

# Czech Mate: Expropriation and Investor Protection in a Converging World

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December 2004

## Abstract

This paper examines the expropriation of a foreign investor by a local partner and the subsequent resolution of that case through international arbitration. Ronald Lauder, a U.S. investor, created a media holding company for investments in Eastern Europe that included a once-successful joint venture with Vladimir Zelezny in the Czech Republic. Despite Lauder's 99% interest in the underlying Czech entity, Zelezny managed to divert the value of the underlying entity for his personal benefit. Subsequent to the expropriation, Lauder employed international agreements and tribunals to recoup 354.9 million USD from the Czech Republic. This clinical examination of an expropriation and its aftermath illustrates how ownership shares can be of secondary importance in determining control, how corporate control is shaped by geography, and how differential access to investor protections in global capital markets can contribute to the persistence of differences, rather than convergence, in investor protections.

*JEL Classifications: F21, F23, F36, F42, G15*

*Keywords: Investor Protection, Bilateral Investment Treaties, Diversion, Multinational Firms*

Kathleen Luchs, Stephen Marks and Hardy Tey provided excellent research assistance. The authors thank Sasha Greenawalt and Michael Ostrove of Debevoise & Plimpton, Petr Panek of White & Case, and Milan Smid of Charles University for help in understanding the Czech legal and regulatory environment; and Dan Bergstresser, John Coffee, Benjamin Esty, Josh Lerner, Kathleen Luchs, John Owen and James Zeitler for comments on an earlier draft. Desai thanks the Division of Research at Harvard Business School for financial support.

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## ***1. Introduction***

Analyses of investor protections typically consider local laws to be the primary measure of legal protections for investors. Similarly, these analyses do not discriminate between types of investors, other than on the basis of their ownership shares or control rights. In contrast to these emphases, multinational firms constitute large fractions of investment in most economies, particularly developing and transition economies, and these firms have legal means available to them beyond local laws as well as unique control problems. Studying the experience of multinational firms and their legal protections through a clinical examination promises to illuminate the unique aspects of their control problems and the forces driving the evolution of legal systems when non-local laws shape investor protections for a subset of investors.

This paper examines the investment experience of Ronald Lauder in the Czech Republic, his expropriation by his local partner Vladimir Zelezny, a prominent Czech, and the aftermath of that investment experience including subsequent international trials and arbitration. In emphasizing one example, this paper contributes a clinical perspective on the mechanisms of expropriation by an insider, on how control can be influenced by geographic considerations, politics and power dynamics rather than ownership shares, and on how the evolution of legal institutions may be driven by foreign direct investment. The lengthy records of the Lauder-Zelezny trials and arbitrations provide a unique opportunity to understand the mechanisms of diversion by insiders in Europe and the role of local and international laws in protecting investors.

In 1991, Lauder created a holding company, Central European Media Enterprises (CME), to invest in media properties throughout Eastern Europe. CME's investment in the Czech Republic was in a Prague-based TV station, TV Nova, which CME jointly owned with a media company controlled by Zelezny. The Czech enterprise prospered until Zelezny, despite a very limited ownership stake, managed to expropriate the value of the entity for his own private benefit. Lauder resorted to international tribunals and Bilateral Investment Treaty (BIT) arbitration to recoup his investment and managed an historic verdict against both Zelezny and the Czech Republic. The Czech Republic ultimately paid damages to Lauder's company in excess of the annual budget of the Czech Health

Ministry.

In addition to providing a detailed look at an expropriation by an insider, this clinical examination illuminates several underappreciated aspects of control in an international setting. First, this clinical examination of expropriation demonstrates that the power of insiders need not be defined by their ownership shares. Prominent insiders – such as leading employees and local representatives of multinational firms – can manipulate policy-makers, conduct public relations, and violate contracts in a manner that expropriates value from owners regardless of actual ownership shares. In this particular setting, Lauder’s eventual 99% ownership stake helped him little in preventing the wholesale expropriation of his firm’s value by Zelezny. Zelezny’s ability to divert the firm’s value arose from his access to critical resources, his public image locally, his manipulation of the media, and his ability to bend the rules of the game at will. In contrast to the traditional notion of “tunneling,” insiders with minimal ownership may be just as effective at expropriating value as majority owners.

Second, this clinical examination also demonstrates how and why control of firm assets appears to have a geographic dimension. The geographical and cultural distance between Lauder and Zelezny distributed decision rights in a way that allowed Zelezny to structure the joint venture opportunistically, to force monetization of his ownership in the company, and, ultimately, to expropriate the value of the asset. Geography’s role in determining control over corporate assets has been emphasized in venture capital settings and in historical evidence but appears to be equally relevant today to multinational firms with operations around the world.

Finally, this clinical examination demonstrates how local laws may be irrelevant to investor protections for many investments. Local laws were of little help to the expropriated owner of the firm and, ultimately, had no influence on the ultimate resolution of the case. Although Lauder appealed to the local courts, he also sought the protections afforded by the web of bilateral treaties that govern most capital flows between countries. These treaties afford significant protections for foreign investors and are an increasingly used recourse for redress against expropriation not just by governments, but also by managers and investors. While scholars have emphasized the role of cross-border listings

in fostering so-called contractual convergence, this clinical examination suggests that these bilateral investment treaties are an increasingly important influence on this convergence dynamic, and that the proliferation of investor protections through these means does not necessarily lead to convergence. Evidence from the CME case is suggestive of how differential access to legal protections can retard convergence rather than promote it. More generally, the importance of multinational firms to many emerging economies suggests that consideration of the additional means available to multinational firms to protect their investments can usefully complement the studies of local laws that are common today.

The rest of the paper proceeds as follows. Section 2 outlines the relevant literature and describes the legal protections afforded by BITs. Sections 3, 4 and 5 detail the origins of the joint venture, the disintegration of the entity, and the subsequent legal wrangling, respectively. Section 6 considers the broader implications of this clinical study, including evidence of the impact of the CME affair on investor protections in the Czech Republic, and section 7 concludes.

## **2. *Related Literature and Bilateral Investment Treaties***

This section outlines some of the related literature and describes the functioning and growth of BITs. Subsequent to the clinical examination, we return to these literatures and consider the implications of the Lauder-Zelezny case in section 6.

### **2.1. *Law and Finance***

Given the evidence on the nexus between financial development and economic growth, the large literature on law and finance seeks to explain the sources of variation in financial development with particular emphasis on legal origins and regulations. This literature, beginning with La Porta et al. (1997, 1998) and as reviewed in Beck and Levine (2004), has amassed evidence on the links between investor protections and the size of capital markets, the valuation of firms, payout behavior, the allocation of capital, and economic growth more generally. The CME case is most directly related to the strands of the law and finance literature that have emphasized the experience of transition economies, the distinctive nature of control of media companies, and the possibility of convergence of investor protections through competition amongst systems.

### *2.1.1. The Experience of Transition Economies*

The transition economies have provided particularly rich settings for considering the importance of investor protections and the mechanisms by which insiders expropriate value from other shareholders. Indeed, the term “tunneling” originated with reference to the experience of the Czech Republic, as noted in Coffee (1996, 1998) and Johnson et al. (2000), to signify the idea that majority shareholders can employ various means to transfer the assets and profits out of firms for their personal benefit through self-dealing transactions. The available evidence suggests that transition economies, particularly the Czech Republic, continue to feature large private benefits of control. Analyzing change-of-control transactions, Dyck and Zingales (2004) construct a measure of the private benefits of control finding that the value of control ranges between  $-4\%$  and  $+65\%$  of firm value. In their paper, the Czech Republic’s value of the private benefits of control is measured in the upper limits of that range at  $58\%$ .

In the transition economy setting, broader measures of investor protections that incorporate enforcement and the strength of the judiciary appear to be particularly relevant. Pistor (2000) and Gelfer, Pistor, and Raiser (2000), using an expanded version of the investor rights indices developed by La Porta et al. (1998), find that the efficacy of legal institutions has a much stronger impact on a firm’s ability to raise external debt or equity than do the written laws themselves, supporting the proposition that the mere importation of a foreign legal system is not sufficient for the evolution of effective institutions. Comparing approaches to regulation in Poland and the Czech Republic, Glaeser, Johnson and Shleifer (2001) show how anemic regulation contributed to a weak capital market in the Czech Republic while strict enforcement of securities laws by a highly motivated and independent regulator was associated with a rapidly developing stock market in Poland. Glaeser, Johnson and Shleifer (2001) note that strict application of well-crafted regulations may substitute for judicial enforcement in transition economies.

While the transition economy setting has already proven fruitful to scholars, the clinical examination of CME’s experience is useful for several reasons. First, prior analyses have examined these economies as if they were closed economies with only local firms and local savers. In reality, these economies are highly reliant on foreign direct

investment, raising the question of how foreign investors are vulnerable in these countries and what recourse they have available to them beyond local laws. Figure 1 illustrates the importance of foreign direct investment (FDI) to developing and transition economies by plotting the weighted average ratio of annual FDI to gross fixed capital formation (Panel A) and the weighted average ratio of the stock of FDI to GDP (Panel B) using data provided by the United Nations Conference on Trade and Development (UNCTAD).<sup>1</sup> By 2002, the ratio of the stock of FDI to GDP had reached 36% for developing countries, and 21% for Eastern and Central Europe. The case for the Czech Republic is even more pointed - for 2002, the ratio of FDI to gross fixed capital formation was 59% and the ratio of the stock of FDI to GDP was 64%. Obviously, understanding the nature of investor protections for over half of national investment merits attention, particularly as these shares appear large precisely where the link between finance and growth can have the largest implications.

Second, tunneling has been conceptualized as the means by which majority shareholders expropriate value from minority shareholders. As the CME case illustrates, insiders with minimal ownership may be just as effective at expropriating value as majority owners. Finally, the legal documents provided by the protracted CME trials and arbitrations afford a new, detailed perspective on the mechanisms of expropriation.

### 2.1.2. *The Media*

As noted by Demsetz and Lehn (1985) and Demsetz (1989), mass media companies may provide owners with large private benefits (or so-called “amenity potential”). As a consequence, diffuse shareholding may be suboptimal given the resulting inability to fully enjoy the private benefits – access, influence or fame – arising from the nature of the media business. Djankov et al, (2003) demonstrate that ownership patterns of media companies are indeed highly concentrated indicating the presence of large private benefits. Dyck and Zingales (2002) note that media companies, in addition to having unique corporate governance characteristics, may play a significant role in monitoring firms and

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<sup>1</sup> The “developed economies”, as defined by UNCTAD, are the European Union (as of 2002), US, Canada, Australia, New Zealand, Japan, and Israel. Central and Eastern Europe includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Moldova, Poland, Romania, Russia, Serbia and Montenegro, Slovakia, Slovenia, and Ukraine. The “developing economies” are all remaining countries.

providing information to investors. By implication, control over the media may make it easier to conceal or expose activities of other corporate entities.

The CME case offers insight into precisely what these private benefits are and why even majority owners may be excluded from enjoying those private benefits. For example, personalities created through television outlets can eclipse ownership shares in creating access to those private benefits. The CME case also illustrates how media companies, because of their status as monitors of the state, may receive distinctive treatment from the state, as alluded to in Djankov et al. (2003). In CME, the state proved an unwilling arbiter given the ability of actors in the dispute to influence public opinion – the amenity potential of TV Nova included more restrained actions by the state.

### *2.1.3. Investor Protections in an Open Economy*

The large law and finance literature has implicitly considered the case of domestic savers and domestic firms with some limited attention to the role of global capital flows. There are a few exceptions. Shleifer and Wolfenzon (2003) explicitly consider the possibility of a global interest rate and consider how open economy considerations influence how investor protections change capital market outcomes. Desai, Foley and Hines (2004a) consider how multinational firms employ their internal capital markets strategically to substitute for more expensive local finance in countries with weak investor protections and Esty (2004) considers how foreign banks respond to local investor protections in funding large projects. Finally, the large literature on cross-border capital listings, as reviewed in Karolyi (1998), emphasizes the motivations for such listings and the valuation consequences of those listings, as in Doidge, Karolyi, and Stulz (2004).

While analyses of investor protections have emphasized closed economy settings, predictions of the future of national differences in investor protections hinge on the role of competition among countries. The most Darwinian view is the one espoused by Hansmann and Kraakmann (2001) who suggest that increased global competition will force a quick convergence in corporate governance and legal structure towards a common standard. Despite apparent divergence in approaches to governance, patterns of share ownership, and habits of business culture across economies, continued convergence is a given according to this view. An alternative view, as articulated by Bebchuk and Roe (1999) emphasizes

political forces and path dependency as constraining economic evolution toward (and possibly away from) convergence.<sup>2</sup> Coffee (1999) and Gilson (2001) emphasize the diversity of mechanisms by which convergence can occur. Specifically, contractual arrangements such as cross-border listings can achieve functional convergence if not formal convergence of legal systems. Khanna, Kogan, and Palepu (2002) provide evidence on the degree and mechanisms of convergence by showing that economically interdependent pairs of countries are more likely to have similar legal protections. Similarly, Lerner and Schoar (2004) and Kaplan, Martel and Stromberg (2004) examine how private equity contracts differ around the world and the degree to which investors with U.S. experience import U.S.-style provisions.

The CME case demonstrates an alternative dynamic to the evolution of legal systems dictated by multinational corporations and foreign investors. Specifically, the growing use of BITs and CME's reliance on them indicate a relatively unexplored, and very effective, mechanism of protection for foreign investors. As discussed below, the CME case also indicates that the availability of these alternatives has ambiguous predictions for the protections of local investors.

## 2.2. *Bilateral Investment Treaties*

The resolution of the CME case employed a relatively new approach to supra-national judicial enforcement, the Bilateral Investment Treaty (BIT). BITs are treaties made between two states that provide specific protections to investments made by nationals of one participating state in the other. BITs define foreign investment and outline various principles regarding treatment, expropriation, and avenues for dispute settlement. BITs negotiated from the 1980s onward tend to include most of the following rights with varying degrees of emphasis:

- National treatment, where investors have equivalent rights to those of nationals of the host state
- Most-Favored Nation (MFN) treatment
- Absolute standards of treatment of foreign investors
- Ability to repatriate profits

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<sup>2</sup> In a related vein, Rajan and Zingales (2003) develop an “interest group” theory of financial development where incumbents oppose financial development because it generates competition.

- Guarantees against expropriation or nationalization without compensation<sup>3</sup>

BITs are distinct from other agreements between governments. BITs grant specific rights not just to the contracting states, but also to individuals who are nationals of each of the signatory parties, and they permit individual investors to pursue claims in international arbitration directly against the host nation. These rights and permissions are explicit in the text of the BIT itself.

Most BITs refer such investment disputes to arbitration under the rules of the International Center for the Settlement of Investment Disputes (ICSID), an arm of the World Bank created by a multinational convention, or less frequently under the United Nations Commission in International Trade Law (UNCITRAL) rules. Typically, international commercial arbitration panels consist of three people. Two members are appointed by each of the parties and the third is decided by mutual agreement. Binding arbitration protects the investor in several ways. First, it protects the foreign investor from the risk that disputes arising under the contract will be resolved in courts that are not impartial because they are aligned with the government of the host country. Even if judicial independence is not an issue, judicial competence can be, especially in transition economies where there is not a long history of a well-trained and experienced judiciary. Second, international commercial arbitration permits the parties to specify resolution of the dispute against a foreign law, thereby limiting the risks of reliance on incomplete or poorly written law of the host country. Although host states could adopt constitutional protections that commit governments to uphold their contracts with private investors, foreign investors may be skeptical of the capacity and willingness of the local courts to enforce these agreements. Rose-Ackerman and Tobin (2004) provide a detailed look at BITs and conclude that “foreign investors are assured a strong, binding property rights system

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<sup>3</sup> BITs outline those terms under which expropriation could be deemed lawful and compensation would be due. That there is some requirement for compensation is not controversial. What can be the terms of the compensation. Standards include “prompt, adequate, and effective” or “payment of full value” or “just compensation”. This has been interpreted to mean the market value of the investment immediately prior to the expropriation being made public. BITs also offer protection in situations different from the “obvious” case of formal expropriation or nationalization. BITs are now being used to resolve a variety of disputes arising out of “regulatory takings,” such as trade bans initiated by the host government, breaches of concession agreements; taxation measures, measures of economic or monetary policy, and domestic court decisions (Friedman (2003)). This supranational extension of judicial power is highly controversial. See Been and Beauvais (2003) for a discussion of regulatory takings under Chapter 11 of the North American Free Trade Agreement (NAFTA).

outlined in international or industrialized country law.”

The first BIT was signed in 1959 between Germany and Pakistan with subsequent proliferation following a general geographic pattern. Most early BITs were signed between African and Western European countries. Asian nations entered into BITs in the 1970s, followed by Latin American and Central and Eastern European countries in the 1980s and 1990s. Elkins, Guzman, and Simmons (2004) show that developing common law countries are significantly less likely to enter into BITs than are similarly situated governments of civil law countries.

BITs enjoyed a remarkable period of growth in the 1980s and 1990s, especially among developing countries. According to UNCTAD, the overall number of BITs rose from 385 in 1990 to 2,181 at the end of 2002.<sup>4</sup> Panel A of Figure 2 shows a time-series from UNCTAD data of the number of BITs signed per year and the cumulative total of BITs for the years 1996 to 2002. The number of BITs is broken down according to whether the signatory country is a “high income” or “low income” economy.<sup>5</sup> Panel B of Figure 2 shows the number of BITs signed between developing economies and developed, developing, and Central and Eastern European economies per decade. Although early BITs were agreements reached between developed and developing nations at the request of the developed nation, the 1990s has seen an explosion of BITs signed by developing countries with each other.<sup>6</sup>

Expropriation cases are increasingly handled through BITs. For example, over its more than 35 year history, the ICSID has registered 120 disputes. However, over half of these disputes have been registered in the past 5 years, with BITs (as opposed to general cross-border contract disputes) involved in an increasing number of cases. Seven of the 12

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<sup>4</sup> Information on the prevalence and diffusion of BITs can be obtained from the UNCTAD website, [www.unctad.org](http://www.unctad.org).

<sup>5</sup> Following Rose-Ackerman and Tobin (2003) and the World Bank, “high income” is defined as having a 2000 GNI per capita of 9,266 USD or higher.

<sup>6</sup> The supranational adjudication of these disputes are not limited to BITs but are an increasingly common feature in developed countries as a result of trade treaties. Been and Beauvais (2003) show that protections afforded to investors under the “regulatory takings” expropriation provision of NAFTA (Chapter 11) significantly exceed equivalent U.S. court rulings for U.S. investors. More importantly, NAFTA provisions require a lower standard of proof for damages, and may even consider changes in the host country law itself as a form of regulatory takings.

cases started in 2000, 12 of 14 in 2001, and 16 of 19 in 2002 explicitly involve BITs.<sup>7</sup>

### 3. *The Development of CME, 1991-1998*

Central European Media Enterprises (CME) originated in 1991 in the Netherlands as a development corporation focused on opportunities in Eastern and Central Europe arising from the fall of Communism in the region.<sup>8</sup> Ronald Lauder, a former U.S. ambassador to Austria and one of the heirs of the Estée Lauder cosmetics fortune, and Mark Palmer, who had served as U.S. ambassador to Hungary, were the original founders. Across the region, there were plans to privatize broadcast frequencies that had been state-controlled under the communist regimes. CME focused on these opportunities in commercial television.

In 1992, the Czech Republic became the first former Soviet Bloc country to announce that it would privatize a broadcasting frequency with national coverage. A Media Council, whose members were elected by Parliament, was established to set programming standards and license conditions. It also had authority to issue broadcasting licenses. Among the interested bidders for the frequency was a group of five prominent Czech professionals and intellectuals.<sup>9</sup> Vladimir Zelezny, a journalist, producer, and a former press official for the Czech government of Vaclav Havel, joined the original group and became its spokesman.<sup>10</sup> The group named itself Central European Television for the 21<sup>st</sup> Century (CET 21). CET 21 needed financial backing to make its bid for the television license credible while CME sought local partners to facilitate its bids for broadcasting licenses and also to ensure locally appropriate programming. The two groups worked together to submit a bid for the first Czech commercial TV station.

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<sup>7</sup> Information on ICSID can be obtained at [www.worldbank.org/icsid/index.html](http://www.worldbank.org/icsid/index.html).

<sup>8</sup> Originally, it was incorporated in Germany as CEDC GmbH (Central European Development Corporation), but it subsequently reincorporated in the Netherlands as CME. We make no distinction between CEDC and CME, although objections as to which relevant BIT applies were brought by the Czech Republic during the course of the arbitration. These objections were dismissed by the tribunal as not relevant.

<sup>9</sup> The CET 21 shareholders consisted of Zelezny, sociologists Josef Alan and Fedor Gal, television directors Peter Krsak and Vlastimil Venclik and psychologist Peter Huncik (*CTK National News Wire*, March 6, 1996.) The original members of CET 21 had no commercial TV programming experience, and were primarily politically active intellectuals who looked at the creation of a national TV network as a high-minded approach to the diffusion of culture through a mass medium.

<sup>10</sup> Zelezny, a prominent political figure, had worked as a producer and show host at Czech TV with some success in the 1960s, and under pseudonyms as a TV scriptwriter in the 1970s and 1980s. Zelezny had also been the official spokesman for Petr Pithart, the first prime minister in the government formed after the “velvet revolution.”

During 1992, the Media Council reviewed proposals and held public hearings on bids for the broadcasting license from more than twenty applicants.<sup>11</sup> CET 21 and CME negotiated terms between themselves and consulted with the Media Council on their joint proposal. The new Czech media law *did not* forbid foreign ownership of television stations, and the Media Council accepted that foreign capital was required to launch a successful station. Nonetheless, the Media Council expressed a clear preference for a combination of domestic and foreign capital. The original plan was for CME to provide substantial capital for the new television station in return for 49% ownership of CET 21. After a number of hearings, the Media Council awarded the television license to CET 21 on January 30, 1993. The decision provoked an outcry in the Czech Parliament from the ruling party. There were charges that the decision was too hasty, objections to the leftist political ties of CET 21's founders, and outrage over the extent of foreign investment in Czech television being allowed by the Media Council.<sup>12</sup>

The Media Council responded to the uproar by asking CET 21 and CME to revise their plans for the television station before it actually issued the license. In particular, the Media Council declared it would not permit foreign ownership of the license.<sup>13</sup> The founders of CET 21 and CME, in consultation with the Media Council, devised an alternative arrangement. CET 21 would be owned exclusively by its founders, including Zelezny, who were all Czech or Slovak nationals. The license would be granted to CET 21 and CET 21 would function solely as a license holder. A new company, to be established by CME and its local partners, would operate the television station. This new company would have exclusive use of the license held by CET 21 and assume all operating responsibility for the new station, including buying and producing programs and the sale of advertising. This arrangement left the license itself in Czech hands but allowed the participation of CME through the operating company.

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<sup>11</sup> Burton Bollag, "Czechs Learning to Release Government's Control of TV," *The New York Times*, June 14, 1993, p. D6.

<sup>12</sup> The decision was bitterly contested, especially by the new coalition government of Vaclav Klaus, winner in the June 1992 elections. The Party's deputy chair, Petr Cermak, in response to the selection of CME/CET 21, said that "it is absolutely unacceptable that so mighty and important a medium as television should be controlled by bankrupt politicians, who have caused so much trouble in the past." (*Denni Telegraf*, [Daily Telegraph] February 2, 1993). Some of the CET 21 owners were well-known personalities associated with the former government, loser in the June 1992 elections.

<sup>13</sup> Although the Media Council suggested this approach, there was no explicit provision or requirement in the Czech Broadcasting Law that the license be held by Czech or Slovak nationals.

The new operating company, CNTS, was owned by CME, CET 21, and the Czech Savings Bank (CSB). CME contributed 75% of CNTS's capital and received 66% ownership. The Czech Savings Bank contributed 25% of the capital and received 22% ownership. CET 21 contributed the use of its television license to CNTS and received 12% ownership. Figure 3 shows the initial ownership and structure of CNTS. These arrangements were finalized in a Memorandum of Agreement and approved by the Media Council in February 1993.<sup>14</sup> The public name of the new station operated by CNTS was TV Nova. At that time, Zelezny became director of TV Nova and began planning the station's launch.

### 3.1. *TV Nova's Opening and CME Growth 1994-1996*

TV Nova enjoyed considerable success under the direction of Zelezny. It first went on air in February 1994 and gained a 70% audience share within a year. Some analysts described TV Nova as the most successful launch ever of a new television station. The station's programming was a mix of dubbed American shows and locally produced programs aimed at a mass-market audience. The station purchased the rights to U.S. series and films from major producers such as Walt Disney and Twentieth Century Fox and produced its own news, sports, variety, and game shows.<sup>15</sup> TV Nova's news programs prominently featured gruesome car crashes and crime reports, and its news teams sought out stories of political chicanery. Zelezny himself presented a weekly program, "Call the Director" which aired on Saturdays at noon and became the most-watched program in the Czech Republic.<sup>16</sup> The station won such a huge market share, Zelezny explained, because "We never overestimate our viewer. We accept the fact that our viewer is a well-educated normal European, he's not over-educated with very sophisticated or unique cultural needs. Our programming reflects this."<sup>17</sup>

The station's popularity with viewers was a strong draw for advertisers. Spending

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<sup>14</sup> UNCITRAL Arbitration, *CME Czech Republic B.V. (The Netherlands) vs. The Czech Republic*, Partial Award, September 13, 2001.

<sup>15</sup> Central European Media Enterprises Ltd., Prospectus, October 13, 1994 (Bermuda: CME, 1994).

<sup>16</sup> In the show, which ran for 26 minutes, members of the public called up and had discussions with Zelezny on air. The show was highly controversial and invited the scrutiny of the Media Council over its content, which frequently involved Zelezny making political statements in contravention to the license conditions.

<sup>17</sup> Normandy Madden, "Bridge Builder," [Interview with Vladimir Zelezny], *Television Business International*, September 1, 1996.

on television advertising increased substantially in the Czech Republic in the mid-1990s, increasing from 57 million USD in 1993 to 167 million USD in 1996.<sup>18</sup> By 1996, TV Nova had net revenues of 109 million USD. CNTS received all of TV Nova's revenues and paid CME a dividend of 8.4 million USD in 1996. The successful launch of TV Nova in the Czech Republic spurred the overall growth of CME. The company reincorporated in Bermuda and raised 68 million USD in its IPO in October 1994. At that time, CME's ventures included TV Nova and two regional stations in Germany. By 1996, CME owned television stations in Romania, Slovenia, the Ukraine, and the Slovak Republic. It had won a broadcasting license in Poland and was competing for a license in Hungary. CME's television stations reached 93.9 million people.

CME financed its ambitious growth strategy through two additional public offerings, in 1995 and 1996. CME revenues grew to 142 million USD in 1996, but the company as a whole was not yet profitable, although CNTS as a standalone entity was extremely profitable. The company's regional German stations, in Berlin and Brandenburg, suffered ongoing losses, and CME curtailed its investments in them. Operating results for CME's largest TV stations at the end of 1996 are shown in Table I.

While TV Nova's success provided a model for CME's other broadcast ventures in Eastern Europe, the Czech television station had its share of critics. Some commentators disapproved of TV Nova's programming and influence, charging that the station was too sensational in its news coverage and too limited in its educational and cultural programming. Zelezny vigorously defended TV Nova, sometimes using his own television show as a platform to answer those who criticized the station or its foreign ownership. He argued, "The intellectuals believed Czechs were special, more sophisticated. We proved they were wrong. We showed that Czechs are like all other Europeans, whose first interest is soccer, with erotica a close second. For that, we will never be forgiven."<sup>19</sup>

### 3.2. *Challenges and Changes to the Ownership Structure of CME, 1996-1998*

TV Nova confronted a challenge when the Media Council launched an investigation into its operations. The Czech Parliament had liberalized the media law at

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<sup>18</sup> Zenith Media, *Television in Europe to 2008*, August 1999, p. 24.

<sup>19</sup> Robert Frank, "Cultural Fare," *The Wall Street Journal*, April 30, 1997, p. A1.

the start of 1996,<sup>20</sup> and this change prompted the Media Council to re-examine the arrangements between TV Nova's license holder (CET 21) and its operating company (CNTS), to ensure that the Council did not lose all authority over the country's most popular television station. The Council particularly wanted to affirm that CET 21 had not, for all practical purposes, transferred its television license to CNTS.<sup>21</sup> As a member of the Media Council explained, "It's like transferring your driver's license... You can't just give it to someone else."<sup>22</sup>

Zelezny and CME executives protested that the Media Council had itself approved the structure of TV Nova, but they agreed to provide a draft contract that defined the services between CET 21 and CNTS and their legal relationship for discussion.<sup>23</sup> The Media Council continued to raise objections, however, and in July 1996 commenced administrative proceedings against CNTS for broadcasting without a license. The police also launched a criminal investigation to determine if CNTS was broadcasting illegally.

The discussions with the Media Council on TV Nova occurred as CME acquired a larger ownership share in CNTS. Figure 4 shows how the ownership of CNTS changed between 1994 and 1997. As shown in Panels A and B of that figure, CME's original stake in CNTS was 66%; the Czech Savings Bank (CSB) owned 22%, and CET 21 had a 12% stake. In 1996, CSB decided to sell its holding in CNTS as the Czech government began pressuring banks to sell their large equity holdings in Czech companies. CME agreed to purchase CSB's 22% share in CNTS for about 36 million USD, increasing CME's holding in CNTS to 88%. CSB lent CME funds for the purchase of its holding. A CME executive described this as "the best deal of my life," explaining, "we increased our holding in our most valuable asset by one-third, buying an immense amount of future cash flow for very little of other people's money."<sup>24</sup>

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<sup>20</sup> The Czech Parliament introduced an amendment to the law that prohibited the Media Council from attaching certain conditions (relating mostly to content and ownership) to the granting of a license. In particular, Condition 17 was repealed, which required that changes in ownership in CET 21 to be approved by the Media Council.

<sup>21</sup> UNCITRAL Arbitration, *CME Czech Republic B.V. (The Netherlands) vs. The Czech Republic*, Partial Award, September 13, 2001.

<sup>22</sup> Robert Frank, "Cultural Fare," *The Wall Street Journal*, April 30, 1997, p. A1.

<sup>23</sup> UNCITRAL Arbitration, *Ronald S. Lauder vs. The Czech Republic*, Final Award, September 3, 2001.

<sup>24</sup> Janet Guyon, "CME Sticks with Fast-Growth Plan in Central Europe," *The Wall Street Journal Europe*, August 14, 1996, p. 4.

While CNTS representatives continued to uphold the legitimacy of TV Nova's split structure, the company also sought to compromise with the Media Council to avoid possible sanctions against TV Nova. The Media Council had the authority to impose substantial financial penalties on CNTS if it was found in breach of the broadcasting law, and it also had the right to withdraw CET 21's broadcasting license. Zelezny considered the license to be seriously endangered and conveyed these fears to CME executives.<sup>25</sup> In May 1997, CNTS agreed to alter its agreement with CET 21, bowing to pressure from the Media Council. Instead of CET 21 granting CNTS "exclusive use of the license," the new agreement gave CNTS the right to use the "know-how concerning the license." While the Media Council expressed satisfaction with these concessions, it did not withdraw its administrative proceedings against CNTS at that time.

A short time later, four of the original founders of CET 21 informed CME that they also wanted to cash out their investment. CET 21 held the broadcast license and a 12% ownership stake in CNTS. CME considered that it was in the company's interest to ensure that ownership of the license company did not pass to possibly unfriendly outsiders.<sup>26</sup> CME therefore lent Zelezny a total of 5.2 million USD to buy out four of the original five founders of CET 21. At this time, CET 21's founders also transferred some of CET 21's original shares in CNTS to Nova Consulting, a company owned by Zelezny. This transaction gave Zelezny a 5.8% ownership stake in CNTS, through Nova Consulting. Zelezny also now had a controlling interest in CET 21, which itself held 6.2% of CNTS. Panel C of Figure 4 shows the new ownership after the original investors in CET 21 sold their stakes.

The terms of CME's loan to Zelezny required him to vote the acquired CET 21 shares as directed by CME until the loan was repaid.<sup>27</sup> Later in 1997, CME attracted unwelcome attention when journalists examining CME's filings with the U.S. Securities and Exchange Commission (SEC) via the internet discovered details of the loan CME made to Zelezny to buy out the founders of CET 21. When these stories surfaced, critics

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<sup>25</sup> UNCITRAL Arbitration, CME Czech Republic B.V. (The Netherlands) vs. The Czech Republic, Partial Award, September 13, 2001.

<sup>26</sup> Normandy Madden, "'Iron Man' May be Coming on Too Strong in Eastern Europe," *Advertising Age International*, May 15, 1997, p. I14.

<sup>27</sup> CME, September 30, 1996 10-Q (Bermuda: CME, 1996).

charged that CME sought to control CET 21 through Zelezny and the controversy over foreign control of Czech television resurfaced. Zelezny protested that he purchased the CET 21 shares “because I wanted to own a television station...not because the Americans wanted control. I’m Czech...I am not a puppet.”<sup>28</sup> The controversy over the CME loan to Zelezny erupted just as CNTS was in discussions with the Media Council over the television license, raising suspicions about CME’s motives. The Media Council demanded an explanation from Zelezny, who assured its members that the terms of the loan would not be fulfilled, meaning that he would not be required to vote his acquired CET 21 shares as directed by CME.<sup>29</sup>

The loan was forgiven when Zelezny transferred 5.2% of CET 21’s holding in CNTS to CME. As a consequence of this transfer, CME’s ownership stake in CNTS rose to 93.2%. CET 21 retained 1% ownership in CNTS, and Zelezny owned 5.8% of CNTS through Nova Consulting. Zelezny then expressed his desire to sell this 5.8% stake in CNTS. He claimed that there were other interested buyers who would purchase his shares if CME did not do so. Zelezny stated that he had received a cash offer from a Czech company called Chemapol that Zelezny claimed was heavily influenced by Russian organized crime. By August 1997, Zelezny had persuaded CME to purchase his 5.8% share of CNTS for 28.5 million USD, leaving Zelezny with no direct shares in CNTS. At that time, Zelezny signed a share agreement with CME that included non-compete clauses preventing him from engaging in activities against the interests of CNTS. He continued to serve as General Director of CNTS as well as Director of TV Nova. Zelezny, however, having bought out the other founders, controlled CET 21, the company holding TV Nova’s broadcasting license. Panel D of Figure 4 shows the final ownership structure of CNTS by the end of 1998.

#### **4. *The CME-Zelezny Dispute***

By January 1999, CME entered into merger negotiations with SBS Broadcasting SA (SBS), a broadcasting company with interests in the newly deregulated broadcasting markets in Scandinavia. During 1998, SBS’s interest in Eastern European ventures led to

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<sup>28</sup> Robert Frank, “Cultural Fare,” *The Wall Street Journal*, April 30, 1997, p. A1.

<sup>29</sup> UNCITRAL Arbitration, *CME Czech Republic B.V. (The Netherlands) vs. The Czech Republic*, Partial Award, September 13, 2001.

initial merger discussions with CME, the region's largest owner of commercial television stations.

While CME's flagship station in the Czech Republic, TV Nova, was profitable from the start, CME ran into problems in some of the region's other larger markets. In 1997, the company lost its bid for a national broadcasting license in Hungary and the next year it wrote down the value of its Hungarian programming library. In 1998 CME sold its interest in its Polish station, taking large write-downs on its investments. At the end of 1998, CME's net losses for the year amounted to 125 million USD. CME's founder, Ronald Lauder, continued to support the company, providing 22.7 USD million in additional equity capital as CME searched for a possible merger partner.

In the months leading up to the merger negotiation, Zelezny had repeatedly demanded changes in the existing agreement between TV Nova's operating company, CNTS (now 99% owned by CME), and its license holder, CET 21. Zelezny argued that CNTS could not continue as the exclusive operator of TV Nova because the Media Council opposed exclusive agreements between television license holders and operating companies. Zelezny proposed that CET 21 assume more responsibility for TV Nova's operations. Instead, CME proposed a merger between CNTS and CET 21 so that there would no longer be two entities – one with the license and one as an operating company. Combining the two companies would simplify the structure of TV Nova and resolve the ongoing question of the respective rights of the operating company and license holder. Of course, the question of how Zelezny should be compensated for his consent to the agreement became central to the negotiations. It is worth noting that this negotiation was merely for Zelezny's consent to the deal rather than any compensation for ownership shares held in any entity.

#### *4.1. Negotiating with Zelezny*

As the merger negotiations between CME and SBS advanced in early 1999, Vladimir Zelezny's hold over TV Nova worried executives of both companies. SBS executives noted that, "the Feudal Lord may continue to resist operational control making

it difficult to institute ‘best practices.’”<sup>30</sup> CME tried to find means of satisfying Zelezny without ceding its exclusive rights to operate TV Nova.

CME needed to assure SBS that it had secured control of TV Nova through its subsidiary, CNTS, and tried to get Zelezny’s agreement on combining CNTS and CET 21. According to Zelezny, CME’s founder, Ronald Lauder, “offered him 100 million USD to 140 million USD to buy CET 21 and lock up Nova’s license.”<sup>31</sup> SBS, in its own valuation of CME in February 1999, calculated that Zelezny should be offered 18% of TV Nova’s new operating and license company worth 72 million USD, and a bonus worth 28 million USD upon renewal of the broadcast license. SBS executives characterized the 100 million USD offer to Zelezny as the “price of peace in the Czech Republic.”<sup>32</sup>

Zelezny had not accepted any offer from CME when the CNTS Board met on February 24, 1999. Zelezny continued as General Director of CNTS, and at this meeting he put his position on record: CNTS could not continue as the exclusive operator of TV Nova and the existing contractual arrangements had to be changed. No compromise was possible, according to Zelezny, because the Media Council opposed exclusive agreements between operating companies and license holders. Zelezny declared that “his proposal was an ultimatum, which meant that CME could either accept or not.”<sup>33</sup>

Given that CNTS represented the “crown jewel” in the CME portfolio, these machinations had substantial implications for the value of CME.<sup>34</sup> Figure 5 shows the stock price of CME for the period starting January 1, 1999 to mid-2003 along with the indexed MSCI Eastern Europe US dollar and MSCI Czech US dollar indices for the same period. Five-day cumulative abnormal returns for CME (CAR, against the Nasdaq index where CME was listed) after Zelezny’s ultimatum was -16.9% (Marker 1 in Figure 5.)

After Zelezny’s ultimatum, Zelezny directly solicited the support of the Media

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<sup>30</sup>UNCITRAL Arbitration, CME Czech Republic B.V. (Netherlands) vs. The Czech Republic, Final Award, March 14, 2003, p. 120.

<sup>31</sup> Craig Mellow, “Ron Lauder’s Disappearing TV Station,” *Institutional Investor*, Jan. 1, 2000, p. 54.

<sup>32</sup> UNCITRAL Arbitration, CME Czech Republic B.V. (Netherlands) vs. The Czech Republic, Final Award, March 14, 2003, p. 122.

<sup>33</sup>UNCITRAL Arbitration, Ronald S. Lauder vs. The Czech Republic, Final Award, September 3, 2001, p. 27.

<sup>34</sup> Although CME represented not just CNTS, but all of the CME investments in the region, the present value of CNTS expected cash flows represented over 90% of CME’s firm value.

Council with a request that the Council clarify its position in writing. A few days later, the Council wrote a letter stating that exclusive agreements between operating companies and license holders were “incorrect.” This letter dealt a serious blow to CME, since it challenged the company’s right to control TV Nova. Nonetheless, CME continued to negotiate with Zelezny. Zelezny was quoted as saying “I am not interested in selling my child.”

By the end of March 1999, CME and SBS had increased their estimates of the ‘price of peace’ with Zelezny; the cost rose to 125 million USD and now included a fee of 4% of TV Nova’s revenues, payable to CET 21. Although Zelezny had still not signed any agreement, SBS and CME publicly announced their merger on March 29. SBS offered 615 million USD in stock for CME but included a release clause in the merger agreement, allowing it to withdraw on payment of a termination fee. The five-day CME CAR after the merger announcement was 47% (Marker 2 in Figure 5.)

The impasse between CME and Zelezny continued up to the April meeting of the CNTS Board. At that meeting, CME CEO Fred Klinkhammer accused Zelezny of violating CNTS’s exclusive right to acquire programming for TV Nova by authorizing AQS, a separate entity controlled by Zelezny, to buy programs for the station, which Zelezny denied. Not convinced by Zelezny’s denial, Klinkhammer fired him as General Director of CNTS on April 19, 1999. Klinkhammer deplored Zelezny’s dealings with AQS, declaring, “such bad faith actions could hardly been expected, especially after CME purchased a 5.8% interest in CNTS from Dr. Zelezny for over 28 million USD less than two years ago and he agreed not to compete with CNTS as a condition of that purchase.”<sup>35</sup> Zelezny claimed, “the law says TV Nova is CET 21” and reportedly claimed, “I am the executive of CET 21, owner of the name and Nova’s license. I am Nova.”<sup>36</sup> Despite being dismissed as Director of CNTS, Zelezny continued as Director of TV Nova and still controlled CET 21. Five-day CME CAR after Zelezny’s firing was -32.1% (Marker 3 in Figure 5.) Zelezny’s firing caused an uproar in the Czech Republic, with both sides in the dispute seeking media support. The Czech Media Council ordered the two parties to cease their public pronouncements but declined to intervene in the dispute.

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<sup>35</sup> “Zelezny Dismissed from CNTS,” *PR Newswire*, April 19, 1999.

<sup>36</sup> “CME Company Wants to Prevent Zelezny from Heading Nova,” *CTK Business News*, April 20, 1999.

#### 4.2. *Zelezny Retaliates*

Zelezny retaliated a few months after CME fired him. On August 5, 1999, CET 21 terminated its service agreement with CNTS and withdrew the use of its license. CET 21 cited as grounds for its actions the failure of CNTS to deliver the daily log for TV Nova the previous day – a technical violation of the agreement between CNTS and CET 21. Five-day CME CAR after the termination of the service agreement was -50.5% (Marker 4 in Figure 5.)

CME immediately sought a hearing with the Media Council and decried Zelezny's actions in the press. Klinkhammer declared, "Zelezny had less than 200 USD when he started with TV Nova. We have paid him more than 35 million USD in salary and other benefits. Now he is probably the first or second richest man in the country. We have created a monster."<sup>37</sup> Zelezny responded with a book entitled "We Shall Not Surrender This Television Station" and maintained, "CME is a flop...When it started it had a fantastic chance to win the television market in half of Europe, but it has been awfully managed and many decisions amounted to disasters."<sup>38</sup>

Lacking the use of a broadcast license, CNTS could not operate TV Nova. The Media Council refused to intervene in what it characterized as a commercial dispute, and the Czech courts offered no quick remedy, so CNTS was out of business. TV Nova, however, continued to broadcast, with CET 21 securing the services of other companies (through AQS) to provide programming and sell advertising. With the loss of TV Nova, SBS reassessed its planned merger with CME and exercised its right to withdraw from the agreement in September.<sup>39</sup>

#### 5. *The Endgame, 1999-2003*

Ronald Lauder used his political influence to gather support for his cause. These efforts included enlisting the help of several senior U.S. administration officials, including Secretary of State Madeleine Albright, to press his case with Czech officials. In November 1999, when the Czech Prime Minister visited Washington D.C., Lauder paid for full page

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<sup>37</sup> Kevin Done, "Czechs Watch CME TV battle," *Financial Times*, September 17, 1999, p. 30.

<sup>38</sup> *Ibid.*

<sup>39</sup> SBS paid CME a termination fee of 8.25 million USD. SBS did purchase selected assets from CME in separate transactions.

notices in *The New York Times* and *Washington Post* warning potential investors that the Czech Republic lacked safeguards for foreign investors (Figure 6) Some observers judged that Lauder and CME would gain little satisfaction now that Zelezny controlled TV Nova. The Director of the American Chamber of Commerce in Prague concluded, “No Czech politician who has any desire to continue being a politician is going to cross swords with Zelezny.”<sup>40</sup>

CME attempted to regain control of TV Nova through continued appeals to the Media Council and the Czech courts, without success. CME and Ronald Lauder, as its principal shareholder, also turned to international tribunals to hear their case. CME charged Zelezny with breaking the non-compete clauses in his agreement with the company and sought damages from him personally. In separate actions, CME and Lauder claimed that the Czech Republic and the Media Council violated international treaties by failing to protect CME’s investment in TV Nova. Separate tribunals held hearings in different cities, and the press dubbed the actions accordingly: “The Amsterdam Tribunal,” “The London Tribunal,” and “The Stockholm Tribunal”:

- On April 26, 1999 CME initiated arbitration in The International Court of Arbitration of the International Chamber of Commerce (ICC). The ICC heard CME’s complaint against Zelezny, as provided for in the share agreement between CME and Zelezny. The two parties had signed the agreement in 1997 when CME purchased Zelezny’s shares in CNTS (the “Amsterdam Tribunal”).
- On August 19, 1999 Lauder began arbitration against the Czech Republic in London under the UNCITRAL Arbitration Rules, claiming breaches of the 1991 BIT between the United States and the Czech and Slovak Federal Republic (the “London Tribunal”). This BIT was one of 70 that the Czech Republic has entered into since the fall of the Iron Curtain to the present.<sup>41</sup>
- Six months later, on February 22, 2000, the Dutch parent company through which Lauder had made his investment, CME Czech Republic, initiated arbitration against the Czech Republic in Stockholm, also under the UNCITRAL Arbitration Rules, claiming breaches of the 1991 BIT between the Kingdom of The Netherlands and the Czech and Slovak Federal Republic (the “Stockholm Tribunal”). On behalf of CME shareholders, the Dutch parent company claimed 500 million USD in damages from the Czech

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<sup>40</sup> Craig Mellow, “Ron Lauder’s Disappearing TV Station,” *Institutional Investor*, Jan. 1, 2000, p. 54.

<sup>41</sup> The Czech Republic is a member of the New York Convention on the Recognition and Enforcement of Arbitral Awards, and, as a member of this convention, is required to uphold arbitration awards in disputes between the Czech Republic and foreign parties.

Republic for failing to protect its investment in CNTS.<sup>42</sup>

### 5.1. *The Amsterdam Tribunal and the London Tribunal: Outcomes*

In February 2001, the Amsterdam Tribunal found that Zelezny breached the terms of his non-compete agreement with CME by authorizing AQS to purchase programming for TV Nova. The Court nullified the original agreement between the parties, and ordered Zelezny to repay to CME the 23.35 million USD he had received to date for his CNTS shares.<sup>43</sup> CME was ordered to return to Zelezny the CNTS shares it had purchased from him, once it received repayment. CME also claimed damages against Zelezny of 470 million USD for the destruction of CNTS. The Court found that CME had not proved this case and granted no damages to CME. On September 3, 2001 the London Tribunal found that the Czech Republic had arbitrarily discriminated against Lauder as a foreign investor at the time of the founding of TV Nova. At that time, the Media Council refused to allow CME's direct investment in TV Nova's license-holding company although such foreign investments were permitted under Czech law. The tribunal ruled, however, that Lauder failed to prove that CME's subsequent losses were caused by this discrimination and awarded no damages.

This last ruling was a clear victory for the Czech Republic and a spokesman for the government explained, "Mr. Lauder invested here; the investment was not really a success, and it has nothing to do with Czech laws."<sup>44</sup> Zelezny declared: "Everything ended well. We've won and it is clear that only Ronald Lauder himself is to blame for his business failures."<sup>45</sup> CME stock did not respond positively. Five-day CME CAR after the Amsterdam Tribunal ruling was -16.8% (Marker 6 in Figure 5.)<sup>46</sup>

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<sup>42</sup> This BIT, formally known as the Agreement on Encouragement and Reciprocal Protection of Investments between the Kingdom of the Netherlands and the Czech and Slovak Federal Republic, was executed on April 29, 1991. The BIT entered into force in the Czech and Slovak Federal Republic on October 1, 1992 and, after the Czech and Slovak Federal Republic ceased to exist on December 31, 1992, the Czech Republic succeeded to the rights and obligations of this BIT.

<sup>43</sup> The original price of the shares was 28.5 million USD, but CME had stopped its installment payments to Zelezny for the shares when it fired him.

<sup>44</sup> Marius Dragomir, "TV Nova Courtroom Drama Set to Continue after London Episode," *Prague Business Journal*, September 10, 2001.

<sup>45</sup> "Swedish Ruling Deals Blow to State as Zelezny's Accomplice," *CTK Daily News*, September 1, 2001.

<sup>46</sup> It should be noted that at this point the stock was trading well below 1 USD, had been delisted from Nasdaq, and was considered a "highly speculative" over-the-counter stock.

## 5.2. *The Stockholm Tribunal: The Denouement*

The Czech Republic's victory was short-lived. Ten days later on September 13, 2001, the Stockholm Tribunal, examining the same facts and legal issues, reached a very different conclusion. The tribunal ruled that the Media Council's 1996 demand for changes in the agreement between CNTS and CET 21 weakened CNTS' control over TV Nova and caused CME to be wrongly deprived of its investment in TV Nova three years later. The Tribunal's decision stated that CME's acceptance of the new agreement in 1996 was irrelevant: "Such a decision for a compromise, however, does not make the Council's unlawful acts legal and cannot be deemed as a waiver of CME's rights under the Treaty."<sup>47</sup>

Unlike the London Tribunal, the Stockholm Tribunal found causation: "The collapse of CME's investment was caused by the Media Council's coercion against CME, in requiring in 1996 the amendment of the legal structure as the basis of its investment and by aggravating the Media Council's interference with the legal relationship between CET 21 and CNTS by issuing an official regulator's letter which eliminated the exclusivity that was the cornerstone of CME's legal protection for its investment."<sup>48</sup> The Tribunal concluded that the Czech Republic "is obligated to remedy the injury that Claimant suffered as a result of Respondent's violations of the Treaty by payment of the fair market value of the Claimant's investment as it was before consummation of the Respondent's breach of Treaty in 1999 in an amount to be determined at the second phase of this arbitration."<sup>49</sup> CME sought 556 million USD in damages. Five-day CME CAR after the Stockholm Tribunal ruling was 843% (Marker 7 in Figure 5.)

To determine the compensation due to CME for the loss of its investment in TV Nova, the tribunal first established the fair market value of CNTS at the time it lost use of the license. The tribunal considered different valuation approaches presented by both parties, including discounted cash flow models, reports of stock market analysts, previous transactions in CNTS stock, and the merger offer by SBS. In March 14<sup>th</sup>, 2003, the

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<sup>47</sup> UNCITRAL Arbitration, *CME Czech Republic B.V. (The Netherlands) vs. The Czech Republic*, Partial Award, September 13, 2001, p. 139.

<sup>48</sup> *Ibid*, p. 159.

<sup>49</sup> *Ibid*, p. 178. The decision of the tribunal was not unanimous. The arbitrator chosen by the Czech government refused to sign the decision and issued a separate opinion. His action had no legal force, and a new arbitrator was chosen for the next phase of the proceedings.

tribunal ruled that the fair market value of CNTS in August 1999 was 400 million USD. Using this as a starting point, the tribunal determined the compensation due to CME from the Czech Republic as follows:

Market value of CNTS	400.0 million USD
Less: Residual value of CNTS <sup>50</sup>	38.5 million USD
Less: “Zelezny Factor”	<u>72.0 million USD</u>
Adjusted value of CNTS	289.5 million USD

Thus, CME compensation for its remaining 93.2% stake in CNTS<sup>51</sup> amounted to 269.8 million USD plus 10% simple interest from February 2000 to date of payment. The tribunal reduced CME’s compensation by the “Zelezny Factor” –or 72 million USD – on the basis that Zelezny’s business and managerial skills accounted for that share of the value of CNTS. The tribunal ruled that the Czech Republic and its Media Council was not responsible for this part of CME’s lost investment. Five-day CME CAR after the damages award was 8.6% (Marker 8 in Figure 5.)

The Czech government tried to get Zelezny and TV Nova to accept some financial responsibility for the award. However, a TV Nova spokesperson described the judgment as “a dispute between the Czech Republic and CME.”<sup>52</sup> The Czech Premier pointed out that the sum “represented three times the annual budget of the Ministry of Environment, or the annual budget of the Ministry of Health.”<sup>53</sup> One analyst estimated the cost of the award at about “40 USD per person in a country where the average monthly wage is less than 600 USD.”<sup>54</sup> The damages also dwarf, by at least a factor of ten, those in any other known investment arbitration.<sup>55</sup> However, Czech media reported that most Czech politicians accepted that any damages owed would have to be paid. Foreign Minister Cyril Svoboda stated that “prompt payment is a must in order to safeguard the nation’s

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<sup>50</sup> The residual value of CNTS included dividends paid to CME by CNTS after August 1999, the value of property and assets subsequently sold by CNTS, and the value of property and assets still held by CNTS.

<sup>51</sup> CME owned 93.2% of CNTS after the ICC Tribunal (“The Amsterdam Tribunal”) ruled that Zelezny should repay CME for the CNTS shares it purchased from him and that CME should then return 5.8% of CNTS shares to Zelezny.

<sup>52</sup> Marius Dragomir, “Pay TV,” *Prague Business Journal*, March 24, 2003.

<sup>53</sup> “Revenge of the Nerd, Part One,” *Prague Business Journal*, May 19, 2003.

<sup>54</sup> Richard Morgan, “Ron Lauder’s Prague Spring,” *Daily Deal*, May 26, 2003.

<sup>55</sup> Luke Eric Peterson, “Czech Republic Hit With Massive Compensation Bill in Investment Treaty Dispute,” *Investment Law and Policy Weekly News Bulletin*, March 21, 2003.

reputation abroad.”<sup>56</sup> A two-year 1.5% increase in the Czech value-added-tax was contemplated to finance the payment.

On April 3<sup>rd</sup>, 2003, after a five hour debate, the government dismissed the existing Media Council, holding it responsible for the loss in arbitration. The dismissal of the Media Council was a controversial and close decision, with 90 out of 179 deputies voting in favor of the dismissal. The Media Council was accused of corruption and incompetence by members of Parliament and commentators,<sup>57</sup> and, as part of the dismissal proceedings, the government launched an inquiry into the affair.<sup>58</sup> The CME ruling also emboldened a number of foreign investors to seek relief through international arbitration in their commercial disputes with the Czech Republic.<sup>59</sup> In May 15, 2003 the ruling was upheld on appeal, and the Czech government promptly paid CME a total of 354.9 million USD, including the compensation for its lost investment, interest, and a share of legal costs. Five-day CME CAR after the final ruling was 20.9% (Marker 9 in Figure 5.)

Zelezny was elected to the Czech Senate in November 2002 but stripped of his parliamentary immunity in early 2003 to allow police to investigate fraud charges against him, some stemming from his failure to repay CME for the CNTS shares. In October 2003, PPF, a Czech financial conglomerate, agreed to buy CNTS for 53.2 million USD. Zelezny’s interest in CET 21 passed to PPF, which paid the money he owed to CME. CET 21’s new owners dismissed Zelezny as Director of TV Nova, hoping to distance the station from the lost arbitration. In 2003, CME’s Slovenian station launched a successful sitcom based on the Zelezny debacle. In 2004, Zelezny and his party won two seats in the European Parliament.

## **6. *The Post Mortem***

What new insights does CME’s experience in the Czech Republic provide? We conclude with the lessons of this clinical examination for i) the links between ownership

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<sup>56</sup> *Ibid.*

<sup>57</sup> Dinah Spritzer, “Leaders: Fired Council Was Inept,” *The Prague Post*, April 10, 2003.

<sup>58</sup> Originally, the inquiry by the House of Deputies should have been finished by the end of 2003. However, as of this writing, the commission is expected to issue its report by the end of 2004. (*CTK Daily News*, June 23, 2004.)

<sup>59</sup> Luke Eric Peterson, “Investors Emboldened by Arbitral Verdict Against Czech Republic,” *Investment Law and Policy Weekly News Bulletin*, April 11, 2003.

rights, control and geography, ii) the politics of finance, iii) the nature of control of media companies, and iv) the role of BITs and foreign direct investment in fostering or retarding convergence of investor protections.

### *6.1. Ownership Rights, Geography and Control*

Zelezny's ability to expropriate CME's value of its Czech investment arose from his power over TV Nova and the Czech regulatory apparatus. CME was forced repeatedly to pay Zelezny in order to maintain "peace" – from the initial compensation for the use of the license through subsequent purchases of the shares. Of course, the inability of CME and SBS to consummate their merger stemmed from their inability to pacify Zelezny with over 120 million USD for what was, on the surface, a mere 1% ownership stake.<sup>60</sup> The final act of expropriation occurred when Zelezny blocked CNTS and CME from accessing Czech airwaves, which effectively destroyed all the value in CNTS. While CME owned 99% of CNTS and, initially, the exclusive rights to employ the license, Zelezny expropriated the value of this enterprise by manipulating the Media Council to narrow the terms of the license to limit the effective control of foreign owners, by using his public persona (as gained through his TV show) to galvanize public opinion on his side and attack politicians that might criticize him, and by creating related entities (AQS) that competed with CNTS and ultimately allowed him to control TV Nova without using CNTS.

The striking aspect of Zelezny's expropriation of the value of CNTS is that it occurred without a significant ownership share and without the legislated need to have a domestic partner in Czech broadcasting. The irrelevance of ownership in this setting is further illustrated by the fact that Zelezny was gaining more and more control of the underlying entity, and the value supposedly embodied in the shares of CME, precisely when he was selling his shares back to CME.

This example suggests a more nuanced view of control and authority than is typical in the financial economics literature. To adopt the language of Aghion and Tirole (1997), the CME example demonstrates that employees can wield considerable "real authority" despite being endowed with limited "formal authority" through ownership. While Aghion

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<sup>60</sup> Undoubtedly, the SBS offer of 615 million USD only made Zelezny raise his own reservation "price of peace."

and Tirole (1997) emphasize information asymmetry as the source of the allocation of real authority, the nature of the employment contract itself may be the source of such authority. As emphasized in Stole and Zweibel (1996), the nonbinding nature of the employment contract can lead to intricate intrafirm bargaining since employees can withhold key inputs. Even more broadly, Rajan and Zingales (1998) consider how the distribution of power arising from the unique capabilities or resources of employees can shape optimal ownership and investment incentives. As Stole and Zweibel (1996) suggest in their conclusion, a richer theory of the firm that incorporates intrafirm bargaining with highly-skilled employees may yield new predictions on profit-sharing and ownership structures. These works, and their extensions to the basic property-rights view of the firm, receive support from this example as Zelezny's skills – his political connections and local knowledge – provided the foundation to his leverage over CME.<sup>61</sup> The CME example is particularly supportive of the work of organizational theorists, such as Emerson (1962) and Pfeffer and Salancik (1978), who emphasize “resource dependence theory.” As emphasized in these theories, the key uncertainties created by CME's environment – high dependence on a unique resource that was controlled exclusively by the local partner – provided the foundation for Zelezny's power in this situation. Further consideration of these insights from organizational theorists may yield deeper insights into the implications of power dynamics within firms for corporate governance.

The example of CME also illustrates how little ownership shares can matter *particularly* in settings where property rights are ill-defined. In this case, Zelezny was convinced that “[he] was Nova” and, by implication, CNTS and CME. His access to his own human capital, control of the license, and the threat of their withdrawal led to his effective control over all the corporate assets. Zelezny's control of the Czech regulatory apparatus meant that without Zelezny's cooperation, the assets of CNTS (physical plant, programming library, and management) were worthless. Because of the weak property rights in place, CME did not have clear access to the resources required to monetize

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<sup>61</sup> Of course, it is possible to interpret Zelezny's power over CME as a classic hold-up problem as Zelezny ultimately controlled the license, the specific asset required to broadcast. This interpretation is certainly possible but must account for the fact that CME had exchanged 12% ownership in CNTS for exclusive use of the license. Zelezny's power arose from his ability to effectively renege on that agreement and have the broader Czech regulatory and political structure support him. For this reason, we don't frame the issue as a classic hold-up problem as it's not clear if rearranging ownership shares could have solved this problem.

CME's investment in CNTS – secure access to the license and the knowledge of how to navigate the Czech business environment. In settings where contracts of all kinds are difficult to enforce, it is likely that ownership may own loosely translate into control

A final lesson regarding control arising from the CME example is the relevance of geography to control considerations. In their examination of ownership patterns in the UK, Franks, Mayer, and Rossi (2004) speculate that trust between investors and managers arising from geographical proximity was an effective substitute for formal systems of regulation and investor protections.<sup>62</sup> The role of geography in mediating effective control over entities has been emphasized in the venture capital setting (see Lerner (1995)) and in the ways in which multinationals structure repatriation policies for their overseas subsidiaries (see Desai, Foley and Hines (2003)). The CME example illustrates the centrality of geography to determining control of assets. Zelezny's ability to control the value of CNTS arose, in part, from the ability to access Czech officials and court public opinion while CME was viewed as a remote foreign entity. CME officials have speculated in private interviews with the authors that the absence of a Prague office allowed Zelezny disproportionate control over CNTS. The CME example suggests that proximity to critical resources can lead to greater control and that remote owners may not retain the level of control indicated by their ownership shares.

## 6.2. *The Politics of Finance*

The resolution of the CME case also illustrates the nexus between politics and finance in a global setting. Most directly, Lauder spoke directly to the Czech Prime Minister about the case in Washington D.C. and sought the support of various senior political appointees in the U.S. government to resolve the case. These individuals, such as Madeleine Albright, had historic ties to the Czech Republic and pressed for Lauder's case with leading Czech politicians. Of course, Zelezny protected himself with his own access

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<sup>62</sup> In a related vein, Banerjee and Newman (1998) examine how the transition to modernity is associated with greater information asymmetries and the need for legal mechanisms to substitute for trust in business relationships. It is useful to note that interviews with participants in the Lauder-Zelezny saga indicate that Zelezny reportedly emphasized (or dissembled) a Jewish heritage in order to engender the trust of Lauder, a large benefactor of Jewish causes in Eastern Europe.

to Czech politicians who were anxious about Zelezny's own domestic influence.<sup>63</sup> More indirectly, Lauder's public advertisements about the Czech Republic were targeted at pressuring Czech politicians concerned with the Czech Republic's pending accession to the European Union. Indeed, payment of the large fee was required, as noted above by the then Finance Minister, to safeguard the reputation of the country. The notion that courts, local or otherwise, would be the *sole* arbiters of the resolution of this expropriation never occurred to the protagonists in this example. Political channels were actively employed to protect investments in parallel with efforts through various courts. A final political lesson of this curious case is that the broader Czech population literally *paid* the price for the expropriation. While scholars often argue that broader populations bear the costs of weak investor protections or institutions, this setting provides a more immediate example of the costs of weak institutions being borne by the broader population.

### 6.3. *Media and Control*

As emphasized above, the control of media companies raises particular concerns arising from their associated private benefits, or amenity potential. The CME case not only exemplifies what these private benefits are but also how they are not always easily marshaled by their owners. In the CME case, TV Nova became a valuable means by which to influence public opinion and a way for Zelezny to fulfill his political ambitions. More broadly, Zelezny used his TV presence to enlarge his public image and self-image. These private benefits did not accrue exclusively from his ownership stake. Indeed, the owners of CME were unable to capitalize on the ability to shape public opinion and were, in fact, the victims of Zelezny's access to these private benefits. This example illustrates the broader point that leading employees of media companies can often access the private benefits of media companies more easily than owners. Indeed, in media companies, the ability of key employees to withhold access to their human capital at critical times may be a considerable source of control, as discussed above.

The CME affair, paradoxically, has enhanced Zelezny's visibility in the Czech Republic. The bully pulpit of his TV show, together with the constant media attention on

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<sup>63</sup> Interviews with company officials indicate that Zelezny had the habit of providing legislators with copies of their confidential secret police files from the period prior to the fall of the Iron Curtain.

the CME case (both through TV Nova itself and through third-party reports), allowed Zelezny to establish himself as an important political figure in the Czech Republic. His election to the European Parliament in 2004, even after being stripped of parliamentary immunity so he could be prosecuted for his role in the CME case, further speaks to Zelezny's skillful use of the media resources at his disposal, and to the intangible private benefits resulting from his control of the media.

#### 6.4. *Implications for the Convergence Debate*

What does the resolution of the CME case through international tribunals illustrate about the possibility or inevitability of convergence? In order to consider this question, we examine (i) if the CME case provoked legal and regulatory reforms in the Czech Republic that strengthened investor protections and (ii) if evidence from capital markets suggests convergence through a reduction of the cost of capital in the Czech Republic. While only suggestive, we consider the experience of CME and the Czech Republic illustrative of a distinct evolutionary dynamic whereby differential access to legal protections leads to the persistence of differences, rather than convergence, of investor protections.

Given the sizable penalty and considerable notoriety of the CME case within the Czech Republic, one might expect to find significant changes to Czech securities or corporate law. With the specific exception of changes to the regulatory structure facing broadcast companies (e.g., the dismissal of the Media Council), the CME case does not appear to have had any material effects on securities and corporate laws in the Czech Republic.<sup>64</sup> Recent changes to securities laws appear to be driven by the stated goal of harmonization of the securities legislation with the European Union, and not directly in response to the issues raised by CME. Similarly, we are also unaware of any significant changes of Czech corporate law since the resolution of the CME case that were motivated by the results or developments of that dispute.

As the local legal environment has changed little, foreign investors continue to rely heavily on BITs and the CME case has greatly increased awareness of the litigation possibilities arising from BITs. In any dispute between foreign investors and the

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<sup>64</sup> This is not definitive as the Parliamentary inquiry report on the CME affair has not yet been completed but exchanges with lawyers in the Czech Republic do not indicate any imminent changes linked to the CME affair.

government, BITs are taken into account and used as leverage. Additionally, foreign investors now routinely “shop” the country of incorporation of the subsidiary that is to invest in the Czech Republic taking into account the strength of the BIT between that country and the Czech Republic. The only change in the legal landscape of the Czech Republic appears to be the determination of foreign investors to strengthen their protections through means not available to local investors.

As Stulz (1999) points out, changes in legal protections and firm governance should also influence a firm’s cost of capital and valuation. If the CME case had a material impact on governance of local firms in the Czech Republic, this should be manifest in evidence provided by the capital markets. In the CME case, we have a set of events (Markers 1-9 in Figure 5) that could have influenced investor risk perceptions and for which we can measure their impact on security prices. Table II provides the cumulative abnormal returns (CAR) for both Czech stock and bond indices for the nine events identified by the markers in Figure 5. We also calculate a “z-score” which captures how extreme a move is for a given event. Three of the events regarding CME had some impact in the Czech capital markets but none of them provide convincing evidence that these events indicated a permanent change in the perception of risk in the Czech Republic. Changes in government bond yields are similarly inconclusive. Czech sovereign yields have dropped substantially since the Russian crisis in 1998 and there has been a narrowing in yield spreads between the Czech Republic and Poland that cannot be explained solely by changes in expected inflation between the two countries. A reduction in the country risk premium (either through convergence or integration) could be the source of this narrowing but this narrowing cannot be tied to the CME case.

In contrast to the intuition of “contractual convergence” of Gilson (2001), the CME case and increased awareness of BITs are not associated with legal reforms or significant capital markets evidence of convergence in governance. Indeed, the proliferation of contracts with legal protections, if only available to a subset of investors and firms, might carry negative implications for firms unable to avail themselves of these enhanced protections. One example of such a possibility is the effect of ADRs on local firms. Karolyi (2004) and Moel (2001) find that firms from developing countries listing their shares in a developed market (through ADRs) generate negative “spillover” effects on the

developing market, with reduced capitalization, turnover ratios, and net new listings of the remaining local market firms. The ability of multinational firms to avail themselves of investor protections may similarly be detrimental to local firms if the unequal provision of investor protections leads to an uneven playing field.

In order to consider this possibility, we revisit the comparison of Poland and the Czech Republic of Glaeser, Johnson and Shleifer (2001). As they point out, the similar initial conditions of Poland and the Czech Republic and the divergent attitudes toward regulation of financial markets make a comparison of their subsequent experiences particularly illuminating. A naïve application of the intuition of Glaeser, Johnson and Shleifer (2001) to FDI in Poland and the Czech Republic might suggest that FDI would be robust in Poland and moribund in the Czech Republic, much as their investigation of capital markets performance suggested. The comparison of Poland and Czech Republic's FDI experience provided in Table III tells the opposite story. The Czech stock market continues to suffer from a severe contraction in the number of listed firms and market capitalization/GDP ratios have dipped while the Polish market has continued to grow. In contrast, FDI is a significantly larger fraction of investment in the Czech Republic where UNCTAD estimates FDI inflows at more than 59% of gross fixed capital formation in 2002. Even if local investor and minority shareholder rights are extremely weak (as evidenced by the undeveloped local capital markets), foreign investors can avail themselves of a favorable property rights environment through recourse to BITs. The experience of the Czech Republic suggests that FDI might be serving as a substitute for local investment or FDI may be crowding out local investment. We cannot attribute this FDI inflow differential to the number of BITs signed, since Poland has a similar number of BITs signed (at the end of 1999, the Czech Republic had signed 52, and Poland 62 BITs).

The limited evidence on BITs more generally is consistent with this view. Legal analysts such as Rose-Ackerman and Tobin (2004) and Daniels (2004) conclude that BITs provide foreign investors with a "safe harbor" property rights system that protects their investment under international or developed country laws while local investors are left to the devices of host country legal institutions. Additionally, Rose-Ackerman and Tobin (2004) find no relationship between increases in BIT activity and improvement in domestic property rights indicators. This view of the impact of BITs is consistent with the

experience in the Czech Republic in the aftermath of the CME debacle. Local firms reliant on anemic local capital markets and weak legal institutions compete with foreign investors protected by supranational agreements that are binding and enforceable. More generally, this evidence is consistent with mounting evidence that multinational firms are able to overcome the rigidities that face local firms and that local firms bear the burden of those rigidities disproportionately.<sup>65</sup> With foreign investors availing themselves of these protections, the political economy dynamic that might lead to pressure for reforms of investor protections might also not have nearly the force it would have otherwise. As such, differential protections can contribute to the persistence of differences in investor protections rather than any notion of convergence.

## **7. Conclusion**

In a world characterized by large FDI flows and sophisticated multinational firms bent on protecting their worldwide investments, the assumption that investor protections can be summarized by exclusively examining local laws seems increasingly tenuous. Similarly, the fact that subsets of investors within an economy enjoy differential protections raises several questions about how local and multinational firms interact, adapt and capitalize on those distinctions. Finally, the example of how easily a local minority owner with access to a key resource can exploit a foreign majority owner provides a dramatic example of expropriation and suggests that ownership alone does not dictate control and that geography may play an important role in allocating control rights. The growing importance of multinational firms, particularly in developing economies, suggests that the intricate Lauder-Zelezny saga may represent an opening gambit in the unfolding story of investor protections in a converging world.

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<sup>65</sup> For example, Desai, Foley, and Hines (2004b) consider how multinational firms circumvent the effects of capital controls that increase borrowing costs for local firms. In a related vein, Desai, Foley, and Forbes (2004) demonstrate how multinational firms outperform local firms in the aftermath of sharp depreciations as they are able to overcome the financial constraints that local firms face.

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**Table I****Operating results for CME units**

Operating results (in thousands USD) for CME subsidiaries, December 31, 1996 fiscal year. Broadcast cash flow is a broadcasting industry measure of performance and defined as net broadcast revenues, less broadcast operating expenses excluding depreciation and amortization, broadcast selling, general and administrative expenses, and cash program costs. Source: CME, Dec. 31, 1996 10-K (Bermuda: CME, 1996).

<b>Consolidated Entities</b>	<b>Nova TV</b>	<b>Pro TV</b>	<b>Pop TV</b>	<b>Markiza TV</b>	<b>Total</b>
Territory	Czech Republic	Romania	Slovenia	Slovak Republic	
<b>Net revenues</b>	<b>109,242</b>	<b>15,803</b>	<b>9,080</b>	<b>7,462</b>	<b>141,587</b>
Station operating expense	(54,578)	(16,497)	(12,764)	(9,570)	(93,409)
Selling, general and administrative expense	(9,247)	(6,351)	(3,989)	(1,605)	(21,192)
<b>Station operating income</b>	<b>45,417</b>	<b>(7,045)</b>	<b>(7,673)</b>	<b>(3,713)</b>	<b>26,286</b>
Depreciation of assets	8,024	2,678	2,516	1,473	14,691
<b>EBITDA</b>	<b>53,441</b>	<b>(4,367)</b>	<b>(5,157)</b>	<b>(2,240)</b>	<b>41,677</b>
Amortization of programming rights	16,207	3,725	1,667	2,401	24,000
Cash program rights costs	(16,520)	(4,648)	(2,904)	(4,663)	(28,735)
<b>Broadcast cash flow</b>	<b>53,128</b>	<b>(5,290)</b>	<b>(6,394)</b>	<b>(4,502)</b>	<b>36,942</b>

**Table II**

**Cumulative Abnormal Returns for Selected CME Events**

Cumulative abnormal returns (CAR) for both Czech stocks and bonds for the nine events identified by the markers in **Figure 4**. Column C shows the 5-day CAR of CME against the Nasdaq market index. Column D shows the Czech Market 5-day CAR, as represented by the MSCI US dollar Czech Republic index excess return over the MSCI US dollar World Index. Column E calculates Column D's "z-score", which is computed by dividing the CAR in Column D by the standard deviation of 5-day CARs for the period January 1, 1999 to May 30, 2003. This measure attempts to capture how "extreme" a move is for a given event. Column F shows the implied 5-day bond returns for 5-year Czech Government bonds. These returns are given by the price difference of the 5-year bond over a 5-day period assuming that the bond trades at par (i.e. coupon rate equals yield rate) at the beginning of the calculation period. Column G shows the same calculation for Polish 5-year Government bonds, while Column H shows the "z-score", which is the return in Column F divided by the standard deviation of all 5-day returns for the period January 1, 1999 to May 30, 2003. Extreme moves are in bold.

A	B	C	D	E	F	G	H
Marker	Event	CME CAR	Czech Market CAR	Czech Market z-score	CZ 5-Yr Bond Return	Poland Bond Market Return	CZ 5-Yr Bond z-score
1	2/24/1999 Zelezny states at a CNTS board meeting that CNTS cannot continue as exclusive programming provider to TV Nova	-16.9%	0.84%	0.25	-0.08%	-0.61%	-0.12
2	3/29/1999 SBS and CME reach merger agreement	47.0%	6.76%	<b>2.01</b>	-0.33%	-0.51%	-0.51
3	4/19/1999 Zelezny fired as director of CNTS.	-32.1%	-1.30%	-0.38	0.11%	-0.14%	0.16
4	8/5/1999 CET 21 terminates relationship with CNTS and withdraws broadcasting license	-50.4%	-0.69%	-0.21	-1.54%	0.28%	<b>-2.37</b>
5	2/13/2001 Amsterdam tribunal reaches minor ruling against Zelezny	-17.0%	-1.03%	-0.31	-0.12%	-0.17%	-0.06
6	9/3/2001 London tribunal rules in favor of Czech Republic	-16.8%	1.50%	0.45	-0.19%	-0.10%	-0.30
7	9/13/2001 Stockholm tribunal rules in favor of CME	843.2%	5.44%	1.62	0.85%	1.52%	1.30
8	3/14/2003 Stockholm tribunal makes final ruling of \$350 million in favor of CME	8.6%	-7.78%	<b>-2.31</b>	-0.93%	-0.07%	-1.43
9	5/15/2003 Stockholm tribunal ruling upheld on appeal	20.9%	3.43%	1.02	0.85%	0.25%	1.31

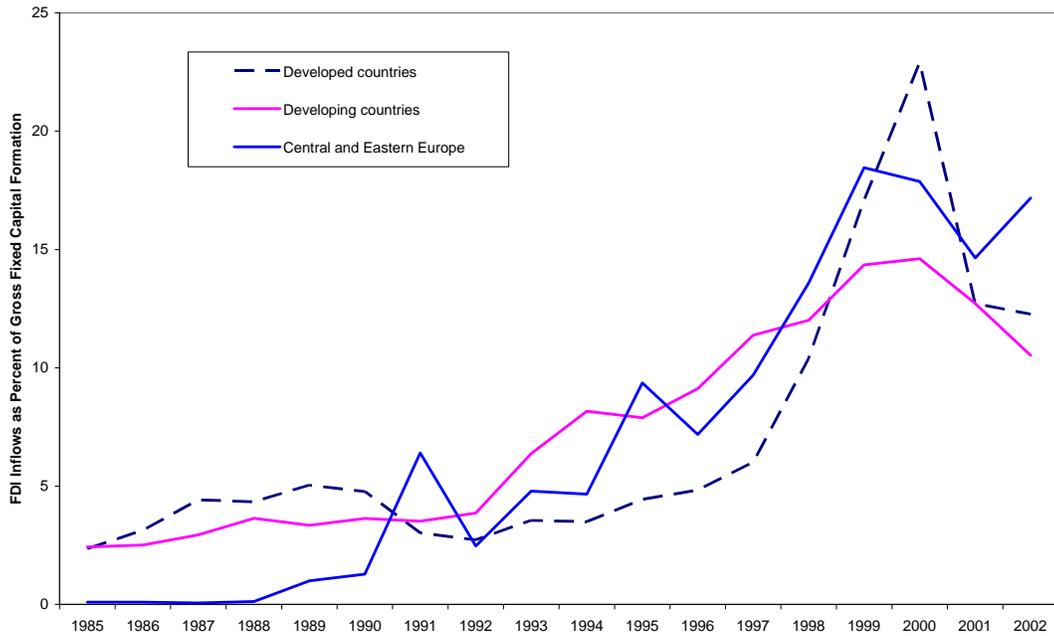
**Table III****Comparison of Czech Republic and Poland Stock Markets and FDI**

Time series comparison of the Czech Republic and Poland stock markets and FDI. All data calculated from current USD. GDP, FDI, and GFCF data from UNCTAD. Stock market data from International Federation of Stock Exchanges (FIBV), Prague Stock Exchange, Warsaw Stock Exchange, at year-end exchange rates. Listed firms and market capitalization data include all main, parallel, and free market companies.

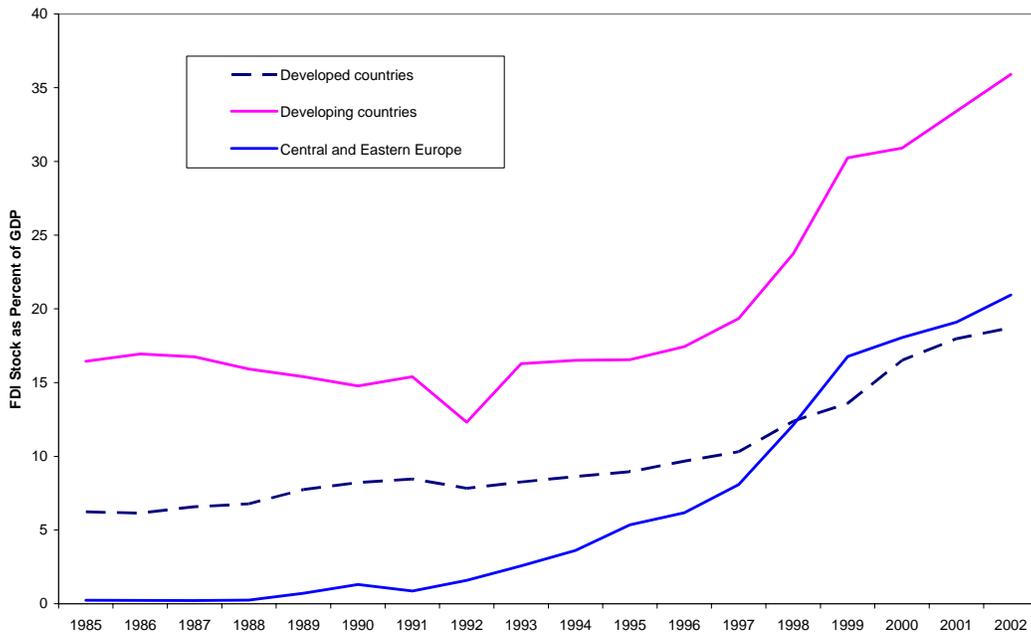
Year	Market Cap/GDP		Number of Listed Firms		FDI Inflows as percent of GFCF		FDI Stock as percent of GDP	
	Czech Republic	Poland	Czech Republic	Poland	Czech Republic	Poland	Czech Republic	Poland
1991		0.2%		9		2.0%		0.6%
1992		0.3%		16		4.8%		1.6%
1993		3.2%	969	22	6.6%	12.6%	9.8%	3.1%
1994	29.9%	3.1%	1028	44	7.4%	10.6%	11.1%	3.8%
1995	34.5%	4.1%	1716	77	15.4%	15.5%	14.1%	6.2%
1996	34.0%	6.4%	1670	100	7.8%	15.1%	14.9%	8.0%
1997	27.1%	8.2%	320	175	7.9%	14.5%	17.4%	10.1%
1998	24.2%	12.9%	304	264	22.3%	15.9%	25.3%	14.1%
1999	24.2%	19.1%	195	308	41.3%	18.4%	32.2%	16.8%
2000	22.9%	19.9%	151	315	34.3%	23.4%	42.1%	20.9%
2001	16.6%	14.8%	102	317	35.6%	14.9%	47.4%	22.4%
2002	16.2%	15.3%	80	300	59.1%	11.4%	64.3%	24.0%

Figure 1

Time Series on FDI Stocks and Flows



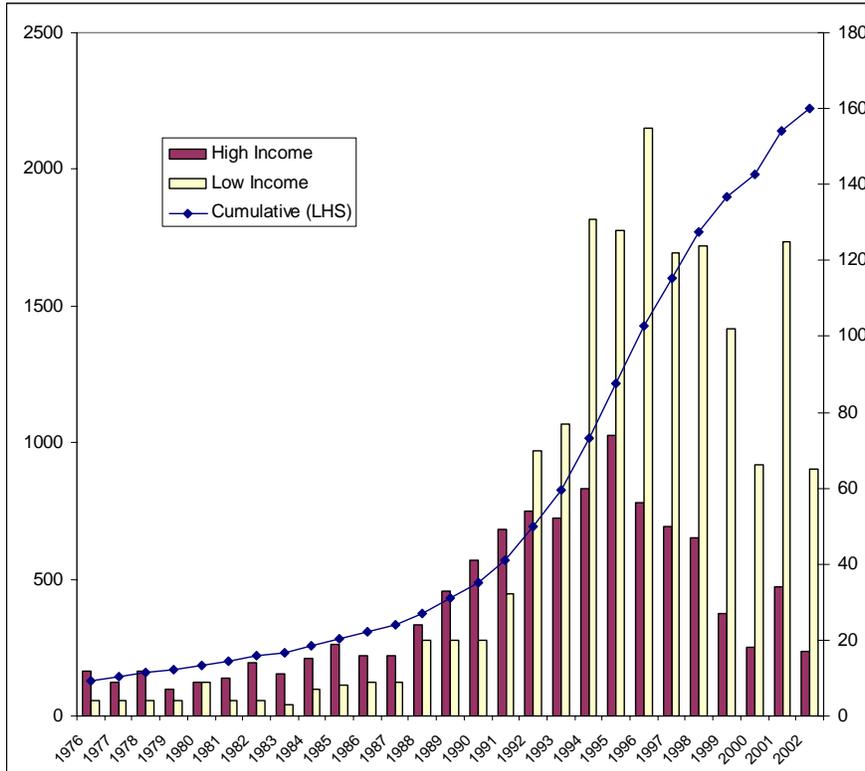
**Panel A.** Time series showing the yearly FDI inflow in current dollars as a weighted average percentage of yearly Gross Fixed Capital Formation for the years 1985 to 2002 for the developed economies, developing economies, and Central and Eastern Europe. The “developed economies”, as defined by UNCTAD, are the EU (as of 2002), the US, Canada, Australia, New Zealand, Japan, and Israel. Central and Eastern Europe includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Moldova, Poland, Romania, Russia, Serbia and Montenegro, Slovakia, Slovenia, and Ukraine. The “developing economies” are all remaining countries. Data from UNCTAD. [www.unctad.org](http://www.unctad.org).



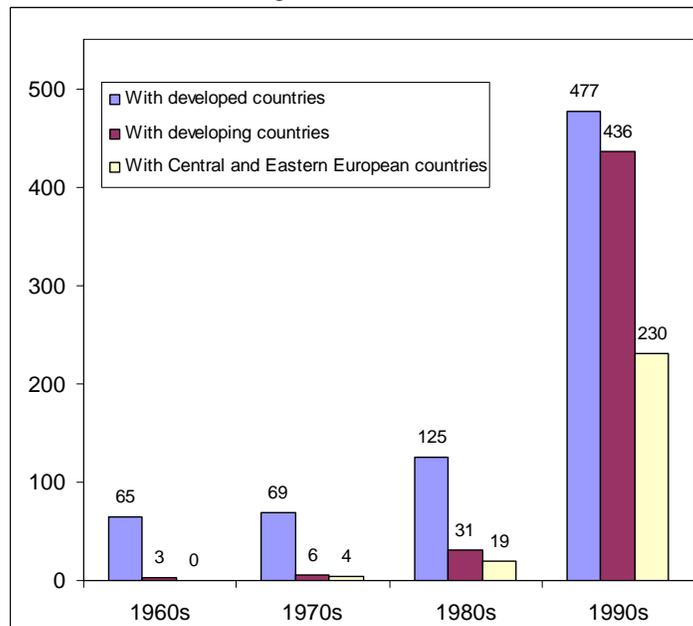
**Panel B.** Time series showing the cumulative FDI stock as a weighted average percentage of nominal GDP for the years 1985 to 2002 for the developed economies, developing economies, and Central and Eastern Europe. The definitions are the same as in Panel A. Data from UNCTAD, [www.unctad.org](http://www.unctad.org).

**Figure 2**

**Time Series on the Diffusion of BITs**



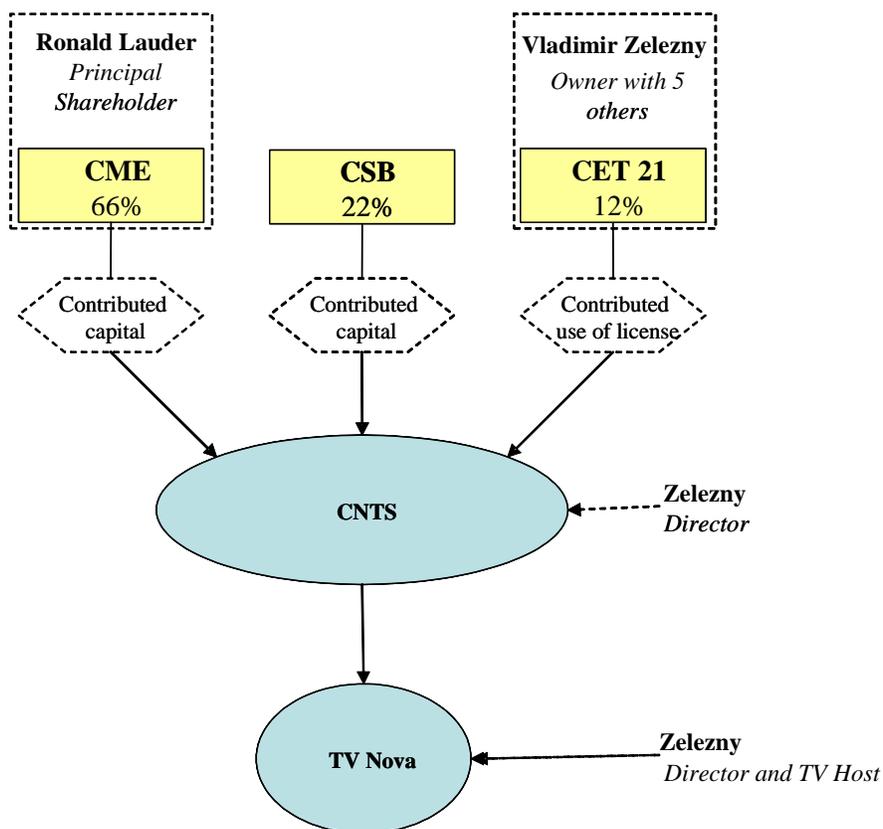
**Panel A.** Time series showing the yearly and cumulative total (left hand side) of Bilateral Investment Treaties (BITs) signed from 1976 to 2002. The number of BITs is broken down according to whether the signatory country is a “high income” or “low income” economy following Rose-Ackerman and Tobin (2003) and the World Bank, with “high income” defined as having a 2000 GNI per capita of 9,266 USD or higher. Data from UNCTAD, [www.unctad.org](http://www.unctad.org).



**Panel B.** Number of BITs signed between developing economies and developed, developing, and Central and Eastern European economies per decade. The data for this figure was taken from figure 2 in UNCTAD (2000).

**Figure 3**

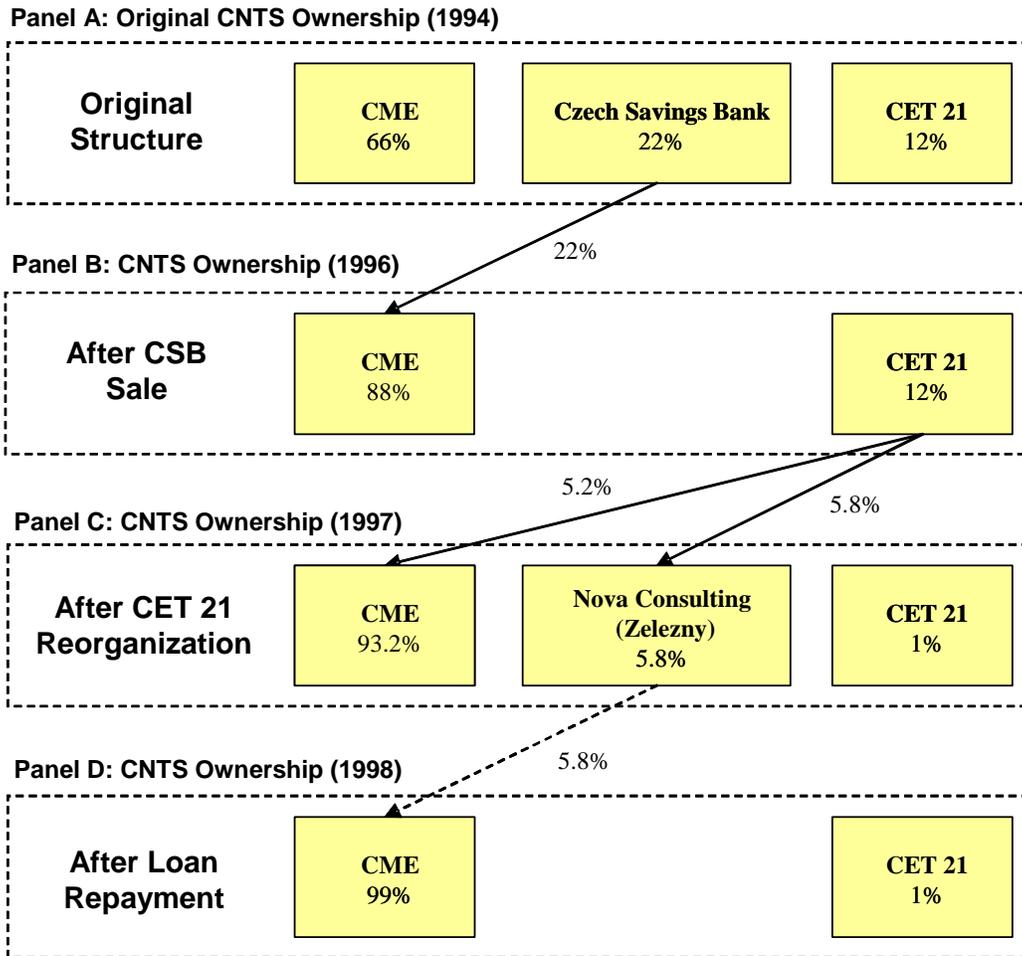
**Initial Corporate Structure of CNTS**



**Figure 3.** Initial corporate structure of CNTS, showing ownership by the three parties. Source: Author's analysis of UNCITRAL Arbitration, CME Czech Republic B.V. (The Netherlands) vs. The Czech Republic, Partial Award, September 13, 2001.

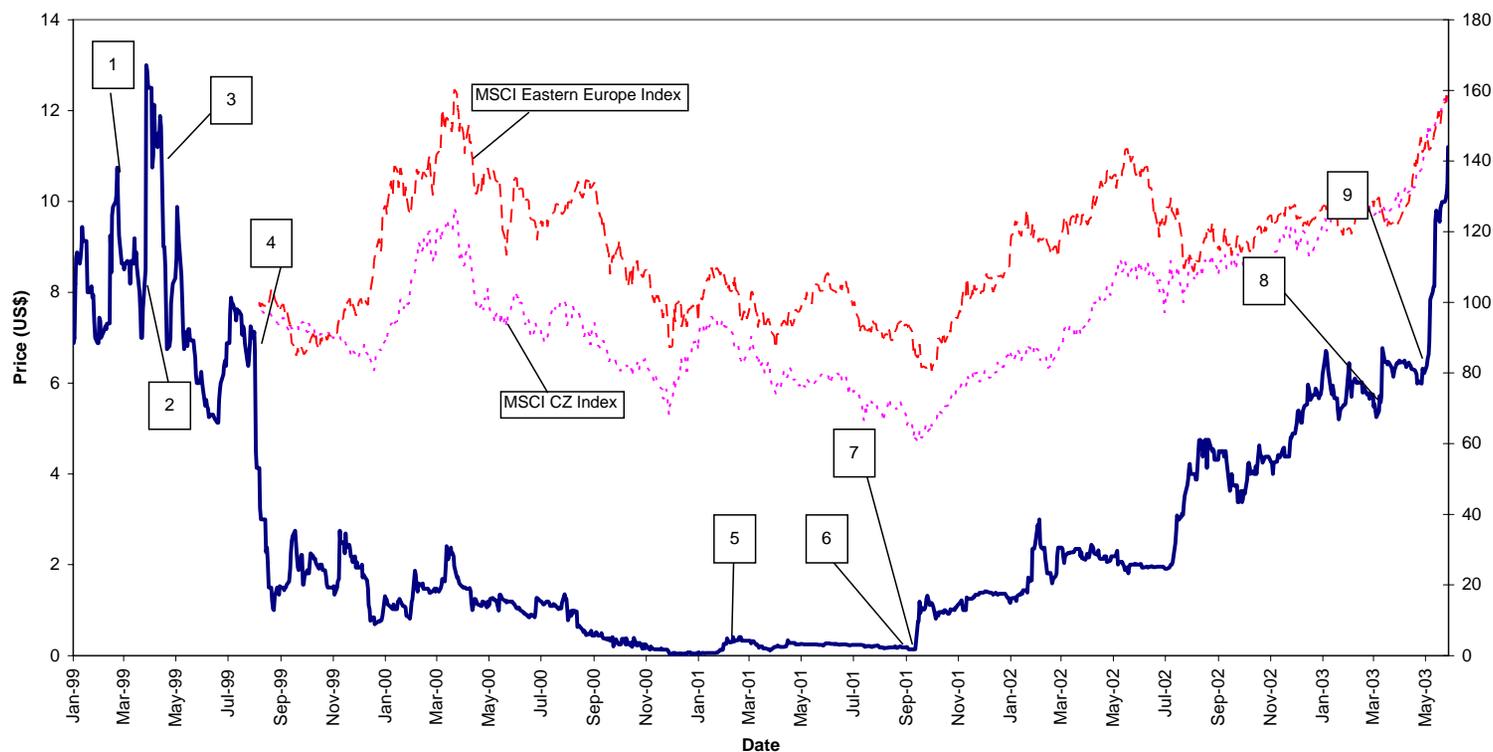
**Figure 4**

**Timeline of CNTS Ownership**



**Figure 4.** Diagram showing the changes of ownership in CNTS across time. Source: Author's analysis of UNCITRAL Arbitration, CME Czech Republic B.V. (The Netherlands) vs. The Czech Republic, Partial Award, September 13, 2001.

**Figure 5**  
**Time Series of CME Stock Price and Eastern Europe and Czech Republic Indices**



1 2/24/1999 Zelezny states at a CNTS board meeting that CNTS cannot continue as exclusive programming provider to TV Nova because the Media council opposes it.

2 3/29/1999 SBS and CME reach merger agreement.

3 4/19/1999 Zelezny fired as director of CNTS.

4 8/5/1999 CET 21 terminates relationship with CNTS and withdraws broadcasting license.

5 2/13/2001 Amsterdam tribunal reaches minor ruling against Zelezny.

6 9/3/2001 London tribunal rules in favor of Czech Republic.

7 9/13/2001 Stockholm tribunal rules in favor of CME.

8 3/14/2003 Stockholm tribunal makes final ruling of \$350 million in favor of CME.

9 5/15/2003 Stockholm tribunal ruling upheld on appeal.

**Figure 5.** Annotated CME stock price chart (adjusted for stock splits), with MSCI Eastern Europe and Czech Market US dollar indexed data for the period January 1, 1999 to June 1, 2003. Source: Bloomberg. Index value at July 1<sup>st</sup>, 1999 equals 100.

Figure 6

Advertising by CME on Investing in the Czech Republic

# THINK TWICE BEFORE YOU INVEST IN THE CZECH REPUBLIC

This may seem like a time of exciting opportunities for investment in the Czech Republic. For example, the Czech government is in the process of selling its interests in certain banks and, in the near future, intends to privatize its interest in a national cellular phone company.

However, if our recent experience as principal investor in the Czech Republic's most successful broadcasting company is any indication, Czech business, regulatory and legal practices fall woefully short of international standards. Before making a significant investment in the Czech Republic, you may want to consider this cautionary tale:

## **CZECH GOVERNMENT WOOS FOREIGN INVESTORS...**

When Central European Media (CME) wanted to establish a Western-style television station in the Czech Republic, the government welcomed CME's influx of capital and business expertise with open arms. Working with a local partner, CME developed TV Nova—which quickly emerged as the most popular private television station in Eastern Europe.

But then CME's local partner, Vladimir Zelezny, exploited his political influence and his network of contacts to undermine the partnership. With the assistance of the government-controlled Czech Media Council, the regulatory body that grants television licenses and oversees broadcast operations, Zelezny cut out his foreign investors so that he could profit more fully from TV Nova's unparalleled success.

Under Zelezny's influence, the Czech Media Council has refused to protect CME's legal rights. According to a recent editorial in the European Wall Street Journal, the council "seems willing to let CME twist in the wind."

## **...BUT THEN ABUSES THEM**

Under a 1991 U.S.-Czech treaty, the Czech government promised to protect U.S. investments from violations of the law. But it has been unwilling to handle this hot potato because—due to TV Nova's success—CME's local partner has acquired too much political clout.

Ronald S. Lauder, the controlling shareholder of CME and a U.S. citizen entitled to treaty protection, has instituted arbitration proceedings, through the UN Commission on International Trade Law, to ensure that the Czech government is held accountable for its discrimination against foreign investors and for failing to protect CME's rights.

The U.S. Ambassador to Prague has said that a just and speedy solution to this dispute would send a strong signal to foreign investors that the Czech Republic has an environment conducive to foreign investment. And leading U.S. Congressmen have rightly called for hearings into the Czech government's conduct. But, so far, *the Czech government has failed to act.*

Until this matter is resolved, we urge the international financial community to think twice before investing in the Czech Republic. Otherwise, you too could be left to "twist in the wind."

*On behalf of its shareholders,*

 **Central European Media  
Enterprises Ltd.**

c/o RSL Investments Corporation, 767 Fifth Avenue, New York, NY 10153

Figure 6. Paid Announcement by CME in *The New York Times* November 8, 1999. Source: *New York Times*, Nov. 8, 1999 available from ProQuest Historical Newspapers at <http://80-proquest.umi.com>.