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focus on

Venture Capital Transactions Under the Commercial Code of the Czech Republic

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Investors are becoming increasingly interested in the Czech Republic as a market for private equity and venture capital investments. In the last two years alone, numerous venture capital funds have been established whose investment mandate is to invest either wholly or partly in Czech companies.

In addition, although statistics on the total amount of private equity and venture capital investment in the Czech Republic are difficult to find, figures on direct foreign investment are available. According to CzechInvest, the Czech Republic's agency for foreign direct investment, in 2000 the Czech Republic attracted over US$4.5 billion in foreign direct investment, and the Czech government predicts that in 2001 the inflow of foreign direct investment will be even greater than that amount.[1]

To be sure, VC investing in the Czech Republic, as well as in central and eastern Europe in general, is at an early stage of development. In a recent survey of venture-capital backed companies, PricewaterhouseCoopers noted that most of the venture capital investments made in the participating companies were made since 1995.

Nevertheless, more and more foreign investors, namely from Western Europe and the United States, are considering this region for VC investments. As foreign investors look to make venture capital investments in the Czech Republic, they should understand the country's legal framework for venture capital investments.

Venture capital investments in the Czech epublic are largely governed by the Czech Commercial Code (the “CCC”),[2] which was most recently amended as of January 1, 2001. This article examines some of the basic elements of a venture capital transaction and how such elements are affected by the CCC.

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1. See http://www.czechinvest.org.
2. Act No. 513/1991 Sb., as amended.

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What is private equity and venture capital?

Private equity provides equity capital to enterprises not quoted on a stock market. Private equity can be used to develop new products and technologies, to expand working capital, to make acquisitions, or to strengthen a company's balance sheet. It can also resolve ownership and management issues, such as through a management buy-out (MBO) or buy-in (MBI).

Venture capital is, strictly speaking, a subset of private equity and refers to equity investments made for the launch, early development or expansion of a business. Among different countries, there are variations in what is meant by venture capital and private equity. In Europe, these terms are generally used interchangeably and venture capital thus includes MBOs and MBIs. This is in contrast to the U.S., where MBO/MBIs are not classified as venture capital.

For purposes of this article "venture capital" is used in the broader, European sense.

Legal form of target

The CCC provides for a variety of company forms, including general commercial partnerships, limited partnerships, limited liability companies, and joint stock companies. Although a full examination of the advantages and disadvantages of these forms (including, importantly, the tax aspects) is beyond the scope of this paper, the preferred form of the VC target entity usually comes down to a joint stock company (an akciova společnost, or "AS") or a limited liability company (a spolecnčost s ručením omezeným, or "SRO").

Under the CCC, both company forms can issue equity interests that have (1) dividend and liquidation preferences, and (2) contractual transfer restrictions.[3] In fact, an SRO's equity interest (*obchodní podíl* or "ownership interest") can even have voting rights in excess of its economic interest;[4] an AS's equity interest (*akcie* or "share") cannot. Furthermore, neither company form can be obligated to redeem stakeholders' equity interests, except under very narrow circumstances.[5]

On the other hand, an SRO cannot issue convertible securities, but, as discussed below, an AS can issue convertible debentures and warrants. Moreover, under the Czech Securities Act,[6] SRO ownership interests cannot be listed for trading on a public market, but AS shares can. Therefore, an AS offers the VC investor both the "upside" benefits of a convertible security and the exit strategy of a public offering. For these reasons and, again, putting aside which form is preferable from a tax perspective, the remainder of this article is based on the assumption that the target entity will be an AS.

Forms of investment

Although different investors have differing appetites for various combinations of risk and reward, the typical instruments used by venture capital investors in the U.S. and Western Europe are stock (common and preferred), warrants, options, debentures (bonds), and other convertible debt instruments. The instrument selected determines economic interests and legal rights between the entrepreneur and the VC investor, typically relating to

3. CCC §123(1); §153; §115.
4. CCC §114(1); §127(2); see also Commentary on Section 127(2).
5. CCC §115 (regarding SROs); see infra (regarding ASs).
6. Act No. 591/1992 Sb., as amended.

priority of return, reward for risk, exit strategy, and corporate control. Venture capital investors prefer to invest in a security that is convertible into, or carries rights to purchase, common stock. If a legal system is not sufficiently flexible in this regard, investment may be hindered or its pricing affected - or perhaps become completely undoable in specific circumstances. If the opportunity is attractive enough, the investment may be made, but through an offshore vehicle that can provide sufficient flexibility - leaving the local entity as a wholly owned subsidiary. Of course there are many other determinants for selecting an offshore entity (primarily tax).

Common stock

Common stock is the simplest form of equity security. It is not convertible into another security. A share of common stock is a security to which is attached a shareholder's right to participate in management of the AS (a right exercised at the general meeting of shareholders) and to share in its profits and in its liquidation remainder.[7]

Convertible debentures and warrants issued with debentures

Convertible debentures (bonds) offer the VC investor upside potential with some downside protection: convertible debentures provide a VC investor with current returns (either through a fixed or variable interest rate) as well as the right to convert the debt into equity (either preferred or common). A warrant is, like an option and a conversion right, a derivative security, a right to buy a security at a fixed (or formulaic) price.

The CCC provides that an AS may issue (1) debentures convertible into shares in such company and (2) debentures with detachable warrants.[8] It is important to note, however, that the CCC does not contemplate any other types of convertible securities. Therefore, for example, the CCC does not allow for convertible preferred stock. Furthermore, in the context of a VC transaction the CCC contemplates that warrants can only be issued with debentures.[9]

Preferred stock

Preferred stock is the investment security most frequently used by investors in venture capital financings in the U.S. and western Europe because of its convenience and flexibility in establishing the relationship between the VC investor and the “non-cash” shareholders (e.g., the founders and/or management). Through preferred stock, the shareholders are best able to handle the critical issues of the investment - principally management control, recovery/return and exit - through, for example, the creation of specific rights in the VC investor such as special voting rights, anti-dilution protects, control shifts, “supermajority” provisions, and the like.

In a typical venture capital transaction in the U.S. or Western Europe, the preferred stock is convertible into a set number of common shares, at a predetermined price, exercisable at the VC investor's option and, usually, upon the occurrence of the company's initial public offering. Thus, preferred shareholders have the upside potential of a liquid equity security traded at significantly appreciated values in the public market. In addition, dividend as

7. CCC §155.
8. CCC §160(1); see also CCC §207 and §217a.
9. Note, that CCC §204 and §217a also allow a company to issue warrants to existing shareholders to evidence their pre-emptive rights to maintain their proportional ownership interests in the company.

well as liquidation preferences are designed to enable the VC investor to recoup its investment if the enterprise fails to achieve its anticipated success. Preferred shares also commonly have the benefit of compulsory redemption at the option of the VC investor in agreed circumstances.

However, as described below, the CCC puts certain limitations on these concepts as well as on other provisions commonly seen by VC investors in the U.S. and Western Europe.

Limitation on amount of preferred stock

Under the CCC, although the company's by-laws can provide for the issue of shares having priority rights to dividends and/or liquidation balance, the total nominal value of such preference shares may not exceed 50 percent of the registered share capital.[10]

Dividends

1. "Preferred"

The traditional notion of preferred stock encompasses a share that takes its "par" value in liquidation (see discussion below) before the common gets anything (a meaningful privilege if the company is being sold) and has a preferred call on the earnings of the corporation during its life in the form of a regular dividend. A "preferred" dividend implies a *fixed* dividend payable at regular intervals.

Of course, it is a fundamental legal pre-requisite in most jurisdictions (including the Czech Republic[11]) that dividends are only payable if the company has adequate retained profit.

The least sophisticated form of dividend preference is the payment upon a preferred share of a dividend in excess of the amount paid upon a common share. Under the CCC, several sections explicitly permit a dividend preference,[12] and therefore allow a company to allocate a different proportion of profits to the preferred stock and the common stock. Moreover, the CCC does not limit the proportion of profits that a company may allocate to the preferred shares.

In the U.S. and Western Europe, the dividend preference is often expressed as either a stated annual amount (e.g., $100) or as a percentage yield based upon the issue price (as opposed to the nominal value) of the preferred share (e.g., 15 percent preferred). There is no CCC provision restricting this kind of dividend preference, except that CCC159(2) does prohibit a shareholder's right to "a fixed interest regardless of a company's financial results."[13] Accordingly, a company's by-laws could provide, for example, that *if and when a dividend is declared,* preferred shareholders are entitled to receive for each preferred share a fixed amount or a percentage of stated value before the common shareholder receives anything. Nevertheless, the VC investor should take care that its target's by-laws are clearly drafted to avoid running afoul of CCC159(2). A similar analysis applies to liquidation preferences which are discussed in more detail below.

10. CCC §159(1).
11. CCC §178(1).
12. See CCC §155, §159 and §178.
13. CCC §159(2).

2. "Cumulative"

If a dividend is not declared for any reason (perhaps illegality, if and to the extent sufficient earnings or surplus are not available), the dividend often "cumulates", meaning that arrearages must be paid in the future before any dividend or liquidating distribution can be paid on inferior classes of stock, such as common. This concept is not prohibited by the CCC.

Furthermore, some U.S. and Western European investors require that if cumulative dividends are passed for several periods then a "default" occurs and something automatically happens, usually in the form of preferred shareholders getting additional seats on the board. However, as discussed below, there is some doubt under the CCC as to the enforceability of voting rights agreements. Therefore, an agreement that provides for such "control flip rights" should be approached with caution.

Noncumulative dividends, meaning that dividends are paid only if, as, and when declared by the general meeting, however, tend to be more likely in venture capital financings of start-up companies. Realistically, young companies often do not have the cash with which to pay cash dividends. As a result, the company and the VC investor could ultimately find themselves in the strange position of having to issue new stock, thereby diluting the (original) VC investor, in order to retrieve the capital paid out in dividends.

3. "Participating"

Participating preferred is preferred stock that may or may not enjoy a fixed dividend, but in any event participates in excess earnings pari passu (or on some other formula) with the common shareholders. Such a right is not prohibited by the CCC.

This can be an important benefit for the VC investor. For example, let us assume that a VC investor invests Kč40 million for 50 percent of a given company in the form of preferred stock and the assets of the company are sold for Kč50 million. Regardless of whether the VC investor holds participation rights, by virtue of the liquidation preference the holder of the preferred would be entitled to the bulk of the proceeds (Kč40 million liquidation preference plus, possibly, accrued and unpaid dividends) to the exclusion of the common stockholders. Now, let us assume that the company's assets are sold for Kč100 million. A preferred holder without participation rights simply receives the same Kč40 million. However, if the preferred holder has participation rights he would *also* be entitled to 50 percent of the remaining Kč60 million.

Liquidation

As described above, preferred stock typically has a preference over the common stock to the assets of the corporation upon liquidation. Liquidation preferences are permitted under the CCC.[14]

The liquidation preference can be a fixed price per share (such as par value plus a premium). However, it is common that the VC investor would like to see the liquidation preference equal the original purchase price of the security plus accrued and unpaid dividends. As with the discussion of dividends above, setting the liquidation preference as a fixed price per share and/or including accrued and unpaid dividends, should be permitted under

14. CCC §159.

the CCC. Nevertheless, the VC investor should take care that its target's by-laws are clearly drafted to avoid running afoul of CCC159 which prohibits a fixed interest regardless of a company's financial results.

The VC investor may also require that the preferred stock has participation rights in the liquidation distributions of the company after payment of the liquidation preference. Again, participation rights are not prohibited by the CCC.

Voting Rights

In a U.S. or Western European financing, preferred stock can either be voting or non-voting, or voting only upon the happening of certain events. In the case of convertible preferred stock customarily issued in venture financing, it is the norm to provide that the preferred votes pari passu with the common as if it had been converted.

The CCC provides for voting and non-voting preferred stock.[15] In the case of voting stock, the number of votes per share corresponds to the proportion of the nominal value of that share to the company's entire registered capital. Note, however, that the by-laws can set a maximum number of votes per shareholder so that, for example, no shareholder could exercise more than X percent of the votes.[16]

As for giving the preferred holders consent rights to certain events, such as a merger or an asset sale, the CCC does not allow for this kind of class voting. Nevertheless, the CCC does permit the by-laws to provide for supermajority shareholder votes.[17] Therefore, the threshold to approve, for example, an asset sale could be set high enough that the preferred holders (or at least a significant proportion) would need to consent. Although this provision is not as strong as a class vote, it would at least give the preferred holders a veto right over such events.

Conversion

VC investors in the U.S. and western Europe expect conversion rights so that their preferred stock may be converted into common shares (1) at the election of the holder at any time prior to redemption and (2) automatically upon the occurrence of certain events (e.g., an initial public offering).

The CCC does not, however, allow for the conversion of preferred stock into common stock. Instead, under the CCC, the only securities which can convert (or be exercised) into common shares are (1) convertible debentures and (2) detachable warrants issued with debentures.[18] Nevertheless, in some ways a debenture issued together with a warrant (often referred to as an "equity kicker") gets the holder to the same place as convertible preferred shares: the ultimate acquisition of the conversion shares at the price paid for the security initially purchased (plus the exercise price of the warrant). Moreover, a warrant is detachable from the debenture it originally accompanied so it can, therefore, be bought and sold on its own.

Additionally, the CCC does not prohibit the automatic conversion (from a convertible debenture or warrant) into common stock upon a given event.

15. CCC §180 and §159(3), respectively.
16. CCC §180(2).
17. CCC §186(1).
18. CCC §160(1); see also §207 and §217a.

In a U.S. or western European transaction, the conversion ratio in a debenture or warrant is usually expressed by a formula based upon the original purchase price paid for the preferred stock, which usually (but not always) yields a one-for-one conversion ratio. The use of a conversion formula is not prohibited by the CCC.

Finally, it should be noted that the total nominal value of the conversion shares underlying convertible debentures and warrants cannot exceed 50 percent of the company's registered capital.[19]

Investors' anti-dilution protection

In U.S. and western European transactions, convertible securities (e.g., convertible preferred, convertible debentures or warrants) also typically contain "anti-dilution" protection, usually giving investors the right to obtain more common stock without having to provide additional consideration in the event the company issues new common stock (or common stock equivalents) at a price below the effective "as converted" common stock price paid by the investors. In other words, if a company issues to VC investor #1 preferred shares of the company convertible into common at Kč400/share, and later the company issues to another investor shares of the company's common stock for less than Kč400/share, then VC investor #1 has been diluted.

The very nature of a derivative security such as preferred stock, a convertible debenture or a warrant, requires some form of anti-dilution protection. With such protection, if a preferred share is convertible into ten shares of common and something happens to make the common cheaper, then the preferred holder is able to maintain his equity position.

The easiest situations involve recapitalizations: stock splits, stock dividends, reverse stock splits, and other similar changes in the number of shares outstanding without an exogenous transaction such as a third-party financing or a consolidation with another firm. These changes are technical. A 100 percent stock dividend doubles the number of shares and cuts the book value of the stock in half (e.g., one Kč400 share becomes two Kč200 shares).

More complicated situations arise, for example, in the sale of common stock or securities convertible into common stock at prices lower than those paid by the VC investor.

There are two principal ways to formulate anti-dilution protection: "Weighted-Average Anti-Dilution Provisions", and (2) the "Full Ratchet".

A. Weighted-Average Anti-Dilution Provisions

Weighted-Average provisions can be expressed by different formulas but the basic concept is this: the VC investor's conversion price is reduced to a lower number which takes into account the number of shares issued in the dilutive financing.

To illustrate, assume that as part of a financing, VC investor ("VC-1") receives a convertible debenture with a face value of Kč1 million which is convertible into common shares at an initial conversion price of Kč100/common share. Now assume the company closes a subsequent round of financing which raises Kč1 million from a new investor ("VC-2") who receives 20,000 common shares, at Kč50 per share. A "weighted average" anti-dilution provision would reduce the conversion price on the convertible debenture to Kč66.67 so

19. CCC §207(2).

that it would be convertible at that time for 15,000 common shares. One weighted average formula commonly utilized by VC investors is:

New Conversion Price = (PD + CS) / (D + S)

where:

P = conversion price in effect immediately prior to the new issue or sale (Kč100 in the above example);

D = number of shares of common stock outstanding, or for which issuance or conversion may be made, immediately prior to the new issue or sale, except for the shares issued prior to the issuance of shares to VC-1 (10,000 above);

C = average consideration per share received by the company for the new issue or sale (Kč50 above); and

S = number of common shares issued or sold, or deemed issued or sold, in the subject transaction (20,000 above).

B. Full Ratchet

A "Full Ratchet" can be a killer from a company's point of view because it operates without regard to the number of cheaper shares of common (or common equivalents) that are issued. Therefore, if only one share of the company's stock is issued at a lower price, then the existing conversion price "ratchets down" to that price. In the above example a "full ratchet" provision would generate 20,000 common shares for VC-1's convertible debentures. There are various anti-dilution formulas available but this issue goes far beyond the scope of this paper.

Under the CCC, each shareholder has a pre-emptive right to subscribe for a part of the company's new shares, so that its proportion of the company's increased registered capital can be maintained.[20] Warrants have explicit pre-emptive rights associated with them. However, relying on the CCC pre-emptive rights would mean that a VC investor would need to invest more money to exercise its pre-emptive rights and thus maintain its proportion of registered capital. From a VC investor's point of view it would be preferable to simply rely on the protections afforded by anti-dilution provisions contained in the actual terms of the security. The CCC does not prohibit companies from granting such anti-dilution protection.[21]

Redemption

VC investors ultimately need a means of recovering their initial investment. However, access to the initial public offering market is only a contingent possibility in many phases of the market cycle, leaving equity investors in need of alternative exit vehicles. In addition, even if there exists a favorable IPO market the VC investor may find itself locked into a company which shows no sign of either going public or going bankrupt. These companies are often called "walking dead" or "lifestyle" companies: management is content to run the company at a modest pace, neither making or losing a lot of money, simply to support their comfortable lifestyle.

20. CCC §204a.
21. Both CCC §160(2)(e) and §217a(2)(d) permit a warrant to set forth the method of determining the issue price of the underlying shares.

The countermeasure often adopted by VC investors in the U.S. and western Europe is to have the right to redeem - that is, the right to put the shares to the issuer after a period of time at a price that can be counted on to energize management into exploring all available alternatives. The redemption price can be set at the initial investment amount plus dividends that have been agreed at the original share issuance but which may not have been paid. Ideally, VC investors expect redemption provisions to be automatic, subject of course to the company's adequate financial condition.

However, VC investors in the Czech Republic should not rely on redemption as a viable exit strategy. The CCC provides that during the company's existence, and even if it is wound up, a shareholder may not demand the return of its investment contribution.[22] Therefore, this provision limits an investor's ability to agree at the time of its investment how and when the company will redeem the investor's shares.

The CCC does provide for a limited exception whereby upon a resolution of its shareholders a company can acquire its own shares so long as, among other things, no more than 10 percent of the nominal value of the company's registered capital is redeemed.[23]

One way to deal with this redemption limitation might be through a put option agreement with the other shareholders so that upon a triggering event the VC investor would have the right to require the other shareholders, rather than the company, to purchase the shares. Clearly, this option is not the optimal solution: not only will the other (non-cash) shareholders resist committing themselves to buy out the VC investor, but also it is not likely that such individuals will have the financial ability to do so (if they did, they would probably not be inviting in a VC investor in the first place). The VC investor may get some relief by agreeing that the put would only be effective to the extent the VC investor's securities are not redeemed through a shareholder resolution made in accordance with the CCC. This way, both the VC investor and the other shareholders will be equally motivated to have a shareholder meeting called to authorize a redemption. But again, such meeting could at best resolve to redeem only 10 percent of the company's registered capital.

In any event, however, it is important to note that VC investors should approach shareholders' agreements with caution. As is discussed in more detail below, the enforceability of shareholders' agreements in the Czech Republic is not without question.

Shareholders' agreements

VC investors in the U.S. and Western Europe also look to agree with the other shareholders (i.e., the founder and any previous investors) as to other provisions including share transfer restrictions and control rights.

However, VC investors should be cautious about shareholders' agreements because the enforceability of such agreements in the Czech Republic is not without question. Much of the uncertainty in this area is due to the fact that there were major amendments made to the CCC as of January 1, 2001. Consequently, there is little official commentary or judicial interpretation to serve as guidance.

In general, the CCC does not prohibit shareholder agreements. However, the CCC does limit agreements on the exercise of voting rights.[24] Although the CCC used to have broader

22. CCC §179(2).
23. CCC §161a(1).
24. CCC §186d.

limitations, as of January the CCC prohibits agreements whereby shareholders agree to use their voting rights "in a predetermined manner…for advantages granted to [the shareholder] by the company." This provision implies that as long as a shareholder does not receive consideration from the company, he/she should be permitted to agree on how he/she will vote in the future.[25] However, again, there are no supporting official commentary or judicial decisions here. Considering the CCC's traditionally broader restrictions on voting pacts, investors should be very cautious here.

Unfortunately, the CCC amendments also added a new provision, CCC §178(11), that prohibits "agreements whose purpose is to grant advantages to any shareholder to the detriment of the company *or other shareholders.*"[26] On the surface, this would seem to prohibit *all* shareholders' agreement because through such agreements shareholders promise (in exchange for benefits) to take actions they would not otherwise have an obligation to act (in other words, act to their own detriment).

This new provision does not appear in the section on voting rights agreements, but rather on the section dealing with dividends. Therefore, it is unclear how broad this prohibition is meant to be applied; it may only apply to agreements related to dividends. Furthermore, official commentary on this provision implies that it has been added to the CCC in order to protect *minority* shareholders.[27] In any event, it seems unlikely that this provision would now void all shareholders' agreement (which agreements are not uncommon in the Czech Republic). It also seems unlikely that a majority shareholder could argue that an otherwise reasonable shareholders' agreement should be voided because he/she was required to agree to it as part of a transaction where his/her company received new financing. Nevertheless, because of the newness of this CCC provision there is insufficient supporting material to precisely understand the meaning of this new provision.

Bearing in mind the uncertainty as to enforceability of shareholder agreements, the following provisions are often sought by VC investors.

Transfer Restrictions

It should be noted that the CCC provides that at the company's election its shares can be made out as bearer shares or shares that are registered with the company. The transferability of such registered shares can be restricted, while the transferability of bearer shares is unrestricted.[28] Therefore, it is important that in order to effectively limit the transferability of the target's shares, the company should issue registered shares; on the other hand, the VC investor may want to have its preferred shares issued as bearer shares.

1. Employees

A VC investor in the U.S. and Western Europe likes to ensure that those employees who hold shares in the target company do so only for as long as they continue to be employed in the business. Accordingly, it is common to find transfer provisions which force an ex-employee to transfer his shares to the remaining shareholders, albeit usually at market value. Such provisions are not just for the benefit of the investor, however.

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25. Note, however, that in any event a shareholders' agreement will be null and void if it binds a shareholder to (1) follow instructions given by the company or any of its organs or (2) vote for proposals tabled by the company's organs (CCC §186d(1)(a)-(b)).
26. CCC §178(11).
27. See CCC §178, "Commentary on Section 178".
28. CCC §156; however, transferability of shares is regulated by the Czech Securities Act.

Managers/owners will find it beneficial for them as individual shareholders to know that a departing employee, who may have left the business under unhappy circumstances, cannot be a problem later on in terms of his/her shareholding.

Assuming that shareholder agreements are enforceable, the CCC does not prohibit employees from agreeing to sell their shares upon termination of employment.

Drag-along Rights; Tag-along Rights; Rights of First Refusal

A VC investor will want to ensure that if it sells its investment to a trade buyer, it will be able to "drag along" the remaining shareholders by requiring them to sell their shares to such buyer. Alternatively if the managers/owners sell their shares, then the investor will want a right to "tag along" and to be bought out on the same terms. Finally, the VC investor may require that in the event one of the common shareholders wishes to sell his shares to a third party he must first give the VC investor the right to purchase such shares. The negotiations regarding these provisions will clearly depend on the relative equity positions of the various shareholders.

Again, assuming that shareholder agreements are enforceable, the CCC does not prohibit shareholders from agreeing to such arrangements.

2. Appointment of Directors; Control Flip Rights

Investors will usually want a non-executive director or chairman to be appointed to the board of the target company. Such individual may be an outside non-executive director or one of its own employees.

Additionally, VC investors often want a control "flip", meaning that they are content with a minority of the board as long as everything is going well; however, in the event of trouble the VC investor would succeed to outright control of the board. A control flip can occur when benchmarks are not met or for some other serious reason, such as a violation of agreed upon covenants.

Under the CCC, the general shareholders meeting elects the board of directors by a majority vote,[29] and, in general, class voting is not permitted under the CCC. In VC transactions in the U.S. and Western Europe, one way to assure that the VC investor is represented on the board of directors would be a provision in the shareholders' agreement requiring the other shareholders to vote for the VC investor's, say, one nominee to the board. As described above, VC investors should be cautious about voting pacts in the Czech Republic. Voting pacts have been traditionally prohibited under the CCC and although the amended CCC appears to relax that prohibition there is insufficient supporting material to know how the relevant CCC provision will be applied.

Under the same line of reasoning, control flipping provisions warrant even more caution considering they could require the majority of the shareholders to elect the VC investor's choice for not just one board member but rather a majority of the board members.

Registration rights agreements

In VC transactions in the U.S., the VC investor typically has the right to compel the company to register its shares with the U.S. Securities and Exchange Commission (SEC). By cre-

29. CCC §186(1) and §187(1)(d).

ating liquidity, this right provides the investor with an opportunity to exit from its investment. There are two basic types of registration rights: demand rights and piggy-back rights. Demand rights entitle the investor to compel a company to file a registration statement with the SEC covering the shares held by the investor. Piggy-back rights are useful where a company is already in the process of filing a registration statement; with these rights, an investor can compel the company to extend the registration statement to cover the investor's shares.

The CCC does not specifically deal with this kind of arrangement. Certainly, a resolution of the general meeting of the shareholders would be required to make the company publicly list its securities. However, there is no CCC prohibition against the general meeting agreeing, prior (and as a condition) to a financing, that the company will publicly list its securities, subject only to the condition that the VC investor exercises its demand registration right. It is advisable, then, that a registration rights agreement be signed by the VC investor and the company, as well as the other shareholders. This way, the non-cash shareholders can (1) acknowledge that they have agreed to the (conditional) public listing and (2) covenant that they will not take actions to rescind that vote through a subsequent general shareholders meeting. It should be noted, however, that by having the non-cash shareholders party to this agreement, such an agreement could be problematic under CCC §178(11) as was discussed above.

Furthermore, piggy-back registration rights could be covered in the same agreement. However, piggy-back rights should not be as important to an investor in a Czech company who hopes to list the shares in the Czech Republic. Under the Czech Securities Act, any listing of a class (e.g., common) of a company's shares on the public market must include all shares of that class.[30] Therefore, if the company publicly lists its common shares, then all common shares held by all shareholders become publicly tradable.

Conclusion

This article examines some of the basic elements commonly found in venture capital transactions in the United States and Western Europe, and how such elements are affected by the Czech Commercial Code. It is clear that with respect to some VC elements, such as those dealing with the variety of available convertible securities, the CCC is not as flexible as VC investors from the U.S. and Western Europe may expect. Additionally, with respect to other elements such as redemption rights, the CCC is not as investor-friendly as such VC investors would like. Finally, some provisions of the CCC, such as those regarding shareholders' agreements, are not as clear and understandable as they could be. Hopefully, however, as more venture capital investors look to make investments in Czech companies, there will be even greater pressure on Czech lawmakers to further improve the CCC in order to make the Czech Republic even more attractive to current VC investors and to potential new ones.

30. Czech Securities Act, §72(1)(j).

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