Reaping the benefits

Dagmar Dubecka, Martin Kubik and Christian Blatchford of Kocian Solc Balastik describe the intricacies of the law governing M&A in the Czech Republic

The financial crisis was not as severe in the Czech Republic as in certain other countries, in large part due to the conservatism of Czech banks and their limited exposure to the high risk operations which gave rise to the crisis. As a largely export-based country, however, the Czech Republic did suffer from an economic crisis. The economic situation improved during 2010, and should continue to improve in 2011, but progress will depend on demand in the countries to which Czech businesses export, principally Germany.

M&A activity practically ceased in the early part of 2009. This had more to do with a sharp decline in the confidence of potential buyers than with actual conditions in the Czech Republic. Even some transactions which had already started stalled due to divergences between the pricing expectations of sellers and the willingness to pay of increasingly cautious buyers.

In 2010, normal M&A activities were extremely limited. Restructurings, outsourcings and distressed M&A with the increased participation of creditors were the order of the day. In the second half of the year, however, a number of smaller transactions could be seen. These were apparently encouraged by an improving economy and the formation of a relatively strong coalition government following parliamentary elections.

The centre-right government intends to complete a radical overhaul of the Czech legal system over the next two years, including in areas materially affecting M&A. Parliament will soon begin to debate a new civil code. Also new acts on corporations and income tax are under consideration. The tax system as a whole should be substantially simplified. Direct taxes should remain relatively low. Pension reform based on private pension insurance should increase the appetite of pension funds for acquisitions and stimulate capital market activity.

Insolvency law continues to move towards a system of reorganisation and away from the traditional liquidation of assets of an insolvent person. As part of the foregoing changes, certain legal provisions which have to date complicated M&A transactions should disappear – unhelpful provisions on transactions between related parties, for instance. Planned new laws attempt to be flexible, modern, European codices which give greater freedom of contract.

All of the above should be of benefit to participants on the Czech M&A market and could further encourage major global entities to base their Central/Eastern Europe operations in the Czech Republic.

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Takeovers

Supervision

The Czech National Bank (CNB) supervises takeover bids involving listed shares in the Czech Republic. It performs this function in addition to its functions as the central bank of the Czech Republic and the regulator of the Czech financial markets. The CNB's independence is directly guaranteed by the Constitution.

The CNB has the power to prohibit a voluntary takeover bid (including any changes thereto), approve the disclosure of a mandatory takeover bid and decide on a number of exemptions from generally formulated prohibitions and restrictions. In addition, the CNB has the right to change the price offered for a mandatory takeover bid if it considers such price to be inequitable. The Takeover Bids Act authorises the CNB to carry out onsite inspections in respect of certain target companies and parties as well as to penalise a number of administrative torts.

Mandatory takeovers

The Takeover Bids Act provides that a mandatory takeover bid must be made to all persons holding

listed shares in a target company by any person (or group of connected persons) who achieves control over such listed target company through at least 30% of voting rights in the same.

The voting rights under the above-mentioned threshold include not only those arising out of a direct holding of shares but also those over which the obliged person is able to exert influence based on his contractual or corporate relationship with the relevant direct shareholder. Conversely, there exist specific limitations of, or exemptions from, the obligation to make a takeover bid, such as in relation to the acquisition of shares by a stock broker not exercising relevant voting rights or the transfer of shares between connected persons or within corporate groups.

Czech law provides for two methods by which a person holding more than 90% of shares or ownership interests in a (listed or unlisted) target company can exclude the minority shareholders or members, always for duly documented and equitable consideration which may be examined by the courts.

The first method, which may only be used in relation to a joint-stock company, is a squeeze-out. This method is applicable without regard to the nature of the majority shareholder. First, the general meeting of the target company, at the request of and supported by the votes of the majority shareholder, resolves on the transfer to the majority shareholder of all other shares and other securities representing the right to participate in voting or in the registered capital of the target company or to obtain any such participation.

This resolution of the general meeting must be registered in the Commercial Register and the registration of the resolution must be published in the Commercial Gazette. The transfer of the relevant shares and other securities occurs automatically one month following the publication in the Gazette. The squeeze-out of listed shareholders must be approved by the Czech National Bank before the making of the relevant resolution at the target company's general meeting.

The second method is known as the transfer of the assets and liabilities of a target company to its majority member and is a form of merger (and so a method which may be used in respect of any target company). The majority member must be a natural or legal person involved in business activities. This method involves the disappearance of the target company and its replacement by the majority member as the general legal successor of the same, to whom all of the rights and obligations of the target company apply (unless otherwise provided for by law). Minority members do not gain an ownership interest or shares in the majority member, but rather cash compensation.

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A mandatory takeover bid may not be subject to any conditions nor to a maximum or minimum threshold of shares for an obliged person to purchase. Such a takeover bid may not be revoked and may be changed only to the benefit of the offerees.

A voluntary takeover bid is not subject to the above-mentioned restrictions and it is therefore possible to apply a threshold of shares and/or to impose objective conditions. A voluntary takeover bid may be changed so as to provide for more beneficial consideration for the offeree and otherwise changed or revoked, provided, in particular, that such a change or revocation was contemplated in such bid.

Intricacies of the local regime

M&A transactions in the Czech Republic are mostly governed by Czech law, irrespective of whether the seller and buyer are Czech entities. The sale and purchase of the enterprise of a Czech entity (or its part) are prescribed under Czech law in a way which excludes the application of a different governing law. This does not, however, apply to pure asset deals. English law is used exceptionally on Czech M&A transactions. German law and the law of the State of New York can be seen, but extremely rarely.

Besides rigid and unsystematic provisions on related-party transactions, which are frequently discussed in the international professional media, there are certain unusual provisions of Czech law worth noting.

The Czech Commercial Code provides that rights to damages cannot be waived before the breach of the obligation which gives rise to such damages; this provision is mandatory and cannot be contracted out of by the parties. M&A market practice has developed as a result of this provision, pursuant to which a breach of a seller's warranty results not in damages for breach of contract but in a reduction to the purchase price for the shares due to a defect in such shares. Limiting liability in respect of defects is not problematic under Czech law.

The Supreme Court has, however, recently come to the view that a limitation of liability due to a breach of contract can, indeed, be valid if partial (that is, it is a limitation and not an outright exclusion) and if not unrea-

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She has advised a number of international and domestic clients on acquisitions and disposals in the Czech and Slovak republics in sectors ranging from construction to beverages to energy, representing some of them in proceedings before the Czech Competition Authority. She recently led the team which advised a major mining group on the demerger, outsourcing and subsequent sale of its energy assets, including the execution of long-term contracts on the supply of energy and utilities.

Dubecká is a member of the International Bar Association and the Czech Bar Association (and has been a member of the latter's Disciplinary Board since 2002). She has authored numerous articles and also lectures on corporate law. She graduated from Charles University, Prague in 1994 and obtained a PhD in private business law in 2001.

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sonable in the circumstances. It will be interesting to see whether this new position affects the way in which Czech law share purchase agreements (SPAs) are structured in future.

Czech law does not generally provide for the legal concept of indemnification, under which a buyer may recover, in respect of serious and/or unquantifiable risks affecting a target company and/or the shares in it, a broader scope of loss than would be available under a damages claim and also be freed from the need to prove or mitigate its loss. Czech law SPAs should provide instead for the payment of damages, suitably broadly defined in the contract, and/or contractual penalties in respect of such matters. The obligation on the buyer to mitigate its loss is, however, mandatory (and a buyer may not recover that portion of any loss which it failed to mitigate).

Similarly to some other civil law jurisdictions, Czech law can give rise to pre-contractual liability in circumstances where contractual negotiations between parties have reached a sufficiently advanced stage for one party to believe in good faith that the relevant contract will be entered into only for the other party to terminate negotiations without good reason (newly-discovered information concerning the transaction, for example).

Dispute resolution clauses

An SPA relating to a Czech M&A transaction will often set out a dispute resolution clause providing for the resolution of disputes before a Czech or (in accordance with the Brussels I Regulation) foreign court or an appropriate forum of Czech or international arbitration.

Under the Czech Act on Arbitration Proceedings and the Execution of Arbitration Awards, an appeal against an arbitration award may be filed with another arbitration forum, provided that the relevant arbitration clause contemplated the same. In the absence of such an appeal, an arbitration award will be final and binding on the parties, subject to its stricking out by a court on certain limited grounds.

An SPA may also set out a binding contractual mechanism intended to escalate a dispute to appropriately senior persons or bodies of the contracting parties with a view to its early and amicable resolution.

Execution risks

The method of execution of an agreement, including an SPA, depends on the character of the contracting parties; a natural person will execute an agreement personally while a legal person will do so acting through its statutory bodies. Attorneys of fact may be duly appointed by the persons or statutory bodies referred to above to execute agreements. A person entered in the Commercial Register may also appoint a procurist (a special attorney) who may also execute such agreements as long as they are made in connection with the principal's regular business operations.

An employee of a legal person can execute an agreement on behalf of such legal person provided that such execution falls within the scope of the duties of such an employee. A failure to conform to such formalities may render the relevant agreement invalid. Extreme caution should be exercised in the event that a person who is a statutory body of a company (or a member thereof) also acts as an attorney of fact, procurator or an employee of or for such company.

An SPA concerning the sale and purchase of an ownership interest in a limited liability company must be executed in writing and the signatures of its signatories must be notarised. Failing this the SPA will be invalid. An SPA concerning the sale and purchase of shares in a joint stock company does not, however, need to be executed in writing. In order for their transfer to be completed, bearer shares must be handed over and registered shares must be handed over and endorsed.

Corporate approvals of SPAs are generally required on the part of a corporate seller or buyer, and, if absent, personal liability can accrue to the person who executed the SPA if damage is caused to such corporate seller or buyer. The absence of such corporate approval does not, however, affect the validity of an SPA.

About the author

Martin Kubík specialises in corporate law, corporate restructuring, mergers and acquisitions, securities and capital markets and data protection.

He regularly advises a group owned by private equity investors on various aspects of corporate law, including on founding documents, internal rules, agreements concluded between companies and statutory body members, the powers of statutory bodies, directors' liability and on corporate group agreements. Kubík also regularly advises an integrated telecoms operator in the Czech Republic on corporate governance, the drafting of and ongoing amendments to corporate documents and on the establishment of corporate and contractual principles for the functioning of the company's bodies, including mutual relations between corporate bodies.

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About the author

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In the area of M&A he has recently advised on the disposals of a convenience food manufacturer, an internet service provider, an engineering company focused on mining activities and a company supplying energy and utilities. He also advised on the recent acquisition of the Czech Mint by a private investor. Blatchford's projects work has focussed on early PPP projects in the Czech and Slovak republics, including the Prague Central Military Hospital and the R1 expressway.

He is an English-qualified solicitor and a member of the Law Society of England and Wales and the Czech Bar Association. He regularly publishes and lectures on the subjects of PPP and public procurement. He obtained a degree in philosophy from the University of Manchester in 1995 and studied law at the College of Law, Guildford.

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Certain transactions (share deals) must also be approved by bodies of the target company in order to be valid and/or effective: the transfer of an ownership interest in a limited liability company must be approved by the company's general meeting (unless otherwise provided by the foundation deed/association agreement of the company) and the statutes of a joint-stock company may make the transfer of shares in the company conditional upon approval by the general meeting or another body of the company.

Further consents and other formalities (including in certain cases an expert valuation of the fair market value of the shares) are required where related parties (for example a buyer and seller belonging to the same corporate group) or married couples are involved in the transaction.

Any transfer (including of ownership interests and shares under an SPA) in violation of the prohibition on the disposal of property in the course of enforcement (execution) proceedings will be ineffective. If a party to an SPA is insolvent, legal acts, including the execution of an SPA, made to the detriment of creditors or favouring certain creditors over others may be declared ineffective by the insolvency court on the basis of proceedings brought by the insolvency administrator.

Protection of deals

The Czech Republic is bound by more than 60 bilateral treaties for the promotion and protection of foreign investments in the context of unexpected or unreasonable interference by the Czech state in respect of foreign investments. The right to bring proceedings for infringement of a foreign investor's rights, with a view to claiming compensation for unequal or unfair treatment, is guaranteed under these treaties.

The Czech Republic is also a contracting party to the Convention on the Settlement of Investment Disputes. This means that a foreign investor which has suffered damage due to a breach by the Czech Republic of any provision of a bilateral treaty can bring proceedings against the Czech Republic before the International Centre for the Settlement of Investment Disputes. The Czech Republic will be subject to the ultimate decision of such body.

Antitrust

The Czech Commercial Code specifies prohibited aspects of unfair competition. Provisions for the protection of economic competition as a general phenomenon are specified in more detail in the Czech Act on the Protection of Economic Competition (PECA). In the context of M&A, PECA regulates mergers, acquisitions (including the acquisition of control) and the creation of joint ventures.

The relevant thresholds above which Czech competition clearance will be required are as follows:

(a) the overall net turnover of all merging undertakings for the last accounting period on the market in the Czech Republic exceeds CZK1.5 billion ($85.8 million), and in the last accounting period at least two of the merging undertakings have each had a net turnover exceeding CZK250 million; or

(b) the net turnover in the last accounting period on the market in the Czech Republic is attained by:

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(i) at least one of the parties to the merger (in the case of mergers);

(ii) the acquired enterprise (business) or a significant part thereof (in the case of a concentration by acquisition of another undertaking's enterprise);

(iii) the undertaking over which control is being acquired (in the case of a concentration by acquisition of control over another undertaking); or

(iv) at least one of the undertakings forming a jointly-controlled enterprise (business) exceeds CZK1.5 billion, and concurrently the world-wide net turnover for the last accounting period of the other merging undertaking exceeds CZK1.5 billion (in the case of a concentration by means of joint-venture).

PECA provides that, besides the European Commission, the body responsible for ensuring the protection of economic competition is the Office for the Protection of Economic Competition. The Office is empowered to supervise the compliance of undertakings with their obligations under antitrust law, to enforce the rules prohibiting restrictive agreements and abuses of a dominant position and to assess merger applications. The Office also supervises the performance of obligations set out in its legally-effective decisions and has the power to apply Articles 101 and 102 of the Treaty on the Functioning of the European Union in circumstances which may affect trade between Member States.

Simplified concentration approval proceedings were implemented in 2009. These simplified proceedings are designed for use in cases where the intended concentration does not, by its nature, raise serious antitrust concerns. The essential features of such simplified proceedings are the shortening of the assessment period, a simplified questionnaire forming part of the concentration notification, the electronic announcement of the initiation of proceedings and the issuance of a simplified decision.