

with the European Commission, which enables Croatia to finally announce the public bid for their privatisation.

Croatia's recent accession to NATO, the prospect of EU accession, and projected economic growth and development are just some of the factors that are expected to stimulate M&A activities in the future, once market liquidity and the confidence of investors is restored.

Chapter 16

CZECH REPUBLIC

*Vladimíra Glatzová and Daniel Hájek**

I OVERVIEW OF 2008/2009 M&A ACTIVITY

The second half of 2008 saw the Czech M&A market fall to its lowest level of activity ever as a result of the global financial and economic crisis. A substantial number of pending transactions was suspended and only few new transactions were commenced. At the beginning of 2009, Czech M&A activities saw the first signs of revival; the second quarter of 2009 recorded considerable growth in M&A activity, which is continuing.

The massive decline in M&A activity in 2008 was mostly due to external reasons such as a decline in foreign investment and a general lack of liquidity. The Czech economy itself was however affected by the global financial crisis significantly less than most of the remaining European countries. The immunity of the Czech financial sector was based in principal on three factors:

- a* Czech banks went through a crisis resulting from imprudent lending practises during a transition of the Czech economy in the late nineties. The Czech government was forced to bail-out most of the Czech banks in connection with their privatisation. The banks thus entered into the new millennium with a sound portfolio and with a good lesson from the past, which led them to introduce prudent lending policy;
- b* Czech people are traditionally less inclined to live on credit than people in Western Europe or the United States; and
- c* the Czech crown has been an extremely strong and stable currency since 1997, enabling the Czech economy to quickly adopt to the new market circumstances.

Due to these reasons, the Czech financial market was kept out of the turmoil recorded by some other Central and Eastern European ("CEE") markets. However, the Czech

* Vladimíra Glatzová is a partner and Daniel Hájek is an associate at Glatzová & Co, v.o.s.

economy, as an export economy dependent on demand in 'Old Europe', followed the fate of Germany, with industrial production and exports plummeting.

The global financial crisis changed the general environment of M&A activities. Lack of bank financing had a fatal impact on leveraged buyouts and speculative private equity investments, and due to an unstable environment, institutional investors significantly limited their activities as well. At the same time, however, M&A activities were boosted by smart acquisitions made by companies with non-cyclical business models or groups operating in multiple sectors and sell-outs in the segments most affected by the global financial crisis.

Although current M&A activity is rather strong, its future development is largely dependent on the effect of the economic crisis in Western Europe and on the stability of the CEE region as a whole.

II GENERAL INTRODUCTION TO THE M&A LEGISLATIVE FRAMEWORK

Since the transition of the Czech Republic to a standard market economy in the early 1990s, the national legal system has lagged behind the country's economic development. The current Commercial Code, which was adopted in 1991, has been the subject of numerous amendments, many of which suffer from discrepancies resulting from rapid economic changes and lack of experience in regulating a market economy. Of these legislative changes, the most significant were two sweeping amendments in 1996 and 2000 that set out basic rules for M&A and related activities, including financial assistance, public takeovers, and transformations. These amendments implemented European Company Directives and were largely driven by the campaign to join the European Union.

The Czech legal system is still under reform, and a full-scale re-codification of legal regulations (including the Commercial and Civil Code) is under way. The draft of the new Civil Code draws its inspiration in particular from Austrian, Swiss, German, Italian and Dutch Civil Codes and represents a return to a pre-World War II legal tradition. The new Civil Code is intended to replace both the Civil and Commercial Codes. The draft has been heavily criticised by legal experts and practitioners, and therefore it is expected to be adopted only after extensive modifications. Due to a recent government crisis, the adoption of the new Civil Code was suspended for the time being.

Until very recently, the Commercial Code was the only significant national regulation of mergers and acquisitions. This situation changed with the adoption of the Takeover Act and the Transformation Act in 2008 (see discussion *infra*). These reforms have clarified the Commercial Code and set out more sophisticated and comprehensive rules for regulation of their respective subject areas.

Czech law contains several rather peculiar legal institutions and rules, which should always be taken into account when structuring M&A transactions.

i Anti-chaining rule

Czech law prohibits the chaining of limited liability companies (i.e., limited liability companies corresponding to a German GmbH or French Sàrl or the equivalent in other jurisdictions). Under this rule, a limited liability company may not be wholly

owned by another limited company with a sole shareholder. Any infringement of this principle invalidates the transfer, which may not be remedied by subsequent transfers of ownership interest. The rule applies even where the sole shareholder is a foreign person. In practice, it can be circumvented by involving a third person, (e.g., a member of the same group) as a shareholder with a symbolic share. Nevertheless, the anti-chaining rule unreasonably complicates group structures involving Czech subsidiaries, and has invalidated a number of transfers. In many cases these transfers were successfully registered in the Commercial Register and their invalidity was only discovered during a subsequent sale and due diligence process.

ii Intra-group transfers of assets

The following prerequisites apply to any intra-group transfer of assets outside of the ordinary course of business if the value of these assets exceeds 10 per cent of the share capital of any of the companies involved: an expert valuation of the transferred assets must be obtained; and in case the transfer occurs within three years from a company's incorporation, the approval of the general meeting of all involved companies must be granted. Breach of this rule invalidates the transfer, which may not subsequently be remedied. The Czech Supreme Court in its recent decision considerably limited applicability of this rule to transfers involving

- a* an enterprise (*fonds de commerce*);
- b* real estate (presumably also involving its lease); and
- c* moveables.

Although its applicability has been limited, it still presents a significant obstacle to any group restructuring involving a Czech company. Unfortunately a recent attempt at a complex legislative modification of this rule was rejected.

iii Controlling agreement

Although Czech law offers a framework for controlling agreements, these agreements provide almost no benefits to the parties and are therefore rarely used. In particular, such agreements do not result in tax unity for its parties, or free them from the above rules on intra-group transfers.

III DEVELOPMENT OF CORPORATE AND TAKEOVER LAWS

As a result of recent reforms, the Commercial Code no longer regulates takeover bids, transformations, or restructuring (i.e., mergers, amalgamations, spin-offs, divisions, transfers of all assets to a shareholder and changes of legal form); these are the subjects of separate acts. In addition, some progress was made in adopting separate rules on squeeze-out procedures.

i The Takeover Act

The Takeover Act (effective as of 1 April 2008) is based on the EC Takeover Directive. This act applies to bids for companies with listed shares, launched with the intention of acquiring or strengthening control over the target company. Where these conditions are

not fulfilled, the bids are governed by the less formalistic rules of public offers under the Commercial Code.

The Takeover Act provides clearer and more comprehensive rules for mandatory takeover bids than previous regulations. It also simplifies the bidding process in the following two respects:

- a A single threshold (30 per cent) now applies for mandatory takeover bids instead of the three thresholds used previously. At the same time, the Takeover Act requires making a supplementary takeover bid in cases where a shareholder acquires at least 90 per cent of the share capital within an unlimited and unconditional takeover bid.
- b Clearer and more straightforward methods are used in calculating the offer price. This calculation is based principally on the premium price, that is, the highest price at which the offeror or its 'cooperating party' (see *infra*) acquired the shares in the target company during the 12 preceding months. Expert valuations, which were time-consuming and frequently contested by other shareholders, are no longer required.

Nevertheless, the Takeover Act contains a number of weaknesses that will need to be clarified by the Czech National Bank as the regulator. In particular, the legislation includes a very broad definition of the term 'cooperating party' that covers not only group members, but also parties to voting agreements on the appointment of target company board members, irrespective of whether these parties have cooperated directly with the offeror. The offer price may be affected if cooperating persons acquire shares in the target company in the period starting 12 months before and ending six months after the takeover bid. Based on the current definition of cooperating persons, shareholders who concluded a voting agreement with the offeror are therefore in a position to increase the price at which they may be bought out.

In addition, the Takeover Act fails to specify the time frame to be used when determining whether an entity or individual is a cooperating party. It is therefore not entirely clear whether an entity that had a voting agreement with the offeror would be viewed as a cooperating party even if such agreement was terminated before the takeover bid took effect.

ii *The Transformation Act*

The Transformation Act (effective as of 1 July 2008) provides a comprehensive and transparent overview of transformation regulations in the Czech Republic. The new act, which is based on the EC Cross-Border Mergers Directive, sets up a legal framework for cross-border mergers for companies with the same form. In contrast, under the previous legislation, only cross-border mergers involving the *Societas Europaea* were permitted. The new law generally relaxes the previously strict and formalistic rules and reduces the need for extensive and complicated documentation. As a rule, mergers are complete upon their registration in the Commercial Register and may no longer be contested after their registration. Separate regulations under the new Insolvency Act also provide for transformations to take place even during liquidation and insolvency proceedings.

The regulation of cross-border mergers under the Transformation Act emphasises the protection and foreknowledge of affected employees. All relevant parties must inform these employees about forthcoming or expected mergers, and the employees may submit statements in this regard. Any approvals required from general meetings or members' boards for a cross-border merger must include confirmation of the future involvement and position of employees.

iii *MiFID implementation*

The EC Markets in Financial Industries Directive ('MiFID') has been implemented into Czech law as of 1 July 2008. Subsequently, the rules of the Prague Stock Exchange have been amended to reflect a new playing field for listed companies. Both these amendments had considerable impact on M&A transactions on the financial market.

Finally, Czech implementation of the EC Transparency Directive will impact M&A transactions on the financial market. The Czech Transparency regulations should take effect in the second half of 2009 or at the beginning of 2010.

IV FOREIGN INVOLVEMENT IN M&A TRANSACTIONS

The Czech economy has developed dramatically in recent years, with an inflow of support from foreign investors. As a result, the national economy now consists largely of foreign subsidiaries and only a limited number of large or medium-sized domestically owned businesses. The M&A market has benefited from this expansion, and the range and volume of transactions involving foreign capital has been significant since the early 1990s. Whereas 15 years ago privatisations of state-owned assets were the main type of acquisition in the Czech market, more recent transactions have revolved around changes to Czech companies' shareholders during multinational transactions. In addition, there have always been a significant number of absorptions of local start-ups, mainly in the IT sector, by large multinational competitors.

As a result of the global financial crisis, involvement of foreign investments increased dramatically. However, foreign investment still represents a significant portion of all Czech M&A transactions.

V SIGNIFICANT TRANSACTIONS, KEY TRENDS AND HOT INDUSTRIES

The global financial crisis changed and to a certain extent limited the types of industries most noted for M&A transactions. The energy, pharmaceuticals and real estate sectors became the industries with the largest M&A transactions in the past year.

A landmark takeover battle of sanofi-aventis with PPF Group over Dutch-based pharmaceutical company Zentiva, one of the biggest manufacturers of generic products in Central and Eastern Europe, was considered as one of the biggest and most complex transactions in modern Czech history. The competition between these companies saw PPF Group launch the first takeover bid under the new Takeover Act. The rival takeover bid made by sanofi-aventis was the first ever competing takeover bid in Czech history. These bids were the only ones ever to be launched over a Dutch company that was

traded on the Prague Stock Exchange, supervised by the Czech regulator and governed by Czech law. It applied not only to the ordinary shares of Zentiva traded on the Prague Stock Exchange, but also to global depositary receipts traded on the London Stock Exchange. Sanofi-aventis's increased bid valued Zentiva at approximately €1.5 billion. Eventually, the takeover battle took almost 10 months with sanofi-aventis achieving an unprecedented 97 per cent acceptance to its offer.

ČEZ, the Czech national energy champion, completed several acquisitions in the last year, in particular the acquisition of a majority shareholding in OSSH, the only Albanian power distribution company, for approximately €100 million and a minority shareholding in Turkish energy producer Akenerij for approximately \$300 million. In addition, ČEZ together with J&T acquired the German mining company MIBRAG for €400 million.

In 2009, PPF Group recorded a significant move into the energy and industrial sector by establishing a joint venture with J&T, a Slovak private equity firm focusing on energy and industry. J&T contributed its energy and industrial assets to the joint venture, whereas PPF Group acts as financial investor.

Since the real estate sector was one of those most affected by the global financial crisis, it recorded unprecedented entries of new investors. The most significant included PPF Group's entry into ECM, one of only two Czech real estate developers listed on the Prague Stock Exchange, as well as the acquisition of shares and options in Central Group, a major Czech residential developer, enabling Global Property Capital, a Swiss investor, to acquire up to 49 per cent within three years. Orco, another struggling real estate developers listed on the Prague Stock Exchange, is currently negotiating the entry of Colony Capital, a US private equity firm.

The agricultural sector has seen significant consolidation with the acquisition of Olma, a major dairy company, and Agropol, a major Czech agricultural group, by Agrofert, creating the biggest Czech agricultural and chemical group.

Recently, the merger of health insurers Zdravotní pojišťovna Agel and Hutnická zaměstnanecká pojišťovna was announced.

Due to unfavourable market conditions only four bidders took part in the tender for privatisation of Czech Airlines. Two of them, including Aeroflot, the Russian national air carrier who was regarded as the likely winner, were excluded from the privatisation tender. The privatisation of Czech Airlines proved to be problematic because of the lack of investor confidence in the company's profitability, which was negatively affected by declining numbers of passengers due to the economic crisis. In addition, only a limited range of investors were eligible to participate in the process since a change of control might result in the loss of the carrier's status as a domestic or EU operator. At this stage, only Air France/KLM and Travel Service remained in the tender process.

Another highly expected privatisation – of the Prague Airport – was postponed due to unfavourable market conditions.

VI FINANCING OF M&A: MAIN SOURCES AND DEVELOPMENT

As a result of the global financial crisis and in particular a loss of liquidity affecting all financial institutions worldwide, bank financing ceased to be the dominant source for

M&A deals involving Czech players in both a domestic and international context. Instead, the most recent acquisitions were financed by companies' own capital and revenues. The acquisitions were mostly carried out by companies operating in non-cyclical industries with strong profit earnings.

Although private equity is not as widely accepted in the Czech Republic as other external financing, its use is increasing rapidly. The global financial crisis hit speculative private equity investors heavily; however the second quarter of 2008 recorded a substantial rise in domestic non-speculative private equity firms such as PPF Group, Penta and J&T.

For historical reasons, capital markets do not represent a viable alternative to bank financing for Czech investors. The widespread mistrust of capital market investment can be traced to the fraudulent mismanagement of investment funds which took place after the 'coupon privatisation' programme of the early 1990s. Under the coupon scheme, all Czech citizens were entitled to receive coupons in exchange for a symbolic administrative fee. These coupons could then be converted into shares in hundreds of Czech state-owned companies. Unfortunately, most coupon holders were lured into entrusting their coupons to one of the 300 newly established investment funds, all of which had been set up within six months preceding the privatisation in the absence of any licensing requirements or other regulatory supervision. Many of these funds proceeded to fraudulently withdraw all valuable assets from the companies in their portfolio, leaving inexperienced investors without a remedy. This beginning to capital markets and collective investments adversely affected the confidence of Czech citizens for many years.

Since 2004, only six initial public offerings have been listed on the Prague Stock Exchange, reflecting residual doubts about capital markets and collective investments. Of these IPOs, only two have been successful. The first, for the pharmaceutical company Zentiva, took place under the direction of Warburg Pincus in 2004. The second, the IPO for New World Resources ('NWR'), the biggest Central European coal mining producer, was held in 2008 and has been hailed as a turning point. Valued at €1.4 billion, this successful IPO of NWR was the largest IPO in Czech history. The NWR offering was also listed on the London Stock Exchange and Warsaw Stock Exchange.

The global financial crisis and unprecedented fall of all world stock indexes recorded in the past year strengthened the widespread mistrust of capital markets among Czech investors. No new IPO is expected to be launched in the foreseeable future.

Since most Czech companies are subsidiaries of global groups, financing is usually worked out at a parental level in line with group interests.

VII EMPLOYMENT LAW

The new Czech Labour Code went into effect on 1 January 2007. Whereas the former Labour Code was very strict and protective of employees, the new Labour Code emphasises the principle of contractual freedom and allows parties to deviate from statutory provisions that do not rule out or expressly prohibit such deviation. These changes have generally strengthened the positions of employers in relation to employees and trade unions. The contractual freedom doctrine of the Labour Code was further

advanced under a 2008 decision of the Czech Constitutional Court, which applied the general principles of private law to Czech labour law for the first time in history.

In 2007, the Czech Parliament also adopted a mainly technical amendment to the new Labour Code. The amendment implemented key changes in the areas of working hours and employment termination. In particular, it allowed employers to include up to 150 hours of overtime work within their managers' wages, which were previously subject to standard overtime fees.

An extensive amendment to the Labour Code is being prepared that is aimed to further promote the employer's position in relation to employees. However, owing to a recent government crisis in the Czech Republic, the future and the content of the amendment depends on the outcome of the autumn 2009 Parliamentary elections.

In June 2009 the new Anti-Discrimination Act was passed and is scheduled to go into effect on 1 September 2009. It is the first unified code summarising rules regarding discrimination in employment, profession, social security, health care, education and access to goods and services, and is aimed at implementing EU legislation in this field into Czech law. For the first time, the Anti-Discrimination Act states the express obligation for employers to adopt measures preventing discrimination. The Anti-Discrimination Act also further strengthens the position of plaintiffs claiming discrimination before a court.

VIII TAX LAW

In general, the Czech Republic does not provide any recourse against legal double taxation. A 15 per cent withholding tax is imposed on dividends, and only a few countries (e.g., Cyprus, Luxembourg and the Netherlands) can benefit from participation exemption based on bilateral treaties.

Although participation exemption does apply to capital gains tax in the Czech Republic, it is subject to a five-year holding period.

In 2009, the applicability of capital gains tax levied upon transfers of shares of the companies with a registered office in the Czech Republic was extended to non-residents. Previously, income from such transfer was subject to the Czech capital gains tax only if a seller was a Czech tax resident. Such income is newly subject to the Czech capital gains tax irrespective of the tax residency of the seller. However, tax residents from the European Union, Iceland, Norway and Switzerland may claim the participation exemption.

On 1 January 2008, complex tax reforms took effect in the Czech jurisdiction. Mergers and acquisitions were particularly affected by important changes to thin capitalisation rules. However, in 2009 most of these changes were revoked.

The tax reforms established a new 2:1 debt-to-equity ratio applicable to intra-group loans (with a ratio of 3:1 where the recipient of a loan is a bank or insurance company).

The tax reforms expanded the applicability of thin capitalisation rules to all loans, irrespective of whether they were concluded on an intra-group basis or between unrelated persons. Fortunately, in 2009, the application of the thin capitalisation rules was again limited to intra-group loans.

The tax reforms set out additional rules on taxable interest. In 2009 most of these additional rules were abolished. The only remaining restriction currently in effect is that the loan liability may not be subordinated to any other liabilities.

The interest accrued as a result of a breach of any of these rules may not be deducted.

Finally, the 2008 changes lowered both personal and corporate taxes in the Czech Republic. On 1 January 2009 the corporate tax rate fell to 20 per cent. In 2010, this rate will drop by a further percentage point.

IX COMPETITION LAW

In June 2009 an amendment to the Antimonopoly Act was adopted, bringing changes mainly to merger control and also to some other areas of proceedings by the Czech Antimonopoly Office.

The most significant changes in merger control proceedings consist in introducing simplified proceedings used in Community law, which comprise:

- a* a shortened time period for merger assessment (only 20 calendar days);
- b* a simplified questionnaire;
- c* electronic announcement of initiation of proceedings; and
- d* publishing of a simplified decision.

The simplified proceedings should be less demanding of the merging parties. However, the simplified proceedings cannot be applied to mergers, which raise concerns of significant distortion of competition.

Other important changes relate to the distinction between responsibility for infringement of competition laws by natural persons and legal entities. There are also provisions amending rules governing the statement of objections, access to files, burden of proof, request for information by the Czech Antimonopoly Office, dawn raids and proceedings with a Community element.