March 2000

Commercial Legal and Institutional Reform (CLIR) Diagnostic Assessment Report for Croatia

A USAID Initiative in Developing Countries

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I. SUMMARY OF COMMERCIAL LAW ASSESSMENT

A. CONTEXT

This commercial law assessment is the result of a joint USAID – OECD mission to Croatia between February 21 and March 3, 2000. The assessment was conducted in coordination with parallel USAID assessments in the areas of budget, tax, pensions, Rule of Law (ROL), agriculture, and other areas of particular importance to Croatia's economic development.

In preparation for this assessment, the team reviewed relevant laws as well as relevant reports and assessments prepared by Croatian and foreign experts. During the in-country phase of the assessment, the team conducted more than fifty interviews with judges, lawyers, professional associations, academics, business support organizations, multilateral and bilateral donor organizations, and representatives of the Croatian and foreign business communities.

B. PRINCIPAL FINDINGS

1. Framework Laws

The basic legislative framework for commercial activity in Croatia is in place. Difficulties in implementation and enforcement arise from a variety of causes. Generally, however, these difficulties can be traced to a lack of practical experience in interpreting and applying these laws. Two areas are of immediate concern:

- Croatia suffers from "hasty transplant syndrome". The specific laws that have been borrowed from other countries are generally adequate; however, in some cases, they have not been fully harmonized with the broader context of the Croatian legal system.

- Following from the above, end-users (e.g., the judiciary, the bar, and litigants) lack specific guidance on how these laws are to be interpreted and applied. Nature—and the legal profession—abhor a vacuum.

Addressing these needs can be initiated in the near-term. Success in meeting this challenge will be determined by the Government's willingness to place pragmatism above tradition, and use "best practices" as its guide for reform.

2. Implementing Institutions

Like other countries in transition, the institutions responsible for implementing and enforcing key economic and commercial laws in Croatia suffer from severe resource constraints. The courts are badly clogged, under-equipped, and suffer from a lack of "hard skills" training in the practical interpretation and application of economic and commercial laws. In other cases, the legal framework is in place, but the institutional framework has not been fully implemented.

Nevertheless, in comparative terms, Croatia's institutional framework for economic and commercial law is in place, and it functions. The most immediate challenge lies in increasing the capacity of courts, relevant administrative agencies (e.g., the Agency for Protection of

Market Competition), and registries to interpret and apply these important laws in a transparent, predictable, and efficient manner. This is a long-term process that will require a considerable investment of financial resources and political capital. As discussed in greater detail below, however, there are a number of concrete steps that can be taken in the near term to help alleviate this capacity deficit.

The challenges of achieving significant improvements in this dimension of commercial law development are considerable. Government's willingness to take bold steps, and the donor community's willingness to place its prestige on the line to support the Government, will determine to a significant degree whether this capacity deficit can be narrowed in the next twenty-four (24) months.

3. Supporting Institutions

Supporting institutions for economic and commercial law that exist in Croatia are good. Nevertheless, a good deal of work needs to be done in this dimension to reach the "critical mass" required to bring Croatia's commercial environment into line with the larger European community.

In macro terms, there is a lack of technical knowledge and information about how Croatia's economic and commercial laws and institutions should operate. For example, there are no institutions, including Croatia's law schools, providing courses devoted to judicial administration and management. Given that 62% of Croatia's judges have less than five years' professional experience, this is a notable gap. Many of those interviewed expressed the need for advanced practical training in interpreting and applying complex economic and commercial laws (e.g., case studies, gaming and simulations, test cases, professional mentoring).

There is also a general lack of specialized professional organizations devoted to increasing the level of understanding and sophistication of economic and commercial laws and practices. Croatia, for example, does not yet have an organization of bankruptcy practitioners who could play a key role in addressing the lack of consensus that exists on how the bankruptcy and related laws are to be interpreted and applied. The same holds true for the other legal areas considered in this assessment.

This dimension of commercial law development in Croatia can be significantly strengthened within a one- to two-year time frame provided Croatia receives focused support from the donor community in this important area.

4. "Market" for Reform

On the "demand" side, there is reason for some optimism. A high degree of consensus seems to exist among those interviewed that commercial law reform is needed. Generally speaking, the broad outlines of what needs to be accomplished seem to be well known; however this consensus may not hold as more detailed proposals on the "what" and "how" of specific reforms are put forward. Nevertheless, there is a sense of pragmatic optimism among those interviewed about the future of commercial law reform in Croatia.

The most "coherent" or organized segment of society demanding reform in this area is, not surprisingly, the legal profession. The judges interviewed during the assessment were unanimous in the view that the current situation is unacceptable. In general, there is recogni-

tion that judicial and administrative review processes are highly inefficient; however, the notion that these can be significantly altered in the near-term is viewed as improbable. Given the generally conservative views expressed among those interviewed, incremental reforms appear more likely than systemic changes.

As noted above, the "supply" of framework laws in Croatia is quite good, even though there is an immediate need to develop and implement detailed regulations in most of the areas considered in this assessment. Currently, legal scholars are consulted in developing legislative reforms. This is a positive feature. However, based on the brief assessment it appears that wider access to the process of developing and implementing commercial law reforms seems to be somewhat limited and ad hoc. Mechanisms for sustainable public-private sector policy dialog do not appear to exist. Nevertheless, the new government has expressed its firm determination to include a wider circle of end-users in the policy development process including judges, lawyers, businesses, and so forth.

Information flows are restricted, which also represents a significant "supply-side" deficit in the development of Croatia's legal and regulatory environment for commercial activity. On the positive side, Croatia's official government websites are among the most sophisticated and content-rich in Europe. The entire official gazette *Narodne novine* is published on-line in Croatian, and constitutes an exceptional resource for the continued development of Croatia's overall legal environment.

While access to framework laws is generally very good in comparative terms, there is a parallel deficit in case reporting that needs to be addressed. For example, only selected Supreme Court decisions are reported, and then only in excerpted form. Both judges and lawyers have complained that this practice does not provide the practical guidance needed to confidently apply the newer economic and commercial laws. Further, this deficit is compounded by a reported lack of authoritative commentary, and practical guidelines, in those areas where a sufficient body of jurisprudence has not yet developed.

Inefficient management of information is also a significant cross-cutting problem. Judicial and administrative review processes are significantly burdened by a paper-based system of record keeping (e.g., court dockets, land registries, etc.) that is done by hand. In addition to the administrative costs associated with operating such a system, the inefficiencies inherent in this system undermine the transparency and predictability of the administration of justice, particularly in the larger urban centers where case volumes are large and backlogs are growing. The lack of clearly mandated periods for judicial action, and a lack of a modern case-tracking system, similarly create opportunities to manipulate the judicial and administrative process either to accelerate, or delay it. Although this situation is by no means unique to Croatia, it is a significant systemic weakness that contributes to the implementation/enforcement gap observed during this assessment.

C. PRINCIPAL RECOMMENDATIONS

Based on its findings, the commercial law assessment team believes that there are significant near-, mid-, and long-term opportunities to strengthen the overall legal and regulatory environment for commercial activity in Croatia. Specific recommendations are organized under three strategic headings:

1. Modernized Systems for Protecting Property Rights

Combined opportunity costs of the current inefficient system for the creation and protection of property rights in Croatia appears to be significant to Croatia's future economic growth. While the costs of the present system are hidden, empirical research establishes that they act as a significant drag on private sector development.

Capacity deficits in this area constrain the development of the entire sphere of commercial activity in Croatia, especially in the spheres of bankruptcy, secured transactions, company, contract, and competition. Conversely, strengthened systems for creating and protecting property rights have been empirically shown to increase property values by 30% - 60 %, spur foreign direct investment, lower interest rates, and stimulate the development of capital markets. To this end, three priority reforms have been identified:

- In collaboration with the banking, business, and legal communities, establish the legal and institutional framework for a modern, fee-based registry for creating security interests in movable property based on recent European experience, and international best practices. Develop registry on a pilot basis, test, and then roll out to principal commercial centers.

- Modernize the existing system of company registries, using appropriate models adapted from Western Europe, and utilizing appropriate information technologies. As above, develop on a pilot basis, test, and roll out to principal commercial centers.

- Consolidate and modernize Croatia's cadastre and land registries into a unified system consistent with European practices, and international best practices. Focus primarily on high-value urban centers, and selected coastal resort areas. Design system on a cost recovery basis to alleviate financial burden of reform effort. Where appropriate, utilize public-private partnership approaches on a pilot basis to reduce the administrative burden of implementation, and create employment opportunities for entrepreneurs and small businesses. Roll out on a national basis.

2. Increased Efficiency & Integrity of the Judiciary

With broad participation from within the judiciary, the wider legal community, academics, the private sector, and other elements of Croatian society, develop and implement a comprehensive package of procedural and administrative reforms that will:

- Adopt measures that will ensure the independence of the judiciary and promote the integrity of the legal profession;

- Streamline administrative procedures for determining commercial and economic cases that will eliminate or reduce frivolous, repetitive, and abusive litigation;

- Implement a modern case management system that will allow courts to better manage case loads, and protect the integrity of docket, case file, and personnel management systems;

- Establish and enforce explicit deadlines for the disposition of economic and commercial cases by courts on both procedural and substantive rulings; and,

- Develop the technical capacity of commercial court judges (and, where appropriate, include court administrative personnel, advisors, trustees, and bailiffs) to interpret and apply specific economic and commercial laws.

3. Improved Access to Legal Knowledge, Information, & the Policy Process

Another cross-cutting constraint to development of commercial life in Croatia is a relative lack of access to legal knowledge, information, and the policy process. *Legal knowledge* as used here is a comprehensive body of practical experience, judicial opinion, scholarly analysis, and informed commentary, that accumulates over time and provides the foundation for a stable and predictable system of economic and commercial law. Based on the team's findings, it is recommended that:

- Existing practices governing the selection and publication of judicial opinions be reviewed and strengthened;

- In newer areas of economic and commercial law (e.g., bankruptcy, competition, international trade), detailed commentary on the practical interpretation, application, and enforcement of the laws be developed;

- Work with law faculties, the judiciary, practitioners, students, and businesses, to review and modernize the curricula employed in training judges, particularly in the interpretation and application of complex economic and commercial laws;

- Develop and implement continuing legal education programs geared toward increasing the capacity of Croatia's judiciary to interpret, apply, and administer complex economic and commercial laws;

- Consider establishing specialized bar requirements (e.g., advanced training, certification, continuing legal education) designed to increase the competency of lawyers in these areas, without unduly restricting access to the practice of law;

- Working with members of the legal profession, promote the formation of specialized commercial and economic law faculties in Croatia's law schools; and,

- Strengthen (or create) programs devoted to technical training for para-professionals in judicial management and administration.

Similarly, *timely access to relevant information* is also a key ingredient in a modern, market-oriented system of law. In this area, it is recommended that:

- Judicial opinions, scholarly opinions, and practical commentary be made accessible on the Internet;

- Mechanisms be strengthened or created to help inform interested parties (e.g., judges, lawyers, academics, businesses, NGOs) of proposed legislative and regulatory changes;

- Systems for creating and verifying ownership rights in property be strengthened, modernized, and made easily accessible to courts, lawyers, and the business community; and,

- Appropriate information technologies be utilized to assist judges and other court personnel to increase productivity, and help ensure the integrity of the judicial process.

Finally, to support *improved access to the policy process* it is recommended that:

- Mechanisms for the development of legislative proposals be reviewed, and that specific measures be implemented by the Government to afford increased private sector participation in the development of commercial law and related regulatory initiatives.

- Special commissions for subject-specific economic and commercial law reforms be organized under the authority of the Ministry of Justice (or other appropriate authorities) to examine the practical challenges of implementation and enforcement identified in the body of this report. Such commissions should have a limited mandate (e.g., 12 months), include balanced representation of relevant end-user interests (e.g., for bankruptcy, this would include judges, lawyers, trustees, bailiffs, academics, banks, commercial businesses, small business, consumer interest groups, etc.), provide modest compensation for service on the commission, and deliver detailed proposals for relevant substantive and procedural reforms.

Significant initiatives can be undertaken in each of the above areas in the near term. The tangible benefits of these initiatives will be felt in the longer-term; however, near-term results can also be achieved. This is an area where a strong partnership between the Government, the private sector, and the international donor community can generate sustainable benefits to segments of Croatian society well beyond the legal sphere.

II. ASSESSMENT FINDINGS

A. BANKRUPTCY

1. Context

The bankruptcy law in force in Croatia was adopted in 1996 and is patterned closely after the bankruptcy law currently in force in Germany. In technical terms it is adequate, and if applied consistently, the law provides a satisfactory framework for carrying out the administration of bankruptcy proceedings in Croatia.

While the existing law is based on sound concepts, it is being implemented in a distorted environment. There are numerous companies that are technically insolvent, some of which cannot continue to operate viable businesses properly because they are not being paid by their clients. As a result they are unable to meet their debt obligations. Before a general solution is found for the existing payment problem, the bankruptcy law cannot be consistently applied.

2. Legal Framework

The underlying objectives of Croatia's bankruptcy law are to:

- Provide adequate guarantees for satisfaction of the claims of all creditors
- Establish a socially acceptable priority of claims designed to protect the labor force of the insolvent company
- Guarantee the rights of the secured creditors, and
- Preserve insolvent enterprises as going concerns whenever possible.

[Note: This law does not apply to bankruptcies of banks, for which special regulations will be passed in the future. Until the proposed special law with respect to the banks is enacted the provisions of the former Law on Bankruptcy will apply.]

Bankruptcy procedures are carried out by the commercial court in the jurisdiction where the head office of the debtor is situated. Bankruptcy procedures may be initiated against a legal person or individual merchants. Certain entities are excluded from the application of the law for social reasons (i.e. the State, various funds financed by the State, pension funds and other similar entities) and special rules apply for enterprises in the defense industry.

Grounds for initiating bankruptcy procedures are the insolvency of the debtor, the danger of insolvency and the over-indebtedness of an enterprise. Those situations are well defined, and substantial protection is granted to debtors, who may request the initiation of bankruptcy proceedings in cases when it is probable that they will not be able to meet their obligations. The principal triggering event to commence proceedings is the failure to pay for thirty days.

Bankruptcy procedures are driven by the creditors, carried out by the receiver and controlled by the court. The creditors are authorized to initiate the procedure and have the power to propose and approve the principal actions. The role of the court is to ensure that the procedures are carried out in accordance with the law and to prevent abuses and fraudulent behavior.

Bankruptcy procedures may be terminated in one of the following manners:

- Liquidation of the debtors property and the dissolution of the debtor (if this is a legal person), in which the claims of the creditors are discharged

- Bankruptcy reorganization, based on a plan, adopted by the creditors and approved by the court, which results in the continuation of the operations of the creditor and the termination of the bankruptcy

- Authorization for the debtor to continue to dispose of the bankruptcy estate under the supervision of the receiver, and

- Relief of the debtor from all obligations towards the creditors which have not been discharged in the course of the bankruptcy proceedings.

The bankruptcy proceedings are carried out by the bankruptcy council, consisting of a panel of three judges (one of whom is the bankruptcy judge, who cannot be the president of the panel), the receiver and the general meeting of the creditors or the committee of the creditors.

As in other jurisdictions, the law establishes unconditional obligations for the management of commercial companies to apply for bankruptcy if the enterprise becomes insolvent, and provides creditors with reasonable opportunities to initiate bankruptcy procedures, even without the participation of the debtor. As discussed further, these procedures are generally not applied in practice.

The law provides adequate protection for the rights of the secured creditors, and is formulated in such way that future categories of secured creditors are also covered by it. It also takes into consideration the possibility of financing of the insolvent debtor in the case of restructuring, and provides adequate treatment of the newly acquired debt. The rights of several special categories of creditors are adequately protected, including the rights of fiduciary creditors, purchase money creditors, and suppliers of goods in transit. The system establishes reasonable priority of the claims in line with the similar provisions in developed market economies, and guarantees the rights of the most vulnerable creditors (employees and persons with various compensation and indemnification claims). Transactions carried out by the debtor in an attempt to defraud creditors can be set aside.

Chapter 6 of the bankruptcy law deals with reorganization and restructuring of the insolvent enterprise. While there are some technical provisions that could be strengthened, the basic approach of Chapter 11 of the United States Uniform Commercial Code (UCC) is followed. In this respect, the law permits practically every action approved by the general meeting of the creditors with respect to the restructuring of the enterprise. The law refers to specific actions, and contains a general clause, which authorizes other action as well. In particular, the law permits the dissolution of the insolvent enterprise, the separation and assignment of the debt to newly established entities (fencing the debt), the merger of the insolvent enterprise with another, and every other reasonable action adopted by the general meeting of the shareholders and approved by the court (Article 213).

Other important features of the law with respect to restructuring are:

- equal treatment for all creditors in a particular category and prohibition of the preferential treatment of particular creditors within the same category (Article 222)

- permissibility of debt for equity swaps

- substantial and adequate protection for the rights of the creditors to accept or reject the restructuring plan, and to supervise or participate in the management of the company

- adequate procedural rules, and

- adequate protection of the minority creditors (Article 247).

Most importantly, once the plan is accepted by the creditors and approved by the bankruptcy council (the court), there are no obstacles for the debtor to receive new capital in the form of loans or equity, and for the business to be operated. At the same time, the amount of new loans is limited to the value of the available assets, and adequate guarantees are provided for the bankruptcy creditors.

3. Implementing Institutions

There are no special bankruptcy courts in Croatia. The competent courts in bankruptcy cases are the commercial courts of first instance, in the jurisdiction in which the principal office of the debtor is located. In fact, certain specialization exists, for bankruptcy cases are assigned to specialized judges. In the major courts, for instance in Zagreb, certain judges resolve only bankruptcy cases.

The workload of the courts is increasing, and despite the increased number of cases resolved each year, the backlog is growing at much higher rate. In 1999 the number of new cases increased by almost 70%, while the number of the resolved cases in the same year increased by 13%. For the first time in 1999 the number of new cases exceeded the number of cases resolved in the same year.

In practice, the bankruptcy process is impeded by several considerations, some of which are out of the control of the courts. First and foremost, there is strong social opposition against the concept of bankruptcy in principle. Bankruptcy judges and receivers face the hostile attitude of the workers in many insolvent enterprises and of the local communities involved. In several cases court officials have been threatened, and in one case a judge was temporarily detained by local officials with the compliance of the police.

While from the legal point of view the procedures are not excessively complicated, the existing attitude makes the completion of cases difficult. Other technical problems are the bad state of company documentation, which requires extensive use of expert witnesses, and the fraudulent behavior of company managers, who are not prosecuted to the full extent of the law, even if there are indications of criminal acts.

The judicial system itself also contributes to the problems. The bankruptcy procedures are particularly affected by the generally poor case management, by the lack of specialized training, especially for the young judges, and by the absence of organized publications of the court decisions, especially those of the appellate courts (in this case the High Commercial Court and the Supreme Court).

Finally, the training and selection of the trustees is considered absolutely inadequate. To alleviate the situation, the Ministry of Justice introduced more stringent regulations for the trustees, which are now required to pass exams and to be licensed, but the effect of those measures is yet to be felt.

4. Supporting Institutions

As of now no supporting institutions of any significance exist in Croatia with respect to the bankruptcy process. For various reasons the major accounting firms are not established in the country or their operations are very limited. The evaluation of assets for instance, which is usually carried by such firms, has been identified as one of the major problems which the courts face in resolving bankruptcy cases. There are no active associations of the receivers or of bankruptcy practitioners, and for that reason there is no organized public reaction to the problems of the bankruptcy in general. The Bar Association has no special section for bankruptcy practice, and there is no special certification for bankruptcy lawyers. There are no NGOs that are involved in any significant public awareness campaign.

5. Market for Reform

At the level of fundamental legislation there is adequate supply of laws and regulations, and absolutely inadequate policy formulation and implementation. While the general economic situation in Croatia is similar to that in other countries in transition, the situation with the wide spread non-payment of related obligations seems to be unique in its dimensions It is out of the control of the judicial system, but it affects severely the ability of the system to function.

The judicial system itself has not been prepared for the dramatic increase of the bankruptcy cases and needs to respond better particularly with respect to the training of bankruptcy judges. It seems there is general consensus that the response so far is inadequate.

On the demand side the popular impression of the bankruptcy process in general is negative. This certainly hinders the development of modern bankruptcy system in Croatia and creates additional problems for the judiciary and other practitioners. At the same time the judges involved in the process are well aware of the problems, and expect some response in particular in the area of judicial training in short term, and in general bankruptcy reform in the medium term. Additional support for reform may be provided by different professional associations, (i.e. national association of receivers, of bankruptcy attorneys, of bankruptcy judges, etc.), which are yet to be formed.

6. Recommendations

The following recommendations are based on the analysis above:

- Speedy resolution of the payment crisis (though not a legal problem, some legal measures such the establishment of a system for debt clearance and offsetting of the existing mutual obligations can alleviate the existing situation)

- Organization of training for the bankruptcy judges, with emphasis on case studies, increased economic education and better case management

- Publication of a representative selection of bankruptcy cases resolved by the courts, particularly those at the appellate courts level

- Public awareness campaign, concentrated on the problems of the insolvent enterprises and on some of the positive aspects of the bankruptcy (i.e. the redistribution and use of underutilized assets of the insolvent enterprises, the liquidation of non-viable industries the possibility to start new production in their place, etc.), and

- Preparation of the amendments of the Bankruptcy law, and in particular the provision for possible reorganization prior to the commencement of bankruptcy procedures.

B. SECURED TRANSACTIONS

1. Context

Credit is fundamental to the operation of a modern market economy. Without it, the development of the economy as a whole is severely constrained. Investment is discouraged, capital market formation is hindered, and incentives for competition and entrepreneurial innovation, especially among smaller firms in the economy, are limited. In short, the potential for economic growth and private sector development is limited.

In a commercial context, credit is extended on terms and conditions that reflect the parties' assessments of relative risk and reward. Generally speaking, the higher the risk, the higher the cost of money. Conversely, the lower the risk, the more affordable money becomes. In most commercial contexts, credit is extended against some form of security. The type of security granted affects the lenders' perceptions of relative risk, and therefore the availability and cost of the money on offer.

Security may be personal in nature (e.g. furnishing a promissory note, or third-party guarantee), or proprietary (involving property). Based on lenders' perceptions of risk concerning the relative quality of these different forms of security, one can say that the better the security, the better the terms upon which credit can be obtained. Of what consequence is this to Croatia? For the economy as a whole, the lack of an efficient legal and institutional framework for creating and enforcing security interests in land, movables, and intangibles acts as a barrier to increased investment, and the formation and operation of capital markets. Additionally, it tends to increase the cost of money, and contribute to the liquidity problem that is prevalent today.

In recent years there has been a concerted effort to revise the laws of countries in transition to allow for a system in which the borrower can keep ownership, possession and use of a movable asset, while at the same time allowing the lender to obtain a security interest in it. Essential to such a system is the development of a centralized registry of security interests in movables. The registry provides information as to whether an asset has already been pledged, to what extent, and establishes priority as between creditors who have lent funds on the basis of the same security. Other important elements in these revised or new laws have been the development of rapid and cost-effective ways of recovering the debt from the asset which is secured, and a system which is user-friendly (i.e. it is easy and relatively inexpen-

sive to establish, maintain and enforce the rights of the creditor). Poland, Latvia, Bulgaria, and other countries in the region have successfully implemented collateral registries with technical assistance support from USAID.

2. Legal Framework

Croatia has an established system of mortgages on real property, in which the borrower retains the ownership, use and possession of the property. A system of registration in the Land Registry and the Cadastre has long been in use. While this system has significant technical problems and is in need of substantial improvement, it is built on sound legal principles, which can be replicated in the proposed system for registration of liens on movable property.

Croatia has a well-organized and detailed Property Law (Zakon o vlastništvu i drugim stvarnim pravima, adopted in 1996), which provides detailed regulations on various forms of mortgages and liens in Part 7 (Articles 297-353). The law allows the formation of different kind of liens, including non-possessory liens on movable property, and has adequate regulations for the establishment, registration and enforcement of various rights related to secured property. While the law does not specifically regulate non-possessory liens on movable property, they are also not specifically forbidden (as was the case in several other European jurisdictions prior to the adoption of specific legislation). In practice, such liens are created at present in Croatia with special notarized contracts between the parties, which are sometimes subject to other legislation as well.

In Croatia, the use of a movable as security for a loan has traditionally involved the transfer of possession of an asset from the debtor to the creditor. Possession of an asset by the creditor obviously reduces the risks and the rate of interest charged. However, it deprives the borrower of the use of the asset, thus adding a cost to the actual interest paid, and thereby increasing the real cost of borrowing (especially when the pledged asset is normally used for productive purposes).

A system of possessory liens has other disadvantages as well. For example, a possessory lien cannot normally be granted in property which is to be acquired by the borrower at some future time (after-acquired property), unless the pledge involves a pool of assets, or in property which is described in generic terms (i.e. two tons of sugar). The borrower must normally pay the entire debt to recover possession. In effect, then, the borrower has no "equity" in the value of the asset which exceeds the unpaid debt. Thus, the borrower cannot leverage the asset to serve as security for outstanding obligations.

A recent legislative change in Croatia has sought to address some of these issues and introduced the mechanism of a transfer of "fiduciary ownership". The title to the property is transferred to a fiduciary, pursuant to an agreement, whereas the rights to possession and use remain with the debtor. These agreements are published in the Official Gazette. However, there is no official centralized registry to record such transactions. Nonetheless, the institution of a central registry appears to be gaining favor in Croatia. At least one private company has started to publish an unofficial listing of pledges of movables. This is obviously a step in the right direction. However, the listing may not be complete, and it does not establish priority of liens. In addition, we have been informed that a major Croatian bank approached the courts with a proposal to finance a central registry of pledges on movables, to be housed in the courts. While amenable to this idea, the courts deferred to the Ministry of Justice on the

grounds of conflict of interest, and no action was taken on the proposal by the Ministry at the time.

A major disadvantage of the "fiduciary ownership" technique is that the asset transferred to the fiduciary cannot be reflected on the borrower's balance sheet, thereby reducing the borrower's net worth and negating any possibility of borrowing against its "equity" in the asset (i.e. the value of the asset less the amount due on the loan). Similarly, because the borrower no longer owns the asset (at least until the debt is repaid in full), the borrower cannot provide a second lien on the asset to borrow more funds against it. Thus, in both cases, the borrower's liquidity is reduced by virtue of its no longer owning the asset. This would not be the case if title were retained, as in the system of non-possessory liens.

Under the legislative change relating to "fiduciary ownership," if the borrower defaults in timely payment, the lender may sell the property and collect the unpaid debt. The enforcement procedure is controlled by the courts but sales may be made through third parties. Private sales are normally not permitted.

3. Implementing Institutions

The proposed system for registration of collateral on movable property can be implemented by a special central registry, located with the Ministry of Justice, the courts, the local administration or in a specialized institution, with branches in several major cities. The register may be integrated with the already existing land registries.

Croatia has a system of land registration, which traditionally played a key role in the registration of transactions with immovable property, including the establishment of mortgages over it. Unfortunately, because of the disincentives for the use of the system in the last 30 years, many of the land records are not up to date, and are not computerized. This is especially true in Zagreb, where transfers and subdivisions of parcels of property were not recorded, so as to avoid taxes. The lack of current land records impedes and delays the granting of credit secured by real property. Updating and modernizing these records will help promote the economy by facilitating traditional lending on real estate.

4. Supporting Institutions

The proposed system for registration of secured transactions would be supported by many institutions, some of which have already demonstrated interest in it. It is of particular importance to the banks and other lending institutions. The introduction of such a system will not only increase the security for lending, but will help to reclassify some of the existing debt through the renegotiation of the terms of the debt and the acquisition of security for it. The banks will support the system through the identification of new assets on which liens can be placed, and through the design of new and improved lending instruments offered to the potential borrowers.

Another major support group would be the borrowers themselves. The proposed system would be of particular interest to small and medium enterprises, especially those with cyclical business, in which the need for credit is stronger in the passive time of the cycle, when preparations are made in anticipation of the active part. Associations of such enterprises with official business, especially in the tourism sector, may provide valuable services to their mem-

bers through the identification of new sources of financing and the promotion of the new system.

The availability of affordable and well organized notarial services are also important part of the supporting institutions for such system. They are already in place and operate relatively efficiently in the Croatian environment.

5. Market for Reform

Reportedly, the introduction of such a system was considered within the Croatian government in the late 1990s, without yielding any results. However, there appears to be a more favorable attitude at present. In fact, it is reported by the Croatian Minister of Justice that his Ministry is considering introducing legislation to establish a system for non-possessory liens using automobiles as collateral.

A draft law on registered pledges has been prepared with the participation of the Dean of the Faculty of Law, Professor Dika. Some of the major banks are also in favor of the introduction of such a system, and in fact were considering the establishment of a private system with the assistance of the commercial courts.

The Ministry of Economy is also in favor, taking into consideration the experience of other economies in transition and the positive effect that the system may have on the small and medium enterprise sector.

On the supply side there is already some legislative response. All possible obstacles for the establishment of the system have been removed, and secured transactions of the proposed type are permitted by the existing legislation. Moreover, the formulation of certain provisions of the Bankruptcy Law, the Law on Property and the Law on Execution will greatly facilitate the implementation of the proposed system. The provisions in place in those laws already provide adequate protection for the secured creditors.

6. Recommendations

The following recommendations are based on the analysis above:

- Because introduction of non-posssesory liens on movables, modernization of the companies register, and unification of the titling system for real estate will constitute significant departures from current practice, a focused effort to identify key stakeholders (all three branches of the government, academia, lawyers, bankers, businesses, accountants, NGOs, BSOs, donors, international organizations, etc.) and generate awareness and support for the broad reform initiative should be organized as quickly as possible.

- Awareness development should quickly transition toward consensus building, and the practical issues of system design and implementation. Technical presentations, workshops, and symposia devoted to these topics should be organized in the principal commercial centers of Croatia. Site visits to similar registries in the region should be organized, and feed directly into design and implementation planning for the systems. Where useful, technical delegations from within the region should be invited to provide short-term, on-site planning and implementation assistance.

- The MOJ should form a Steering Committee for Registries Modernization made up of stakeholder representatives supported by outside technical experts to shape and guide the overall registries modernization initiative. It is suggested that creating a modern registry for movables be considered as a first priority. However, quickly thereafter, modernization of the companies registry, and unification and modernization of the land title and cadastre systems should be pursued aggressively. Subcommittees should be created to lead the work in each of the three main directions of this initiative.

- Within this context, a legislative drafting subcommittee should be formed to prepare, circulate for comment, and revise draft framework legislation among the stakeholder group in each of the three branches of this initiative.

- A subcommittee for system design and implementation should be formed by the Steering Committee to work out practical design, implementation, and financing issues. Since a centralized registry is a *sine qua non* of an efficient and effective system employing non-possessory liens, the infrastructure for this system must be determined as the framework law is developed.

- Draft legislation (and necessary subsidiary regulations, instructions, etc.) should be presented to the MOJ for consideration and Government approval once consensus among the stakeholder group has been achieved.

- Enactment of required legislation should be submitted to the *Sabor* once Government approval is obtained.

- Necessary procurement should be completed, and implementation of systems undertaken on a pilot basis.

- Intensive training/awareness development activities should be pursued in pilot jurisdictions as pilot project implementation is carried out.

- Preparation of guidebooks for borrowers and lenders explaining the new systems should be developed and distributed in conjunction with appropriate training and public awareness initiatives.

- National roll out of a registry modernization program should follow the pilot project.

C. COMPANIES

1. Context

The Croatian Company Law (*Zakon o Trgovaćkim Družstvima*) was adopted in 1993 and is based mainly on the German and Austrian comapny laws, taking into account the applicable directives of the European Community. It is a modern law, permitting the organization of all company forms known to the European legal tradition. The philosophy of the law allows the parties substantial flexibility in the way companies are organized and accommodate the needs of both individual entrepreneurs and small companies, as well as large company forms with substantial capital (such as the joint – stock companies).

The problems of the company law system are mostly technical and related to the Law on the Court Registry. Initially this law was conceived as limited in scope and dealing only with the technicalities of the registration of companies in the commercial courts, but by the time it was adopted it developed into a system requiring the supply of substantial information, often irrelevant for small and medium-size companies, and giving a lot of discretion to the registering institution. The law was adopted without thorough preparation of the necessary infrastructure, and the court registries still cannot meet the expected standards several years after the law has been adopted. The central registry is updated once a day, but the initial idea to make it available to users through the Internet (this will be particularly useful for the public notaries), never materialized because of the lack of technical capacities and the high cost of the proposed service.

On the conceptual side, the current company law offers little protection to the minority shareholders. While the law leaves a lot of contractual freedom to the parties (whereby they are free to shape the founding documents of the company according to their needs and understanding), at the initial stage of company formation this opportunity has not been used, primarily because of the lack of knowledge and practice in the professional community. As a result, in some cases minority shareholders have remained under-represented on the boards of larger companies, and later accused the managers of abusing their rights. Added to other misunderstandings of the law by some minority shareholders, particularly the employees of former socially-owned enterprises, this situation resulted in an increase of the cases in commercial courts, especially in the first several years after the law was introduced. The number of cases has only recently been stabilized and has begun to decline, but the remaining cases are becoming more complex.

2. Legal Framework[1]

In addition to the Law on Commercial Companies (LCC) there are special laws that regulate companies that carry out certain business activities, i.e., banks, savings banks, insurance companies, etc. According to the LCC, business activities may be carried out in following types of business organizations:

a) Companies (partnerships and corporations)

b) Sole proprietorships (craftsmen and individual merchants)

c) Branch offices

d) Representative offices of foreign companies, and

e) Cooperatives.

The LCC allows entrepreneurs to choose one of the types of companies prescribed by this Law. It provides general features for every company and leaves room for independent regulations of matters within the company. There are some mandatory provisions aimed at protecting public interests, the interests of creditors, and the interests of shareholders or the members of a company. The lack of mandatory provisions is more evident in the regulations on partnerships, but is not a practical problem because of the limited number of partners, who

[1] *Materials prepared by Mr. Zdravko Kuzmić at the World Bank were used for the preparation of this part of the report.*

usually know each other well and are able to supervise closely the activities of the partnership.

Companies in Croatian law may be divided into two major groups—partnerships and corporations. A partnership is an association of at least two persons, who may be either physical persons or legal entities. A person becomes a member of a partnership on the basis of the personal involvement, rather than on the basis of the invested capital. Partnerships may be general, limited, silent, economic interest groups, or civil.

Limited Liability Companies - A limited liability company is defined as a company in which one or more individuals or legal persons invest their property and thereby participate in the previously agreed share capital. The name of the firm must have an indication that it is a limited liability company in Croatian, usually by adding the letters d.o.o. to its name. Founders of a limited liability company may be domestic and foreign physical or legal persons.

The minimum share capital of a limited liability company is the *kuna* equivalent of DM five thousand (5,000). A limited liability company is obliged to keep a register of shares.[2] Moreover, the law requires a management board and the general meeting of the participants (the partners). A supervisory board is obligatory only if this is prescribed by a law for companies performing some special activities or if the company has more than three-hundred (300) employees.

The management (directors) consists of one or more participants. There are no restrictions with respect to appointment of a foreign national as director. Members of the management are appointed by the general meeting of the participants in the company. The authority of the directors includes the management and representation of the company. The position of the members of the management of a limited liability company with respect to managing the company is less independent than that of the directors in joint stock companies. The idea of the limited liability company is that close relations exist between the partners and that every one of them will be actively involved in the management of the company in one form or the other.

The general meeting or the Assembly is the principal body in which the participants (partners) in the company reach the decisions, which they are authorized to make by the LCC and by the Articles of Association. The Articles of Association may provide very broad authority for the general meeting of the partners. Unless otherwise agreed in the Articles, the partners shall have votes corresponding to their contributions to the capital. A general meeting shall reach decisions by simple majority of the votes. The Limited Liability Company is the most widely used and at this time is the most important company form in Croatia.

Joint Stock Company - The LCC defines a joint stock corporation as a company whose members (shareholders) participate in the share capital, which is divided into shares. The name of the company must have an indication that it is a joint stock corporation in Croatian, or it must have the letters "d.d." Shareholders are not liable for the obligations of the joint stock corporation, and they may be domestic and foreign physical and legal persons.

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2 *Shares in a limited liability company are not freely transferable as they are in a joint-stock company. In German they are called a Geschaftsanteil or "business interest". The rights to transfer the interest in a limited liability company is usually subject to the agreement of all the participants, and the shares in limited liability companies are not publicly traded.*

The minimum share capital for establishing a joint stock company is the *kuna* equivalent of thirty-thousand (30,000) German marks (DM). The Law on Securities (1995) bans the issuance of share certificates in paper form (a common feature of modern securities laws). Instead, the owner of shares shall have an account with the central depository agency (which, as discussed below, has yet to become fully operational). Shares may be either registered name-shares, or bearer shares, and may be issued as either common (ordinary) shares, or preferred shares. Common shares give the right to vote at the general shareholders' meeting, right to receive dividends, and right to receive a proportional part of the amount remaining upon liquidation of the corporation. Holders of preferred shares enjoy some preferential rights, such as the right to dividends in a previously determined amount, priority right to dividends or to payment of an amount remaining upon liquidation of the corporation, or other rights foreseen by the law or by the Articles of Association.

Only those persons who are registered in the share register are considered to be shareholders. The book of shares is kept by the management of corporations (this provision refers only to registered name-shares). Joint stock corporations are in general prohibited from owning treasury shares, although this is allowed in cases strictly determined by the LCC, only to the extent of ten percent (10%) of the total amount of the stated capital.

Required bodies of a joint stock corporation are the management (sometimes referred to as the management board), the supervisory board, and the general shareholders' meeting. Articles of association must determine the number of the members of the management and of the supervisory board. Management consists of one or more directors (if it consists of more than one member, one of them has to be appointed as the president), appointed by the supervisory board for a maximum period of five (5) years. Members of the management may be either Croatian or foreign nationals. Rights and obligations of the management include: (i) management of the corporation; (ii) representation of the corporation; (iii) preparing decisions which are to be made by the general shareholders' meeting; (iv) preparing contracts; (v) executing decisions of the general shareholders' meeting; and (vi) informing the supervisory board on issues regarding management of the corporation.

The Supervisory Board must have at least three members. The LCC restricts the number of members of a supervisory board, depending on the stated share capital of the corporation. Members of supervisory boards are elected in a general shareholders' meeting for a maximum period of four (4) years and may be reelected. Members elect among themselves a president and at least one deputy president. It is the obligation of the supervisory board to supervise the management of the corporation. It submits its report to the general shareholders' meeting.

General shareholders' meeting of a joint stock corporation is the principal body in which shareholders realize their rights. All shareholders have the right to be present at the general meeting. Competencies of the general meeting are determined by the Articles of Association. Decisions at the general meeting are reached by a majority of given votes. Dissolution and closing of a joint stock corporation are regulated in the LCC. Closing shall be carried out by the Board of the company.

Currently the law does not restrict the introduction of various quotas for the representation of different groups of shareholders, but does not specifically allow them either. As a proposed future amendment the law may provide for a mandatory representation of certain groups of

shareholders (i.e. holding 5 or 10% of the shares) through the mechanism of cumulative voting, which is well established in the United States.

The company law in Croatia provides adequate regulation of well-established forms of business activity in Europe. In some important aspects with respect to the regulation of joint-stock companies it is amended by the Securities Law.[3]

3. Implementing Institutions

Company Registry

The main implementing institution for the Company law is the Company Registry, which has branches at all eight commercial courts in Croatia. The existing system follows the philosophy of the traditional European court registration systems, but is not fully operational due primarily to technical difficulties and lack of funds to bring it up to the expected standards. Company registration in Croatia is a purely administrative procedure, which should be automatic upon the presentation of the required documents, specified by the law. Yet the registration process itself takes a considerable amount of time (usually about 1 month, but even more in some cases) and is far from being transparent and predictable. At the time of adoption of the LCC proposals were made to locate the system outside the courts[4] (within the Chamber of Commerce or with the local administration) and to make the procedure as simple as possible, but at the end the traditional approach prevailed. As a result, the courts are burdened with a large amount of administrative work, the system is inefficient and not fully operational several years after it has been introduced, and it certainly does not provide the expected guarantees that only "serious" companies with adequate capitalization will be allowed at the market.

The system was supposed to assign a universal number to every company. This number was supposed to serve not only as an identification for the purposes of company registration, but also as a tax-payer number and to identify the company for the purposes of several other public administrative services (the social security administration, the local authorities, etc). Instead, the failure of the system resulted in the proliferation of other means of identification, which contributed to the already existing confusion and administrative difficulties. Bringing the system up to date and achieving the projected initial parameters is one of the priorities in this area, but the implementation is impeded by the lack of technical capacity, experience in the design of such systems and funding. The relocation of the system and making it part of an integrated registration system can be achieved with relatively limited resources, while bringing about the immediate effect of reducing the workload of the judges involved in company registration. Even if the registry remains in the courts, the registration functions can

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3 *The Joint-Stock Companies were originally conceived as the company form through which capital should be raised from the public. By its nature the laws regulating them also contained rules regarding the preparation and issuance of the prospectus for public offerings and detailed accounting rules. The rules about the operations of the exchanges were included in separate legislation on stock exchanges. In the 1990s however many countries in transition developed separate securities legislation, which deals primarily with the public offerings of securities, but also regulates the operations of the capital markets. It can be expected, that more systematic approach will be adopted in the future and that the company laws will be amended accordingly in their sections, dealing with the formation and operation of joint-stock companies.*

4 *Locating the company registry outside of the court system is somewhat contrary to the European legal tradition, but has its merits and has been successfully tested in other jurisdictions. The idea was rejected at the time of preparation of the law despite the proposal of the working group in charge of the draft.*

easily be shifted to specialized court clerks. It seems that such an idea will be well supported by the judicial and academic community in Croatia.

The Courts

The courts are not adequately prepared to implement some of the most complex provisions of the Company law. In general the majority of the judges are young, and most of them have never been exposed to the complexities of the operations of private companies anyway. There is almost no judicial practice in certain areas, and what exists is not being published because of the lack of funds. Little continued education is being offered, and the emphasis is not on cases studies, but mostly on theoretical analysis. The local attorneys also offer little support to the courts, and are not well prepared in complex company matters.

The existing complaints about the rights of minority shareholders for instance are related to certain practices of the management, due not so much to the deficiencies of the law, but to the lack of adequate judicial protection of the rights of the shareholders. The Company law provides adequate possibilities for formulation of the Articles of Association and the By-laws of joint stock companies in a way that can guarantee the protection of all classes of shareholders. It does not prevent the adoption of cumulative voting, whereby a certain number of shareholders can elect a pre-determined number of members of the Board of Directors of the company through a combination of their votes. Yet such provisions have not been included in the Articles of Association in the vast majority of the companies formed in Croatia after the LCC was adopted.

The complaints against the managers of certain companies, particularly those with a large percentage of employee-shareholders, primarily relate to actions prohibited by the Company law, but inadequately prosecuted in the courts. The problems of minority shareholders are related to the inadequate operation of the judicial system and to the lack of understanding by the judges of the complexities of the law and particularly of the standard of care due by the directors of joint-stock companies. On the other hand, often times the expectations of the shareholders and their understanding of the law are also inadequate and reminiscent of the rights of the employees during the system of social ownership of the enterprises. Adequate protection of the minority shareholders can be achieved primarily through better education, establishment of judicial standards and building up of body of judicial decisions, and the involvement of specialized professionals in the operation of major companies.[5]

4. Supporting Institutions

For the time being there is no adequate system of supporting institutions in Croatia. The size of the market and the lack of substantial foreign investment did not create enough business for the major international accounting and consulting firms, and they are not present in the country. There are virtually no foreign law firms. While several major banks (primarily Austrian and German) are present in the country, their business is still small and the investment projects they have financed so far are restricted to local companies with substantial export potential or a limited number of projects with substantial foreign participation.

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[5] *A study, of the Croatian Employee Minority Shareholders Rights (1997) prepared by Malcolm Mason, Tod Sawicki, and Susan Wilson confirms some of the factual findings in this section, particularly those, related to the bahavior of the management and the minor shareholders.*

The network of local consultants is not well developed and their services are perceived as unaffordable, especially for the small and medium enterprise sector. Project preparation is also a problem. On one hand, local businesses are not used to this kind of service and perceive them as luxury. This in turn impedes the growth of the services sector and in the same time prevents the enterprise sector from obtaining financing for new projects.

Business and professional associations are only at the initial stage of formation. They lack funding and experience, and their presence is (or at least was) of little importance to the decisions of the government. There are no adequate mechanisms for a dialogue between the public and the decision makers (although there are encouraging indications that this situation might change).

5. Market for Reform

Several years of experience with the implementation of the Company Law created a substantial market for reforms, primarily with respect to the administration of the law. There seems to be wide agreement between the practicing professionals (judges, attorneys and notaries) on one hand, and the members of the academia, who participated in the design and drafting of the law, on the other, that changes should be made in several directions. The most obvious target at this time seems to be the Company Registry. The practicing community feels that gains in efficiency can be made with a relatively small investment in the system, and that the drafters of the law support certain ideas, which were not accepted at the time the law was adopted, but which proved viable in long term.

In the medium term there is strong support for the amendment of the Company Law with provisions for better protection of the minority shareholders. The existing support will certainly increase with the development of the securities markets and the increase of the interest of the small investors in it.

6. Recommendations

The following recommendations are based on the analysis above:

- Because the changes in the procedures for company registration will require certain technical preparation, more detailed study of the existing procedures should be carried out in at least one and preferably in two or three registration courts with the purpose of identification of the redundant action required by the law or established by the existing practices at this time.

- Following the completion of the study, a detailed proposal should be prepared with the participation of local experts (who have already prepared some proposals to that effect) for the necessary legislative and administrative changes. In parallel assistance should be provided in the identification of suitable software and hardware and the development of detailed implementation plans, in which area the local capacity and expertise seems to be very limited.

- The Ministry of Justice (MOJ) should form a Steering Committee for Registries Modernization made up of stakeholder representatives supported by outside technical experts to shape and guide the overall registries modernization initiative. It is suggested that creating a modern registry for movables be considered as a first priority. However, the work

on the Company registry may be initiated in parallel and should be pursued aggressively. Subcommittees should be created to lead the work in each of the three main directions of this initiative.

- Within this context, a legislative drafting subcommittee should be formed to prepare, circulate for comment, and revise draft framework legislation among the stakeholder group in each of the three branches of this initiative.

- A subcommittee for system design and implementation should be formed by the Steering Committee to work out practical design, implementation, and financing issues. Since a centralized registry is a *sine qua non* of an efficient and effective system employing non-possessory liens, the infrastructure for this system must be determined as the framework law is developed.

- Draft legislation (and necessary subsidiary regulations, instructions, etc.) should be presented to the MOJ for consideration and Government approval once consensus among the stakeholder group has been achieved.

- Enactment of required legislation should be submitted to the *Sabor* once Government approval is obtained.

- Necessary procurement completed, and implementation of systems undertaken on a pilot basis.

- Intensive training/awareness development activities should be pursued in pilot jurisdictions as pilot project implementation is carried out.

- Preparation of guidebooks for borrowers and lenders explaining the new systems should be developed and distributed in conjunction with appropriate training and public awareness initiatives.

- National roll out of registry modernization program.

E. CONTRACT

1. Context

Croatia has a long tradition of well developed system of contract law, the use of which was not discontinued during the socialist period. After the independence the Law on Obligations, which is the basic contract law, was cleansed of ideological concepts and references to socialist enterprises. It now represents a sound base for further development. The system of contractual law was further improved with the introduction of the Law on Property in 1996, which added several new contractual forms and liberalized the treatment of secured transactions.

The current Law on Obligations does not specifically regulate certain contractual forms (e.g., factoring, leasing and franchising) developed in the market economies in Europe in the post-World War II period. Nevertheless such contracts are recognized and enforced, based on the principle of wide contractual freedom, on which the Law on Obligations has its foundation.

These contracts might be included in a future revision of the law, but their absence does not represent an obstacle for business development in Croatia.

The principal reason for non-fulfillment of contractual obligations in Croatia is not within the legal system. As discussed further, the main problem for the emerging private sector is the massive blocking of payment accounts throughout the country, which results in non-payment under 80% of all contracts. In such circumstances the parties resort to various barter and other compensatory arrangements, which increases substantially the cost of doing business and contributes to the existing legal insecurity.

2. Legal Framework

The basic legal framework for the formation and interpretation of contracts in Croatia is contained in the Law on Obligations.[6] This law, organized in two parts, is rooted primarily in the Swiss and German traditions, and is consistent with the traditions of the Continental legal system. Part I of the Law addresses general principles of contract law. Part II contains specific contract forms, which in principle, may be departed from by mutual agreement of the parties. The law itself is adequate to the needs of a modern market economy, and does not need significant amendment or revision.

Part I of the Law on Obligations defines the essential preconditions for the formation of a contract, including offer, acceptance, and mutuality of consideration. A contract is deemed concluded when the parties have agreed to all essential terms. Bilateral and unilateral contracts are recognized.

2. Implementing Institutions

The Law on Execution (Distraint),[7] provides the basic legal framework for the enforcement of judgments in Croatia—an area of critical and immediate need for reform. The procedure for enforcement of rulings and decisions[8] begins once a final order or ruling is entered by the court of first instance. In economic cases, this is typically the commercial court. Enforcement actions are initiated when a party (or the court acting in an ex officio capacity) seeking enforcement of a ruling or order submits a petition for a writ of execution to the court for review. The petition is reviewed in a hearing, and on the record. At this level, the court is composed of a single judge.[9] The court is given latitude in accepting additional evidence, including witness testimony to verify the legal or factual basis of the petition. Failure of a party to appear at such hearings does not prevent the court from ruling on the petition. If the petition is deemed legally and factually supported, the court will issue a writ of execution that initiates the collection aspect of the process.

Service of the writ is made at the address of the debtor listed in the petition, or at the principal place of business of a legal person (company). The law contemplates both personal service and service of process by mail. If personal service is not accomplished, the writ will be pub-

6 Law on Obligations (Zakon o obveznim odnosima), No. 53, 1991, as amended, Nos. 73, 1991; 107, 1995; 7, 1996.

7 Law on Execution, 1996.

8 The distinction here is primarily technical, but does have procedural implications. For the purposes of this analysis, a "ruling" is a final judicial determination on the merits. A "decision" is provisional, and by implication, does not significantly impact of the substantive rights of the parties.

9 On appeal, a panel of three judges will review the lower court's decision.

lished by posting it on the court's notice board. In such cases, service of the writ is deemed to have been accomplished on the eighth (8) day of publication. Appeals from enforcement rulings must be made within eight (8) days of the court's decision. Appeals do not act as a stay of the collection process.

Execution is made to verify that a legally valid final judgment has been entered, and that all other legal requirements have been met.[10]

4. Supporting Institutions

Croatia has only the basic network of supporting institutions needed for the implementation of the contract law. The Bar Association and the notary services are well developed and the legal profession is able to meet the needs of the public. The private sector has not yet responded to the needs for valuation services, court reporting or credit rating services, which are practically non-existent.

The response from the public sector has been even slower. The relevant state institutions are based on sound concepts, but none of them is fully operational because of the lack of resources and other administrative problems. With the development of the private sector, the role of the various registries, particularly for real estate transactions and company registration, increases significantly, yet they still face considerable organizational problems, and their services are unreliable and costly. The situation with the land books seems particularly bad.[11]

5. Market for Reform

The market for contractual law reform and improvement is wide and cuts across all other sections of the business legislation. Private sector demand is not so much for improvements in the legislation, which is considered satisfactory, but for better administrative services, which seems to coincide with the declared priorities of the government.

On the supply side, the state has provided a sound network of commercial legislation allowing extensive contractual freedom to the parties. In some areas, such as the organization of the notaries, substantial progress has been made. In others there is political will to improve the situation but limited resources and experience result in delayed response to the increasing demand for better administrative services. There is clear understanding that all registration services need improvement, and the new government and the Ministry of Justice in particular have made improvement in those areas their priority.

6. Recommendations

The recommendations for the contract law area generally meet those made in the collateral and bankruptcy sections and need not be repeated here. In terms of fundamental laws and procedures, the system is in place. Immediate results can be achieved through improvements in the registration system and court administration, as described in the Bankruptcy, Secured Transactions, and Company sections.

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10 E.g., Art. 4 contains limitations of on what may be subject to execution and levy.

11 *Please see the discussion in the bankruptcy section.*

Significant improvement in contract enforcement can be achieved only if the basic political problems with the payment system and blocked accounts are resolved. In the estimate of the High Commercial Court, about 80% of all contracts at this time remain unpaid. The affected parties do not initiate action, because they realize that it is impossible to satisfy their claims with legal means. In turn they do not pay their suppliers. In this situation even the best enforcement system will be helpless and little can be done to improve it through better legislation and especially administrative practices.

APPENDIX A – COMPETITION

ASSESSMENT AND RECOMMENDATION REPORT
OF CROATIAN COMPETITION LAW AND POLICY

OECD/CLP

USAID C-LIR PROJECT
(Zagreb, 20-26 February 2000)

I. INTRODUCTION AND SUMMARY

This assessment and recommendation report has been prepared by members of the outreach team of the Competition Law and Policy Division of the OECD in the framework of the USAID C-LIR (Commercial Law and Associated Institutional Reform Activities) Project in Zagreb between 20 and 26 February 2000. The report is based on interviews, the review of the legal rules and some cases in the field of Croatian competition law and policy.

Two developments give primary importance and urgency to such assessment: (i) the fact that the recently elected democratic Government of the Republic of Croatia has asked for help in managing transition to democracy and market economy, that the United States would be keen to provide through USAID; and (ii) the decision that the OECD would serve as a Secretariat for competition law and policy issues within the framework of the Investment Compact of the South East European Stability Pact, which was founded by the G7 countries and the European Union.

In general, this report finds that the Croatian competition law enforcement agency has been engaging in significant work to promote the development of an efficient market economy in Croatia. It is headed by a dynamic and politically astute economics professor who participated in drafting and lobbying for the law. Having obtained an exemption from normal civil service laws, she is able to provide training and salary packages that have permitted her to assemble a small but impressive team of lawyers and economists. While some of the agency's enforcement decisions protect competition rather than competitors (a common problem in transition countries), the agency has been willing and able to make analytically sound and potentially unpopular decisions, for example, seeking to prevent the domestic tobacco monopoly from keeping out BAT from the Croatian market. The agency's effectiveness has been jeopardized by its inability to get the court to enforce its orders and by *de facto* exemptions provided through other laws and regulations. However, with assistance in overcoming these and other, lesser obstacles the agency can be a powerful force for market-oriented reform.

1. Methodology

The present report follows the approach of the USAID Synthesis Report on Commercial Legal Reform Assessments for Europe and Eurasia prepared by Booz-Allen & Hamilton with regard to Kazakhstan, Poland, Romania and Ukraine in 1999 ('the 1999 Report'). The present

report assesses Croatian competition law and policy in four dimensions: (i) the framework law; (ii) the implementing institutions; (iii) the supporting institutions; and (iv) the "market" for reform.

In each of these four dimensions, the interviews carried out in Croatia have built on the updated version of the development indicators of the 1999 Report. In the field of competition law and policy, the development indicators have been updated by Booz-Allen & Hamilton on the basis of comments and recommendations presented by participants at the USAID's Regional Commercial Reform Workshop in Prague between 6 and 9 December 1999. The interviews have been carried out with a view to cover the development indicators as comprehensively as possible and taking into account the experience of the Competition Law and Policy Division in other transition economies.

The present report has four parts according to the above-mentioned four dimensions of the assessment of Croatian competition law and policy. Each part includes a narrative draft assessment of Croatian competition law and policy in the respective dimension.

Nevertheless, the four dimensions are to a great extent intertwined in the context of Croatian competition law and policy. Therefore, at the end of the present report practical proposals are put forward in order to make Croatian competition law and policy more efficient and effective with regard to all four dimensions. Finally, the report predicts the possible impact of each proposal.

I. FRAMEWORK LAW

The main legal sources of Croatian competition law and policy are:

- the Croatian Law on the Protection of Market Competition ('LPMC') (14 July 1995);
- the Bylaws on the Methods of Keeping a Register of Concentrations (20 February 1997);
- the Bylaws passed by the APMC and adopted by the Croatian Parliament on 18 June 1997 (referred to by the 1997 Annual Report of the APMC, p. 3.);
- the Charter of the Agency for the Protection of Market Competition ('APMC') adopted by the APMC and ratified by the Croatian Parliament (referred to by Article 28 (4) LPMC);
- the Book of Regulations adopted by the Council for the Protection of Market Competition ('Council') under Article 31 (4) LPMC;
- the Rules of Work Procedure adopted by the Council (referred to by the 1997 Annual Report, p. 3.);
- and the Joint Stock Company Takeover Procedures Act (13 November 1997).

The procedures of the Croatian Agency for the Protection of Market Competition ('APMC'), which started to operate in 1997, and the procedures of the administrative appeal courts are generally regulated by the Croatian Administrative Procedure Code.

The fairness of competition is regulated only to a limited extent by two Articles of the Croatian Law on Trade. Violations of the fairness of competition are investigated and sanctioned by the Trade Inspectorate organized within the Ministry of Trade. The Consumer Protection

Act to be adopted in the near future will also be enforced by a special body within the Ministry of Trade.

Rules on national standards, customs, trade and public procurement have been recently adopted according to Western models, such as Austrian, German, Slovenian or, generally, EC law. Nevertheless, the mere transposition of such laws into Croatian law is not necessarily the best solution to regulating such fields, as the models are often not adapted to the special circumstances in the Croatian market. Moreover, the high level of sophistication of the models creates the risk that the transposed laws may not be understandable to enforcers of, and subjects to, such laws. Further, coherence between the transposed laws in different fields of commercial law leaves much to be desired.

In Croatia, at least until the new Government took office recently, standards, customs, trade and public procurement regulations have been strongly influenced by politicians and professional lobbies. Such tailor-made laws often include unnecessary and anti-competitive barriers to entry, in other words, they are discriminatory against actual or potential (foreign) competitors.

The LPMC was modeled on EC competition law. As the primary source of Croatian competition law, the LPMC sets out predominantly substantive rules on anti-competitive agreements, the abuse of a dominant position and mergers and acquisitions both in a horizontal and a vertical context. It specifically prohibits price fixing, market sharing, refusals to deal, exclusive dealings, predatory pricing and tying. The LPMC does not cover bid rigging in public procurement as this form of price fixing is apparently covered exclusively by the public procurement law.

In June 1998 the LPMC was amended to extend the powers of the Director of the APMC, to lengthen procedural deadlines as regards taking a decision on concentrations and the lapsing of infringements of competition law and to provide for the official publication of APMC decisions in the Croatian Official Gazette, Narodne Novine.

The LPMC contains a few procedural provisions such as the fees charged by the APMC for its procedures. Otherwise, the legal rules on the procedures of the APMC are contained in the Croatian Administrative Procedure Code. The APMC regards the procedures of the Administrative Procedure Code as adequate, but it seems unlikely that this general law is totally well-suited to the special task of competition law enforcement. Including all specific procedural rules and rights into the LPMC would enhance the transparency and availability of the procedural rules and rights before the APMC.

The LPMC covers all sectors of the economy. The only sector exempted by law is individual and collective labor agreements. However, in various sectors laws or regulations entitle business associations with compulsory membership to adopt further rules in the given sector or industry. Such rules are often anti-competitive or discriminatory towards foreign or potential competitors.

The main objective of the LPMC seems to be the protection of competitors' fundamental rights rather than protecting competition or consumers' general interest in the efficiency gains of greater competition. Article 6 LPMC mentions the protection of "entrepreneurial freedoms". Indeed, the Croatian Constitution establishes such entrepreneurial freedoms as fundamental constitutional rights. Further, Article 10 LPMC, although modeled on the basis of

the individual exemption of Article 81 (3) EC (formerly Article 85 (3) of the EC Treaty), does not reproduce the exemption criteria that consumers should get a fair share of the benefits of a *prima facie* anti-competitive agreement.

The above approach is reinforced by the several occasions on which the LPMC provides an opportunity for protecting and promoting "national champions" in Croatian export markets. In the field of anti-competitive agreements, Article 10 LPMC defines the "increase of the competitive power of entrepreneurs in the international market" as a possible exemption criterion. As regards concentrations, Article 24 LPMC implies that it is positive if "the goals and effects of a planned concentration [involve] expanding in the international market." Although, from the viewpoint of competition, Croatian undertakings might need to achieve greater economies of scale, the above mentioned exemptions for national champions do not seem to be primarily driven by such concern. In the light of the limited competitive environment in the Croatian market, the promotion of national champions in the export markets might further deteriorate the yet rather underdeveloped competitive environment and structure in Croatia.

The LPMC applies market shares as important benchmarks in a number of fields: *de minimis* agreements (Article 9 LPMC), the definition of a single and joint dominant position (Articles 16 ad 17 LPMC), *etc*. Given the importance of the correct definition of the relevant market, it is regrettable that Article 19 literally defines the relevant geographic market in a too narrow way, as being "the geographic area of the entrepreneur's business operations where restrictions of free market competition have taken place". Similarly, Article 19 attaches interchangeability to "the area where the entrepreneur's market power is exercised." In reality, the relevant geographic market may well be wider than the territory where the infringement of competition has been put into place. When the relevant geographic market is the Croatian market or a smaller market, it is unclear whether the APMC would be entitled to assess the relevant market in broader way. Moreover, due to the fact that the APMC protects competition in the Croatian market, the above definition might imply that the relevant market could not be defined as extending beyond the borders of Croatia even in the context of regional, continental or global products and markets. Although, competition in such regional, continental and global markets might be taken into account by the APMC at a later phase of its procedure, given the fact that the LPMC relies heavily on market share benchmarks, a limited approach to the assessment of the relevant geographical or product markets might lead to a distorted picture and a waste of the scarce personal and financial resources of the APMC.

Article 11 LPMC provides for block exemptions similar to the ones in EC law. Nevertheless, no block exemptions have been adopted so far. In the period before the adoption of block exemptions, the workload of the APMC might grow considerably and unnecessarily due to the lack of any transitory rules in this context. Further, in the context of a transition economy, the usefulness of a sophisticated but not very modern and certainly too legalistic EC exemption model of vertical agreements might be questioned.

Article 14 LPMC defines joint monopolistic position on the basis of "no market competition between [the companies concerned]." Single and joint dominance is established on the basis of market power. It is questionable to what extent there is a real difference between a (joint) monopolistic and a (joint) dominant position, and to what extent such distinction is useful and can be defined with certainty in the framework of a competition procedure. This ambiguous definition seems to be the product of using different, *i.e.*, US, EC and German models of competition legislation in an incoherent way.

Furthermore, it remains to be seen whether in its jurisprudence the APMC will base the assessment of market power simply on the market share thresholds defined in Article 17 LPMC or whether the efficiency and other economic consideration laid down by Article 18 LPMC will also play an important role in this respect. Similarly, it will depend on the APMC's discretion to what extent the efficiency and other economic considerations will be taken into account in the assessment of concentrations.

Article 10 LPMC sets out the following criterion for predatory pricing: "provided that [the lowering of prices as a basis for exemption] is not a short-term lowering of prices below the costs of production." Article 20 (1) (1) LPMC also requires "pricing below unit costs" and "intention" as criteria for a price being predatory. These criteria do not take account of the developments and sophisticated economic criteria applied in model jurisdictions, such as average total costs, average variable costs, structural considerations and the possibility of recoupment, which are all necessary to establish illegality. It remains to be seen how this element will be used in the jurisprudence of the APMC.

Following the EC model, Article 7 (1) (3) LPMC includes tying both in the law on anti-competitive agreements and the abuse of a dominant position. From an economic point of view it is questionable whether tying is harmful in the absence of market power and whether, as a consequence, it is a good approach to include tying into the law on anti-competitive agreements.

Further, in order to follow the EC model, the LPMC reproduces Article 86 EC (former Article 90 of the EC Treaty) on special and exclusive rights. In other words, undertakings assigned with carrying out special economic tasks on the basis of special and exclusive rights are subject to competition law to the extent that the application thereof does not hamper the execution of the special tasks. It remains to be seen how this paragraph is applied in practice and whether such a paragraph may remedy the lack of special regulation or withstand special regulations of certain infrastructures, industries and natural monopolies adopted under an anti-competitive approach. Indeed, the Law on Telecommunications regulates telecommunications and the energy industry is also regulated by special laws, however, such legislation sets out anti-competitive rules and lays down anti-competitive incentives on a number of occasions, thereby limiting the enforcement of the freedom of competition by the APMC in these fields. Moreover, certain local service industries, like funeral services, waste management, *etc.*, are regulated by the local governments in a similarly anti-competitive manner. On many occasions, the regulating local governments have retained the ownership rights of the formerly public local service monopolies. This creates an incentive for the local governments to favor such undertakings and to establish unnecessary barriers to entry and/or discriminatory operating conditions for actual or potential competitors.

Industrial property rights are recognized by Article 11 (2) LPMC as being a necessary basis of dynamic competition, and they are exempted only to the extent "that the restriction on market competition…is essential for the protection of [such] industrial property rights, and provided that they meet other restrictions stipulated by the [LPMC]."

According to Article 33 LPMC, competition proceedings may be initiated by any natural or legal person, entity, the Government or any state authority. Pursuant to the Administrative Procedure Code, the APMC is bound to process all formally acceptable requests. The APMC may also initiate cases *ex officio*.

Article 34 LPMC sets out the powers of the APMC to investigate competition cases. Such powers include access to all information and data of the parties involved in the procedure as well as any other private and public entities and state authorities and access to the premises of private and public entities.

Furthermore, according to Article 36 LPMC, the Director of the APMC may impose interim injunctions, for instance the Director may order that the suspected perpetrator immediately cease its anti-competitive practices.

The LPMC also provides the possibility to order procedural fines and fines at the end of the procedure. The minimum and maximum amount of fines is limited for physical persons, whereas the fines payable by other entities are set between 1% and 30% of the annual turnover of the entity in question. In general, the amount of fines that may be issued in competition procedures is far higher than in other Croatian administrative procedures. The APMC only makes a proposal regarding the amount of the fine and other sanctions to be ordered. The fine and other sanctions are formally imposed by the locally competent first instance misdemeanor court. The decision of local misdemeanor courts imposing the fines and other sanctions may be appealed before the Supreme Misdemeanor Court of Croatia, which has it seat in the capital, Zagreb. Non-pecuniary sanctions include cease and desist orders. Moreover, anti-competitive agreements and concentrations that have not been properly notified to the APMC are automatically null and void. Thus, the Agency may break up non-notified anti-competitive concentrations, however, it may not break up a firm as a result of the abuse of a dominant position. The APMC may authorize or exempt agreements and concentrations under certain undertakings by the parties involved.

The APMC may impose sanctions against undertakings operating in regulated industries and against state-owned undertakings. However, apart from competition advocacy and lobbying, the APMC has no effective means to fight anti-competitive central or local regulations or anti-competitive bylaws issued by business associations on legal authorization by the state.

The APMC may not withdraw its positive decisions. However, if its decision was based on false facts, it may newly assess the case in question.

The APMC's decisions may be appealed before the Administrative Court of the Republic of Croatia, which has its seat in Zagreb.

As regards the Bylaws on the methods of keeping a register on concentrations, the problem arises of the fact that such register is not publicly available. Therefore, this rather unique registry system seems to have no value added in comparison with the more generally applied notification system without registration. Further, the question arises whether or not the system of keeping a registry of concentration is flexible enough a method to monitor and assess concentrations.

II. IMPLEMENTING INSTITUTIONS

The APMC was founded in 1997 and it is responsible for the enforcement of the LPMC. The APMC defines itself as a "Government agency", although by law it is "fully independent", its budget is determined by the state budget and each year it is bound to submit its annual report

to the Parliament. The APMC is managed by the Director, who is appointed by the Parliament. There are no detailed rules on the Director's removal from office.

Currently, the APMC has 19 employees: economists, lawyers, a journalist and administrative staff. Economists and lawyers have started to develop specialization according to special economic sectors. Each case is investigated and processed by a group of one economist and one lawyer. The journalist is responsible for copying articles from the daily press for each employee of the APMC according to his/her specialization. Further, the journalist manages the APMC's public relations with the media.

The Director of the APMC is very keen on further educating the staff; most employees follow post-graduate courses in economics and English language training is also regarded as a priority.

There are no rules on professional incompatibility or ethical rules applicable to the employees of the APMC. However, the employees of the APMC refrain from holding positions on the board of companies or from having any remuneration from outside of the APMC, except for scientific activities. They also respect the rules of the Administrative Procedure Code concerning procedural incompatibility.

The Council for the Protection of Market Competition ('Council') is established as a professional advisory body to the APMC, which consists of a President and 8 members, all distinguished legal and economic experts. The President and the members of the Council are appointed by the Government on the proposal of the Director of the APMC. There are no detailed rules on the removal from office of the President and members of the Council. The Government sets the remuneration of the President and the members of the Council. There are no rules on professional or procedural incompatibility and ethical rules as regards the President and the members of the Council. In fact, they are mainly active in other positions, as professors, senior employees of the National Bank, *etc.*

The most important task of the Council is to make opinions on the outcome of competition cases initiated before, and investigated by, the APMC. The Council meets once a month to reach an opinion by consensus on all cases submitted to it by the APMC. The Council's opinion is in practice always followed by the APMC, which issues the formal decision in each competition case.

In practice, the APMC's financial resources originate exclusively in the state budget. Although the APMC would be entitled by law to a certain proportion of the fines imposed in competition cases, so far the Ministry of Finance has not transferred any part of the fines collected.

Nevertheless, in the course of the last 12 months, due to the political contacts of its Director, the APMC managed to increase the number of employees from 9 to 19, and it has a further 6 places on offer. Recently, the APMC has decided to occupy further office space in addition to the offices that it currently uses. Due to an exemption from the law on civil servants incorporated into Article 28 (3) LPMC, the Director of the APMC can offer a relatively competitive salary to the colleagues of the APMC, who are employed according to the rules of labor law. Indeed, it is the Director's priority to invest as much as possible into the professional and linguistic education of the employees, thereby trying to avoid that the employees leave the APMC for an employer with a higher salary or better carrier perspectives. So far, the em-

ployment policy of the Director has been rather successful. The colleagues of the APMC are highly competent and they have mostly stayed with the APMC.

On the other hand, this results in the APMC having few or no financial resources for computers, books, subscriptions to legal and economic periodicals and US and EC legal databases, and for organizing conferences and financing research in the field of competition law and policy. Further, the APMC lacks the financial resources to offer its official gazette for free or to place its decisions on its website.

Although during the three years of its operation the APMC has delivered a limited number of decisions, its enforcement activity is in general vigorous and it also initiates potentially unpopular cases *ex officio*. At the same time, there are some basic conceptual problems with the enforcement activities of the APMC.

First, as it is suggested by the LPMC, the APMC's practice protects competitors to the detriment of protecting competition and consumers' general interest in the benefits of competition. Apart from protecting competitors, social and unemployment issues are very one the agenda of the APMC.

As it has happened in many transition economies, the APMC wastes much of its limited resources on protecting small business against the alleged abuse of the dominant position of bigger undertakings, even in cases when small business might simply be less efficient than bigger undertakings. Further, the APMC engages in too many cases dealing with the proper, *i.e.*, non-predatory or non-discriminatory price of products, even though it admits that defining the proper market price is almost impossible. A recurring problem in the jurisprudence of the APMC is that in alleged predatory pricing cases it imposes the sanction that the alleged predator raise the price to the level of prices before the alleged predatory pricing was put into place. The APMC also has an inclination to treat foreign and domestic competitors in a different way both within and outside the Croatian market.

The Council may comment on draft legislation from the viewpoint of free competition. However, in practice it is rarely consulted, at least not with regard to the laws having the greatest (negative) impact on the competitive structure and environment. On certain occasions, such as the recently adopted new telecommunications law, the Government intentionally leaves only a few days for the APMC to comment on a very complex body of draft legislation. Nonetheless, the APMC keeps commenting on draft legislation and to lobby against anti-competitive central and local regulations and licenses, as in many cases that is the last available means for the APMC.

Similarly, the APMC may only express its opinion on decisions of the Croatian Privatization Fund, the Republic Fund for Pension and Health Insurance of the Employees of Croatia, the Republic Fund for Pension and Health Insurance of the Craftsmen of Croatia and the Republic Fund for Pension and Health Insurance of the Individual Agricultural Producers of Croatia, if it is so requested by the above institutions. Again, the APMC is rarely consulted and its opinion is not binding. The general approach of the APMC is that it refrains from investigating privatization cases from a competition law point of view.

Other institutions regard the APMC simply as a "Government agency" (Croatian Chamber of Commerce) or a "paper tiger" (Croatian Investment Promotion Agency). The APMC has problems communicating the role and importance of competition to regulatory bodies.

Further, the APMC fails to communicate the importance of competition to its most natural constituency: to competitors and small business, which are the direct beneficiaries of its competition policy, and to consumers, who are currently only the indirect beneficiaries of its competition policy.

III. SUPPORTING INSTITUTIONS

Courts would be the primary support institutions helping the enforcement of Croatian competition law and policy. The local misdemeanor courts and the supreme misdemeanor court have the task of imposing the fines and sanctions ordered by the APMC, whereas the Administrative Court of Croatia is competent to adjudicate appeals against decisions of the APMC. Nevertheless, in practice, such courts are practically inactive in the field of competition law.

The problem with courts, which affects the entire legal system is manifold. First, courts have a serious backlog of over 1,000,000 pending cases. In practice, it takes several months, sometimes even a year until the first hearing is scheduled. Having a judgement delivered is a matter of years. In fact, Croatian courts have inherited much of this backlog from the Yugoslav era. Second, the body of commercial laws has been amended considerably or introduced just recently on the basis of models different from Croatian legal tradition. As a result, judges are cautious to deliver judgements in legal fields that they do not understand. Third, there is widespread corruption in the judiciary. As a general experience, court procedures can be slowed down and also sped up with bribes, and judges can often be bribed to deliver judgements even against the law. Alternatively, politicians and people with political contacts can influence courts by effectively threatening to remove certain judges.

In the specific context of competition procedures, local misdemeanor courts, the Supreme Misdemeanor Court and the Administrative Court of Croatia lack the necessary knowledge about competition law and economic arguments. As a result, no fine has yet been imposed by misdemeanor courts as both local misdemeanor courts and the Supreme Misdemeanor Court have decided that they would only impose sanctions in competition procedures if the decision of the APMC has been approved on appeal by the Administrative Court of Croatia. Apart from the lack of specialization, by definition local misdemeanor courts are too close to where the anti-competitive practice takes place and they might find it difficult to impose fines that have an adverse social effect in their district. Similarly, so far the Administrative Court of Croatia has been reluctant to deliver any appeal judgements in competition case.

According to the LPMC, an appeal against the decisions of the APMC does not delay the execution of the decision. The incapacity and unwillingness of Croatian courts to deal with even the least complicated technical issues of competition cases results in the APMC having no enforcement clout. No matter how progressive the APMC's enforcement agenda and practice might be, in the lack of minimal co-operation by courts, its decisions and sanctions cannot be effectively enforced. For instance, a perpetrator has newly raised its price by more than 500% with regard to one of its clients following the APMC's negative decision in an earlier discriminatory pricing case against the same undertaking.

Another possible supporting institution would be the Croatian Chamber of Commerce. With obligatory membership, regional offices in the 20 counties of Croatia and 40 professional associations in 10 economic sectors it is a significant representation forum of Croatian business and foreign business established in Croatia. On many occasions the Croatian Chamber of

Commerce co-operated with leading professors and the Ministry of Justice and Administration on drafting commercial legislation in a number of fields. The Parliament is legally obliged to ask for the chamber's opinion, the old Government also co-operated with the chamber on the basis of personal political contacts. It also has regular training courses and discussion *fora* covering the most relevant legal and business issues. Nevertheless, none of the activities of the Croatian Chamber of Commerce cover competition. The chamber's only activity in the field of competition law is that it informally provides information to the APMC on members of the chamber. The Croatian Chamber of Commerce does not know or at least does not want to recognize the possibility that business associations might serve as *fora* for anti-competitive agreements, even though in the past the APMC initiated cases against the chamber for minimum and maximum price fixing.

The situation is similar with regard to the Croatian Chamber of Small Business and the Croatian Handicraft Chamber.

The APMC regularly contacts various authorities and associations for basic information indispensable for adjudicating the competition cases brought before the APMC. The general lack of co-operation by other entities is perfectly illustrated by the fact that even the state statistical authority asks for payment for such information. Some other entities require that the APMC pay for the costs of making copies of the relevant documents of the entities in question.

Since the economy is highly politicized, regulatory bodies, such as the one in the field of telecommunications, are not independent of the undertakings operating in the regulated industries. Similarly, enforcement bodies, such as the ones in the field of standards, customs, visas, *etc.* are politicized. Local authorities are still grappling with understanding the basics of competition and market economy.

The Constitution explicitly prohibits monopolies, and the Constitutional Court delivered some judgements on the basis of the relevant constitutional provision. However, constitutional judges are also political figures, and the limited constitutional jurisprudence in this field is at most complementary to the enforcement of competition law by the APMC.

There is also the possibility to initiate a civil procedure in order to restore the reasonable balance between a service and its remuneration in civil contracts. However, this kind of cases has had very limited relevance from the viewpoint of competition law enforcement.

The Trade Inspectorate within the Ministry of Trade has 600 employees, significantly more than the APMC. Nevertheless, recently the Trade Inspectorate promoted the idea that rather the APMC should deal with fairness of competition cases.

The Croatian Consumer Protection Association is an NGO founded by eleven private persons. It promotes consumer rights in the media and by educating the younger generation, organizing consumer rights days and protecting consumer's rights. The Association collects, compares and publishes prices of interchangeable products and issues brochures on basic consumer rights on a regular basis. The Association promoted the idea of introducing consumer rights and democracy as a subject into the teaching program of elementary schools. The Ministry of Education accepted the proposal and invited the association to write the schoolbook for teaching democracy and consumer rights. Further, the Association prepared the draft of the Consumer Protection Law, which is currently being discussed by the Parlia-

ment. According to the draft, a special department within the Ministry of Trade will be responsible for the enforcement of consumer protection law. Being and NGO, the Association received some minor support from the Croatian Government and a fee of USD 20,000 as a remuneration for drafting the Consumer Protection Law. Otherwise, the Association's financial resources are limited to the small amount of membership fee paid by its some 400 members.

The Croatian Investment Promotion Agency is a well-prepared, professional body for the facilitation of FDI in Croatia. However, notwithstanding its professional work and proposals, the Government, especially the privatization authority has left the Agency out of the bigger and, thus, more political privatization deals. As a final step of minimizing the role of the Agency, the new Minister of Economy has recently expressed his intention to close it.

Universities are one of the few institutions where there are some people with a certain understanding of market law and economics in Croatia. However, although the few professors at the law and economics faculties dealing with market laws and economics take an active part in advocating for reform in the Croatian market, they are still regarded by some, especially by foreign investors, as people who need to learn more about the subject. Further, people teaching market law and economics at universities are mostly the same people as the ones who enforce the laws. There is no independent purely academic community dealing with competition law. Competition law and policy is not taught at universities or only to a very limited extent.

There have been some articles in Croatian newspapers and interviews with the Director of the APMC in different TV and radio channels. However, it is instructive, that the 1998 Report of the APMC complains about not getting coverage in the Croatian state television.

IV. MARKET FOR REFORM

The economic environment in Croatia is not conducive to more market competition. Business players and regulators do not have a precise understanding of the overall benefits of market competition and they are not interested therein. Whereas the majority of undertakings is bankrupt, collection of payments is highly problematic. Around 70% of Croatian companies are still state-owned with the majority of the private companies being small undertakings or former state-owned undertakings privatized to mostly incompetent political allies of the former Government. Many privatized undertakings have retained considerable market power, which is further reinforced by special and exclusive rights obtained through political contacts. Such privatized undertakings do not necessarily compete and they are rather interested to keep competition out of the Croatian market, whether in the form of foreign undertakings or of local small competitors, by using economic and political influence and contacts. State-owned undertakings are under no financial pressure to restructure and compete as the Government is ready to offer soft loans through the mostly state-owned banks operating in Croatia. Croatian armed forces still employ a considerable proportion of the workforce. Due to bankruptcy and the problem of collecting payments, small private undertakings are more keen to work for the state-owned or otherwise secured undertakings, *e.g.*, by special and exclusive rights, and for the armed forces, than to effectively compete with such undertakings.

Entry into the Croatian market and potential competition is hindered by a number of factors. Apart from the political and economic instability of the region, potential investors feel disadvantaged in the Croatian legal and economic environment. Due to widespread corruption, the

playing field is not equal for all players. Government standards and health regulations, the legislation and enforcement whereof can be easily influenced by political and economic lobbies, represent a serious barrier to entry. It takes a long time for foreign employees to obtain visas and work permits in a longer period of time. Company registration procedures take several months and cost approximately USD 1,000. Commercial laws are not freely available, as important technical and procedural issues are regulated by non-public internal orders issued by the Government, the regulating agencies or the Chamber of Commerce. Entry into the Croatian market is limited by high interest rates (approximately 18%) and the general unavailability of loans, due to a number of bad, politically decided loans and the lack of an effective law on collateral. Barriers to entry on the local level include the difficulty of obtaining land purchase licenses and complying with other local registration procedures.

The effectiveness and efficiency of keeping competition out of the market is shown by the fact that a number of fully equipped factories, that had been left abruptly at the outbreak of the war, have remained unused, in particular, in the textile industry. Similarly, recently the monopolist tobacco factory of Rovinj has successfully prevented BAT (despite the vigorous action by the APMC) from buying the fourth, not used and only independent Croatian production site.

The Croatian economy is highly integrated vertically. This in part is a holdover and in part due to the fact that bigger undertakings are not willing to contract with small businesses, which are generally unreliable as regards quality. Since so far FDI to Croatia has remained rather limited, small undertakings do not have the possibility to turn to other companies. Indeed, certain sectors, like the tourist industry are by general understanding not open to FDI. Entry through privatization is very much politicized and, therefore, a non-transparent, discriminatory and non-predictable procedure. In one of the biggest privatization cases, the sale of a 35% stake in the Croatian fixed telephone and telecommunications monopoly, HT, to Deutsche Telekom, it is a widely known fact that the former President of the Republic preferred the German company to other ones.

Another typical illustration of the case is the Croatian food and household goods market. Until recently, there have been two major wholesale and retail distribution chains in the country. Both have been privatized to political tycoons. The two chains seem to compete more against the remaining smaller competitors – even try to buy their stores – than against one another. Certain popular foreign goods have limited or no access to the shelves of the two bigger chains, especially in comparison with the products of local monopolists. For example, a popular Slovenian mineral water of low mineral content is much more difficult to find than Jamnica, a Croatian mineral water of high mineral content, which was privatized to another political tycoon. Although recently foreign chains have started to enter the Croatian food and household goods market, prices still remain high. As a result, a large number of Croatian consumers travel to neighboring countries like Austria and Hungary on a regular basis to buy basic food and household goods.

Exit from the Croatian market is also limited, as bankruptcy and insolvency procedures take years or are absolutely ineffective. Moreover, the Croatian market is a small market of less than 5 million consumers with practically no free trade agreements with neighboring countries. Croatia is still in the process of negotiating WTO membership and membership of CEFTA as well as other bilateral free trade agreements. Negotiations on association, let alone accession to the European Union have not even started.

In general, the Croatian economy is very much politicized. Laws are non-transparent, they are not readily available and, therefore, they are not predictable. Legislative and enforcement bodies, do not have a user-friendly approach when issuing legislation or decisions. In particular, the APMC fails to create a direct link to the competitors and the consumers that its policy and decisions are ultimately conceived to protect.

Consumers and even competitors are rather ignorant about the overall benefits of free competition. For instance, cases that have been usual in other transition economies, such as the abuse of a dominant position by former and current monopolies, are rarely initiated by private parties. Either these typical anti-competitive practices are not perceived as problematic, or the APMC is not yet regarded as a real forum for preventing and remedying such problems. In fact, the general comments on the APMC have emphasized its lack of clout. “Paper tiger” and “Government body” were labels put on the APMC by heads of business associations, competitors and consumers. Even the Director of the Agency admitted that currently the APMC is regarded by many as just a piece of decoration required by the European Union.

The World Bank has been the only international donor organization helping Croatia in the past years. Its former and current projects were dealing with privatization, the development of small and medium-sized enterprises, technical assistance to the APMC as regards the amendment of competition legislation and the training of the staff.

V. RECOMMENDATIONS ON COMPETITION LAW AND POLICY

- Co-ordinate with OECD/CLP, which has the lead in the competition law and policy part of the SEE program. Terry Winslow, former USFTC official, heads OECD “outreach” in competition and is seeking to put together a two year program that incorporates or at least co-ordinates with programs of G7, EU, and other major donors. (As of now, the WB program consists mainly of 12 man-months of resident advisors; the agency is disappointed that the advisors funded by the Bank will apparently lack experience in a competition enforcement agency. The WB has refused to fund books, website, or any other “hard goods.”)

- Assist the Agency for the Protection of Market Competition (APMC), a potent force for market-oriented reform if not thwarted by courts and de facto exemptions.

- Promote co-ordination among SEE competition agencies through series of regional seminars/conferences that create network, spread knowledge, create "peer pressure" for "best practices." Provide funding to permit use of OECD Member countries in transition (especially Hungary) as part of panel. Perhaps promote sense of shared mission through organization of SEE Competition Policy Forum.

- Reduce judicial problems.

- As APMC decides competition cases, and courts merely impose APMC-proposed fines and decide appeals from APMC decisions, judicial problems are different from other areas; set up group of 4-6 interested judges to rule on fines and hear appeals.

- If small number of judges identified, assist in funding OECD-organized judicial training events (including USG panelists).

- Support APMC staff development/research by supplying books, journals, virtual law collections.

- Support APMC staff development by funding:

  – 2-year program of SEE seminars organized by/with OECD (including USG panelists).

  – Resident advisors from FTC/DOJ lawyers/economists (3-6 months; begin toward end 2000, when consultants hired by World Bank as resident advisors have left.

  – Participation of APMC officials in SEE/other regional seminars and conferences; possible internships at US agencies.

- Refine APMC legal/economic approach toward benefiting consumers, rather than small businesses and employees by:

  – Economic training – in some of seminars noted above, educate agency on costs of current approach; in regional events, show that other agencies (Romania) are more advanced.

  – Creating demand for shift – (a) fund Croatian Association for Consumer Protection efforts to publicize that APMC (i) deserves support for benefiting consumers (ii) but should so more consistently, (b) use the EC accession carrot/stick, and (c) fund high level event(s) to educate public, Ministries. Perhaps limit funding for APMC public education to brochures etc. that address the consumer benefit.

- Support APMC "outreach" and public education by (a) supporting agency website project, (b) advising (through FTC) on building relationships with consumer groups and small business groups, (c) funding desktop publishing or printing expenses for brochures, etc., and (d) supporting high level events as noted above (bringing in Croatian Chamber of Commerce, Croatian Chamber of Small Business, and Consumer Protection Association).

- Promote support for competition by events, publications that connect it to related concepts that are easier for public to understand, such as corruption. For example, OECD has helped promote competition in Russia by helping the Antimonopoly Ministry to show how its work helps reduce corruption and promote the rule of law. (e.g., when an exclusive license is granted in an irregular manner but an actual bribe cannot be proved beyond a reasonable doubt, the competition agency can void the license without evidence of a bribe, thus taking away the benefits of the (presumed) bribe or cronyism.)

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APPENDIX C—USAID COMMERCIAL LAW ASSESSMENT SCHEDULE

Monday, February 21, 2000

11:00	Mr. Mladen Dragicevic Law Firm Private Practice Belcher, Schwartz, Yanachkov, Carter, Volkai
12:00	Mr. Marion Hanzekovic President Croatia Bar Association Tel: 617-1270 Belcher, Schwartz, Dragicevic
13:00	Mr. Nadan Vidosevic, President Croatia Chamber of Commerce Roosevelt trg Tel: 4828-501 Yanachkov, Volkai, Carter, Dragicevic
14:00	Mr. Jurisic Milivoj Chamber of Small Businesses Tel: 4619-252 Belcher, Schwartz, Volkai
18:00	Cocktail Reception & Dinner Aanenson Residence Grskoviceva 13 Belcher, Schwartz, Yanachkov, Volkai, Shapleigh, Carter

Tuesday, February 22, 2000

10:00	USAID and Embassy Introductory Briefing Belcher, Schwartz, Shapleigh, Yanachkov Volkai, Carter
13:00	Mr. Vanja Kalogjera, President Richard Babajko Croatia Investment Promotion Agency Velesajam blue building to right of Zagreb Bank (15 ave Dubrovnik) tel: 655-4559 Belcher, Schwartz, Yanachkov, Volkai

15:00 Mr. Andrew Krapotkin
EBRD
Petrinjska 59, 5th Floor
Tel: 48-12-400
Yanachkov, Volkai

15:00 Mr. Michael Glazier, AmCham President
Auktor Securities
Belcher, Schwartz

16:30 Mr. Zdravko Kuzmic
World Bank
Trg J.F. Kenneyda 6b
Tel: 238-7260
Belcher, Schwartz, Yanachkov, Volkai

Wednesday, February 23, 2000

10:00 Mr. Ivan Turudic, Assistant Minister
Ministry of Justice
Ulica Republike Austrije 14
Tel: 371-0601
Belcher, Schwartz, Yanachkov, Volkai

11:00 dr. sc. Vesna Brcic-Stipcevic, President
Alan Miler, Member of Board
Croatian Association for Consumer Protection
USAID Office
Volkai, Carter

12:30 Professor Alen Uzelac
Zagreb Law Faculty
Tel: 480-2444
Yanachkov, Schwartz

14:00 Dr. Desa Mlikotin-Tomic, General Secretary
Ms. Mirva Pavletic-Zupic, Head of International Affairs Dept.
Agency for Protection of Market Competition
Savska cesta 41, 7th floor
tel: 617-6449
Winslow, Volkai, Belcher, Carter

16:00	Vlatka Vedris Attorney, Private Practice Ozaljska 136 tel: 363-6335 Belcher, Yanachkov

Thursday, February 24, 2000

9:00	Mrs. Maja Pavlek, Johnson & Johnson Mr. Miho Glavic, AWT Int'l American Chamber of Commerce Hotel Intercontinental, Room 226 Tel: 4836-777 Belcher, Schwartz, Carter, Yanachkov
9:15	Agency for the Protection of Market Competition Savska cesta 41, 7th floor tel: 617-6449 Volkai, Winslow
11:00	Dr. Branko Vukmir, legal advisor Richard Babajko Croatia Investment Promotion Agency Velesajam blue building to right of Zagreb Bank(15 ave Dubrovnik) tel: 655-4559 Yanachkov, Schwartz
11:30	Mr. Drazen Odorcic, Mr. Marijan Klanac Croatian National Bank Legal Affairs & General Services Trg burze 3 Tel: 456-4555 Belcher, Volkai/Winslow
13:00	Duro Sesse, Judge Municipal Court Ulica grada Vukovar 84 Tel: 6114-222 Belcher, Yanachkov, Schwartz
15:00	Team Meeting Sheraton Hotel Lobby
18:30	U.S. Embassy DCM Cocktail Reception

Friday, February 25, 2000

8:45	Mr. Dominik Menu Bank de Paris Dresner Andrije Zaje 61 Tel: 365-2703 Schwartz, Yanachkov
11:00	Chuck Aanenson, USAID Mission Director USAID Office Schwartz, Belcher, Yanachkov, Winslow, Volkai, Carter
12:00	Tom Rogers, Rule of Law USAID Office Belcher, Schwartz, Yanachkov
13:00	Agency for Protection of Market Competition Savska cesta 41, 7th floor tel: 617-6449 Volkai, Winslow
13:00	Team meeting Schwartz, Belcher, Yanachkov, Carter

Monday, February 28, 2000

8:30	Professor Barbic Law Faculty Main Building across from Opera, 2nd Fl. Room 67 Tel: 4564-342 Yanachkov, Schwartz
10:00	Ms. Ana Krleza Jurisic Local Misdemeanor Court J.F. Kennedya 11, Room 210 or 211 Tel: Yanachkov, Carter
10:00	Fred Jahn, Nena Vukadinovic ABA/CEELI Berislaviceva 3/1 (Café courtyard) Tel: 4872-535 Schwartz

12:00	H.E. Stjepan Ivanisevic, Minister Ministry of Justice Ulica Republike Austrije 14 Tel: 371-0601 Belcher, Schwartz, Yanachkov
15:00	Mr. Miljenko Leppee, Dragica Karajic Ministry of Economy Dept.for Trades, SMEs Vukovarska 78, Room 311 Tel: 6106-117 Carter, Yanachkov
15:00	Ms. Vesna Grubic Croatian Law Center Hebrangova 21 Tel: 4856-445 Schwartz
17:30	Mario Vukelic, Bankruptcy Judge Zagreb Commercial Court Sheraton Hotel Lobby Yanachkov

Tuesday, February 29, 2000

9:30	Nenad Sepic, President High Commercial Court Berislaviceva 11 Tel: 4811-400 Yanachkov
11:00	Kathy Redgate U.S. Embassy Tel: 481-7297 Schwartz
12:00	Honorable Jadranko Crnic Crvenog krica 14 Tel: 4655-814 Schwartz

12:00	Judge Gredejl Croatian Judges Association Sheraton Hotel Lobby Fax: 043-274-150 Yanachkov
14:00	Mihajlo Dika, Dean Zagreb Law Faculty Near theater Tel: 4902-444 Yanachkov

Wednesday, March 1, 2000

8:30	Mr. Ivan Jakovic, Minister Ministry of European Integration Ulica grada Vukovara 62 Tel: 4569-336 Belcher, Schwartz

Thursday, March 2, 2000

10:00	USAID Meeting
15:00	U.S. Ambassador U.S. Embassy