DEVELOPMENT OF LEGAL FRAMEWORK OF MERGERS ON THE TERRITORY OF TODAY’S CZECH REPUBLIC BEFORE 1938

KONEČNÝ, ALOIS; VALOUCH, PETR
Department of Finance, Faculty of Economics and Administration
Masaryk University
Lipová 41a, Brno
CZECH REPUBLIC
alois@econ.muni.cz    https://is.muni.cz/auth/person/62535?lang=en
valouch@econ.muni.cz    https://is.muni.cz/auth/osoba/valouch?lang=en

Abstract: In the article “Development of legal framework of mergers on the territory of today’s Czech republic before 1938” we aim to analyse, compare and find differences between individual legal regulations and subsequently highlight reasons which led to the creation of the various concepts of the attitude to the valid legal framework. The work consists of two basic parts – the so called Austrian period and the period of Czechoslovakia between 1918 and 1938. In each of these chapters we will make effort to depict not only the formal side of things but also the substance of mergers over the given period as well as relating issues and other characteristics of the subject matter (such as charges). As we will explain, the differences were huge and had several important causes.

Key Words: Merger, legislation, Czechoslovakia, Czech countries, Austrian period, General Commercial Code

1 Introduction
It is always important to learn about historical development of social sciences when studying these (i.e., in our case, economic and legal sciences). The proverb saying that “those who do not understand history are bound to relive it” is applicable here. An insight into transformations of legal regulations enables a better understanding of the way individual institutions were developing – in relation to the development of the period, of course.

We have decided to pursue legal framework of mergers on the territory of today’s Czech Republic in this work. We hope that this analysis, resulting in the future in comparison with the present state of affairs, will facilitate understanding of the development and comparison of individual legal regulations of a given area, which would consequently lead to our outlining possible changes.

Mergers, along with acquisitions, i.e. various forms of business alliances (the terms merger and acquisition are rarely or not at all used over most of the time period we will deal with) fit into a wider area of law, i.e. law on trading partnerships and commercial law. That is why we will briefly present the development of the whole area at the beginning.

Due to the fact that Czech countries gained independence relatively recently, a part of the work will be devoted to the legal regulations of the political systems Czech countries used to be a part of.

As finding a common definition of mergers or other processes corresponding with the term is likely to be difficult, we will have to make do with a general description when looking for processes in which formerly independent entities merge/get together/integrate etc. and during which one or more of these cease to exist.

It is important to point out at the beginning that where we mention the language of specific legal sources, it is the language of the date of its origin, or a different date (which is mentioned in such case). Where we speak of contemporary regulation in force, we refer to the situation of 15 November 2011.

Although we will deal with development of a modern legal regulation of a given area in this article, it must be said that all modern legal constructions in our region are derived from Roman legal framework. The core of legal regulation on trading partnerships arose from the original societas iuric civilis, i.e. units without legal entity which were established by a social contract laying obligation solely upon partners, but not upon external individuals. New partnerships, on the other hand already had their special assets separated from private property of partners and also not only
unlimited and immediate liability of partners, but gradually also joint liability and enterprising of partners under a joint venture. This led to the creation of the first general partnerships in north Italian cities of the 15th century and later also of limited partnerships. Only many years later did the first capital partnerships, especially public companies come into existence (in 1602 in Holland, 1603 in Britain, in 1628 in France etc.) In the 18th century we could see a rise in the number of partnerships companies limited by shares. [2, p.42-43]

This contribution was initiated as a part of no. 403/11/0447 GACR project called Analysis of Accounting and Tax Procedures in Mergers.

2 Problem Formulation
The first stage of the solution of the above mentioned project consisted not only in obtaining and analyzing the input data on the mergers implemented among commercial entities but in finding the reasons leading to such a development too.

Therefore, we have decided to pursue legal framework of mergers on the territory of today’s Czech Republic in this work. We hope that this analysis, resulting in the future in comparison with the present state of affairs, will facilitate understanding of the development and comparison of individual legal regulations of a given area, which would consequently lead to our outlining possible changes.

Mergers, along with acquisitions, i.e. various forms of business alliances (the terms merger and acquisition are rarely or not at all used over most of the time period we will deal with) fit into a wider area of law, i.e. law on trading partnerships and commercial law. That is why we will briefly present the development of the whole area at the beginning. Due to the fact that Czech countries gained independence relatively recently, a part of the work will be devoted to the legal regulations of the political systems Czech countries used to be a part of.

The methods used in this paper include analysis, comparison and literary research.

3 Problem Solution
3.1 Austrian period
In that period the law of partnerships on the territory of the Hapsburg monarchy was regulated by a series of laws valid for individual countries of the monarchy, and also customary law was in force. In the following years there were efforts to integrate the codification, which gradually led to the formation of a variety of draft proposals for an Austrian commercial code (in 1809, 1842, 1855 and 1857). As for this period, we must not forget the Imperial patent no. 946/1811 Coll., Common Civil Code (further ABGB from the German expression). This patent later became, as lex generalis, a secondary legal source of the commercial code as lex specialis.

However, there were no further autonomous codification attempts thanks to strengthening tendencies of states of the German federation to push through a single legal regulation for all states of the federation. In 1861 these efforts resulted in a formation of common Austro, Prussian and Bavarian proposal, which was submitted for approval to individual federal governments. Austria enacted (but for the fifth book of the proposal concerning marine law) no. 1/1863 law of imperial code which was applicable to Czech countries as well. [5, p.22]

Taking into account other legal acts dealing with the area of mergers which were applicable to Czech countries, we must not omit regulation no.175/1899 of imperial code, stock regulation, which regulated details of formation and transformation of public companies, and also act no. 58/1906 of IC on limited liability companies, which dealt with similar subject matter.

3.1.1 The content of legal regulation in force
The legal regulation of that time, defined by the above mentioned legal enactments, described the terms we look into rather differently from our perception of them today. Despite the fact that the expression “merger” was generally used for merging of two large enterprises, which by the practice of that time did not have to be public companies, legally they had to be. This rigid interpretation was based on para.1 of art; 247 GCC, one of few articles dealing explicitly with regulation on mergers. According to it a merger gave rise to a new company, which continued to run two or more of the former companies. The expression takeover was used to describe an alliance of a large and a small company (when a general partnership takes over a sole proprietorship).

For a transaction to be considered a merger in accordance with para.247 GCC, the following criteria had to be met: [3, p.10 onwards]

• property must be transferred to another, exclusively public company. However, it was
possible to avoid the strict interpretation, as described later in the article.

- property must be transferred in any case – this means dissolution of one of the companies involved (in the sense of now in force act no.513/1991 Coll., of commercial code – further only CC). This means that various forms of agreement concerning sharing profits and losses were not considered a merger.

- the continuing company must take on partners (shareholders) of the company that is being dissolved as their members. A merger is considered to be such transformation of a company, when shareholders of the dissolved company are compensated for with shares.

- assets of the dissolved company can only be transferred to an already existing company. Moreover, unless stated differently in the contract, the lines of business of dissolved and acquiring companies must coincide (art.215 of GCC).

Dissolution of one or more companies involved is an essential characteristic of mergers. Therefore a substantial part of legal regulation usually focuses more on the company which is dissolved and relating protection of owners’ rights and especially on creditors, whose legal position does not allow them to protect themselves. This de facto means protection of proprietary rights, which was included in the Austro-Hungarian legislation too.

Compulsory split administration of the dissolved company was the most significant obligation leading to total appeasement or assurance of creditors’ rights. This meant that until all creditors’ rights were satisfied, both companies had run their businesses separately, which ensured that the acquiring company could not deal with assets of the dissolved company (art. 247, no.1 of GCC). Moreover, art.245 of GCC specified that “The assets of a dissolved public company will be, after debt repayment, shared out among shareholders according to the number of shares they hold.” According to para.2, art. 202, creditors traceable in commercial papers of the dissolved company had to be summoned to claim their rights, and in case of not doing so, their receivables were placed with the court.

Other protective measures were defined by art.247 of GCC. According to no.2 and 3, during split administration the dissolved company could not turn to a different competent court of justice, and creditors of the dissolved company had to invoke their rights at the newly established company, but at the originally competent court. And last, but not least, companies were also liable to notify, as regulated by no.4 ibid, which meant an obligation to enter the merger into a commercial register. The same liability was repeated in art.243 with the ordinance that it was necessary to announce the particular event “at three different times in a public newspaper chosen for this purpose”.

Companies were also obliged to apply for a state permission to merge.

As for public limited companies, from legal point of view there were: [3, p.11]

- merger linked with liquidation of a company – in this case the shares (compare [3, p.48) of a continuing company were assigned directly to the dissolved company, which was subsequently liquidated. The dissolved company either allocated the shares to its shareholders as a lump-sum settlement or cashed them in and shared the cash out among them. This was a way of evading the rigid interpretation of the GCC, according to which payment to shareholders was carried out not as a consequence of a merger but of dissolution of a company with subsequent liquidation. Nevertheless, GCC did not explicitly exclude such transaction and that is why it was commonly used in the economy of that time [5, p.322).

- merger without liquidation of a company – shares of a new company were directly issued for shareholders of the dissolved company, and the company was dissolved immediately. This procedure seemed to comply more with the spirit of the law.

Apart from the above stated statutory conditions, the boards of merging companies had to agree on the so called merger agreement first (which automatically meant complying with the above stated conditions of mergers) and the whole transaction then had to be approved unanimously at general meetings of the companies involved. Approval procedure followed two steps, when at the general meeting of the dissolved company a resolution about dissolution of the company was adopted and when the continuing company decided to merge, or more precisely increase the share capital and take over assets and liabilities of the dissolved company. However, consolidation of assets is possible (art.245 in connection with art. 247, no. 5) “no sooner than a year from the date of the third announcement of the event in the public newspaper designated for the purpose (art.243)”. In a later version, the period was shortened to three months [5, p.323]. The merger is over when new shares are underwritten and entered into commercial
possibility of a merger (consolidation) provided in exchange and if both parties give up limited liability legally implemented (para.84) a no.58/1906 of imperial code on companies with companies were also possible. For instance, act subsequent laws, we will see that mergers with other types of trading companies. When we look at it was caused by nonBexistence of legislation on public limited companies expunged from the register.

The original version of GCC allowed only public limited companies to merge. Nevertheless, it is important to take into consideration the fact that it was caused by non-existence of legislation on other types of trading companies. When we look at subsequent laws, we will see that mergers with other companies were also possible. For instance, act no.58/1906 of imperial code on companies with limited liability legally implemented (para.84) a possibility of a merger (consolidation) between a limited liability company and another company with limited liability and also between (the order is important) a limited liability company with a public limited company. Para.96 explicitly states that “Liquidation will not be executed if the assets of a limited liability company are transferred as a whole along with its debts to a public limited company and if shares of that company are provided in exchange or if they are transferred to another limited liability company and corporate shares are provided in exchange and if both parties give up liquidation. Any other issues must comply with regulation in accordance with art.247 CC. It must be emphasized here that thanks to the coercive character of the regulation, partners with limited liability of the dissolved company always had to be compensated for with equity shares of the continuing limited liability company.

When a public limited company was to merge with a limited liability company as a continuing company, it was necessary to keep to a standard formal procedure. The first option enabled a merger without liquidating companies – a company was first transferred into an Ltd (para.97, act no.58/1906 Coll.) or a Plc (similarly para.96 ibid) and consequently the companies merged.

The second option involved a preparation of liquidation of the dissolved company according to the regulation in force then. A competent majority (as specified in the articles of partnership) of partners (members) of the dissolved company had to approve the dissolution at a general meeting, then unanimously approve a decision that liquidation will not be done by cashing assets but by transferring them to the acquiring company, and finally unanimously declare that they do not request redemption of their shares in cash, but agree to have them exchanged for shares of the continuing company. At the general meeting of the acquiring company measures were adopted to take over assets and liabilities. [4, p.41]

Prior to this procedure, however, it was recommended that all creditors of the dissolved company express their consent with the shift in the person of debtor. Their disapproval would lead to a regular dissolution. There were other pitfalls to the entire procedure, such as procrastination and the need of unanimous approval of all partners, and others.

Another form of company which was subject to mergers was an association, as defined by act no.70/1873 IC on trade associations supporting trade and economy. The law itself did not deal with mergers and that is why other procedures were used. Jurists (Wenig) maintained that mergers between associations (by transfer of assets and liabilities) were not possible. The economic need enforced specific practices, which were consequently acknowledged by the Supreme Court and were characteristic of the following [4, p.35-36]:

• General Meeting (further only GM) of a merging association agree on liquidation and puts an obligation upon receivers to prepare the liquidation so that the assets of the association can be transferred as a whole to the acquiring association, while boards (later approved by GM) of the associations preliminarily agree on a merger. Receivers then, among others, draw a balance, a proposal concerning the size of compensation for the members of the dissolved company (as a rule in the form of shares of the acquiring association) and the method of its acquisition. The act no.70/1873 IC, para.3 stated that “Members or shareholders approve the association through a written declaration.”

• the board of the acquiring association will, on the basis of a balance prepared by receivers, draw their own balance specifying assets and liabilities of the dissolved company and determine the number of corporate shares to be acquired by members of the dissolved association.

3.2 Czechoslovakia 1918 till 1938

However strange it may seem at first sight, the legal regulation in Czechoslovakia between its formation and 1938 may also be defined as the “Austrian” period. After the creation of the Czechoslovak republic, all existing regulations in force on the territory of the republic before its creation were adopted by the so called reception act no.11/1918 Coll. This amendment was later (by act no.76/1920 Coll. and by governmental decree no.152/1920 Coll.) extended to the Hlučín area, which was acquired through a peace treaty with Germany.
With emergence of laws of the new republic specifics concerning mergers started changing. It was e.g. necessary to abide by a decree no.465/1920 Coll. (concerning establishment of limited liability companies and public limited companies (limited by shares) on increasing equity capital of such companies and establishing subsidiary institutions), which, in case equity capital of such companies increased during a merger, now required (and this was the same for public limited companies) approval of the minister of interior trade (following prior hearing of the ministry of finance).

Practical issues led to initiation of works on a new commercial code in the 1930s. However, for a variety of, mainly political reasons, the whole process did not lead further than to a draft (in 1937 a part called The Draft of the Commercial Code was published in print).

### 3.2.1 The content of legal regulation in force

In 1924, act no.279/1924 Coll. on transformation of a limited liability company into an association came into effect and enabled mergers between various types of companies. A public limited company could (as a company which is dissolved) consolidate with an association, in such a way that (para.97 of act no.58/1906 of IC) it was first transformed into a limited liability company and this was subsequently, thanks to this law, transformed into an association. The transformed association could then (until 1939) merge with the original association following the procedure described at the end of previous chapter.

The decree above stipulated (part I, sect. A) procedure and conditions of mergers of associations in a way similar to the amendments of regulations of GCC mentioned earlier with respect to mergers of public limited companies, with exact quotation here and there. Among others, when associations merged, rights and liabilities, as well as trade and other certifications of a dissolved company were transferred ex lege, Members of a dissolved company were guaranteed the right to turn down transfer ex lege, Members of a dissolved company were guaranteed the right to turn down membership in the new association in a time limit. The only substantial difference was para.3, no.1, which stated that to approve a merger agreement, a majority “of at least three quarters of members present at the GM” suffices.

### 3.2.2 Taxation of mergers and related charges

Taxation of mergers grew in significance in the beginnings of the 1st Republic. When two companies merged, it was important (para.96, act no.220/1896 of IC. on income tax) to tax the difference between the cost price and the selling price, i.e. liquidation surplus. However, as the cost price was the historical price of the time of purchase (in “pre-war crowns”) and the selling price was set at a new, higher price level (in devaluated currency), by definition, there was no profit and also the so called liquidation tax (of 10% plus war and especially substantial autonomous surcharges) was not appropriate.

The first attempt to settle the situation came through an act no.293/1921 Coll. and decrees, an amending law on income tax, exempting from tax only pre-tax advance payments, funds and other surpluses generated during “mergers of enterprises”. It did not eliminate the main impediment of mergers, i.e. foreign exchange differences. Neither did it pay much attention to transformations of specific types of enterprises entering mergers (see above) nor remove capital issue charges, transfer tax, turnover tax, accrual property tax and others [3, p. 15-23]. The law was later amended by a governmental decree no.247/1921 Coll. and decrees, specifying individual cases of exemption.

Act no.151/1923 Coll. alleviated the tax burden further. It set that for mergers of public limited companies, limited liability companies and “publicly charging enterprises, the property transfer is exempt from transfer as well as from depository charges.”

Except for some modifications, the above mentioned legislation on relief from charges and taxes on mergers remained in force (acts no.151/1923 Coll. and no.163/1924 Coll.) until the end of 1925. It was because legislators found out that the original deadline of 23 July 1924 was too tight. Not only was it necessary to approve a merger agreement between individual contractual parties, but it was also necessary to receive a state permission for the tax exemption in due time.

For mainly economic welfare of the country, mergers and transformations continued to be backed by relief from tax and other charges. There was a law, which was analogous to act no.153/1923 Coll. and that was act no. 88/1927 Coll. on tax relief on mergers and transformations of legal forms of enterprises. Again, it set that mergers of public limited companies, limited liability companies and also associations are liable to property transfer and also depository charge relief. Originally it was supposed to be in force until 1929, but its effectiveness was protracted until 1938. On all newly issued shares it was still necessary to pay a charge, the sum of which was based on the higher one of nominal and issue prices. There were exceptions of exemption from this and other charges (building societies, pension institutions etc.), but these were not numerous.
Act no.153/1930 Coll. was one of the protracted laws, which, in addition, in para.3 (para.1 and 2) stated: “For very serious economic reasons, the government can allow, along with a proposal between the ministry of finance and another participating ministry, that also in other cases of mergers and transformations of legal forms of companies, relief on tax and other payments generated from such deals is granted or that these charges are completely or partially waived, should they pose a hindrance to the due transaction.” The same applied to municipal rate on accrual tax on property or property or share transfer connected with such transaction.

4 Conclusion
In the article we have tried to outline gradual (even if turbulent at times) changes in the legal regulation on corporate mergers. The first legal regulation on our territory came into existence in the form of General Commercial Code in 1863. The GCC introduced mergers as such, but the regulation was short and only public limited companies were subject to mergers. The whole concept was rather rigid. Further development was enhanced by adoption of new laws, such as stock regulation or act no.58/1906 of imperial code on limited liability companies. Apart from specifications of the procedure itself, legislation also started dealing with legal protection of rights of creditors involved in mergers. Gradually, other procedures enabling mergers between parties, whose alliances had not been regulated by law previously, emerged in economic practice. These transactions were mostly based on transformation of legal forms of merging entities.

When Czechoslovakia was established, the legal system of the former monarchy was taken over and as time went by, first amendments were made. Despite efforts to form a new commercial code, for a variety of reasons (mainly political) the original General Commercial Code remained in force throughout this period. The beginning of the 1.Republic was very interesting from economic point of view as a range of laws and governmental regulations dealing with taxes and charges were put into force. The regulation was aimed at facilitating mergers for economic reasons and also at mitigating consequences of a monetary reform disadvantaging mergers. The decree of government from the period of protectorate, which finally regulated mergers of associations, was very important. Until then only mergers of public limited companies and limited liability companies had been regulated.

References:
[1] Císařský patent č. 946/1811 sb.z.s.
[7] Zákon č. 70/1873 ř.z., o společenstvech pro napomáhání živnosti a hospodářství
[8] Zákon č. 220/1896 ř. z., o osobních daních přímých
[9] Zákon č. 58/1906 ř. z., o společnostech s ručením obmezeným
[10] Zákon č. 11/1918 Sb., o zřízení samostatného státu československého
[12] Zákon č. 279/1924 Sb., o přeměně společnosti s ručením obmezeným v družstva
[13] Zákon č. 88/1927 Sb., o poplatkových úlevách při splnění (fusi) nebo při přeměně právního útvaru některých podniků
[14] Zákon č. 153/1930 Sb., kterým se prodlužuje účinnost zákona ze dne 9. června 1927, č. 88 Sb. z. a n., o poplatkových úlevách při splnění (fusi) nebo při přeměně právního útvaru některých podniků, a doplňuje jeho ustanovení