Prof. Dennis Campbell (ed.)

Legal aspects of Joint Ventures in Eastern Europe

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LEGAL ASPECTS OF JOINT VENTURES IN EASTERN EUROPE

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LEGAL ASPECTS OF JOINT VENTURES IN EASTERN EUROPE

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Table of Contents

Introduction

DENNIS CAMPBELL AND MARK MILLER

Introduction

Within the last decade, there has been significant expansion in both the frequency and quantity of direct foreign investment by Western countries and multinational corporations (MNC's) in the form of joint ventures in Eastern Europe.[1] These joint ventures, as well as other forms of mutual-cooperation trade arrangements, represent positive evidence of the increasing enthusiasm towards East-West transactions now found on both sides of the European frontier. The spirit with which Western governments and business interests have sought to expand involvement in the East European market has been well documented. However, there has been relatively little attention paid to the extremely important internal changes which have come about within the foreign-trade policies of the Eastern European countries and which have served to accommodate the growth of trade with the West. This dramatic increase in direct foreign investment in the form of joint ventures results primarily from the passage of enabling legislation in a number of the East European states, legislation which has facilitated and attracted business investment from the West. Thus, it is opportune to examine and review the policy reforms and amendments which have been enacted in Eastern Europe and the Western responses thereto.

As a preliminary matter, the term 'joint venture', as well as other mechanisms for foreign investment as used here, should be defined and distinguished. Although the term 'joint venture' is oft-defined,[2] as used here it connotes that form of business enterprise utilized for the purpose of realization of joint business aims at a common risk in which both parties have an equity position, formed under the laws and regulations of the host country, which in this instance means under the laws of an Eastern European state.[3]

For the purposes of this survey, other forms of cooperation agreements between East European and Western entities, which are not joint ventures, include the classifications of franchising, licensing, sales of turn-key plants, and co-production agreements.[4] Definitions of these forms of cooperation arrangements are set forth below:

(1) Franchising

A franchise can be defined as an arrangement whereby the ownership of the enterprise remains in the host state and all taxes on the entity are borne by the owner. Management is conducted locally, with experts and other personnel from the Western company available on request and on a fee basis. In return for the franchise's right to use the name of the parent company and to have access to other services, the Eastern European entity generally agrees to pay a fixed percentage of the gross sales.[5]

(2) Licensing

The licensing of cooperation usually entails a firm with sophisticated technical expertise in a specific industry which sells packages of technology to another entity or country.[6] The company supplying the technology often is compensated for its contribution immediately.

(3) Turn-Key Plants

The sale of a turn-key plant, on the other hand, is an extension of the licensing concept; here, the Western firm also provides machinery and supervises the assembly of a production line for the product which it has licensed.[7] Payments for this process may be either whole or segregated, with compensation designated, for example, for know-how, equipment, and parts. In addition, payment also may be spread over a period of time. The agreement also may provide for cut-off dates for stages of development and penalties applicable to matters concerning output quality, operability of the production line, and breakdowns prior to expiration of the warranty.

(4) Co-Production Agreements

A co-production agreement is a relationship in which there is joint manufacturing of a product, generally for an extended period of time. One partner usually supplies components to be integrated into the equipment produced by the other partner. The final product then is marketed by both parties in and outside of the respective home states.[8] Occasionally, this form of cooperation combines both a licensing agreement and a turn-key plant sale.

The distinction between these forms of cooperation and the joint venture should be apparent. The joint venture in actuality is an independent entity with its own separate legal identity. Although the joint venture is formed under the laws and regulations of the host country, it is a contractual creation and, thus, each joint venture has its unique character, despite the fact that all joint ventures in a given country are subject to the same laws.[9]

It is interesting to note that, at the beginning of the 1970s, there was disagreement between East European and Western interests as to the general meaning of the term joint venture. In the East European states, the preferrence was to label any type of commercial or technical cooperation extending over a period of time a 'joint venture'. Western businessmen, on the other hand, preferred a more narrow application, reserving the term for an enterprise in which the limited-liability partner owned at least a minority share of the equity.[10] A primary concern for

Western interests in the pursuit of joint-venture relationships in Eastern Europe has been the manner in which one secures ownership of the means of production, a matter of some sensitivity given the Marxist view that the means of production are not subject private ownership.[11] In the recent past, East European policy has been modified to allow State enterprises to acquire shares in Western enterprises. There resulted a serious question as to whether, however, East European countries would allow Western interests to acquire a share in the means of production in a socialist state.

Emile Benoit of Columbia University's School of Business Administration has suggested a means of obtaining rights of ownership in East European ventures, as follows:

> 'The right to manage can be conveyed by a management contract instead of by majority stock ownership, or even though a know-how or licensing agreement. The right to draw financial benefits from the thing owned can be provided by licensing royalties, fees under a management contract, profits on the sale of machinery, spare parts, and materials, as well as interest charged for financing payment terms. Perhaps some equivalent of the right to sell may even be preserved by contractual arrangements to recover patents and trademarks upon expiration of the agreements or in premature cancellation, and by export credit insurance, or investment guarantees from the investor's government against such political risks as confiscation, inconvertibility of currencies, or destruction by war or revolution'.[12]

Other observers of East-West business relations have been less optimistic than Benoit. They pointed to the inherent contradiction between Western capitalism and the Eastern view of ownership. They argued that maintaining ownership by Western enterprises would be difficult once it became apparent that its impact resulted in altering the basic nature of the socialist society. They feared that the East European states would change their view of such East-West ventures and eventually would dismantle them.[13]

For the time being, however, industrial and technical agreements between the East and the West have continued to grow. East European and Western negotiators have found new ways of structuring business cooperation so that both parties gain more than they otherwise could through direct trade arrangements. Thus, there has developed a wide array of cooperation, ranging from one-time transactions to direct equity investment.

At some point, of course, an industrial-technical agreement becomes a joint venture.[14] That point is reached when both partners have an influence over the decision-making processes, a step basic to the venture's success, and when both parties share in the successes and failures of the joint arrangement. By this definition, it safely can be said that most arrangements in the early 1970s were not true joint ventures.

Historical Development

In order to explain the increasing importance of joint ventures and to portray their particular relevance to the current conditions under which East-West trade must develop, it is essential to consider the history of the slow re-emergence of East-West relations and certain aspects of Eastern European economies. The transfer of technology between the capitalist and socialist countries began in the post-World War II period, with the Soviet Union primarily representing the interests of the East European countries.[15] The Soviet Union at the time utilized foreign technology on a relatively broad scale[16] to serve its process of socialist industrialization, and it transferred its technology to those interested East European countries. In the later post-war period, when the United States and other Western countries placed tight restrictions on deliveries to the socialist countries, this process was disrupted.[17] During this period, the Eastern European countries found themselves linked to the technical experience of the Soviet Union,[18] and this economic relationship was culminated in the creation of the Council for Mutual Economic Assistance (CMEA) in early 1949, as a response to the Western formation of what now is the Organization for Economic Cooperation and Development.[19] At its inception, the CMEA included the Soviet Union, Czechoslovakia, East Germany, Hungary, Poland, Bulgaria, and Romania.[20] Mongolia and Cuba subsequently became members in 1962 and 1972, respectively.[21] It is noted that Yugoslavia never has been a member of the organization but was granted 'non-member participation status with equal rights'.[22]

Consequently, the CMEA countries and Yugoslavia preferred to trade as little as possible with the Western nations, this for ideological reasons,[23] believing that it was imperative to remain isolated and to demonstrate to the Western world that, as a group, the Eastern countries could be entirely self-sufficient, producing goods and services of a quality and quantity competitive with their Western counterparts.[24]

At the same time, the United States dissuaded its Western Allies from initiating industrial and technological trading relations with Eastern Europe. The United States and Western Europe expressed these trade reservations through embargo lists.[25] However, from the end of the 1950s and especially from the mid-1960s, there was a gradual movement away from confrontation to 'peaceful coexistence[26] and the easing of trade restrictions with the Eastern European countries. In addition, an environment was created for the re-establishment and re-development of commercial ties, including the exchange of technology.[27] Coincidentally, it became apparent to the East European states that their need for capital goods and technology, as well as for marketing and managerial skills, demanded increased trade with the West.[28] As a consequence, these states embarked on a series of economic reforms designed to make their economies more conducive and attractive to Western investment.[29] To accomplish this goal, as well as to make their economies more responsive to outside market forces, the Eastern countries modified the rigid central planning mechanisms of their economies[30] and also attempted to increase hard-currency reserves and improve the status of their domestic currencies.[31] However, industrial cooperation agreements between the East and the West remained rare.[32] The primary forms of East-West cooperation in this period were non-commercial exchanges of experience and knowledge, mainly of a theoretical character, in the form of mutual visits by scientists and experts, exchanges of literature, conferences and symposia, technical and scientific exhibitions, and commercial exchanges – namely trade in licenses – as the most universal form of the transfer of technology.[33] Cooperation during the 1960s consisted of barter-type trading agreements and buy-and-sell arrangements. These barter agreements, however, did not substantially increase trade because of the lesser quality of the Eastern European manufactured goods.[34] Buy-and-sell arrangements also were limited by the inability of the Eastern European nations to generate sufficient hard-currency reserves to offset the cost of their imports.[35]

During the period 1953-1969, East-West trade almost tripled with growth at an average rate of 12.6 per cent annually; total world trade in the comparable period has increased an average of 7.7 per cent.[36]

Nevertheless, there remain fundamental structural differences that distinguish the East-West economies, and certain of those differences particularly hinder East-West trade.

Western trade is carried on mainly through private enterprise, with the goal of achieving profit and interacting with consumer interest and demand. Generally, capitalist governments play only restricted and subordinate roles in the implementation of international trade. Prices assume an allocative function in distribution and production and are determined by the interaction of supply and demand forces in both the domestic and foreign markets. Thus, domestic prices are interwoven with world-market prices. The commercial policies of Western regimes generally are implemented by influencing the market through tariffs and other direct methods, without use of a state monopoly of foreign trade.[37]

In the Eastern states, on the other hand, foreign trade is only a small part of macro-economic planning, and the government inevitably takes a dominant role in the decision-making process involving import-export transactions. Specialized state instrumentalities, overseen by state planning agencies, control and conduct international trade. The result is that the foreign trade of these countries, under the government's direct control, becomes a more prominent instrument of foreign policy than in the West. Consequently, political considerations may take precedence over economic considerations.[38] However, despite the incongruity of the systems of the two trading partners, East-West trade was the most rapidly expanding part of world trade in the 1960s.

By the mid-1970s, the socialist countries had accumulated a large collective trade deficit owed to the West. Most of the Eastern countries have a high debt-service ratio (the ratio of principle and interest to export earnings).[39] In 1976, the total trade deficit of CMEA countries had reached almost seven billion US dollars, and CMEA states were approximately fifty billion US dollars in debt.[40] For this reason, Western banks have been reluctant to lend hard currencies to the East European countries in fear that, in the event of a debt crisis, such a borrower would have a difficult time in making principal and interest payments when due.[41] With the exception of Romania, the Eastern European countries do not belong to the International Monetary Fund (IMF) and, therefore, are ineligible for IMF financial assistance.[42]

In an attempt to correct their debt-service ratio problem, the Eastern European countries have been engaging in industrial-cooperation agreements[43] with an emphasis on joint ventures as a means to increase exports and, at the same time, hard-currency reserves.[44] By utilizing such joint venture agreements, the East has hoped to lure Western management and marketing skills, in addition to technological know-how, by offering to share with its Western partners a portion of profits or goods produced in lieu of expending its foreign exchange reserves for payment. There are a number of reasons why joint venture agreements might be preferred to the more traditional forms of cooperation, from both the perspective of the East European government and the Western businessman. For the Eastern partner, the joint venture approach secures a greater commitment by the Western affiliate to the eventual success of the joint venture activity, and on a continuing basis. Consequently, the Eastern partner believes it has a much better opportunity for continuing access to the Western partner's technical and managerial expertise, and a continuing up-date of that know-how.[45] Other apparent potential benefits include the financial contribution of the Western partner, and its assistance in processing additional financial support from other sources not directly available to the Eastern country.

From the Western partner's perspective, the joint venture may be preferred over other forms of cooperation for a variety of reasons. The joint venture offers the possibility for a greater measure of control over the management decision-making process, thus allowing the Western partner more opportunity to protect its world wide investments and marketing networks. Another potentially important benefit is the greater measure of control over production than would be possible through more traditional industrial cooperation links. A third possible advantage of the joint venture is that it can allow broader scope for profit-taking, sometimes with lower effective taxes.[46] Another advantage is the opportunity to obtain direct know-how about marketing within Eastern Europe.[47] At the same time, the Western partner can maintain its separate identity and earmark its contributions for later recovery when the joint venture terminates.

Once it was recognized that joint venture could offer an ideal method by which to expand East-West trade, certain of the Eastern European countries were quick to enact legislation facilitating the creation of joint ventures.[48] Yugoslavia was the first Eastern country to undertake such legislative reform, enacting a law in July 1967 which allowed limited foreign-equity investment in joint business ventures, a first break from the orthodox ideology concerning ownership of the means of production.[50] By allowing for joint 'ownership', Yugoslavia opened the way for both the East and the West to achieve the desired benefits from increased commercial contact. Yugoslavia's initiative served as an example which was followed by similar legislation in Romania in 1971 and in Hungary in 1977. Poland initiated legislation in 1976 which allowed joint ventures in the trade and service sections.[51] In each of these countries, except Poland, it now is possible to establish joint ventures which have legal characteristics similar to joint ventures in market-economy countries, with rights of co-management, co-ownership of capital, and sharing of profits and risks.

This adoption of joint venture legislation in Eastern European countries illustrates the increasing recognition by those nations that ventures involving at least some elements of Western joint ventures can co-exist with socialist ideology.

The degree of compatability is related directly to recognition of the developmental benefits available through the relaxing of previous rigid beliefs concerning foreign investment. Previous reluctance usually restricted foreign investments to licensing agreements, without any degree of management participation or return of profits.[52]

Obstacles to East-West trade

The decisions of certain Eastern European countries to accept some limited-equity joint ventures was a major policy move, but one which carried with it two difficult problems which required resolution by each European nation contemplating utilization of the joint-venture form.

The first problem concerns the admissibility of foreign direct investment with an element of ownership interest in the venture, and consequently, an investment return received as a share of profits, geared to performance rather than in the form of royalties. The second issue, related to the first, involves participation in management by the foreign investor.[53]

The Eastern European countries have relaxed prior restrictions on foreign direct investment by establishing the foundations for joint ventures with the properties of profit-sharing and management. They, however, have been hesitant to allow the foreign investor to occupy a dominant role in either ownership or management. Presently, the Eastern European countries allow only a forty-nine per cent foreign equity ownership, except for Yugoslavia which in special circumstances allows a limited 'majority' ownership. It is doubtful that this soon will change. Management control is the more delicate question for the foreign investor; however, if the Western businessman were to receive a substantial return with a minority ownership, he would not be as reluctant to invest.[54]

During the 1970s, there was a shift in the East European countries from import to domestic production (orientation) and with it the emergence of the joint venture in a number of structures. While economic cooperation agreements generally substitute a management for a corporate role, nations involved in joint ventures consciously have selected traditional capitalist incentives to attract their Western affiliates. From the viewpoint of the Eastern partners, the joint venture, like the cooperation agreement, encompasses a wide spectrum of East-West collaboration, extending over a long period of time in order to build the Eastern enterprise, to utilize underused capacities, to develop resources, and to promote Eastern exports and foreign currency holdings; from the perspective of the Western partner, the device has been useful to broaden or protect markets for technology, products, and services.

The essential difference between the economic-cooperation and joint venture mode of investment lies in the form of financing utilized for the transfer of capital, technology, and management. While economic-cooperation agreements are financed through loans and credits, with a set period for repayment of capital and interest, the joint venture basically is financed by the investment of risk capital by both the Eastern and Western partners, with repayment mainly in the form of a portion in the earnings and possibly long-term capital gains.[55] In addition, the joint venture also may include other agreements for the transfer of technology and management in exchange for royalties and fees.

A significant obstacle to the development of East-West trade has been and remains the emphasis on bilateral trade agreements by socialist states.[56] This emphasis has been based in part on use by those states of a centralized system of planning, such as the five-year plans, and the relative ease of creating large trade plans. Nevertheless, the inherent incumberances of bilateralism common in the Eastern European countries has restricted both the character and volume of trade with the Western countries. Several factors have contributed to this development First, the amount of imports by the Eastern European states has been limited in general by corresponding volume of their exports. Second, Eastern European trade at least has been affected adversely by quota lists which often limit the type of goods subject to import. Third, the administration of these bilateral agreements has been rigid. However, there is evidence now that Eastern European nations have begun to move away from this emphasis on formal bilateralism.[57]

Another obstacle which has limited the volume of East-West trade has been the export capacity of East European nations.[58] Eastern European production, partially due to the nature of the domestic patterns of consumption in those states, has not been well-suited to the needs of Western European consumers. Generally, the variety of Eastern products is limited, quality at times is of a lesser standard, and marketing and servicing are inadequate; often, restricted access to Western export credit adds to the difficulty of competing in world markets. In addition, the import demands of Western consumers tend to modify quickly and, because of this, it has been difficult for the structured, planned economies of the socialist states to adapt production for such markets, particularly as to consumer products. Finally, Eastern European countries have had little experience in Western consumer markets and have been less willing to take the risks inherent in extensive involvement in such a market. This situation also has begun to change, with the joint venture approach a leading device for facilitating increased Eastern involvement in the Western markets.

Two further obstacles to East-West trade have involved internal pricing and management.[60] The problem related to internal pricing has been one in which domestic prices converted at official rates of exchange have borne little or no relation to world prices, and a variety of devices have been required to allow enterprises to export and import without triggering losses or excess profits. A typical arrangement which has had some success has been the system of levies and subsidies, which vary for each product and which are used to equate domestic and external prices.[61] Matters of management skill and experience also have presented difficulties for East European countries in export markets, this resulting from the socialist system of centralized planning. Essentially, the systems have not been sufficiently flexible to adjust easily to foreign markets. The utilization of the joint venture has helped several of socialist states overcome at least in part many of these trade obstacles. The joint venture concept tends to open new markets to developing economies, such as those in Eastern Europe, and the recipient country, in turn, gains a more flexible foreign trade policy, increased continuous technology, and a better awareness of Western consumer demand and pricing. Most joint ventures are formed in the West and perform some function for which the East European partners lack the resources or capability. Often this function is marketing. But some third-country production joint ventures have been established, as well, and there is evidence that this trend will continue.[62]

Joint Venture Legislation

The specific provisions contained in the joint venture legislation enacted in Yugoslavia, Romania and Hungary, among other East European states, will be examined in some detail in subsequent chapters. However, by way of an introduction, it is of value to survey some of the more noteworthy aspects of these laws, briefly summarizing their similarities and distinctions. The Yugoslavian legislation will be emphasized because that law has had the most impact on the other Eastern countries since it was the first such legislation.

(1) Similarities among the Three Investment Laws

In Yugoslavia, Romania, and Hungary, joint ventures are individually negotiated agreements; the contract between the Western entity and the Eastern counterpart is the most important aspect of the relationship because it represents an arrangement between parties with essentially divergent views concerning ownership, control, and operation of the means of production. The contract also is vital because of the lack of a classical corporate structure in such transactions. The joint venture laws do not include, for example, the extensive treatment of management functions which are contained in a typical company law. In addition, there usually are joint venture by-laws, and the contract, thus, serves as the dominant document to control those areas usually treated in the articles of incorporation and the by-laws. The significance of the contract is recognized in each of the three legislative schemes.[63] Each of the laws states that a contract must be in writing and that it will control the interactions of the parties.[64] The relevance of the joint venture contract is made apparent through the registration requirements. The Yugoslavian law includes a lengthy article which governs the registration of the contract in the Federal Secretariat for the Economy, and it sets out a number of requirements which must be addressed before registration will be accepted. The Hungarian and Romanian decrees include an approval form of registration for the joint venture contract.[65] In addition to the aspects of the joint venture contract provisions noted, the approval of the agreement by specified governmental agencies in the host country is universally required. Under each law, there is established the normal upper limit on the amount of a foreign investor's equity participation to a minority interest of forty-nine per cent of the joint venture's total capitalization.[66] The Yugoslavian and Hungarian laws also provide that a foreign investor may have a majority equity participation under special conditions, though in the Yugoslavian joint venture, a foreign investor never may possess an effective control despite a majority equity position. All three laws contemplate that the nature of assets contributes by the Western affiliate will include technology, capital, and expertise, and that those contributed by the Eastern host partner will include labor, resources, and property.[68] Under each of the laws, various fields of investment are restricted and others encouraged, although the fields vary from country to country. One of the more apparent aims of each of the three Eastern countries is the generation of increased earnings of hard currency, to be achieved by the export and marketing of a significant portion of the manufactured goods. One of the important similarities here is that each of the three countries guarantees certain rights to the investor, including the assurance that the joint venture will not be affected adversely by subsequent changes in the law. Another major similarity in the three laws concerns their sanctioning of repatriation of profits. The Yugoslavian and Romanian acts provide that the manner in which the two joint venture partners share profits may be fixed by contract provisions. Although the Hungarian law does not expressly state how profit-sharing will be controlled, it may be assumed that the partners also may negotiate this issue in the partnership contract.[69] Each law imposes a tax on the profits of the foreign investor. However, in addition to basic profit taxes, each law imposes additional tax liabilities on the joint venture's profits before the foreign investor can transfer its share abroad. The Yugoslavian law also imposes an annual payment of an unspecified amount to the 'social community'. The Romanian law requires a foreign investor to contribute five per cent of annual profits to a 'reserve fund' until the fund reaches twenty-five per cent of the foreign partner's capital investment. The Hungarians require two special assessments which limit the foreign investors ability to repatriate his profits. The first resembles the Romanian 'reserve fund', requiring that a 'risk fund' amount to ten per cent of the value of the joint venture. The other assessment is voluntary, whereby an 'employees profit-sharing fund', not to exceed fifteen per cent of the annual wages, may be established.[70]

Related to the ability of the investor to repatriate his profits is the question of the type of currency in which profits may be repatriated. The Romanian provisions indicate that this issue can be negotiated in the contract.[71] Under Hungarian law, a foreign investor's profits may be repatriated only to the extent that they are deposited in the Hungarian National Bank. Unlike Romania and Hungary, Yugoslavia provides no guarantees that all accrued profits may be repatriated in convertible currencies. The amount depends entirely on the degree to which the joint venture's earnings are in hard currencies.

In discussing the distinctions among the laws of these three countries, it must be emphasized that in Romania and Hungary the State itself acts as the partner under the joint venture contract, while in Yugoslavia the co-venturer is the workers' council.[72] Therefore, during contract negotiations, the foreign investor in the first two instances will interact directly with government officials and with an enterprise in the third case. The result of this distinction is a greater direct State influence in Romania and Hungary at the operating stage of the joint venture. Somewhat paradoxically, both the Romanians and Hungarians utilize Western corporate terminology to set forth the structure and organization of the joint venture, whereas the Yugoslavians define the new company through the structure of a workers' enterprise.

Although the laws of three countries provide some similarity in the powers of