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PRIVATIZATION IN EASTERN EUROPE: AN OPPORTUNITY FOR AMERICAN LAWYERS

*CLYDE E. RANKIN, III**

Privatization in Eastern Europe is a difficult undertaking. In fact, you have heard some of today's speakers indicate that the situation is rather bleak. In my view, however, the complexities should not be unexpected; after all, we are not talking about economies that were booming up to this point. We certainly are not talking about privatization like that undertaken in the West, particularly in Great Britain, where you had nationalized industries become available for public ownership. Thus, it is a mistake to equate privatization success in Eastern Europe with the successes of Western economies. Privatization in Eastern Europe is actually a transformation of what was, for the past forty years, a command economy. Privatization will not occur immediately. It did not occur in the West overnight. However, there are some glimmers of hope; Eastern Europe has just begun to move forward. Let us explore some of these directions.

In order to invest in Eastern Europe, an investor must first have an understanding of local laws and customs. We must remember that Eastern Europeans are proud people; they have their histories and have worked under unwelcomed regimes.

Investing in Eastern Europe also requires creativity. Several different systems must be melded and merged. American attorneys can assist by incorporating American ways of doing things. For instance, American attorneys will not come to a road block and say, "Here's an obstacle, I can't go further." American attorneys are unique in that they try to find innovative and workable solutions to clients' problems. Thus, American attorneys can be very helpful.

That Eastern Europeans need patience is obvious. However, Westerners need patience as well. They are entering foreign countries and investing in those economies. This is something that is not done overnight; it is a long-term process with no short-term profits to be gained.

Finally, an investor in Eastern Europe needs some humor. Without a

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sense of humor an investor cannot keep that certain balance necessary to deal with inevitable obstacles. Eastern Europeans do not enjoy the technological advances Westerners take for granted, such as facsimile machines, overnight-mail systems, or reliable courier services.

As you can see, privatization in Eastern Europe presents many new and challenging issues, which signify opportunities for American attorneys and for Western investors in the 1990s. These are opportunities that, several years ago, no one could have expected. There are, however, some transformation and structural problems existing in Czechoslovakia, and to a lesser extent in Hungary, but these can be resolved.

Czechoslovakia, as a Federal Republic, consists of two components: the Slovak and the Czech Republics. Together, they have embarked upon a mass privatization plan. What is this plan? Approximately one and a half years ago the Federation came out with what they called the "Small Privatization Act." "Small," because it was for small companies, small industries, and small services, such as restaurants and shops. For the first time in their lives, individuals were able to own the places in which they worked. This was open only to Czech citizens. The individual would offer a price, and if they put up the highest bid, cash was due within thirty days. In April 1991, the "Large Privatization Act" was passed. This Act dealt mainly with large enterprises, such as state-run insurance companies, institutions, and so-called factories.

As you may be aware, Czechoslovakia has a long industrial history. Before the war, it was the industrial center in that part of Europe. Even today, large Czech companies produce such things as heavy machinery, trucks, and airplane equipment. Although these factories are outdated, they symbolize a proud past, standing as a reminder of their production capabilities, and what was once the industrial engine of the Austrian-Hungarian Empire. However, in most cases, investors will not be interested in these enterprises. These enterprises have poor balance sheets and have no history in terms of profits and losses. Currently, through their own initiative or through outside urging, they have been presented with plans of privatization at either the federal level, where the plans are governed by the federal ministry, or at the local Czech/Slovak level. This process of privatization had been somewhat delayed, but it is now proceeding at a steady pace.

As far as Western investors are concerned, they should be selective in their investments. Early in the acquisition process, the investor should make the decision whether it wants to buy stock or assets. If stock is bought, everything is bought—the good and the bad, the liabilities and the assets. Under the privatization program in Czechoslovakia, an investor has the ability to buy part of the enterprise. This is something that is

negotiated, and the investor may or may not succeed. The government may try to impose the liabilities of the entire enterprise, or the privatization proposal may become subject to an auction or public tender. Hence, the investor must understand that there are risks because it may not be able to control the process.

An investor may elect to establish a stock company, select its management, and proceed by creating a new enterprise that will have some appeal to consumers. On several occasions in Czechoslovakia, investors have begun with merely a representative office. For example, when an Austrian investor found that the process of privatization was slowing down, it set up a branch office and exported its products to Czechoslovakia. The investor basically created a consumer demand for its products. Setting up a representative office is fairly straightforward. First, an application is made to the ministry of foreign trade. Upon approval, the branch may engage in informational gathering activities, marketing activities, and to some extent, distribution activities. These types of activities are creating a sense that economic success is possible. This belief will be bolstered as individuals in Czechoslovakia begin to experience the benefits of the transformation from a command to a market economy.

The privatization process itself presents many difficult problems. Privatization is not the be-all end-all cure. For example, many of these companies are just too entangled in their old ways to succeed. Their managements are entrenched and cannot be removed. The management has been in the same position most of their lives and are now being asked to risk their futures. Whole new systems are being imposed upon them. Where will they go? What type of pension plans will they have? And how will they get along with a Western manager? These are not insurmountable problems, but they exist, and they must be addressed. This is just one of the major problems for Westerners.

Another potential problem is that the employees will be locals. A group of outsiders cannot be brought in to displace local workers. This created a problem when it was tried in Western Europe after World War II, even though it was necessary to some extent. Americans arrived, put up their subsidiaries, and said, "We'll do it ourselves, we'll import our managers from the U.S."

Today, most American subsidiaries in Europe are run by Europeans. There is a whole group of European managers in the last ten years who were educated abroad, many times in our own schools, and then returned to Europe. This will probably be the continued scenario in Eastern Europe, because the brightest individuals increasingly are coming to the West to receive an education. Attorneys are coming to the United States and acquiring their masters at institutions in major cities. They spend a year

or two in some of the large firms, get practical experience, and return to Eastern Europe to start up their own practices. Many of these attorneys are now learning how to run private firms. They are in great demand because a transaction cannot be completed without a local lawyer. The reason is that a foreign attorney will not know if the laws are going to be changed; it can happen overnight. The local attorney, then, is better positioned to anticipate the changes and to know what must be done as a result.

One such change in the laws has been Czechoslovakia's passage of a new commercial code, which displaced the old one. What does this new commercial code provide? Well, it is based principally upon the German code. It provides for a limited liability company, which is a very popular method of doing business in Czechoslovakia. It is akin to the closely held company. The code also provides for a stock company, which generally requires the establishment of a supervisory board. Large companies must have a supervisory board to supervise the managers and report to the owners. If the company has over 200 employees, it should have at least a third of the supervisory board made up of its employees. The supervisory board gives the workers a role in managing the company. This is the same system used in some Western European nations, such as Holland and Belgium.

In terms of passing laws to address the issues of privatization, Czechoslovakia has been a bit slower than its neighbor, Hungary. Hungary was first from the starting line and it had a bit more freedom; hence it had the greatest group of traders and entrepreneurs. The traders and entrepreneurs returned home and wanted to provide some economic support for their country. For example, about three years ago, a successful Hungarian made a significant gift to the University in Budapest—old Xerox copying machines. The University previously did not have any. Twenty-thousand dollars provided a tremendous number of old copying machines, which most Westerners would think obsolete and not worth fixing. Yet to the university it was a gold mine. This type of activity is becoming more popular. Successful emigres are returning after many years and providing needed support.

A further testament to Hungary's growth is that it has resulted in some tax liability. There is now a tax code in effect in Hungary. Hungarians have given benefits to foreigners in the form of so-called tax allowances. Certain joint ventures that produce goods receive a sixty percent break on taxes for the first five years and a forty percent break for the second five years. Previously, if the goods were in a particular strategic sector of the economy, the corporation had a tax break of one-hundred percent for the first five years and a tax break of sixty percent for the next five years. This, however, was found to be a little too generous and a slowdown in

such incentives has begun.

The use of a Western-style contract is still a novelty in Eastern Europe. Here, we generally deal with lengthy contracts, but throughout Eastern Europe there is a civil code system, under which contracts are usually much shorter. I remember an amusing story about an investor who received a proposal to buy assets from the federal republic of Czechoslovakia in the form of a two-page contract. The investor replied, "This must be just the letter of intent." He was told, "No, that's supposed to be the binding contract." So you can see that you cannot just impose a typical American-style fifty or sixty page acquisition agreement. The Western and Eastern European attorneys must work in tandem to find a compromise that covers all of the important issues and is not an aberration of Eastern European contract law.

One requirement of the contract is that it must state the benefits to the local economy. It is not possible to simply take the profits out of the country. In Czechoslovakia they have what is called "internal convertibility" of the Czech Crown, which basically means that the earnings must be sold to the state bank for conversion to dollars, marks, or francs. The investor must deal with a system whose purpose is basically that of exchange control and must also deal with the Czech banks. These are facets of business that the West has not experienced in the past. It should eventually work its way out, but for now the Czech government does not want companies to take the profits out of the country.

Hungary has a similar situation. It allows the use of foreign currency only for limited purposes; hence the investor is dealing with Hungarian currency. Dividends can be declared out of foreign earnings and converted into foreign currency provided enough Hungarian currency is left behind. Through these policies, both Hungary and Czechoslovakia have gained some degree of stability and protection.

Moreover, stability is enhanced because investors' properties cannot be expropriated without compensation. The National Bank of Hungary will give an investor a guarantee that it will get back its initial capital investment. Since it is difficult to obtain insurance for such an investment, most Westerners will accept the risk and will be comfortable if they are sure to recoup their initial investments.

Now, how can contract disputes be resolved? By arbitration. Do not lose sight of arbitration; in fact, take advantage of it. Investors should negotiate into their contracts that if they have a dispute, it should be resolved by an arbitration panel. Since both Hungary and Czechoslovakia have become signatories to multilateral treaties that recognize and enforce arbitration awards, why should an investor submit itself to dispute resolution before a court in Hungary or Czechoslovakia, when it probably

will not understand the proceeding or, worse, know whether or not it is fair? To advise a client to take a risk in this regard is not practical. Choose another jurisdiction. Austria should be acceptable to the parties. Or maybe Switzerland, France, or even England. In any event, make sure that the arbitration clause is included and that it is acceptable to both sides before completing the deal.

In closing, I believe that the prospect of future growth in Eastern European countries presents exciting opportunities. Investors will find immediate receptivity for certain consumer products. They may also be successful in the so-called heavy industrial sectors. Of course, growth will not occur overnight. It was noted earlier that the environmental issues could be significant. Some of the existing factories may not be worth acquiring. Investors may want to start from scratch to build brand new sites—so-called “greenfields.” Also, investors should be aware that these countries need to completely re-build their entire infrastructures, such as by making efforts to provide adequate electrical power.

All of these issues present challenges for us, but I reiterate that we must be patient. We must recognize that these people have their own institutions, their own backgrounds and history. As lawyers, I believe that we can enhance the process of change. Over the next ten years, Eastern Europe is going to be an exciting place to be practicing.