

Joint Ventures in Yugoslavia

Bob Starr has given you a general overview of joint ventures in Eastern Europe. My talk will be limited to Yugoslavia. What I propose to do, in the time available, is, first, to tell you a little more about the distinctive features of the Yugoslav economic system that are of direct concern to foreign investors. Then I will mention the kinds of investments that may be made and the industries and the forms of organizations in which you may make these investments. Next I will discuss the procedures for making these investments, including the negotiation process and Governmental approval. Following that I will give you a closer look at what a joint venture agreement should contain, and finally I will mention a few of the problems and lessons gleaned from the experience to date in joint ventures in Yugoslavia.

Before getting to my prepared remarks, I would like to comment on Bob Starr's interesting figures concerning the amount of investments that have actually been made in Yugoslavia through the joint venture route. I think that all figures concerning such matters are to be handled with care. Personally, I think there has been more hard cash invested in Yugoslavian joint ventures and certainly more equipment financed by foreign industrial investors or the International Finance Corporation than would appear from the amounts he mentioned. In addition, of course, there has been an influx of loan funds from American banks and imports of equipment financed by the U.S. Eximbank for joint venture projects. In any event, I don't think that the slow start we have seen in Romania, Hungary, and even Yugoslavia, should be as much as a cause of concern as you might infer from the statistics Bob has collected. Most new programs or institutions anywhere in the world take a while to get going, and their initial results are not usually equal to the expectations aroused by the publicity attendant upon their inauguration. However, if the new institution or the new program is a good one, eventually it takes hold, and I think the basic idea of joint ventures in Eastern Europe is a good idea. Also, many of the startup problems that Bob indicated Yugoslav joint ventures have experienced are simply the kind of problems that any new industrial enterprise in any country might encounter.

With that little aside, we will turn now to what I had originally intended to say.

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Bob Starr mentioned earlier the unique nature of the Yugoslav economic system. In many respects it is virtually the same as the economies of Western Europe and the United States. The most commonly used label for the Yugoslav system is "Market Socialism." Better yet, it may be called "Decentralized Market Socialism." The foundations of this system are so-called "social ownership of the productive means of property" and "workers' self-management." "Social ownership" means that in any given Yugoslav enterprise the factory and its working assets belong to all the people of Yugoslavia, but the workers in that enterprise (including white-collar and executive personnel) have a usufruct in respect of these assets. "Workers' self-management" means that these workers have the right to decide how to use these assets, what products to produce, the rate of production, selling prices and marketing strategy, as well as the right (within limits) to set the firm's policy regarding distribution or reinvestment of profits. In other words, Yugoslav enterprises are much more like a self-managed private enterprise than a state corporation. Perhaps a cooperative is the closest analogy found elsewhere.

Under the Yugoslav system today, there is no longer a central economic plan of the type found in other Eastern European countries. The Yugoslav five-year and one-year plans are called "indicative," and are not binding on individual enterprises or the commercial banks that supply them with much of their financing.

Yugoslav business organizations are generally referred to as "enterprises" or "working organizations" or "associations of associated labor." These organizations are, by and large, controlled by their workers through democratic means. The work force as a whole decides certain fundamental matters by plant-wide referenda. For example, they must approve the enterprise's so-called self-management agreement, statutes and regulations which are roughly the equivalent of corporate articles of incorporations and by-laws. However, the workers delegate most of their authority to a workers' council of fifteen or more members. The workers' council is roughly equivalent to the board of directors of an American company.

A Yugoslav enterprise is managed on a day-to-day basis by a managing director and other directors, implementing the policies set by the workers' council. The director is chosen by the workers' council for a fixed term, after public advertisement for the position.

Without going further into the matter, I would simply generalize that the workers' council and directors are able to manage the Yugoslav enterprise with substantial freedom from outside interference. If they are successful, the workers will have a profit to enjoy. If they are not, the enterprise may be put into receivership and even dissolved in bankruptcy proceedings.

Wages, which are at present based on certain minimum wage formulae worked out by the government, labor unions and chambers of commerce of each republic,

may be increased substantially by bonuses paid out of the enterprise's profits. Certain of what we might consider to be profits are retained in the organization for the common needs of the workers, such as recreational and medical facilities.

With this background in mind, let us turn to the laws governing investment in Yugoslav enterprises.

In the late 1960s the Yugoslavs decided to find a way to permit foreign capital and technology to be associated with Yugoslav enterprises on a more intimate and permanent basis than by mere licensing or cooperative arrangements. Since the Yugoslavs could not abandon the institutions of social property and workers' self-management, it was ideologically impossible to permit foreigners to form, say, joint stock corporations. Therefore they adopted the contractual form of joint venture. Under this arrangement, once the foreign partner contributes his assets they become "social property" and, at least conceptually, his relationship to the assets is thenceforth only contractual, not a property right. However, in practice, the law and the joint venture agreements may give him substantially all of the rights he would have as owner of a share of a limited liability company.

The laws permitting foreign investment in Yugoslav enterprises were first adopted in 1967. They were improved by amendments over the next four or five years and in 1973 a codification of the law, as amended, was adopted. This is the Law on Investment of Resources of Foreign Persons in Domestic Organizations of Associated Labor. This foreign investment law is quite straightforward in most respects and I will not repeat its contents here, but will only mention some of its principal features. The law specifies the fields of activity in which foreign investment is *not* permitted; namely, banking, insurance, internal transportation, retail trade, and governmental activities. Not every proposed investment in one of the open sectors will actually be permitted. To obtain government approval, an investment must be a long-term one and must show promise of resulting in increased productivity or technological advancement of a Yugoslav industry and, in nearly all cases, must have prospects of increasing Yugoslav exports.

Let us now consider what may be contributed as an "investment." Foreign investments may be made by contributing machinery, cash, or industrial property rights. The law says that the valuation placed on a foreign investor's contribution of non-financial assets must not be unrealistic—that is, overvalued. In practice, there is probably more difficulty in determining the value of the *Yugoslav* partner's contribution. Usually the Yugoslav partner will contribute part of a going enterprise, including the cash flow generated during the construction period, while the foreign partner will contribute foreign currency or new assets. Placing a value on a going enterprise in Yugoslavia will be even more difficult than it is in the case of mergers and acquisitions in the United States, where the accounting system is familiar to both parties and audits are relatively easy to obtain.

Investment may be made in a new organization or in an existing enterprise. In the latter case the investment may be made in the Yugoslav enterprise as a whole or in one of its divisions. As part of the progressive decentralization of political and economic power, the Yugoslavs have attributed more importance and granted more power to the individual productive units within enterprises. These units are called "basic organizations of associated labor." A very small enterprise may consist of only one unit, which in such a case will simply be referred to as an "enterprise" or "working organization," not as a "basic organization of associated labor." If an enterprise has two or more units, these units must settle the terms of their association in the overall enterprise by means of a so-called "self-management agreement." Each of these units will have its own workers' council and managing director, while the overall enterprise will also have a workers' council and managing director.

A foreigner may invest in the whole of the existing Yugoslav enterprise, or it may, instead, invest in one or more of these "basic organizations of associated labor." Usually a foreign investor will invest in a new basic organization of associated labor that is formed for the purpose of manufacturing some product that is a specialty of the foreign partner.

How do you go about making an investment in a Yugoslav enterprise or one of its units? First you negotiate an agreement with your prospective partner, who, unlike his counterpart in other Eastern European countries, will be essentially a private businessman rather than a government employee. The agreement should spell out in great detail the rules that are going to govern your investment, since there is no all-encompassing corporation law or even a comprehensive foreign investment law. (In fact, the foreign exchange laws and regulations are perhaps of equal importance to foreign investors.) In addition to the joint venture agreement itself, the statute (or articles) of the new organization, and its by-laws will normally be negotiated by the co-venturers. The statute and by-laws will repeat much of what is stated in the joint venture agreement. The statute and by-laws must also be in harmony with the self-management agreement of the Yugoslav enterprise with which the joint venture unit will be associated.

Negotiating these agreements can be a difficult and tedious affair. You will find the assistance of a local lawyer invaluable, and you might want to use the services of the International Investment Corporation for Yugoslavia, which has, for a fee, helped to negotiate, arrange financing for, and obtain government approval of, a significant number of joint ventures in Yugoslavia.

Since the joint venture agreement must be registered by the Federal Committee for Energy and Industry, it is important to be sure the terms you are working out in these negotiations will not run afoul of any law, policy or regulation. This can often be checked out by your Yugoslav partner or your local lawyer, or by yourself while the negotiations are progressing.

The law specifies a number of reasons why a joint venture agreement may be disqualified for registration. Most of these statutory provisions are self-explanatory. One principle, which is expressed several ways in the law, is that the Yugoslav partner must not be treated unequally. In fact, the capital ownership share of the foreign partner must not exceed 49 percent of the total. Except for those investors who always insist on full control of their foreign ventures, this should not be a real problem. The law allows the parties to establish a joint business committee which will have or will share jurisdiction over most fundamental matters.

Once the agreement has been approved by the Yugoslav partner's workers' council and by the workers' council of the joint venture unit, it is registered with the Federal Committee for Energy and Industry. Upon registration it enters into full force and effect as of the date it was signed. The law says the joint venture is protected from that date against adverse changes in the law governing foreign investment, but not from changes in the tax laws; and it is doubtful that you are protected against changes in the foreign exchange laws or regulations.

I will not try to cover here all the points that should be dealt with in a joint venture agreement. This has been discussed in various publications available in this country or in Yugoslavia. A few of the highlights are worth mentioning, however. Of course you must describe and place a value on the partners' capital contributions. You should state how the enterprise is going to be controlled and managed. You must discuss how profits are to be calculated. (This has been a major problem area and is probably one of the principal causes of the disappointment of the foreign investors to which Bob Starr referred.) Some joint ventures that, by one method of calculation, have been profitable, have turned out to be unprofitable by another. So, you'd better make sure that you understand what "deductions" Yugoslav law allows or requires you to take. If you don't settle this properly in the joint venture agreement, you may never receive any profit from an otherwise "successful" operation. You must also state how net profits are going to be allocated between the partners. Usually the allocation is made proportionately to the parties' relative capital contributions.

In this connection, the whole question of how accounts are to be kept and the accounting principles to be followed should be covered specifically in the joint venture agreement. I will say a few more words about this in a minute.

It is, of course, essential for the agreement to set forth the basic production and marketing objectives and policies of the enterprise.

The agreement should also mention the duration of the joint venture. Although the law says that the agreement must be of a long-term nature and cannot be terminated prior to the time stated in the agreement, the law also allows you to terminate if the venture fails to show a profit for two consecutive years, "if business results are substantially below the envisaged results," or if there is a breach of contract by either party. You may also provide for termination if the tax

laws are amended adversely or an event of *force majeure* upsets the business.

A related point to cover is the foreign partner's right to transfer his interest in the venture. The law allows the foreign investor to sell his rights to another foreign investor or to another Yugoslav party, unless the investment agreement provides otherwise.

Dispute settlement is another point to be covered. Most, if not all agreements, have provided for arbitration. It is permissible to provide for arbitration by foreign arbitral tribunals or by the Yugoslav arbitral tribunals.

Finally, the agreement should contain regulations governing the dissolution of the joint venture. Provisions may be made for a buy-out of the Yugoslav partner. If the buy-out is to be based on the value of the enterprise upon termination of the joint venture, the agreement should specify the method to use in valuing the enterprise.

Despite my admonition to make your agreement very detailed, covering these and many other points, I hasten to add that the agreement is only a framework for future cooperation, like a marriage contract. Unless the parties are committed to making it work, no matter what problems arise, it doesn't matter how well you've drafted it. Similarly, if you fail to cover an essential point, you may still survive if you have the proper partner and the project is based upon a mutual, economic interdependence (as Mr. Pope mentioned in a related context yesterday).

Some of the points I have mentioned deserve further elaboration.

The first problem area is the joint venture's capital account. Since the dinar has tended to decline in value in relation to other currencies, many foreign investors have established a capital account, denominated in the currency of the foreign partner's contribution, for the purpose of allocating profits. For example, if the foreign partner contributed \$1 million and the Yugoslav partner contributed assets the value of which was then \$1.5 million, the capital account would show entries of \$1 million and \$1.5 million. Profits and losses of the joint venture would be divided in a ratio of 1 to 1½. This ratio would not change thereafter if, because of inflation in Yugoslavia, the dinar value of the Yugoslav partner's contribution were to increase over the life of the joint venture. Any profits reinvested and any other new investments in dinars would, before entry into this capital account, be converted into the foreign currency at the exchange rate prevailing on the date of the new investment.

This brings me to another point of considerable importance. Since there may well be divergent views on the desirability of reinvesting profits, the joint venture agreement should spell out an agreed policy concerning this matter. The law no longer requires foreign investors to reinvest a portion of their profits; but all Yugoslav enterprises, including joint venture enterprises, must reinvest some of their profits. If you wish, you may require the Yugoslav partner to invest or lend the required amount of *its* share of the joint venture's profits. You may follow the same practice in dealing with some of the other mandatory allocations of profits,

contributions and deductions required of all Yugoslav enterprises by law.

The whole subject of accounting is a difficult one. Perhaps it has been the greatest cause of trouble for foreign investors in Yugoslavia, not only in the negotiation stage but in the implementation of the projects. The Yugoslav accounting system is somewhat different from the Western system, especially the profit and loss statement. In order to keep track of where your investment stands, you are allowed to maintain separate books for the joint venture, in addition to the books that are maintained for Yugoslav authorities. Although your joint venture books will be based largely on Yugoslav concepts, you may modify them with Western accounting concepts, at least to a degree.

One point you will want to cover specifically is your policy regarding revaluation of assets. Because of the inflationary history of the country, there have been many revaluations of industrial assets, both voluntary and pursuant to legal requirements. Since any revaluation will increase the depreciation basis, this will reduce the annual profits of the enterprise, hence also the amount of profit you will earn from your investment. It is permissible for your agreement to forbid revaluation of assets (for the purpose of the joint venture) except to the extent such revaluations are required by law. Similarly, you may set maximum limits on the rates of depreciation to be charged in determining the joint venture's income. Otherwise, the joint venture may end up with little or no distributable profits during the life of the venture, yet your Yugoslav partner will acquire assets that may still have a long and valuable life when the joint venture is dissolved. You may or may not succeed in getting appropriate compensation for those assets at that late date.

I mentioned earlier the joint business board or committee. This joint business board can be given a great deal of power. In a typical case the Yugoslav and foreign partner will elect an equal number of members even though the Yugoslav partner must have at least 51 percent of the capital of the joint enterprise. It is permissible to provide that certain issues must be decided unanimously. The joint business board may have general jurisdiction over most questions of policy, including many of those most important to the foreign partner, such as production and quality control. The board is usually given exclusive jurisdiction over certain matters. Other matters, which are more closely connected with the system of workers' self-management, must be left to the workers' council to decide, although in certain cases the joint business board may submit proposals to the workers' council. Examples of matters as to which the workers' council has the final decision are the annual financial, manufacturing, marketing and investment plans. The definitive approval of the firm's annual financial statements, the determination of the workers' bonuses and the appointment of the managing director must all be made by the workers' council, although guidelines may be spelled out in the joint venture agreement.

In practice, the division of authority between the joint business boards and

workers' councils seems to be working out satisfactorily.

The managing director of a joint venture enterprise and his deputy will be Yugoslavs, for practical if not for legal reasons. They will be elected by the workers' council in the same manner as the directors of purely Yugoslav enterprises. However, it is not unusual for the foreign partner to have the right, say, to present a panel of names from which the joint business board will select a nominee for deputy director to present to the workers' council. The foreign partner may also have the right to propose individuals, who may be foreigners, for other key positions such as the technical director or quality control officer.

A problem which must be recognized in operating in Yugoslavia is the difficulty in determining what the applicable law is. This derives partly from the federal structure of Yugoslavia and partly from the Yugoslav propensity for experimenting and revising any and all laws, agreements, economic institutions and rules. Fortunately, this unpredictability is merely the negative side of the Yugoslavs' strong point; namely their pragmatism. You will find that there is virtually no legal problem which cannot be overcome by a Yugoslav and a foreign partner who really wish to do business together. Laws may be interpreted liberally, amended, or rendered irrelevant by skillful negotiation and practical compromises. For this reason, it is wise not to give in on a point just because you are told early on in negotiations that what you are proposing is not allowed by Yugoslav law.

Perhaps the greatest deterrent to foreign investment in Yugoslavia, at least for certain kinds of businesses, lies in the foreign exchange regulations that limit remittable profits to a percentage of export earnings (generally, about 50 percent). This restriction virtually excludes foreign investment from projects that will not be oriented toward exporting to countries that will pay for the products in a convertible currency. Consequently, most foreign industrialists could not, until recently, use an investment in a Yugoslav enterprise as an avenue for supplying Eastern Europe (unless they were willing to leave their profits in Yugoslavia for the indefinite future). However, Yugoslavia now settles its export transactions with Romania, Poland, Hungary, and Bulgaria in convertible currencies, rather than in bilateral "clearing" currencies. Profits from these exports would appear to be eligible for repatriation to the West.

Foreign investors' experience in Yugoslavia is rather difficult to generalize about at this point, but certain conclusions seem safe to make. First, the joint business boards seem to be working successfully with the workers' councils, by and large. On the other hand, the investments made to-date have perhaps not been as profitable as originally expected. I suspect that this may have been due partly to the foreigners' failure to understand Yugoslav accounting concepts or the underlying financial aspects of the ventures.

From Yugoslavia's standpoint, the rewards for opening its doors to foreign investments for the past eight years have probably been disappointing. There

have only been about 100 foreign investments, much fewer than the number of long-term cooperation agreements concluded between Yugoslavia enterprises and foreign parties. Also, there have been very few large investments. Perhaps the potentially enormous investment recently announced by Dow Chemical represents a major breakthrough. Understandably, the Yugoslavs hope that the Dow project will be only the first of many large investments from the United States.

