

The Changing Legal Environment of Business in the Emerging Economies of Central East Europe

*God's blessing on all nations
Who long and work for that bright day
When o'er earth's habitations
No war, no strife shall hold its sway,
Who long to see
That all men free
No more shall foes, but neighbors be.*

Slovenian national anthem

I. Introduction

This paper examines one aspect of the remarkable transformation that has taken place during the 1990's in Central East Europe ("CEE"). For four decades up to the summer of 1989, all of these states were, to various degrees, totalitarian, communist states. With the exception of Albania and Yugoslavia, all were economically and militarily aligned with the Soviet Union (Dornberg, 1995).

The communist CEE states had command economies with economic decisions such as pricing and production made from the top down by government ministries. All significant property was owned by the state and the production and distribution of goods and services was controlled by the state. The goal of course was to provide a more equitable distribution of wealth, but a result was oppressive bureaucracy and inefficiency. Because there was little opportunity for personal profit, within these economies there was little incentive to create, invest, or find ways to satisfy the needs of others.

Even as late as early 1989, the prospect of these states becoming democracies aligned with Western Europe was hard to imagine. Equally difficult

to foresee was any possibility of these states entering the next century as free market economies. Nevertheless, that is where they stand today.

By the end of the 1980s it had become clear that the communist states were unable to keep up with the economic and technological growth that had been taking place in the free markets of Western Europe and North America. The political and economic goals of communism no longer seemed feasible (Volgyes, 1995). Once the Soviet Union under reform-minded Mikhail Gorbachev loosened its grip on the CEE states, it became possible for the totalitarian regimes to be replaced with democratic ones. The change was so rapid that by summer of 1990, after a period of only one year, most of the countries of the region had changed governments and had begun the process of writing new constitutions grounded in principles of freedom and democracy. The CEE states thus moved towards becoming states based on the rule of law rather than of men. At the same time they sought to transform rapidly from central planning to free market economies.

Free markets are not, of course, anarchic. They are supported by and exist within a system of laws. Ironically, this necessary legal system is more extensive and complex than that needed to maintain command economies. Therefore, to accomplish the political and economic transitions sought in the CEE states, significant legal reform and development would be necessary. Until reform of these inchoate legal systems is complete, those investing or trading in these economies will assume extra risks.

This paper observes what legal reforms have been achieved in the past decade in the CEE states and analyzes what remains to be accomplished to enable business in these emerging economies to prosper. The author recognizes, however, more must be done than simply changing the laws on the books: processes must be established, institutions must be built, and customs must change before these states can truly make their desired transformations. This point is understood in the region. As the President of the Czech Republic warns, "The best laws and the best-conceived democratic mechanisms will not in

themselves guarantee legality or freedom or human rights - anything, in short, for which they were intended - if they are not underpinned by certain human and social values" (Havel, 1992).

This paper examines the legal environment of business in five states in particular: The Czech Republic, Hungary, Poland, Slovakia, and Slovenia. These five states were selected because of their cultural and geographic proximity to Western Europe. They each share a border with a European Union (EU) member state, and are among the states most likely to be admitted to the EU in the decade that lies ahead.

II. The Legal Environment of Business in Central East Europe

A. The Rule of Law

Some of the most fundamental changes that need to take place to transform an economy from communism to a free market are not themselves economic measures. Rather, they involve transforming the political process by which laws are made and enforced. Only when the processes of lawmaking and enforcement meet certain basic requirements can the markets they regulate truly be free.

People are less likely to invest, invent, create, or employ within an economic system whose rules are subject to the will of a party or a boss. Rules that serve the interests of those in power, rather than the interests of society, typically discourage entrepreneurs. Such rules often set up unnecessary barriers to establishing and operating businesses. Furthermore, entrepreneurs' efforts and risk-taking aren't justified if their expected rewards can be confiscated arbitrarily.

1. Necessary Conditions for the Rule of Law

Free market economies exist only in societies governed by the rule of law, i.e., an economy is only free to the extent it is subject to regulation by law, not by

men. The authority to regulate such economies comes from the people and is based on law. For this to occur, the legal and political systems of the state must have certain characteristics, both in form and practice.

a. Democracy

The rule of law cannot exist unless those who make the laws are representative of the people. Lawmakers must be chosen in free and fair elections, with widespread suffrage and secret ballots. There must be freedom to form political parties, to propose candidates for office, and to criticize those in power and their policies.

b. Independent Judiciary

A second characteristic of a political system necessary to support a free market economy is an independent judiciary. The proper role of the judiciary is to decide cases in accordance with the law, i.e., to determine what the law is and to apply it to the cases before them. Cases should not be decided arbitrarily by judges, but only in accordance with the law as it reflects the will of the legislature. Furthermore, judges must be independent of others outside the judiciary who may want to influence the judicial function.

The judiciary must do more than merely determine the will of the legislature in deciding cases. It must also act as a check on the legislature. Only an independent judiciary, one not under the control of the executive, the legislature, or a political party, can protect society from the enforcement of laws that violate constitutional limits placed on lawmakers.

c. Transparency

To participate actively in society or the marketplace, one must be able to know what the law is. A free society and a free market both depend on laws being publicized, as well as the laws being enforced as published. In fact, to have a vibrant economy, it is perhaps more important that market participants know what the rules are, than it is to have the best possible rules. With bad rules

at least there is certainty, and one can plan one's transactions in light of the rules. But when there is no way to know *ex ante* what rules will apply or whether the rules will be applied consistently, the level of legal uncertainty can be so high as to discourage any transacting at all.

In addition to transparency of the *substance* of the law, it is likewise necessary there be transparency as to the *procedure* of the law. The proper operation of government within the rule of law depends on citizens being informed of how the laws actually are made and how they actually are enforced. Transparent procedures make corruption of the process more difficult.

Transparency depends not just on having open procedures within the executive, legislature and judiciary, but also on having free and independent news media.

2. Communism and the Rule of Law

The rule of law did not exist in the CEE states before 1989. In *form* these states were all democracies. They had constitutions with guarantees of liberties such as are assured in Western Europe and North America, legislatures elected through universal suffrage, and even political parties. However, in *substance*, these characteristics of a *bona fide* democracy were all a sham. While people had the right to vote, and were often required to vote, there typically was only one candidate for office. Power was not in fact exercised by the elected legislature, but rather by the Communist Party. Real power lay with the head of the Communist Party and was exercised from the top down, with the legislature merely rubberstamping the wishes of the Party (Dornberg, 1995). Inevitably regulation came to serve the interests of the Party. Such a political system, one based on highly centralized control and not subject to public approval, could not tolerate dissent from the Party's position. Therefore there were no independent means, other than the Party itself, for correcting unwise or corrupt regulation.

The Communist Party similarly controlled the judiciary. Judges were appointed and subject to dismissal by the Party on political grounds. As a result,

they were not an independent check on the Party's power. Typically the state attorney, a political official, could intervene even in civil cases and had the power to upset final court judgments on political grounds (Zweigert and Kötz, 1992).

The communist political, legal, and judicial systems were not transparent. To ensure its control over government and society, the Communist Party deliberated in relative secrecy, free of public oversight and criticism.

3. Progress Towards the Rule of Law

Communism did not succeed, however, in maintaining control. Following the collapse of communist control in 1989, legal reform over the political process took place with amazing speed. Establishing democracy and the rule of law were among the most immediate priorities of the new governments.

Their success in achieving these objectives was evaluated in 1997 when the European Commission issued opinions on the application for EU Membership of the five states reviewed in this paper as well as others in the region. With respect to the Czech Republic, Hungary, Poland, and Slovenia, the Commission opined that each state "presents the characteristics of a democracy, with stable institutions guaranteeing the rule of law, human rights and respect for and protection of minorities." This assessment was crucial to the promotion of these states to the first wave of countries likely to be admitted to the EU. With respect to each of these four states, however, the European Commission identified specific areas for improvement related to the rule of law.

As discussed below, the EU Commission was not so sanguine with respect to the rule of law in Slovakia. As a result, Slovakia was relegated to the second wave of applicant states.

a. Czech Republic

In December 1992, shortly before its separation from Slovakia on 1 January 1993, the Czech Republic adopted its new constitution. The Czech

Constitution created a parliamentary democracy. A Constitutional Court was added in June 1993, and since then the Constitutional Court has been very active reviewing the constitutionality of legislation.

The EU Commission, in its 1997 Opinion on the Czech Republic's Application for Membership, concluded its institutions of government were working well. Furthermore the EU Commission found "[t]he Opposition plays a recognized and participatory role in the functioning of the institutions in the Czech Republic." The Opinion cited a problem with communist-era laws still on the books that criminalize defamation against the Republic or the President. In 1997, however, President Vaclav Havel signed into law a repeal of the criminal statute as it pertains to defamation of the President. The law against defaming the Republic remains effective, but there have been no convictions under it since 1996 (U.S. Department of State, 1999).

The Czech Republic has an independent judiciary. Judges have life appointments and can be removed or transferred only on strict legal grounds. Improvements are needed however in the interrelated problems of filling the many vacancies in the judiciary, providing better training for judges, reducing the caseload of courts, and shortening the average time for completing cases. As of November 1998, when the EU Commission issued its first Regular Report on the Czech Republic's Progress Towards Accession, little improvement had been observed in this area. As discussed in section II.A.4 below, improvements also need to be made in the fight against corruption.

One may conclude, therefore, that the rule of law exists in the Czech Republic to an extent necessary to support a free market economy; nevertheless those doing business there should anticipate problems of delay with judicial dispute resolution. Section II.B.3.b of this paper discusses arbitration as an alternative method of dispute resolution.

b. Hungary

Hungary also has succeeded in making the transition from communist rule to the rule of law. It has a new constitution as of December 1990 and a parliamentary democracy. Free and fair elections are held, there are many active political parties, and the rights of political parties are respected. The EU Commission concluded in its 1998 Regular Report on Hungary's Progress Towards Accession that proper democratic institutions are in place and operating well. At the same time, the Commission encouraged Hungary to take more steps in fighting corruption.

Hungary has an independent judiciary, as well as a Constitutional Court able to act as a check on the legislature. Judges are prohibited from political activities and enjoy protection from dismissal except in accordance with legal procedures. In the past few years, Hungary has greatly increased the number of judges, created new appellate courts, and made other initiatives for improving the court procedures. However, as in the other CEE states, there continues to be inefficiency in the judiciary, and in the short term, businesses should consider alternative methods of dispute resolution.

c. Poland

The rule of law exists also in Poland. It enjoys free and fair election, a well-functioning parliament, and a multiparty political system that respects the rights of the opposition.

Poland adopted a new Constitution in 1997, following amendments in 1992 to its 1952 Constitution. The new Constitution clarifies the role of the Constitutional Tribunal. Before 1997 Polish citizens did not have access to this court, and the Sejm, one of two chambers of Parliament, could overturn the Constitutional Tribunal's decisions by a two-thirds vote. Now, beginning in 1999, the Polish Constitution gives citizens recourse to the Constitutional Tribunal and ends the Sejm's power to override the Constitutional Tribunal's decisions.

The Polish judiciary is independent. Like its CEE neighbors, however, Poland has a court system marked by inefficiency and delay. The Polish public lacks confidence in the system as a result (U.S. Dept. of State, 1999).

A potential problem with the rule of law in Poland is its criminal prohibition of slander and abuse of public authorities. However the most recent Progress Report of the EU Commission found this was not now creating problems for free expression in Poland.

d. Slovakia

Slovakia has had a much more difficult transition from communism to the rule of law. In its 1997 Opinion on Slovakia's Application for Membership of the European Union, the EU Commission concluded "Slovakia does not fulfil in a satisfying manner the political conditions set out by the European Council in Copenhagen, because of the instability of Slovakia's institutions, their lack of rootedness in political life and the shortcomings in the functioning of its democracy." Since then there have been free and fair elections resulting in a change in government in October 1998, and the signs are more positive that Slovakia will enjoy the rule of law in the short term.

Slovakia's Constitution provides for a parliamentary democracy with multiple parties and separation of powers (U.S. Dept. of State, 1999). However during the previous administration of Prime Minister Vladimir Meciar, the letter and spirit of the Constitution were often ignored. For example, the Meciar government blocked participation of opposing parties in parliamentary oversight, prevented referenda that had been constitutionally authorized, ignored decisions of the Constitution Court, and used its powers to intimidate the media. The new government of Prime Minister Mikulas Dzurinda has undertaken to correct these abuses and to respect the rule of law.

On 29 May 1999, Meciar was defeated in a nationwide vote for President, making Slovakia's fragile democracy more secure and improving its chances for EU accession among the first group of applicant states. It is encouraging that the

recent transition of power in Slovakia occurred through democratic elections that have been respected by those removed from office.

With respect to its judiciary, Slovakia suffers from long delays and inefficiency, a common problem in the CEE states. In addition, judges in Slovakia are not as independent as they should be. While they are prohibited from political affiliation, they nevertheless are subject to political control, particularly during their four-year probationary appointment by Parliament. The manner of their reappointment following the probationary period allows for too much interference by the government in the makeup of the judiciary (Bartole, 1998).

The Constitutional Court of Slovakia has the task of monitoring the compliance of laws with the Constitution. It has demonstrated its independence and was very active in trying to control the excesses of the Mercur government.

e. Slovenia

Slovenia has a stable political system that operates within the rule of law. Although Slovenia did not achieve independence from Yugoslavia until late 1991, it began the groundwork in 1989 by undertaking constitutional reform in the areas of political association and election laws (Ramet, 1998). Since then, there have been several free and fair elections and opposition political parties have functioned normally. In addition, free speech is guaranteed, and all political parties are well represented in the media.

Slovenia has a Constitutional Court that may hear cases from citizens and judge the constitutionality of legislation. Although the judiciary is independent of the other branches of government, as in all the CEE states the judicial process is slow and needs reform. In Slovenia, a shortage of judges, resources, and expertise have resulted in serious case backlog and delay.

The legislative process in Slovenia is exceptionally slow, yet this has not interfered with the rule of law. Nevertheless, it may make it hard in the near

term for Slovenia to incorporate into its national law the huge body of EU law, the *acquis communautaire*, a precondition for accession in the EU.

4. Waging the Fight Against Corruption

Corruption is a contagium that, if allowed to spread, threatens the rule of law. In a corrupt environment, unfair and inefficient laws can be bought, and fair and efficient laws can be avoided. As a result, the market suffers both from unnecessary burdens as well as a reduction in helpful government input and oversight.

In addition to affecting the environment in which the market operates, corruption also directly affects private transactions within the market. Corruption causes agents to bargain primarily for their own benefit, rather than that of their employers. This causes inefficient contracts that send the wrong investment signals to the marketplace. As a result, the market allocates resources less efficiently, and productivity, invention, and employment decrease.

It is important therefore that the CEE states protect their fledgling economies by joining the fight against corruption. This requires more than merely adopting any particular set of laws, it also requires reinforcing in the culture respect for honesty in government and business.

The CEE states are generally perceived as having a corruption problem. The EU Commission has recommended each of the states take greater steps towards fighting corruption as part of the effort to achieve accession with the EU. The Commission identified as a common problem the lack of a modern civil service law.

Some steps have been taken. For example, the Czech Republic, Hungary, Poland, and Slovakia are among the thirty-four states to have signed the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. The Convention was the result of efforts of the Organization for Economic Cooperation and Development (OECD) and came into force on 15 February 1999 (Weinstein and George, 1999).

The Czech Chamber of Deputies (lower house of Parliament) passed a bill on 1 April 1999 to toughen penalties against those paying or receiving bribes involving civil servants or public officials. The bill, which is part of the Czech government's "clean hands" program, still needs to be approved by the Senate before it becomes law. The Czech government is also drafting a proposed law to ban anonymous bank deposits in order to improve transparency and help fight money laundering.

A recent Polish Interior Ministry report claims that corruption in Poland has worsened during the 1990s. Recognizing a growing problem, Finance Minister Leszek Balcerowicz asked the World Bank to survey the level of corruption in Poland. The World Bank survey should enable Polish authorities to understand the problem better before taking further measures.

Other steps have been and are being taken in the region, however the perception still persists that the CEE states lag the developed economies in controlling corruption. The most recent report by Transparency International on perceptions of the level of corruption bears this out, but it also shows that the CEE states in some cases suffer less corruption than do some EU member states. Table 1 below shows how the CEE states rank with respect to others in Transparency International's 1998 Corruption Perceptions Index (CPI). A score of 10.0 represents "highly clean," while a score of 0.0 represents "highly corrupt." It is interesting to note that the cleanest of the CEE states, Hungary, places ahead of two EU member states, Italy and Greece, which have approximately the same level of perceived corruption as the Czech Republic and Poland.

**Table 1 -
Transparency International 1998 Corruption Perceptions Index**

Rank	Country	1998 CPI Score
1	Denmark	10.0

15	Germany	7.9
17	United States of America	7.5
21	France	6.7
33	Hungary	5.0
36	Greece	4.9
37	Czech Republic	4.8
39	Poland (and Italy)	4.6
47	Slovakia	3.9
76	Russia	2.4

B. Making and Enforcing Contracts

A vibrant economy, one with free and fluid trading and investing, depends, *inter alia*, on legal structures that support the making and enforcement of private agreements. There needs to be a coherent body of law governing contracts as well as effective enforcement mechanisms and dispute resolution.

1. Contract Law

A state's contract law establishes (i) requirements for an enforceable agreement, (ii) a method for finding the meaning of the agreement, (iii) minimum standards for acceptable performance, (iv) excuses for nonperformance, and (v) remedies for breach of contract.

A free market requires laws founded on the principle of freedom of contract. Under this principle, legislatures generally resist the temptation to establish *ex ante* the terms for standard agreements, and courts enforce private agreements without interfering *ex post* with the parties' bargain. One premise of a free market is that free individuals determine for themselves whether an agreement serves their best interests. Through repeated free exchange, a state's goods, services, capital and other resources tend toward their most valued and efficient use. A more efficient use of resources results in an increased level of production, profit, and employment throughout society. This logic justifies a state's dedicating its scarce resources toward enabling and enforcing what is essentially the mere *private* agreement of two parties.

Contract law should also avoid unnecessary formality. The requirements for a valid contract ought to be limited to those necessary for reasonably assuring the parties are competent, intend to contract, and do so with procedural fairness and legal purpose. Excess formality, such as requirements for written agreements, notarization, or registration, slow down and impose costs on a free market, reduce its efficiency and, in turn, lower the levels of production and employment.

Contract law in the five countries studied here generally follows the appropriate principles, and before communism, these countries had contract laws based on the traditional western theory of the free market. Communism never supplanted these laws completely, but rather added a separate layer of contract law governing transactions between the large state enterprises. Such contracts were not free, rather, they were subject to state planning, compulsory, and subject to being rewritten according to changing economic conditions.

State planning and control over contracts did not extend to less significant transactions involving personal property, which continued to be governed by traditional contract principles. However, in this area of traditional contract law, the CEE states did not keep pace with developments in the West in terms of new types of agreements, new customary practices, and new legal concepts. In this way, although liberalization took place during the period of market socialism, 1968 - 1989, communism effectively retarded the modernization of contract law in the region. As a result, these countries emerged from communism with a body of contract law founded on free market principles, albeit a relatively unsophisticated one.

One area of sophistication that evolved outside the communist states concerned the development of contract law devices for achieving fairness in the marketplace. For example, modern concepts such as the duty of good faith performance and unconscionability are now well entrenched contract law principles in western legal systems and are designed to enable courts to find an appropriate balance between freedom and fairness in contracting. It would be

ironic indeed if, as one of the legacies of communism, the countries of Central East Europe are late to attain sufficient controls over the excesses of *laissez faire* capitalism.

The most significant change to contract law during the 1990s in the CEE states was the adoption of a new Commercial Code, effective 1 January 1992, in the Czech and Slovak Federal Republic. One year later, when the Czech and Slovak Republics separated, each retained the new Commercial Code. The new law *inter alia* codifies the principle of freedom of contract, reduces the number of mandatory terms in contracts, and reforms Czech and Slovak contract law to approximate the modern rules found in most advanced free market economies (Bejcek, 1997).

2. Choice of Law in International Contracts

The substantive provisions of a state's contract law have more significance for parties to a purely domestic transaction than they do for those to international transactions. In international transactions, it is common for the parties to negotiate a contract term designating which nation's laws are to be applied to the contract. These choice of law clauses, if freely agreed to, are generally enforced. Thus, to the extent a state's contract law is unsophisticated, outdated, or confusing, the parties to an international contract usually choose an alternative.

The domestic contract law of the CEE states would not apply to international contracts even when the parties have made no choice of another state's law in their contract. Each of the CEE states has acceded to the United Nations Convention on the International Sales of Goods (the "Vienna Convention"). Worldwide, most states are members of the Vienna Convention. Hungary became a member of the Vienna Convention 1 January 1988, followed by Slovenia on 25 June 1991, Czech Republic and Slovak Republic on 1 January 1993, and Poland on 1 June 1996 (Enderlien, 1997). The Vienna Convention

provides a comprehensive body of contract law similar in scope to Article II of the United States' Uniform Commercial Code. It applies to contracts for the sale of goods between parties whose places of business are in different states so long as those states are members of the Vienna Convention [Art. 1(a)] and so long as the parties have not chosen to have some other law apply [Art. 6]. Therefore, in the case of an international sales contract involving a party from a CEE state, the contract law that will apply will either be that of the Vienna Convention or that law the parties have freely chosen. Thus even to the extent contract law in the CEE states may be relatively unsophisticated, untried, or unclear, it should not impact foreign trade. Furthermore, the more exposure businesspeople and courts in the CEE states have with foreign contract law or the Vienna Convention, the more one can expect further harmonization to take place.

3. Contract Enforcement

Parties make transactions based on their expectations concerning the outcome of the transaction. Unless parties can be reasonably sure of having their expectations met, they will not transact. A vibrant economy thus depends on the fulfillment of reasonable expectations with respect to transactions. A quintessential goal of contract law, therefore, is to protect parties' reasonable expectations.

A sophisticated and well-understood body of contract law is incomplete, however, without an effective system for resolving disputes. Contract law sets out standards for determining the rights of parties to an agreement, but it does not apply those standards to the agreement nor does it enforce those rights. Often, of course, the parties differ concerning their rights, or a party is unwilling or unable to perform its obligations. For this it is necessary that, in addition to a body of contract law, there are means for resolving such disputes.

Ideally there should be multiple means of dispute resolution. No single means incorporates the ideal procedures for resolving all types of disputes.

Different disputes require different degrees of formality and flexibility for fair and efficient resolution.

The two most important methods of dispute resolution, other than settlement by negotiation between the parties, are litigation and arbitration. Both means have been available in the CEE states since before communism. Hungarian law, for example, provided for arbitration as early as 1868 [Schwartz]. As discussed below, however, the processes of dispute resolution in the CEE states need many improvements before meeting standards found in most advanced free market states.

a. Litigation

Litigation in the CEE states is problematic. For several reasons, their court systems are inadequate for promptly and fairly resolving commercial disputes. One problem is the courts' lack of experience with the commercial laws they are asked to apply. Many of these laws, particularly those effecting business, have only recently been adopted, and there has not been sufficient time for courts to become accustomed to their application to disputes. This process of familiarization will likely proceed faster in those states which have in place specialized commercial courts, for example the Czech Republic, than in others which direct commercial disputes to trial courts with general jurisdiction.

A second problem is the substantial delay between the time a claim is filed and when it is finally resolved. All of the CEE states suffer from this slowness. The causes are many: judges are underpaid and hence too few competent attorneys pursue judicial careers; courts have insufficient technical and personnel support to keep up with a large case load; and there are insufficient alternatives to litigation. As a result, resolution of disputes by the first court alone, before any appeal, typically takes from one to five years or longer.

In its opinions on the applications of the CEE states for accession in the European Union, and in its regular reports on their progress towards accession, the European Commission has criticized the slowness of the judicial process in

all the CEE states reviewed in this paper. The efficiency of litigation as a means of enforcing contract rights in the CEE states is significantly below what business people are used to in the developed western economies. As a result, those who do business in this region need to give special attention to arbitration as an alternative to litigation.

b. Arbitration

Arbitration offers many advantages over litigation as a means of resolving disputes. It is a much more flexible device in that it can be designed by the parties to fit the needs of their situation. Litigation on the other hand tends to have a rigid structure and is used to resolve all classes of disputes. For example, in arbitration the parties can agree on the identity of the decision makers, using professionals with expertise in the subject matter of the dispute rather than judges who are burdened with having to handle a wide variety of disputes. Furthermore, only through arbitration is it possible to have a multinational panel decide the dispute. This helps alleviate the fear of local bias were a dispute to be resolved by litigation in the home country of one of the parties. Similarly, the parties have greater flexibility in choosing the time, place, language, procedures, and governing law of the arbitration proceedings.

Of particular benefit in commercial disputes is the fact that arbitration proceedings are nonpublic, which allows for the protection of trade secrets and the avoidance of bad publicity.

Arbitration awards can usually be obtained more quickly than court judgments, particularly where, as in the CEE states, court dockets are overburdened with cases. Once given, arbitration awards are generally considered final, and the merits of the dispute can not be retried in court. There are very few bases on which arbitration awards can be set aside.

Finally, arbitration awards are more easily enforced internationally than are court judgments. International treaties, in particular the New York Convention on Acknowledgement and Enforcement of Arbitration Awards, to

which the CEE states and most of their trading partners are party, provide for mutual recognition of arbitration awards. In contrast, the enforcement of court judgments internationally depends on a more *ad hoc* system of bilateral agreements and reciprocity.

During the period of communist rule, arbitration proceedings were essentially limited to resolving disputes between state-owned enterprises. Since 1989, the CEE states have revived arbitration as a process primarily for the resolution of private commercial disputes, and the Czech and Slovak Republics and Hungary have adopted new arbitration laws. Arbitration has been used increasingly in the region during the 1990s, however in international contracts, parties still tend to choose arbitrators and arbitration centers outside the region for their proceedings (Schwartz, 1998). This may have more to do with a lack of confidence in the region's courts than in its arbitration system *per se*. Although arbitration is seen as an alternative to litigation, arbitration often depends ultimately on the court system to order arbitration and to enforce the arbitration award, ideally without interfering in the process or decision. To the extent therefore that businesspeople lack confidence in a state's court system, some of that will carry over to its arbitration system as well. Thus while an ineffective court system will tend to cause more demand for arbitration, at the same time it will tend to create a preference for foreign arbitration. Therefore, although the use of arbitration in the CEE region is likely to increase greatly in the future, the speed with which it does will depend on how well courts in the CEE states understand and support the arbitration process (Schwartz, 1998).

C. Creating and Protecting Property Rights

Socialist property law perceives and seeks to prevent exploitation caused by private ownership of the means of production. It therefore places ownership of most property in the state. Theoretically, such property is owned by all of society or by co-operative organizations recognized by the state. Only

the least economically significant property can be owned by the private individual, for example, household goods, earned income and savings, a car, and in some states, a small amount of land (Zweigert and Kötz, 1992). During the period of communist rule, these principles were incorporated into the CEE states' property law.

Social ownership of property, that is ownership by the state, results in inefficiencies for at least two reasons. First, where the state monopolizes productive resources, the allocation of those resources is determined by the state, rather than through the aggregation of decisions made in a market by all those affected by the allocations. Accordingly, the allocations are less likely to match the needs of those affected. Second, to the extent property is owned socially, there is less incentive for anyone to maintain the property or invest in new property. By contrast, under a system of private ownership of property, owners benefit in proportion to the productive use of their property.

Since 1989, the CEE states have been working to establish efficient free market economies. The benefits of an efficient economy may be obtained only where the ownership of property, both tangible and intangible, is largely private. This has required profound changes to their socialist property laws.

To make the transition to a property law regime that supports a free market economy, the CEE states have established rights to private ownership of all categories of property, including intellectual property, and been privatizing state-owned enterprises.

1. Property Law

The CEE states all guarantee private property rights, however some reforms still need to be made. First, the process of returning property to the owners from whom it was taken by the communist regimes is incomplete and somewhat problematic. Nevertheless, businesspeople face little risk of further expropriations today in the CEE states. These states now recognize the same

limits on their power as the western democracies in this respect, and now may expropriate property only for a public purpose and with adequate compensation.

Second, reform is needed in the area of land registries (Borish and Noël, 1996). These are the public records where landowners record their titles and creditors record their mortgages and other liens. Without an effective registration system, titles are uncertain and mortgagees run the risk of losing their lien. The result is that land transactions become slower, less frequent, and more expensive, because buyers and lenders can't be certain of getting the property rights they expect (de Soto, 1993). Once the CEE states succeed in centralizing and automating their land registries, they should have in place systems superior to that which exists in most of the developed world, where such systems are older and inefficient.

Third, investment in real property has been slowed by regulations that are strongly pro-tenant, for example laws which control rents and restrict evictions (Borish and Noël, 1996).

2. Intellectual Property

Before communism, the CEE states had intellectual property laws similar to those in Western Europe. However, during the period of communist control, those rights, although not eliminated entirely, were rolled back in keeping with Marxist political theory. Meanwhile, as technological advances caused new and stronger intellectual property protections to be implemented in the West, such developments were neither necessary nor politically correct in the communist states.

With the fall of communism came the need to catch up in terms of a legal environment supportive of intellectual property. Whether they wanted to do business with companies in the West, or whether they wanted to stimulate their domestic economies, the CEE states found it necessary to bring their intellectual property regime up to western standards.

Inadequate protection for patents and copyright slows down the creativity necessary for economic development. Infringement deters invention because those who make the effort to invent or create profit less from doing so. At the same time, businesses will find it harder to import other's inventions or technology if the owner is uncertain his or her rights will be protected. Inadequate protection for trademarks harms consumers by allowing confusion over the origin of goods in the market and by reducing incentives for businesses to create goodwill.

Significant progress has been made during the past decade to protect intellectual property rights in the CEE states. The Czech Republic, Hungary, Poland, Slovakia, and Slovenia are all members of the Central European Free Trade Agreement (CEFTA), which imposes mutual obligations respecting intellectual property rights (von Lewinsky, 1997). In addition, all are members of the World Trade Organization since 1995, and as a result are obligated by the terms of the Agreement on Trade-Related Aspects of Intellectual Property rights (TRIPs). The CEE states adopted new legislation during the 1990s in an effort to bring their laws up to the standards of the EU. In general, as of mid-1999, they are almost at that level, except with respect to further improvements necessary in the area of copyright protection.

Despite generally having adequate intellectual property laws on the books, all the CEE states need to improve the administration and enforcement of those laws. The problem is especially bad at the borders, where customs officials have been given inadequate training to enable them to stop the importation of pirated materials like videos, software, and compact discs. An additional problem for intellectual property owners is the severe backlog and inefficiency found in the civil courts in the region. This problem, discussed in section II.B.3 of this paper, is exacerbated by the courts' lack of experience with intellectual property law and litigation, and thus makes it very difficult for owners to enforce their rights. This in turn lowers the value of intellectual property in the region.

Of all the CEE states, Slovenia appears to have made special efforts to enforce intellectual property rights. Going beyond even Western European standards, Slovenia allows authors to recover punitive damages for copyright infringement. In addition, it gives exclusive original jurisdiction in intellectual property cases to the District Court of Ljubljana, and provides its judges with special training to handle such cases (von Lewinski, 1997). As a result of this special attention, Slovenia should make the greatest progress in the region during the next decade in enhancing enforcement of intellectual property rights.

3. Privatization

Although there were exceptions, at the fall of communism in 1989 most business enterprises in the CEE states were state-owned and woefully inefficient. Slovenia had always been the most liberal in permitting worker ownership and management through so called "socially-owned enterprises," and permitted private enterprises to be formed as early as 1988. Nevertheless, even in Slovenia, much work needed to be done to transfer the ownership, control, risk, and reward of enterprises from the state or social sector to the private sector.

Private ownership creates incentives for operating enterprises efficiently and profitably. In a free economy, that objective will be met only if the company provides goods and services that people want and at a price they are willing to pay. The more customers value the enterprise, the more profit will accrue to the owners. Thus, owners are motivated to organize their enterprise to produce what society wants as efficiently as possible. Wasteful or unnecessary enterprises will fail, freeing up resources for other, better uses.

Private ownership also invites foreign investment. Foreign companies are more likely to invest in an economy when their trading partners and competitors are privately owned rather than state-owned. State-owned customers and suppliers are comparatively slower and less reliable in performing their obligations. In addition, state-owned competitors have unlimited resources with which to compete. Therefore, not only does privatization *directly* create private

ownership, but it also establishes an environment that leads indirectly to private entrepreneurship and investment.

During the 1990s, significant progress was made in privatizing state-owned enterprises in the CEE states. Within the Visegrad states alone, the Czech Republic, Poland, Hungary, and Slovakia, by 1996 over 170,000 state enterprises had been privatized (Borish and Noël, 1996).

Among the CEE states, the Czech Republic moved most quickly to privatize, adopting laws governing small privatizations in 1990 and large privatizations in June 1991. It completed privatization of small enterprises by the end of 1994, and today private ownership of business is the norm. The state continues to control a large part of certain sectors in the Czech economy, in particular banking. Progress continues to be made here as well, however, as the Czech Republic sold one of four of its large state-owned banks, Investicni a Postovni Banka (IPB), in March 1998, and announced the sale of another, Ceskoslovenska Obchodni Banka (CSOB) in May 1999. The Czech Republic expects to sell the remaining two banks, the largest in the republic, by the end of 2000.

Although Hungary has proceeded more cautiously in privatizing state-owned enterprises, it has perhaps come the farthest. Hungary adopted privatization legislation in 1992 and amended it in 1995. By the end of 1997, Hungary had completed its mass privatizations and disposed of its controlling interests in the banking sector. Hungary got back into banking during 1998, however, when it nationalized Postabank so as to prevent the bank's impending failure from hurting confidence in the entire banking system. That bank, once the second largest bank in Hungary, is currently being investigated for having made corrupt loans to politicians and other elites.

Poland's progress has been slower than in the other states studied in this paper. While it completed its small privatizations between 1990 and 1992, it was late beginning large privatizations, and as a result many of the largest enterprises

in Poland still are state-controlled. Poland plans to dispose of the remaining enterprises by the end of 2001.

Slovakia was part of the Czech and Slovak Federal Republic until separation on 1 January 1993. Therefore it participated alongside the Czech Republic in the rapid privatization that occurred during 1991 and 1992. The benefits of privatization were jeopardized in 1994, however, when the administration of former Prime Minister Vladimir Meciar began using the privatization process as a form of political patronage. In a recent effort to make the process more transparent, the government of Mikulas Dzurinda approved a law in May 1999 eliminating ownership through bearer shares. In addition the government has succeeded in recovering some state assets previously transferred in suspicious privatizations. While Slovakia's privatization has been tainted by scandal, it nevertheless has been fairly thorough: as of the end of 1998, the private sector in Slovakia accounted for more than 82% of GDP (U.S. Dept. of State, 1999).

Under communism Slovenian businesses were subject to much less state ownership and control than businesses in the rest of the CEE region. Yet, while Slovenia has had less drastic reforms to make, its progress in privatization has lagged. During 1991 and 1992, the government failed in four attempts to reach agreement on a scheme for privatization (Ramet, 1998). The privatization process then did not begin in earnest until 1996. Slovenia recently succeeded in completing the privatization of the large number of socially-owned enterprises, but there remain very significant state-owned enterprises. In March 1999, Prime Minister Janez Drnovsek announced Slovenia would begin privatizing two of the three state-owned banks during 1999.

D. Accession with the European Union

Certainly the greatest stimulant for rapid legal reform in the CEE states has been the desire to become members of the European Union (EU). While membership means sacrificing some of the sovereignty these states have only

recently realized since the breakup of the Soviet Union, this price is outweighed by the economic and political security membership promises. There are also many cultural and psychological benefits for the people of these states as they turn their focus from the East back to the West.

1. Effect on the Legal Environment of Business in CEE

A prerequisite to membership in the EU is the alignment of national law with the vast body, 80,000 pages, of European Union laws and regulations known as the *acquis communautaire*. There are two aspects to this: first, adopting or revising laws and regulations in accord with the *acquis*; and second, having in place administrative and legal systems able to implement and enforce the *acquis*. The *acquis* itself is extremely detailed and covers a wide range of trade and non-trade matters. It will take years to be adopted by applicant states. Yet the second aspect, implementation and enforcement, may prove even more problematic. This requires having effective administrative agencies, judiciaries, and law enforcement bodies able to apply the laws in practice.

Almost every aspect of doing business in the CEE states will be affected by the *acquis communautaire*. For example, it contains detailed regulations covering, *inter alia*, competition, employment, the environment, taxation, privacy, consumer protection, accountancy, company law, professional certification, and public procurement. It also regulates particular industries like agriculture, energy, telecommunications, transportation, and pharmaceuticals.

As the CEE states adopt these new laws and learn to apply them consistent with the way they are being applied in the EU, they are likely to undergo significant turmoil and change. For example, industries that once enjoyed a high level of government protection, now will find themselves in open competition with companies throughout the EU and worldwide. Without pressure to conform to the standards of the EU as a condition of membership, it is unlikely such profound changes could take place, as it appears they will, within a single generation.

2. Progress Towards Accession

The five states studied in this paper, along with five other CEE states, have formally applied for membership in the EU. To become members they must meet requirements set out by the European Council in Copenhagen in June 1993 as follows:

"The associated countries in Central and Eastern Europe that so desire shall become members of the Union. Accession will take place as soon as a country is able to assume the obligations of membership by satisfying the economic and political conditions. Membership requires:

- that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities;

- the existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the Union;

- the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union.

The Union's capacity to absorb new members, while maintaining the momentum of European integration, is also an important consideration in the general interest of both the Union and the candidate countries."

Membership will occur only after first receiving a favorable opinion from the European Commission, negotiation of the terms of accession, approval by the European Parliament, approval of a treaty of accession by the European Council, and finally ratification of the treaty by all the EU Member States in accordance with their law.

The European Commission has analyzed the applications of the ten CEE states, and in July 1997 it issued an opinion on each. The Commission concluded that five of the states, the Czech Republic, Estonia, Hungary, Poland, and Slovenia, were sufficiently close to meeting the quoted economic and political conditions such that negotiations for accession could be opened. The same conclusion was reached with respect to the application of one non-CEE state,

Cyprus. Together these six states make up what is known as the "first wave" of applicants for accession.

The other CEE applicants, Bulgaria, Latvia, Lithuania, Romania, and Slovakia, all were found to be too far from meeting one or more of the criteria for membership and were relegated to the "second wave" of applicants. Accordingly, negotiations for accession with these states will not occur until sufficient progress has been made in meeting the criteria.

With the election of a new, more democratic and pro-EU government in Slovakia in 1998, it is now considered likely that Slovakia will be joining the first wave of applicants, perhaps as soon as December 1999.

When these applicants will become members is hard to say, and the EU has not been willing to set any target dates. The applicant governments had hoped to be admitted by 2000, but now are targeting 2002 - 2004 for accession; the EU has been hinting it will be 2005 at least. The final decision of course will depend not just on how well the applicants have conformed their law to EU law, but will instead be largely a political as well as economic decision.

III. Conclusion

What once were communist states are now for the first time in forty years enjoying freedom, democracy, and economic vitality. These states now have in place a legal environment that is conducive to investment, invention, and trade. The transformation, however, is incomplete, and businesses in Central East Europe face legal risks and difficulties beyond those found in Western Europe and North America.

First, the CEE states have much slower and less reliable systems of dispute resolution. Businesspeople therefore must anticipate problems with enforcing claims through litigation and look instead to alternatives.

Second, corruption is a more serious problem than in the West. The CEE states are making efforts to combat this however. Should they fail, corruption could jeopardize their social, political, and economic goals.

Third, although the CEE states are rapidly adopting modern commercial laws, for example in the areas of contracts and intellectual property, it will take time before they have the capability to apply and enforce the laws effectively.

Looking back only ten years, one sees that extraordinary progress has been made. An important stimulus for such rapid change has been the goal of the CEE states to align themselves with Western Europe through membership in the European Union. It may be another five, ten, or twenty years before they achieve accession; but by the time they do, they will have brought about a remarkable transformation of their political, economic, and legal systems.

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