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CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES IN THE CZECH REPUBLIC

Comparison of Corporate Governance of State Enterprises and Business Corporations

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The author is interested in the comparison of state enterprises and joint-stock company with state participation, as both are types of state-owned enterprises. The author concludes that the state unjustifiably favours state enterprise.

KEYWORDS:

company law, business law, corporate governance, state-owned company, Czech Republic

This paper discusses the legal regulation of the participation of the Czech Republic in legal entities focused on business and an appreciation of the legislation and practice from the perspective of OECD recommendations for entities with state participation as revised in 2015.¹ For the purposes of this article, we define an enterprise with participation of the state as a legal entity whose primary, but not sole, purpose is business, and in which the state has participation. The concept of an enterprise with state participation in this article follows the concept of enterprise under European law, but it is a subcategory which is also characteristic of legal personality, in addition to the state's participation.

Firstly, let us explain the system the state uses for the organization of state property. In basic classification, we can distinguish state organizational units and state organizations. The state organizational units do not have legal personality; they are only the internal division of the state, but with their own name, registered office and competences. Some of them are individual accounting units. They do not own property. They act on behalf of the state. Examples are ministries, other administrative offices, courts, etc.² On the other hand, state organizations have legal personality but they differ from other legal entities that do not have their own property, but manage state property. Under state organizations, we can include semi-budgetary organizations³ and state enterprises.⁴ While the primary purpose of the state enterprise is business, it is not as much for the semi-budgetary organization as for the other kind of state organization. Although these may also be involved marginally in the business, their primary mission is yet another: the fulfilment of public interest, e.g. the operation of schools, nurseries, hospitals, museums, theatres, etc. As legal entities of private law, they are closer to being institutes.⁵ The nature of a state-owned enterprise is not only state enterprise but also business corporation with the majority participation of the state; but this cannot be classified as a state organization. We can speak of them both together as state-owned enterprises.⁶ They are only the subcategory of state-owned entities, among them, we can reckon all listed above entities, i.e. state organizational units and state organizations.

1 OECD Guidelines on Corporate Governance of State-Owned Enterprises [available from www.oecd.org/corporate/guidelines-corporate-governance-SOEs.htm]

2 In detail: PLÍVA 2001, 8. Also BAKEŠ 2005, 139.

3 In detail: MITWALLYOVÁ 2014, 772 et seq.

4 In detail: PLÍVA 2001, 18.

5 Civil law divides legal entities into three basic types: corporate, foundation and institute. An institute is defined as a legal entity created for the purpose of pursuing socially or economically useful activities using its personal and property resources. An institute pursues activities the results of which are equally available to everyone under predetermined conditions (sec. 402 Civil Code).

6 Theoretically, we can imagine that the nature of the state-owned enterprise will also be a semi-budgetary organization in a particular case.

In short, state-owned entities are state organizational units,⁷ state organizations,⁸ including state enterprises⁹ and business corporations.¹⁰ Only a part of them can be described as state-owned enterprise. We can still come across as state-owned enterprise which is a national enterprise. A specific case of a legal entity as a national enterprise is Budějovický Budvar, n. p.¹¹

How can we define a state-owned enterprise? There are three regular characteristics: 1. economic activity, 2. public policy objectives and 3. ownership and control of the state. Economic activity shall be the main purpose of existence, not only an additional purpose which we can recognize in some semi-budgetary organizations. Economic activity does not mean that its subject matter shall be only business, i.e. the purpose is only achieving profit. Economic activity is included and provision paid services given to the public. The public policy objectives can or cannot be given. The public policy objectives are not a necessary condition for inclusion among state-owned enterprises. This qualifying characteristic is declared, for a state enterprise, in the State Enterprise Act. But it is mostly absent in a joint-stock company with state participation. We can say that between economic activity and public policy objectives there is an indirect relation. The more the state-owned entity focuses on economy activity the more the importance of public policy objectives decrease. And vice versa, the more the importance of public policy objectives increase the more the state-owned entity is dependent on the state budget.

The last characteristic of state-owned enterprise is the ownership of the state.¹² The ownership and control by the state can be direct and indirect. State enterprises and business corporations with state participation can found and participate in other business corporations. The problem is that the state's attention, as owner, is paid only to direct state-owned enterprises and not to indirect state-owned enterprises. While directly-owned enterprises have a stricter regulation, indirectly-owned enterprises have a paradoxically freer regime. For example, the approval of the state as founder is required for many kinds of acting by state enterprise.¹³ But when a state enterprise establishes a limited liability

7 Their position in the management of state property is regulated in the Act no. 219/2000 Coll. on Property of the Czech Republic as amended (State Property Act). The questions regarding rules of economy are regulated in the Act no. 218/2000 Coll. on Budget Rules as amended (Budget Rules Act).

8 Their position in the management of state property is regulated in the Act no. 219/2000 Coll. on Property owned by the Czech Republic as amended (State Property Act). Questions regarding rules of economy are regulated in the Act no. 218/2000 Coll. on Budget Rules as amended (Budget Rules Act).

9 State enterprises are regulated in the Act no. 77/1999 Coll. on State Enterprise as amended (State Enterprise Act). This article reflects the valid wording after the last amendment by Act no. 253/2016 Coll., which will become effective on 1 January, 2017.

10 Business corporations are regulated in Business Corporations Act (Act no. 90/2012 Coll.) and Civil Code (Act no. 89/2012 Coll.). The state can be a founder only of a joint-stock company (sec. 28 State Property Act). For specific conditions the state can acquire participation in other forms of companies, but not by foundation.

11 Budějovický Budvar, n. p. is an important producer of beer. The reason for the unmodified form of this legal entity and conservation originating from the period of socialism is the fear of weakening rights to trademarks, which form a significant part of the value of the business enterprise.

12 Also counties and municipalities can own enterprises. They can establish their own semi-budgetary organizations and business corporations without any legal limitations. They cannot set up a state enterprise because a state enterprise can be established only by the state.

13 Sec. 17–17e State Enterprise Act.

company, then this company is not under this strict regulation. The difference is also this: for the foundation of a business corporation, the state represented by ministry needs the approval of government and the state can only establish a joint-stock company.¹⁴ However, only the approval of the ministry is required for foundation of business corporation by state enterprise and there is not any restriction on choice of forms of business corporations.¹⁵ In both cases the state assets for foundation are used. These differences are not reasonable and justified. The question is if the state enterprises shall be titled as a founder of business corporations. De lege lata it is possible. But de lege ferenda it might be considered whether a better solution is to be prohibited or to set the same conditions, as in the case of the foundation of a business corporation directly by the state. In the case of the participation of the state in a joint-stock company, we can consider another problem. A joint-stock company with state participation can construct a complex structure of a group of companies but the state as a “final owner” is not in the same position as head of the group of companies as it would be if somebody else would be in its position. The reason in question is whether the state can be qualified to be a directing person.

If we look at more important entities with state participation from a substantive point of view, we find that they hold an important place in the national economy, namely in transport (České dráhy, a. s.,¹⁶ Řízení letového provozu, s. p.,¹⁷ Český Aeroholding, a. s.¹⁸), in the energy sector (ČEZ, a. s.,¹⁹ ČEPS, a. s.,²⁰ OTE, a. s.,²¹ ČEPRO, a. s.,²² MERO ČR a. s.²³), in the financial sector (Česká exportní banka, a. s.,²⁴ Českomoravská záruční a rozvojová

14 Sec. 28 para 1 State Property Act.

15 Sec. 17a para 3 State Enterprise Act.

16 The national railway operator is a joint-stock company (addition in business name is a. s.). The state is a sole shareholder.

17 The air navigation services operator is a state enterprise (addition in business name is s. p.).

18 A holding company manages four subsidiaries operated in air transport, namely the operator of Prague Airport, Czech Airlines etc. The state is a sole shareholder.

19 The most important company in the energy market with many subsidiaries (operator of many power plants, including the two nuclear power plants Temelín and Dukovany). The state owns 69% shares.

20 The operator of Czech transmission system. The state is a sole shareholder.

21 The Czech electricity and gas market operator. The state is a sole shareholder.

22 The company is engaged in transportation, storage and sale of petroleum products. The state is a sole shareholder.

23 The owner and operator of the Czech section of the Družba crude oil pipeline and the IKL crude oil pipeline, is the only transporter of crude oil into the Czech Republic and the most important company ensuring storage of strategic emergency crude oil reserves. The state is a sole shareholder.

24 Specialized bank for state support for export. The state owns 84% shares directly and 16% indirectly through Exportní, garanční a pojišťovací společnost, a. s.

banka, a. s.,²⁵ Exportní, garanční a pojišťovací společnost, a. s.,²⁶ Státní tiskárna cenin, s. p.²⁷), in agriculture (Lesy ČR, s. p.,²⁸ Povodí Vltavy, s. p.,²⁹ Povodí Labe, s. p.,³⁰ Povodí Ohře, s. p.,³¹ Povodí Odry, s. p.)³² or in society in general (Česká pošta s. p.)³³.³⁴

State participation in business is indirectly affected through joint-stock companies and state enterprises.

To differentiate these entities with state participation sufficiently, let us first examine what is the same and what is different for such legal entities.

A joint-stock company is regulated by the Civil Code and the Business Corporation Act, in specific cases as well as by other laws (e.g. in business on the capital market). A state enterprise has its own regulation in the State Enterprise Act, with subsidiary use of the Civil code provisions related to legal entities generally.

It is typical for joint-stock companies and state enterprises to be incorporated upon registration in the Commercial Register. The consequence of registration is very important because it means that state enterprises and joint-stock companies are in a position as an entrepreneur in all legal relations. The law therefore puts them under specific rules, e.g. stricter requirements,³⁵ giving them weaker protection,³⁶ creating a wider framework for the exercise of freedom of contract for them.³⁷ The purpose of the state enterprise is always business but a particular business which has given rise to major strategic, economic, social, national security or other interests of the state (sec. 2 para. 1 State Enterprise Act). The goal of a joint-stock company may not always be business; a joint-stock company can be established for non-profit purposes. In fact, the state uses a form of joint-stock company only for business, not for the other purposes.

Let us try to categorize enterprises with state participation, depending on whether they are a form of enterprise accessible only to the state or not. Among the most important enterprises

25 Specialized bank is focused on providing assistance to small and medium-sized enterprises. The state is a sole shareholder but its shareholder's rights are exercised by four ministries (ministry of finance, ministry of industry and trade and ministry of regional development).

26 A credit insurance corporation insuring credit connected with exports of goods and services from the Czech Republic against political and commercial risks is uninsurable by commercial insurance. The state is a sole shareholder but its shareholder's rights are exercised by four ministries (ministry of finance, ministry of agriculture, ministry of industry and trade, and ministry of foreign affairs).

27 The state enterprise mainly provides the printing of banknotes, stamps, *securities etc.*

28 The state enterprise mainly provides the management of state-owned forests.

29 The state enterprise is an administrator of watercourses in the Vltava catchment area.

30 The state enterprise is an administrator of watercourses in the Labe catchment area.

31 The state enterprise is an administrator of watercourses in the Ohře catchment area.

32 The state enterprise is an administrator of watercourses in the Odra catchment area.

33 The state enterprise is a provider of the universal postal services.

34 Attachment no. 1 to the draft of an act on the choice of persons for executive and supervisory bodies of state-owned enterprises.

35 For example, we can state information obligation (s. 434 and 435 CC) or consumer contracts.

36 For example, we can state confirmation letter (s. 1757 CC), presumption solidarity obligation (s. 1874 CC) and exclusion of the possibility to require the contract to be cancelled at *laesio enormis* or invoke an invalidity of usury (s. 1797 CC).

37 For example, we can state commercial terms (s. 1751 CC).

with state participation in number, but also in size, include commercial companies and state enterprises.

Commercial companies as sub-legal entities primarily aimed at businesses are open in principle to all persons. For limited liability companies and joint-stock companies, special conditions for shareholders are not required. Both forms of these companies can be established by only one founder.

On the other hand, the state enterprise is a legal entity which may be established solely by the state. It cannot be founded by other public corporations such as the county or municipality.

A state enterprise differs from joint-stock companies in many ways. A joint-stock company has its own property, while a state enterprise does not have its own property, it has a right to manage state property entrusted to it or that is acquired by its activities.³⁸ The assets of the joint-stock company are separated from the assets of shareholders. Stock law contains rules, which ensure that their own resources cannot be distributed to shareholders to the detriment of creditors.³⁹ In a state enterprise it does not apply. State enterprise disposes of state property. The state has legal tools that put it in a better position with the creditors than a joint-stock company and its shareholders.⁴⁰

We can distinguish state property in the managing of a state enterprise into two categories: indicated assets and the other assets. The indicated assets are specified in the Deed of foundation and registered in the Commercial Register. The state enterprise can dispose of them only with the previous approval of the state.

The state as a shareholder is not liable for the debts of the joint-stock company during its existence, after its termination it is liable for its debts up to the amount of their share of liquidation balance. The state is not liable for the debts of the state enterprise; neither is it liable for them after its termination.

In stock law, the protection of creditors is ensured by legal request to the creation of registered capital to the minimum amount. The same rule is absent in the legal provisions of state enterprise. Prohibition of undercapitalization is not stated as in other cases for the protection of creditors.⁴¹ Theoretically, a state enterprise can be founded without any property. We can conclude that in the beginning of existence the creation of capital is mandatory in the joint-stock company and in the state enterprise it is voluntary.

In a joint-stock company, shares are a manifestation of equity investment. Shares are securities and as such subject to separate legal relationships. The state can dispose of shares which it owns. There is no manifestation of equity investment in shares or any other thing

38 From sec. 8 para 1 sub b) State Property Act implies that state assets could be used for business, not only for fulfilling state functions and providing public benefit activities.

39 For example, we can mention the prohibition of the return of contributions, the prohibition of the distribution of profit and the other resources in the case of the threat of bankruptcy.

40 For example, the state can decide on the transfer of property in the management of the state enterprise to another state enterprise, state organization or state organizational unit free of charge (sec. 17–17e State Enterprise Act).

41 In detail: ČERNÁ 2015, 183 et seq.

in the legal sense in the state enterprise. The reason is that only the state can be a founder, nobody else. The assets of a state enterprise may be privatized.⁴² But there is a substantial difference. On privatization, the state enterprise is terminated. We can say that privatization is similar to a transfer of business enterprise in private relations. This means that the privatized enterprise is absolved from obligations of a public character (as taxes) and obligations of a private character in relation to the director and the members of the supervisory board of the state enterprise.

Other important differences are found in the organizational structure. A joint-stock company is entitled to choose between one-tier or two-tier structures. The member of its body can be a natural or legal person. The minimum number of members is not regulated. Codetermination is basically not required. A state enterprise creates only a two-tier structure. The executive body is a director. The controlling body is the supervisory board. The director is unipersonal.⁴³ The supervisory board is multi-personal.⁴⁴ Only a natural person may be a director or a member of the supervisory board.⁴⁵ One third of the supervisory board members are elected by employees.⁴⁶ The director and the members of the supervisory board of the state enterprise are obliged to exercise their functions with a duty of care and loyalty. But there is a difference in the space of responsibility. The State Enterprise Act reduces the responsibility of the director as if he was in the position of employee.⁴⁷ The same is substantially applied to the members of the supervisory board.⁴⁸ This moderation of duty of care cannot be considered as “commonly accepted corporate norms” as recommended by the OECD Guidelines.

If we look at the rules relating to representation – a legal person as a member of its body in a manner registered in a public register – the Civil Code generally sets the norm that no one may invoke that the legal person failed to adopt the necessary resolution, that the resolution was defective, or that a member of the body breached the resolution adopted (sec. 162 CC). For business corporations an exception is given in sec. 48 BCA from this rule for so called “legal limitation”. Legal limitations mean legal acts to which the law requires the approval of the general meeting. The consequence of acting without approval is a possibility to request invalidity. Cases where the approval of the general meeting is required by law are few, e. g. sale or pledge of business or a substantial part⁴⁹ or the conclusion of a contract on silent partnership.⁵⁰ Next to legal limitations, we can distinguish internal limitations.

42 The process of privatization is mainly regulated in the Act no. 92/1992 Coll. on transfer of the state property to other persons as amended. A business enterprise managed by state enterprise may be subject to contribution into joint-stock company or subject to sale.

43 Sec. 12 para 1 State Enterprise Act.

44 Sec. 13 para 2 State Enterprise Act.

45 Sec. 13 para 3 State Enterprise Act.

46 Sec. 13 para 3 State Enterprise Act.

47 Sec. 12a para 2 State Enterprise Act.

48 Sec. 13 para 4 State Enterprise Act.

49 Sec. 421 para 2 l. m) Business Corporations Act.

50 Sec. 421 para 2 l. o) Business Corporations Act. In detail: EICHLEROVÁ 2015, 249 et seq.; ČECH – FLÍDR, 2015, 9 et seq.

Internal limitations are only an internal request for approval by the other bodies (the supervisory board or the general meeting) given by the Articles of Association. A breach of these rules is not effective for third parties.⁵¹ For state enterprises legal limitations are provided in sec. 16 of the State Enterprise Act. The scope of legal acts for which previous approval of the state as a founder under law is required is substantially wider than in the case of business corporations. Previous approval is required for the pledge of state property,⁵² disposal of indicated assets,⁵³ acquisition of participation in legal persons,⁵⁴ transfer of real property free of charge.⁵⁵ The consequences of an absence of approval are the same as in the case of business corporations: a possibility to request invalidity. The law for request invalidity is also connected with the absence of prior approval required by statute of a state enterprise. And here a problem arises, because such restrictive rules in the Statute have the character of internal rules. The state transfers risk connected with wrongly chosen persons to the bodies of state enterprise to a third party entering into legal relations with the state enterprise. This gives rise to unreasonable inequality in rights and obligations, which does not contribute to security of trade. Additionally, this can be considered as a rule inconsistent with the recommendation of the OECD Guidelines to respect the generally applicable rules of corporate law.

In March 2014, the government set up the Government Committee for staffing nominations as an advisory body. The committee has three members and its role is to consider the nomination of candidates for members of the supervisory boards of state-owned enterprises. Its opinion is not binding for ministers as persons to whom the final decisions belong. Currently, the draft of an act on the choice of persons for executive and supervisory bodies of state-owned enterprises is in the legislative process. This act should detail modifications to the nomination process, extending to executive members of bodies and will make it binding. The draft Act extends the requirements for the exercising of members of bodies for indebtedness and a certain level of professionalism. What will be the fate of this legislative intent cannot be anticipated. It can be assumed that this nomination process might not be regulated by law, but merely by government resolution. Legal regulation again raises the question of the consequences connected with failure of the prescribed procedure for state-owned enterprise.

In passing, I would like to mention special conditions regarding state employees and some public officials. They may not be members of executive or supervisory bodies of business corporations operating in business, with the exception of cases where the state sent them to these bodies.⁵⁶ In such a case they are required to act in the interest of the state. They are not required to be remunerated by business corporations. The obligation to exercise the

51 Sec. 47 Business Corporations Act.

52 Sec. 16 para 7 State Enterprise Act.

53 Sec. 17 para 2 State Enterprise Act.

54 Sec. 17 para 3 State Enterprise Act.

55 Sec. 17e para 2 State Enterprise Act.

56 Sec. 81 para 2 Civil Service Act (no. 234/2014 Coll. as amended), sec. 303 para 3 Labour Code (no. 262/2006 Coll. as amended), sec. 4 and 5 Conflict of Interest Act (no. 159/2006 Coll. as amended).

function of a body member with due care and loyalty is unlimited. Remuneration is a basic motivational element in corporate governance. Its removal may endanger the functioning of business corporations with state participation.

CONCLUSION

In conclusion, we can say that the legal regulation regarding state enterprise as a specific legal person created solely for state participation in business is unjustifiably favourable compared to legal regulation regarding other legal persons. The question is whether the state as a legislature abuses its position to provide a greater protection of its interests than it provides other persons in the private sector. The question is whether a state enterprise as a legal person should exist and whether it would be desirable that the state uses for business only types of legal persons which are open for other persons, i.e. as a joint-stock company.

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