialist setting, bankruptcy procedures characteristic of those in industrial market economies were not needed in the former socialist states. In most Central and Eastern European countries, all claimants were arms of the state or ultimately supported by the state. For example, state-owned banks had little incentive to collect on bad debts because state guarantees lay explicitly or implicitly behind such debts. Moreover, the state guaranteed workers jobs, steady income, and related support systems whether or not their particular firms thrived. Measures in lieu of bankruptcy, including financial rehabilitation, served to keep ailing firm alive and to preserve employment.

The availability of bankruptcy procedures assumes much more importance as formerly socialist states attempt to transform their economies and develop private markets. Just as the Czech Republic needs a modern and comprehensive enterprise law to govern the entry of new private companies into the market, it also requires a bankruptcy law to govern the exit of failed private firms. Many new or privatized firms are likely to fail as the economy undergoes fundamental structural adjustment. Bankruptcy law matters not only to shareholders, employees, and creditors, but is of critical importance to the newly emerging private entrepreneurs themselves. The ability of banks and other financial creditors to collect on bad debts is a *sine qua non* for the growth of private credit, which is essential to the start-up of new firms.

The former CSFR recently adopted a new law on bankruptcy and settlement.<sup>81</sup> The law has not yet been widely used due to a moratorium on claims against state-owned enterprises in effect until April 1993.<sup>82</sup>

---

81. Law 328/92.

82. The moratorium was originally scheduled to end on October 1, 1992, but was re-



The law is based on prewar German and Austrian law and focuses on liquidation. Reorganization is not available under the law as it is in the United States ("Chapter 11") or in the new Hungarian law,<sup>83</sup> although a pro rata reduction in outstanding claims of creditors—requiring approval of those creditors—is envisioned as a means of keeping a firm operating as a going concern in lieu of liquidation.<sup>84</sup>

While a more active reorganization option may be advisable, by far the biggest challenge in the area of bankruptcy will be equipping the judicial system to deal with the surge in cases likely to emerge as the real restructuring of the enterprise sector occurs over the coming months and years. If events in Hungary or Slovenia are any indication,<sup>85</sup> the lifting of the moratorium on claims against state-owned enterprises is likely to result in an influx of cases. It is highly unlikely that any judicial system, much less one with relatively little exposure to economic matters, could handle a large reorganization of a state-owned enterprise efficiently and effectively. A different, perhaps extrajudicial, mechanism may be needed to handle the stock of bad debt of enterprises and banks carried over from socialism.<sup>86</sup> That would free the bankruptcy courts to concentrate on ailing firms in the newly emerging private sector.

Prebankruptcy debt collection, including the possibility for registering and foreclosing on collateral, is linked to the legal framework for bankruptcy. The system of collateral in the Czech Republic is underdeveloped both in law and in practice. Although lenders in theory are able to take mortgages on real property and register them in the land registry, this method has not been commonly used to secure loans, primarily because of the impossibility of evicting tenants or residents from housing and the availability in practice of other forms of security (such as garnishment of wages). With regard to movable property, the Civil<sup>87</sup> and Commercial<sup>88</sup> Codes provide a legal basis for using such property as collateral. But because no central registry exists, no practical method, short of transfer of possession or title, exists to inform third parties about the claim and

---

extended by Parliament for another six months soon after the original deadline expired.

83. See Gray et al., *supra* note 69.

84. This compulsory settlement procedure existed in many CEE countries during the socialist period but was not part of the Czechoslovak socialist legal framework.

85. See Gray et al., *supra* note 69, and Cheryl W. Gray & Franjo D. Stiblar, *The Evolving Legal Framework for Private Sector Activity in Slovenia*, 14 U. PA. J. INT'L BUS. L. (forthcoming 1993).

86. A systemic approach to simultaneous bank/enterprise restructuring is being considered, for example, in World Bank programs in Poland and Slovenia.

87. Civil Code, ¶ 151a.

88. Commercial Code, ¶¶ 297-302.

thus ensure its priority. Providing viable means to mark property serving as collateral, or setting up a central registry for collateral interests in movable property (as in the United States), would help increase the security of loans and improve debt collection.

### VIII. COMPETITION LAW

Moving from a socialist to a market economy requires a profound change in the structure of the enterprise sector and in the climate and attitude towards competition. The private sector is still relatively small in the former CSFR, accounting for an estimated eight percent of Gross Domestic Product and sixteen percent of employment in 1991.<sup>89</sup> The economy continues to be dominated by the public sector, consisting primarily of large public enterprises. Promoting competition in this environment will require strong and concerted action to break up public monopolies, privatize public firms, open any remaining barriers to foreign competition (both trade and investment), and prevent anticompetitive behavior or mergers among competing firms. Programs of privatization and trade liberalization are progressing steadily. Breaking up public monopolies and preventing anticompetitive behavior lie within the mandate of antimonopoly law.

The former CSFR's antimonopoly law, the Law on the Protection of Economic Competition,<sup>90</sup> was passed January 30 and took effect March 31, 1991. It follows closely German and EC law and is quite similar to the Polish antimonopoly law. This law is concerned primarily with cartel agreements, mergers, and dominant behavior. With regard to cartel agreements, section 3 prohibits agreements among entrepreneurs to set prices, limit production or sales, divide markets, tie purchases of certain products to purchases of other unrelated ones, discriminate against certain purchasers, or restrict others' access to markets.<sup>91</sup> These prohibitions do not apply if the market share of the participants is less than thirty percent of the relevant market.<sup>92</sup> Section 5 deals with the licensing of intellectual property rights and prohibits licensing agreements that impose unrelated conditions on the transferee.<sup>93</sup> Section 5 allows the Competition Office to exempt certain agreements from the prohibitions in sec-

---

89. D. Swanson and L. Webster, "Private Sector Manufacturing in the Czech & Slovak Federal Republic: A Survey of Firms," International World Bank Memorandum, August 18, 1992.

90. Law No. 63/1991, translated in JPRS-EER-91-077-5, June 7, 1991).

91. *Id.* § 3.

92. *Id.*

93. *Id.* § 5.

tions 3 and 4 for a set time upon request of the parties "as long as the restriction of competition . . . is necessary for reasons of public interest, especially in the production of goods or in support for technological or economic development."<sup>94</sup>

With regard to mergers, section 8 requires prior approval from the Competition Office of merger agreements that would give the new firm a market share of over thirty percent. The office is to approve the merger if "the loss, which may occur due to the restriction of competition, will be outweighed by the economic benefits provided by the merger."<sup>95</sup>

In line with the European emphasis on dominance, section 9 requires any firm with at least a 30 percent market share to inform the Competition Office.<sup>96</sup> It prohibits such a firm from abusing its dominant status through unfair contract terms, tied sales, discrimination among purchasers, or monopolistic restrictions in production, sales, or technological development.

In delineating the various types of anticompetitive behavior, the law does not distinguish between horizontal and vertical restraints, although antimonopoly theory in the United States and to some extent Europe tends to view horizontal restraints as the most egregious inhibitors of competition. The law also fails to provide a clear distinction between behavior that is always illegal (the *per se* approach) and behavior that is illegal only under certain conditions (the rule of reason approach). In almost all cases, except perhaps in section 9, the approach appears to be that of rule of reason, because the Office possesses almost unlimited discretion to grant exemptions from the prohibitions in the law.

Because of the CSFR's federalist structure, the law originally set up not one but three Competition Offices—an office in each republic and a federal one to deal with cases affecting at least 40 percent of the market in both republics.<sup>97</sup> The existence of three offices complicated the administration of the law because of their lack of expertise and because of unavoidable confusion concerning their respective jurisdictions. The federal office was abolished in late 1992 in preparation for Czechoslovakia's split. All cases in the Czech Republic currently are handled by the Czech Competition Office. The powers of this office are broad. It can bring cases on its own initiative or on the request of an outside party, investigate and decide those cases, and impose fines or demand specific

---

94. *Id.*

95. *Id.* § 8.

96. *Id.* § 9.

97. *Id.* § 10(1).

action to undo an identified wrong.<sup>98</sup> Any party can appeal the decisions of this office to the court within thirty days.<sup>99</sup>

One positive aspect of the law is its linkage with the privatization program. Section Nineteen requires that the government analyze the market conditions likely to result from a privatization proposal and "to stipulate specific conditions which, when they are met, will terminate the monopolistic status of the former enterprise or will prevent the creation of the monopolistic status of newly created enterprises."<sup>100</sup> The analysis must be submitted to the relevant Competition Office for comment before a final decision on the privatization is rendered. This link is intended to help prevent public monopolies from becoming private ones.

As in Hungary and Poland, the impact of antimonopoly law in the Czech Republic will depend on how this law is applied in practice. Unfortunately, it is notoriously difficult, even in advanced market economies, to distinguish a restraint on trade that harms efficiency from a legitimate business initiative that enhances it. Overzealous enforcement, particularly by means of price regulations, could do great harm by contradicting reasonable business decisions and more generally by inhibiting entrepreneurship throughout the economy. On the other hand, it is clear that certain types of highly restrictive monopolistic behavior, such as price fixing among competitors or aggressively freezing new competitors out of the market, need to be stopped. Furthermore, the Competition Office can fulfill a valuable public service function by acting as an advocate for competition, both by publicizing its own initiatives and decisions and by lobbying more generally for freer trade. Helping to change public attitudes and educate the public about the benefits of competition may be its most important current mission.

## IX. JUDICIAL INSTITUTIONS

As in other CEE states, judicial institutions in the Czech Republic are ill-prepared to cope with the rapidly emerging challenges of a market economy. The plethora of new legislation in the past two years has bred many new types of disputes never before seen by this generation of judges and lawyers. In 1991 some 121,000 commercial cases were filed in the Czech Republic (48,000 in Prague alone). That number is expected to jump significantly higher in 1992 and beyond as new restitution cases enter the courts and as the moratorium on bankruptcy claims

---

98. *Id.* § 11.

99. *Id.* § 13(2).

100. *Id.* § 19(1).

is lifted.

A new law passed in late July 1991, the Law on Judges and Courts, restructured the court system in preparation for its new role.<sup>101</sup> The law divides the courts into three levels, the Supreme Court, twelve regional courts, and about one hundred twenty local courts. The Supreme Court hears appeals from the regional courts, while the regional courts hear appeals from the local courts and serve as the courts of first instance for cases with over 50,000 Kcs. at issue. Pursuant to recent legislation, the Supreme Court and the regional courts each have four departments, for criminal, civil, administrative, and commercial<sup>102</sup> cases. Property and restitution cases are handled by the civil departments (which, together with criminal departments, were carried over from the previous system), while company and contract cases under the new Commercial Code are handled by the newly established commercial departments.<sup>103</sup> As of January 1, 1992, the newly established administration departments hear citizen's complaints against civil servants once internal avenues of redress have been exhausted, thus providing potentially important new avenue of protection against arbitrary government action.

In addition to restructuring the court system, efforts have been made both to give existing and new judges greater independence<sup>104</sup> and to remove judges clearly compromised by the socialist regime. As a result of the purge, the generally low pay and prestige of the profession, and the growth of opportunities in private legal practice, a serious shortage of judges now exists. While demand skyrocketed, the number of judges actually fell in the first two years after the 1989 revolution.<sup>105</sup> It will remain very difficult to staff the courts with competent and experienced judges. Incapacity in the court system therefore is likely to be a constraint on legal reform for some time to come.

---

101. Law on Judges and Courts, July 19, 1991.

102. In three districts, new commercial courts have been set up in lieu of specialized departments within the regular district courts.

103. The latter are staffed primarily by former arbitrators from the recently abolished state arbitration system, which decided disputes among state enterprises.

104. Judges generally have life tenure, but it is still possible to remove judges associated with the previous regime.

105. Before November 1989 there were 1600 judges working in the Czech Republic. This number had fallen to 1300 by April 1991. Jiri Pehe, *Reforming the Judiciary*, REPORT ON EASTERN EUROPE, vol. 2, no. 34, August 23, 1991, at 9.

## X. CONCLUSION

Like its CEE neighbors, the Czech Republic is moving rapidly to create a legal framework conducive to private sector development and the growth of a market economy. Real property rights are being redefined, and large amounts of property are being returned to former owners. Laws on intellectual property have been amended, in large part due to prodding from the United States and the EC, to bring levels of protection in line with those of the most advanced market economies. A new commercial code now lays out a thoroughly modern structure for companies (whether domestic or foreign) and for commercial contracts, but this code's simplicity appears somewhat compromised by continuing bureaucratic interference through other laws and regulations. A new competition law provides a reasonable framework for antimonopoly protection, while a new bankruptcy law provides at least the beginning of a legal framework for the liquidation of nonviable enterprises.

Yet major challenges lie ahead in implementing the new laws now on the books. The interests of former property owners are clashing with those of current tenants, and have led to a surge in new disputes entering the courts. The surge in cases is likely to be exacerbated as the current moratorium on bankruptcy claims against state enterprises expires in 1993 and as disputes develop under the new intellectual property laws and commercial code. The courts, suffering from the recent purges of judges compromised by the former regime as well as generally low pay and prestige, are not likely to be capable of handling this surge. The specialized offices handling intellectual property and antimonopoly concerns also face daunting challenges adjusting to the radical changes in policy and thinking now sweeping the country. Their areas of concern are complex, and those offices will need continual resources to train their staff to understand the issues and keep up with the growing workload. All in all, it is a time of great progress, great confusion, and great challenge in the Czech Republic.

