



International Insolvency Institute

Special Colloquium

on

**Privatization and Restructuring/Insolvency:
New Directions for Transforming
State-Owned Enterprises**

February 5-6, 2011
Astir Palace
Athens

Overview of the Colloquium

from the Colloquium Organizing Committee

In 2011 the International Insolvency Institute (III) undertook a unique and unprecedented initiative to share its international restructuring and insolvency expertise with a country experiencing severe financial distress: Greece. As part of this special III initiative to address the fallout from the financial crisis in Greece, the III organized a high-level Colloquium in Athens in February 2011 to brief senior Greek government officials and representatives from the private sector on new ways to approach the privatization of state-owned enterprises (SOEs).

Specifically, the aim of the Colloquium was to discuss how insolvency/restructuring approaches and techniques could be harnessed to facilitate the privatization of troubled SOEs in Greece. The issue of privatization has assumed critical significance to Greece as privatization has been identified as key condition that needs to be fulfilled in order for Greece to receive continued financial assistance from the European Union and the IMF as part of the financial rescue package for Greece.

For purposes of this colloquium, the III assembled a leading group of experts from around the world—the US, Europe, Asia and Latin America—to share with its Greek participants a broad range of country experiences and “best practices” as to what has worked in prior national privatization efforts and the useful role that insolvency/restructuring could play in making troubled SOEs more attractive candidates for privatization. For its experts, the III was fortunate to be able to draw upon a number of its distinguished members and some friends of the III—including insolvency and restructuring lawyers, academics, turnaround professionals and even the former chair of a national government restructuring agency-- to participate in person at the Colloquium in Athens. These III experts also prepared thoughtful and detailed papers and presentations that were distributed to participants in the Colloquium. (The full list of members of the III delegation is set forth in the Conference Agenda and Bios which are included as part of the Colloquium materials posted here on the III website.)

Thus, the Colloquium featured, for example, discussions of one of Japan’s most high profile privatizations in the mid-1980s—Japan National Railways—as well as the myriad experiences from the Central and Eastern Europe privatizations in the 1990s and the varied experiences of China in this area in recent decades. The Colloquium also highlighted how the types of government institutions that are created to direct the privatization process—e.g., the Treuhandanstalt created in Germany following the collapse of the Berlin Wall and the types of coordinating agencies that were used by Brazil in its privatization efforts—can play a decisive role in determining whether the privatization process runs smoothly and achieves its fundamental objectives.

The III participants also stressed the critical connection between successful restructuring and privatization, on the one hand, and a country’s economic turnaround and growth, on the other hand. The participants also noted some of the thorny issues

raised in privatizations—such as how to restructure the labor force at state-owned enterprises—and creative ways that such challenges might be addressed. Furthermore, the III participants underlined areas in a country’s insolvency laws—e.g., prepackaged bankruptcies, post-commencement financing, cramdown, etc.—that are indispensable to establishing an effective and efficient insolvency and restructuring regime, particularly where time is of the essence in achieving a successful restructuring.

Overall, the Colloquium successfully achieved its key objective of laying out for the Greek participants a broad array of options and models that could be used as Greece undertakes its privatization efforts in the midst of the major financial crisis that Greece is now confronting. The Colloquium was not a one-way conversation but rather involved a lively and interactive exchange of views between and among the III participants and the participants from Greece, with the Greek participants having contributed greatly to the Colloquium’s success through their active engagement in the discussion.

Based on the feedback received at the conference, the Greek participants from government and the private sector found the Colloquium to be very useful and informative as well as very timely and relevant to Greece’s ongoing privatization efforts. Needless to say, the Colloquium would not have been possible without the outstanding efforts and contributions of each of the individual members of the III delegation. Those of us who traveled to Greece from afar acknowledge the wonderful hospitality and excellent arrangements by our Greek hosts.

Colloquium Organizing Committee

Steven T. Kargman
Kargman Associates
New York, NY

George Bazinas
Bazinas Law Firm
Athens, Greece

Stathis Potamitis
Potamitis Vekris
Athens, Greece

Richard Gitlin
Gitlin & Co.
Hartford, Connecticut



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International Insolvency Institute

**Special Colloquium on Privatization and Restructuring/Insolvency:
New Directions for Transforming State-Owned Enterprises**

Astir Palace, Athens, Saturday-Sunday, February 5-6, 2011

Saturday, February 5

10-10:30 am Registration/Coffee

10:30-10:45 am Welcoming Remarks

- **George Bazinas**, Managing Partner, Bazinas Law Firm, Athens/**Stathis Potamitis**, Managing Partner, Potamitis Vekris, Athens
- **Richard Gitlin/Steven Kargman**

10:45 am-12:15 pm Session I: Using Restructuring/Insolvency to Facilitate Privatization of State-Owned Enterprises

- Restructuring and Insolvency as a Platform for Economic Growth and Competitiveness in a Global Economy (**Richard Gitlin**, currently Chairman, Gitlin & Co., Hartford, Connecticut; formerly, president, American Bankruptcy Institute and INSOL International and chair, American College of Bankruptcy)
- Privatization and Restructuring/Insolvency: Understanding the Relationship (**Steven T. Kargman**, currently, president, Kargman Associates, New York, NY; formerly, Lead Attorney, Export-Import Bank of the United States, Washington, DC and General Counsel, New York State Financial Control Board, New York, NY)
- Revitalizing Business Enterprises: Necessary Precondition to Privatization (**Dr. Shinjiro Takagi**, formerly Chair, Industrial Revitalization Corporation of Japan; currently, Executive Senior Advisor, Nomura Securities Co., Ltd., Tokyo, Japan)

12:15-1:45 pm Luncheon

1:45-3:15 pm

Session II: Privatization of Diverse Sectors: Experience from Other Countries

- Japan: Railroad Privatization (**Mr. Hiromu Emi**, Oh-Ebashi LPC & Partners, Tokyo, Japan; statutory auditor, The Central Japan Railways Co. Ltd., one of the privatized Japanese National Railways (JNR); in the mid-1980s was actively involved in the privatization of JNR)
- Brazil: Industrial and Financial Institutions (**Thomas Felsberg**, Senior Partner, Felsberg e Associados, Sao Paulo, Brazil; chairman, Turnaround Management Association—Brazil; member, drafting committee, Brazil's new bankruptcy law enacted in 2005)
- China: **Professor Charles Booth**, Professor of Law, Richardson School of Law, University of Hawaii, and Director of Institute of Asian-Pacific Business Law, Honolulu, Hawaii/**Professor Wang Weiguo**, Dean of the School of Civil, Commercial and Economic Law, China University of Political Science and Law, Beijing, China; key member, national drafting committee, new China Enterprise Bankruptcy Law adopted in 2006

3:15-3:30 pm

Coffee Break

3:30-5:00 pm

Session III: Managing and Mitigating the Employment Impact of Privatization

- Experiences from Other Countries: China (Professor **Charles Booth/Professor Wang Weiguo**); Japan (**Mr. Hiromu Emi**)
- Overview of Approaches for Addressing Dislocation of Employees (**Aharon Schorr**, Intern, International Insolvency Institute)—presentation via materials included in conference notebook

5-6:15 pm

Session IV: Thorny Legal Issues to be Addressed in Privatization and How the Legal Framework Can be Made Conducive to Privatization/Insolvency

- Key Legal Issues under Greek Law in Privatization Scenario—Discussion to be led by **George Bazinas and Stathis Potamitis** in coordination with their colleagues in attendance at the conference from the Greek bar

- Comparison of Existing Greek Insolvency Code with US Bankruptcy Code and International Standards in Key Areas (**Sarah Filcher**, Intern, International Insolvency Institute)—presentation via materials included in conference notebook
- Areas for Possible Amendment in the Existing Greek Insolvency Code

7:30-9:30

Conference Dinner

Sunday, Feb. 6

9:30-10:30 am

Session V: Large-Scale Privatization on a Nation-Wide or Regional Scale: Pitfalls to Be Avoided

- Central and Eastern Europe (**Marko Mitrovic**, Director, CRG Capital, Vienna, Austria; **Stephen Gray**, Senior Managing Partner, CRG Partners, Boston, Massachusetts—both Mr. Gray and Mr. Mitrovic have vast experience working on privatization and turnaround matters in Central and Eastern Europe and very broad experience in turnaround matters in the US; Mr. Mitrovic will be in attendance at the conference and will make the in-person presentation on behalf of himself and Mr. Gray)
- Privatizing the Economy of the Former German Democratic Republic in the Wake of German Reunification (**Professor Christoph Paulus**, Professor of Law, Humboldt University, Berlin, Germany; member, official German Delegation to UNCITRAL Working Group on Insolvency Law)

10:30-10:45

Coffee Break

10:45-12:15

Session VI: Concluding Session: Open Discussion and Exchange of Views Concerning Policy Options and Strategies Going Forward

- How to implement program of privatization based on restructuring/insolvency principles and approaches

12:15-1:45 pm

Concluding Luncheon



International Insolvency Institute

Special Colloquium on Privatization and Restructuring/Insolvency: New Directions for Transforming State-Owned Enterprises

Astir Palace, Athens, February 5-6, 2011

Brief Biographical Sketches of Key Colloquium Participants on the International Insolvency Institute Delegation

George Bazinas—Managing Partner, Bazinas Law Firm, Athens, Greece

George Bazinas specializes in complex civil & commercial litigation and arbitration, as well as domestic and cross-border insolvency and reorganization, with extensive experience in transnational disputes and proceedings. He is widely published in his field and is repeatedly featured among the handful of specialized practitioners for Greece in prestigious legal directories. He has published articles and chapters on Greek civil and commercial litigation, insolvency and reorganization proceedings as well as the reform of the Greek insolvency code. He is a member of the International Insolvency Institute (III), the American Bankruptcy Institute, INSOL International, INSOL Europe, the American Hellenic Institute, the International Bar Association and the Hellenic Commercial Lawyers Association.

Charles Booth—Professor of Law, Richardson School of Law, University of Hawaii,
Honolulu

Professor Booth is a top scholar on insolvency and commercial law issues in the Asia-Pacific region and has written extensively on insolvency law reform in China, Hong Kong, Vietnam and other Asian jurisdictions. He taught for sixteen and a half years at the University of Hong Kong. He serves as Founding Director of the Institute of Asian-Pacific Business Law and has participated in many insolvency and commercial law reform projects in Asia and currently is involved in a major insolvency law reform project in the South Pacific nation of Vanuatu. He has been an adviser to the World Bank, Asian Development Bank and other international organizations. His primary research interests are in comparative and cross-border insolvency and commercial law, Hong Kong and Chinese insolvency law reform, and the development of insolvency and commercial law infrastructures in Asia and the Pacific in the aftermath of the Asian financial crisis. He lectures and publishes extensively on these topics and has authored or co-authored more than 60 publications.

Hiromu Emi, Oh-Ebashi LPC & Partners, Tokyo, Japan

Mr. Hiromu Emi, formerly a senior judge in Japan, served on the bench from 1969-2008 and during that period served as a judge of Tokyo District Court and Yokohama District

Court for fifteen years and the Tokyo High Court for eight years. He served as President and Chief Judge of Taskamatsu High Court in 2007 and as President and Chief Judge of Niigata Family Court in 1998. From 1984-1987, he was on temporary leave from the bench to take on a special assignment related to the privatization of the Japanese National Railways (JNR). During that time, he served in the legal section of the Office of the President of JNR and was actively involved in the privatization of JNR. After retiring from his judgeship in 2008, he joined Oh-Ebashi LPC & Partners, Tokyo Office as an Of Counsel and since 2009 has also been serving as a statutory auditor of one of the privatized JNR companies, JR Tokai.

Thomas Felsberg—Senior Partner, Felsberg e Associados, Sao Paulo, Brazil

Thomas Felsberg is a top insolvency and restructuring lawyer in Brazil. He played a key role in the drafting and adoption of Brazil's new insolvency law (2005) which represented a sweeping reform of Brazil's insolvency system. He serves as Chairman of Turnaround Management Association-Brazil and for many years has been a key and active player in Brazil's major restructurings and insolvencies. He is regularly invited to lecture at international conferences on international insolvency and restructuring topics and has an extensive listing of book and article publications in both English and Portuguese. Mr. Felsberg is a member of the Legal Board of the Federation of Industries of the State of São Paulo; Bar Association's Commission of Attorneys' Societies; Director of the International Relations Committee of the Attorneys' Societies' Center of Studies; Past Board Member of Meritas; chairman of the Columbia Alumni Association of Brazil. He is also a member of the American College of Bankruptcy; American Bankruptcy Institute; Conselho do International Insolvency Institute; Editorial Board for the Annual Review of International Insolvency; Brazilian Bar Association; International Bar Association; Inter-American Bar Association; American Society of International Law and São Paulo Bar Association.

Richard Gitlin—Chairman, Gitlin & Co., Hartford, Connecticut

Richard Gitlin has been a leading figure in the international insolvency and restructuring field for many years. He served as Examiner in the US bankruptcy proceeding in the landmark Maxwell case, one of the first major cross-border insolvency cases (with proceedings pending in both the US and UK) and the case in which the use of cross-border protocols between insolvency proceedings in different countries was first introduced. He has served in leadership roles in major professional organizations in the insolvency and restructuring field, including having served as President of the American Bankruptcy Institute, President of INSOL International, and Chair of the American College of Bankruptcy. Among his numerous accomplishments, he has helped many countries integrate restructuring solutions into an economic recovery strategy.

Stephen Gray—Senior Managing Partner, CRG Partners, Boston, Massachusetts

Stephen Gray is a senior turnaround professional who has worked with distressed businesses for 36 years. He was the founder of The Recovery Group (predecessor of CRG) and was a leading participant in the restructuring of post-privatized enterprises in

Central and Eastern Europe. He is widely recognized throughout the US for his turnaround and restructuring work and is well known for his fiduciary work in bankruptcy. Mr. Gray has led the successful operational and / or financial restructuring of hundreds of companies and has worked as a turnaround consultant and crisis manager for a wide variety of companies. He has served as Chapter 11 trustee, state or federal receiver, examiner and post-confirmation trustee in numerous situations. He is highly skilled in the dynamics of the insolvency process, bankruptcy procedures, cash flow management and all general areas of business, management and finance. In addition, he has managed the sale of many companies in a variety of industries. He is a Fellow of the American College of Bankruptcy and a member of the American Bankruptcy Institute and the International Insolvency Institute (where he serves as a member of the III Committee on Extraordinary Restructuring Solutions).

Steven Kargman—President, Kargman Associates, New York

Steven Kargman is a leading expert on international debt restructurings and cross-border insolvency, with a special focus on the emerging markets. He formerly served as Lead Attorney with the Export-Import Bank of the United States, the official export credit agency of the US Government, and General Counsel of the New York State Financial Control Board, the chief financial oversight agency for New York City. Has been actively involved in many of the most challenging and complex international restructurings in the emerging markets and has published numerous articles on international restructuring and insolvency issues. He has served as a member of the United States and American Bar Association delegations to the UNCITRAL Working Group on Insolvency Law, and he serves as Co-Chair of the Subcommittee on International Bankruptcy of the American Bar Association's Business Bankruptcy Committee as well as a Director of the International Insolvency Institute. He has published many articles on topics in international debt restructuring and international insolvency, and he has lectured at major professional and industry conferences around the world.

Marko Mitrovic—Director, CRG Capital, Vienna, Austria

Marko Mitrovic has 15 years of experience in special situations private equity, restructuring, and investment and interim management in the US and Central and Eastern Europe. During his entire professional career to date, Marko has been with CRG Capital / CRG Partners – formerly also known as The Recovery Group or TRG – a leading turnaround firm in the US, which has in Central and Eastern Europe (CEE) pioneered enterprise restructuring (in the mid 1990s), interim management (late '90s), replacement GP in private equity funds (early 2000s), and institutional distressed private equity investment (late '00s). He has served as an Investment Committee member of the CEE Special Situations Fund, the first regional restructuring fund, with IFC and EBRD as its cornerstone investors. Over the past six years, Marko also held executive-level positions in portfolio and/or client companies, serving as interim CFO or Chief Restructuring Officer (CRO) in both the US and CEE. He has advised GPs, Boards of Directors, and senior creditors of public and private companies. He developed and implemented

restructuring plans in a broad range of industries, including manufacturing, FMCG, construction, and service industries. His work was published by leading industry journals, including Norton Annual Review of International Insolvency, and he has co-prepared and co-presented several seminars on restructuring, including for IFC's global loan workout team.

Alexios Papastavrou, Partner, POTAMITISVEKRIS, Athens, Greece

Alexios is widely recognized as a leading expert in employment and social security law in Greece. He provides advice, mainly to employers, on all types of individual and collective employer-employee relationships, including trade union relations, collective bargaining agreements and industrial action. His client base consist primarily of multinational companies across a range of industries with a focus on finance, pharmaceuticals and consumer goods. Alexios has held various appointments, including Advisor to the National Chemical Weapons Department of the Ministry of Justice and Technical Representative of Greece at the European Council for the introduction of the International Treaty on Money Laundering. He recently advised the Greek state on the labor aspects of the reorganization of the Hellenic Railways Organization.

Christoph Paulus—Professor of Law, Humboldt University, Berlin, Germany

Professor Paulus is a leading scholar on insolvency and commercial law in Europe and has published several books and numerous articles in this area. For many years, he has represented the German government as a member of its official delegation at the UNCITRAL Working Group on Insolvency Law and has been actively involved with the Working Group's major initiatives in this area. He has served as an adviser to World Bank and the International Monetary Fund on insolvency law reform efforts. He is frequently invited to speak at major academic and professional conferences around the world.

Stathis Potamitis, Managing Partner, POTAMITISVEKRIS, Athens, Greece

Stathis Potamitis has a broadly based transactional practice and has acted in numerous cross-border mergers and acquisitions across South-East Europe. He has been practicing law since 1986 (New York and Greece), and he has handled major transactions and cases in M&A, capital markets, international arbitration and, more recently, insolvency law. He is an INSOL International Fellow and a member of the International Insolvency Institute. In his role as Deputy Chairman of the Athens Derivatives Exchange from 1998-9, he was instrumental in the preparation of the Investment Service Firms Code of Conduct as well as the legislative framework for the dematerialization of listed securities, the operations and products of the Athens Market for listed derivative instruments and the clearing and settlement of trades in listed derivatives.

Dr. Shinjiro Takagi—Executive Senior Advisor, Nomura Securities Co., Ltd., Tokyo, Japan

Dr. Shinjiro Takagi has held his current role at Nomura Securities since 2007. From 2003-2007, he served as Chair of Industrial Revitalization Corporation of Japan (IRCJ), a special-purpose body created by the Japanese Government in the early 2000s to address widespread financial distress in the Japanese economy. From 2003-2006, he served as a Professor at Chuo University Law School. After engaging in private practice for 25 years, he was appointed as a Judge of Tokyo District Court in 1988, President and Chief Judge of Yamagata District and Family Court in 1995, President and Chief Judge of Niigata District Court in 1997, and Presiding Judge of Tokyo High Court (Court of Appeal) in 1998. After resuming private practice in 2000, he reorganized many large ailing companies including Daiei and Kanebo. In 2001, he served as chair of the committee organized by the Japanese National Bankers Association to establish the Guidelines for Out-of-Court Workout to Reorganize Business Corporations. In addition to his work on IRCJ, he has been called upon by the Japanese government to handle other important, high-profile assignments, such as serving as the head of the Japan Air Lines Revitalization Task Force in 2009. He has published numerous books and articles regarding Japanese, American and international bankruptcy laws and civil procedure.

Professor Wang Weiguo—Dean of the School of Civil, Commercial and Economic Law, China University of Political Science and Law, Beijing, China.

Professor Wang Weiguo is Assistant President of China University of Political Science and Law (CUPL) and Dean of the School of Civil, Commercial and Economic Law, CUPL. He is a leading scholar in China on insolvency and commercial law matters, and he was a chief drafter for China's new Enterprise Bankruptcy Law and has been involved in the drafting of other major civil, commercial and economic legislation in China. He is Chairman of the Banking Law Academy, Vice Chairman of the Civil Law Academy and Vice Chairman of the Information Law Academy, the Law Society of China. He is a founding member of the International Insolvency Institute and a member of Academic Advisory Board, the Asian Institute of International Financial Law, Hong Kong. He serves at the Executive Committee of the National Bar Examination, the PRC Ministry of Justice and the Expert Group for the UNCITRAL program on Commercial Fraud. He is also an arbitrator at the Arbitration Court of the International Chamber of Commerce, the Arbitration Institute of the Stockholm Chamber of Commerce and the Beijing Arbitration Committee.

**PAPERS/PRESENTATIONS AND RELATED MATERIALS
FOR COLLOQUIUM**

(ARRANGED IN ORDER OF CONFERENCE AGENDA)

Restructuring and Insolvency as a Platform for Economic Growth and Competitiveness in a Global Economy

Presentation for Special Colloquium on Privatization
and Insolvency and Restructuring:
New Directions for Transforming State-owned Enterprises

Richard A. Gitlin
Astir Palace, Athens
February 5, 2011

Gitlin & Company, LLC
rgitlin@gitlinco.com

Observation

Economic theory

must give way to

Economic Strategy

The Real Economy – Second Fiddle

- ▶ In an economic crisis, most attention and resources are devoted to the financial sector.
- ▶ But it is the real economy that creates growth and employment.
- ▶ A delay in fixing the real economy is very costly to both the economy and financial institutions.

Double Negative

- ▶ When viable companies are not fixed:
 - They have little money to invest in their future...become weaker.
 - Loans to banks become less valuable causing more capital impairment.

Double Negative (continued)

- ▶ When non-viable companies are not liquidated or sold
 - they hurt competing viable companies,
 - the productive assets are not transferred to people who can use them to create more economic value and employment, and
 - the loans to the banks become less valuable causing more capital impairments.

Need a New Platform for Growth

Fixing viable companies and recycling assets of non-viable companies is essential to create a platform for growth of the economy and employment.

A Few Restructuring Principles

- ▶ The restructuring process is not simply fixing a balance sheet...It is positioning the company for growth of value and jobs.
- ▶ Fixing the balance sheet of a company that cannot compete effectively does damage to the economy...it is not neutral.
- ▶ If Government funds are to be utilized, the policy must reflect the value to the nation...why will it make the economy stronger, better to compete while serving the public interest?

But Be Real

- ▶ Many countries have an underdeveloped infrastructure for fixing trouble companies;
 - Laws
 - Customs
 - Professionals
- ▶ This is inadequate for normal times and we are in extraordinary times with larger parts of economies in trouble.
- ▶ Even those with seasoned restructuring systems may need to take extraordinary actions to fix their economies.
- ▶ Restructuring need interim and long term capital which is on short supply these days... both private and public capital is necessary.

Three Approaches

- ▶ Improve countries laws and systems for restructuring;
- ▶ Establish a quasi-government organization for expedited restructuring with public (and private) funds;
- ▶ Government direct intervention in industry and companies using existing restructuring laws;

I. Improving Country Laws and Systems for Restructuring

- ▶ Restructuring laws are a framework for doing deals. Deals can be done:
 - Out of Court – INSOL Principles
 - Modified Out of Court / Court Process
 - Pre-packaged – US / UK
 - Full Legal Proceeding

II. Establish a quasi-government organization for expedited restructurings.

- ▶ Handle crisis that existing systems can not effectively handle.
- ▶ Allocate government/IFI funds to preserve, rebuild and reposition the economy.

Government Direct Intervention in an Industry or Company using Existing Restructuring Laws.

- ▶ Example: General Motors / Chrysler
- ▶ Four Elements:
 1. Policy
 2. Decisions
 3. Execution
 4. Management / Exit

Observations

- ▶ This is not a wait-it-out economic crisis. Real economies and companies must not only be repaired, they must be repositioned.
- ▶ Delay makes problem loans less valuable exposing a second capital crunch.
- ▶ Delay extends the time to rebuild employment.
- ▶ Be prepared to utilize quasi-government organizations.
- ▶ Although there have been many improvements made in restructuring laws and systems, few countries are up to the necessary task.
- ▶ Must use significant energy and resources for putting in place systems to expedite recovery of the real economies in an economic crisis.



Transforming State-Owned Enterprises: Utilizing Insolvency/Restructuring Approaches to Achieve the Aims of Privatization

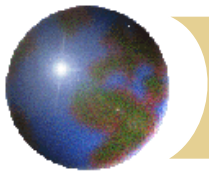
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Steven T. Kargman

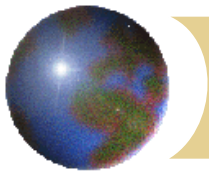
President, Kargman Associates/International Restructuring Advisors

skargman@kargmanassociates.com



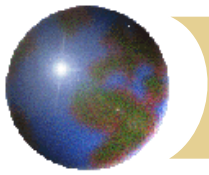
Insolvency/Restructuring: A Neglected Tool for Addressing Plight of SOEs

- ✿ Privatization and restructuring/insolvency are generally treated as two completely separate disciplines
- ✿ In privatizations, limited attention, if any, may be devoted to how insolvency/restructuring approaches and processes can be harnessed to facilitate or otherwise support the privatization process
- ✿ However, many of the tools and techniques applied in restructuring/insolvency can be directly relevant and applicable to the privatization of state-owned enterprises (SOEs)



Insolvency/Restructuring: A Neglected Tool for Addressing Plight of SOEs (cont'd)

- ⊗ Domestic insolvency laws for commercial enterprises may be drafted in such a way that they not only address private enterprises, but possibly also the situation of financially distressed SOEs
- ⊗ Some domestic insolvency laws, in fact, do this by putting SOEs on the same plane as private enterprises for purposes of identifying those debtors that are subject to the ambit of a nation's insolvency law (i.e., who are "eligible" debtors)
- ⊗ For example, this approach is reflected in the insolvency law treatment of SOEs set forth in the *UNCITRAL Legislative Guide on Insolvency Law* which has helped establish a standard for international insolvency law



Insolvency: A Neglected Tool for Addressing Plight of SOEs (cont'd)

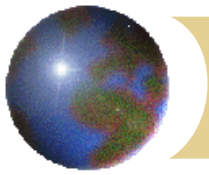
✚ UNCITRAL Legislative Guide notes

- ✚ “An insolvency law can apply to all types of debtor engaged in economic activities, both private and state-owned, especially *those state-owned enterprises which compete in the market place as distinct economic or business operations and otherwise have the same commercial and economic interests as privately-owned businesses.*” p. 40 (emphasis added)

- Note: UNCITRAL does provide a caveat for “large-scale privatization programmes or where [SOEs] are involved in sensitive sectors of the economy...”

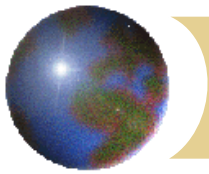
✚ Some States have set up their insolvency statutes in a way that basically considers SOEs in a similar manner as private enterprises for purposes of insolvency law

- ✚ See, e.g., China in its new Enterprise Bankruptcy Law



Insolvency: A Neglected Tool for Addressing Plight of SOEs (cont'd)

- ✚ Yet actual practice in this area may diverge substantially from what is set forth in the relevant insolvency statute
 - ✚ In practice, few SOEs may be subjected to the discipline or rigors of the insolvency process even in those States which purport to treat SOEs similarly to private enterprises
 - e.g., China's carve-out of over 2000 of its largest and most significant SOEs from the application of its new Enterprise Bankruptcy Law



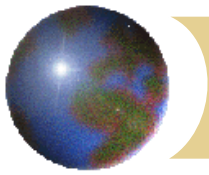
Basic Value Proposition: How Value is Central to Both Privatization and Restructuring/Insolvency

✚ Privatization

- ✚ A core objective: Unlock **value** of State-Owned Enterprises (SOEs) by putting assets and/or operation of SOE in private hands
 - “The disinvestment process [is designed] to facilitate **unlocking the true value** of the Central Public Sector Enterprises for all stakeholders – Investors, Employees, Company and the Government” (Indian Min. of Finance, Dept. of Disinvestment)

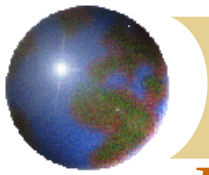
✚ Restructuring/Insolvency

- ✚ Micro level: maximize **value** of estate and distribute value among stakeholders in accordance with established priority scheme
- ✚ Macro level: recycle **value** in economy from less productive uses to more productive uses



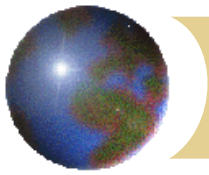
Basic Value Proposition (cont'd)

- ✚ Valuation Process: central to both insolvency/restructuring and privatization
- ✚ In both privatization and insolvency/restructuring scenarios, analysis starts with understanding the value of the troubled enterprise—i.e., valuation process as a threshold and indispensable step in the process
 - ✚ Restructuring/Insolvency: What is the value of the enterprise, and is the enterprise worth more as a going concern or in liquidation
 - ✚ Privatization: What is the (maximum) value of the enterprise that can be achieved in the privatization process (whether through private sale, auction, IPO, etc.)
- ✚ Of course, in certain privatizations, States may temper pure value-based considerations with other social, political, and/or economic considerations
 - ✚ i.e., emphasis on receiving highest bid or price may not be sole or even decisive consideration in a particular privatization
 - ✚ governments may also focus, for example, on which bidder will be committed to making investment in plant and equipment, preserving most jobs, etc.



Issue of Hard Budget Constraints

- ✚ **SOEs:** generally considered not to be subject to hard budget constraints
 - ▣ this means that a serious fiscal burden can be placed on the State to prop up unprofitable and inefficient SOEs
 - also need to take into account the role guarantees that may be extended by the State in support of SOE obligations (as this may only way for SOEs to get third-party financing)
 - ▣ indeed, lack of hard budget constraints for SOEs may be one of the central policy concerns with SOEs and also may be one of the principal drivers for the desire on the part of governments to privatize SOEs
- ✚ **Privatization:** attempt to subject former SOEs/now privatized enterprises to hard budget constraints inherent in a market economy and competitive environment
 - ▣ newly privatized enterprises can no longer count on financial support from the State—must stand on their own
- ✚ **Insolvency:** insolvency process provides ultimate tool for enforcing hard budget constraints



Privatization Needs/Restructuring-Insolvency

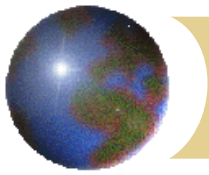
Answers

✚ **Privatization Needs**

- ✚ Make SOE more efficient
- ✚ Generate maximum value for SOE
- ✚ Dispose of SOE's non-core assets

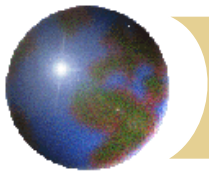
✚ **Restructuring/Insolvency Answers**

- ✚ Reorganize and restructure entity on an economically viable basis
- ✚ Ability to conduct auction to achieve highest value for reorganized enterprise
- ✚ Sale of assets free and clear of liens



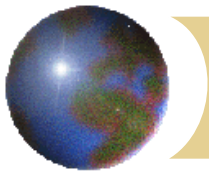
Specific Thorny Issues Arising in Privatizations

- ✿ Paring down massive debt overhang of SOEs
- ✿ Reducing redundant labor employed by SOEs
 - ✦ Yet doing so while ensuring that employment and other social needs of displaced employees are taken into account and properly addressed
- ✿ Running SOE on a commercial basis—need to introduce an entrepreneurial ethic
- ✿ How to achieve consensus among diverse stakeholders when privatizing an SOE, esp. with all of the divergent interests involved



Specific Thorny Issues Arising in Privatizations-- Insolvency/Restructuring Responses

- ✿ **Debt:** Insolvency/restructuring process provides a classic tool for reconfiguring the debt profile of a troubled enterprise—i.e., a balance sheet restructuring
- ✿ **Labor:** Insolvency/restructuring process often results in reduced workforce or renegotiated labor agreements
 - ✦ Obviously, there has to be some transition plan for employees displaced in any SOE rationalization process
 - ✦ Note the important parallel between privatization and insolvency
 - Insolvency is essentially predicated on there being a social safety net in place to cushion the blow to any workers displaced in the insolvency/restructuring process—in fact some countries have put in place employee guarantee funds to address just this need
 - For privatization to be successful, there needs to be some type of social safety net as well to smooth the transition for displaced workers

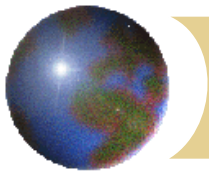


Specific Thorny Issues Raised by Privatization-- Insolvency/Restructuring Responses (cont'd)

✿ **Commercial Basis:**

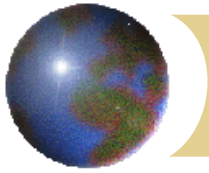
- ✦ Idea is to come up with a business plan that will be sustainable or viable over a period of time (e.g., notion of “feasibility”)
- ✦ Insolvency process can lead to the installation of new management (including so-called Chief Restructuring Officers during the pendency of a restructuring) to put the troubled enterprise back on a more sound footing

✿ **Consensus:** Insolvency law provides a mechanism for achieving consensus among key stakeholders, particularly through the use of “cramdown” mechanism as a way to bind dissenting classes of creditors



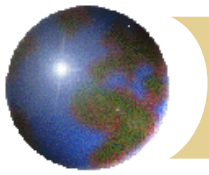
Need to Attract New Capital to Troubled SOEs

- ⊗ One of the recurrent issues with SOEs is that they have been woefully underinvested
 - ⊠ capital expenditures and maintenance may have been neglected, possibly for an extended period of time
- ⊗ In other words, there may be a need for a massive infusion of new capital in order to modernize the enterprise so that it can operate in an efficient and profitable manner and be competitive
- ⊗ Yet no one except State may be willing to put new money into an insolvent SOE
 - ⊠ Unfortunately, this can represent a continuing drain on the national treasury—i.e., ‘throwing good money after bad’



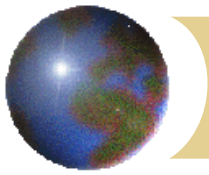
Need to Attract New Capital to Troubled SOEs (cont'd)

- ⊕ Insolvency/restructuring provides the tools for putting new capital into troubled enterprises by providing a clear and predictable framework for new money coming in (i.e., assigning priority to new money)
 - ⊠ Debtor-in-possession (DIP) or interim financing
 - ⊠ Exit financing
 - ⊠ New equity investors



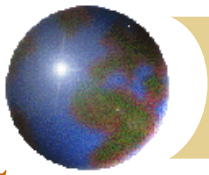
Importance of New Strategic Investors to Privatization and Restructuring/Insolvency

- ✪ Privatizations have often been helped where there are strategic investors who invest in the SOEs
 - ✚ Such investors may be domestic or foreign
 - many privatizations—including many successful ones--have relied upon foreign capital
- ✪ Restructuring/insolvency provides a well-defined process for strategic investors to come into the picture in an orderly way that maximizes value for the existing stakeholders
 - ✚ E.g., role of 'stalking horse bidder' in stimulating interest by other potential bidders



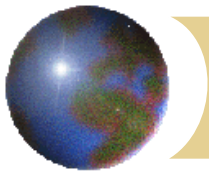
Sequencing Privatization and Restructuring/Insolvency—Which Should Come First

- ✿ Not necessarily one standard formula for proper sequencing
 - ✦ approach will likely depend on the specific facts and circumstances of the particular SOE being privatized as well as the overall objectives of the State in the privatization process
- ✿ One possible scenario
 - ✦ Step I: Insolvency/Restructuring
 - Put the SOE in a position where it is restructured so that it is an attractive candidate for privatization
 - ✦ Step II: Privatization
 - With the SOE having previously been restructured, it is now in a position where it can be privatized—moved from Government hands to private hands—using the approach that best accomplishes the specific goals of the State for that particular privatization



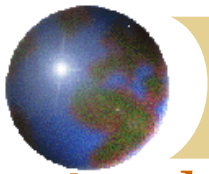
Sequencing Privatization and Restructuring (cont'd)

- ✧ How to sequence privatization and restructuring/insolvency may be affected by various factors
 - ▣ what type of restructuring of SOE is required—i.e., financial restructuring versus operational restructuring
 - ▣ who is better positioned to effect the necessary restructuring—government (while enterprise is still controlled by the State) or private owners (following privatization)
- ✧ May be considerations of effect on purchase price if restructuring is—or is not—completed prior to the time of sale or other form of privatization
- ✧ Also considerations of impact on timing of whether necessary restructuring is done pre- or post-privatization
 - ▣ Will undertaking the necessary restructuring pre-privatization unduly delay the privatization process?
 - ▣ Might the Government do some of required restructuring pre-privatization and private owner/operator the rest post-privatization



Applying Insolvency/Restructuring Approaches to SOEs that are Potential Candidates for Privatization

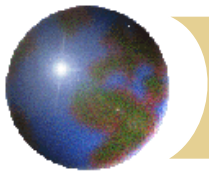
- ⊕ Conduct thorough and comprehensive due diligence
- ⊕ Undertake meaningful, hard-headed valuation of enterprise
- ⊕ Make decision as to whether to reorganize or liquidate troubled enterprise
- ⊕ Develop sensible and realistic business plan for reorganized enterprise going forward
- ⊕ If decide on reorganization, should it be an out-of-court restructuring versus in-court restructuring?
 - ⊕ Need to consider issues and desirability of speed, formality (or lack thereof), ability to bind dissenting creditors, etc.
- ⊕ Also, should reorganization be on an expedited basis (i.e., “prepack”) or on normal timetable?
 - ⊕ Prepacks can be invaluable where speed is of the essence to a successful reorganization



Applying Insolvency/Restructuring Approaches

(cont'd)

- ✚ Arrange appropriate and necessary financing for entire span of restructuring process
 - ✚ whether or not this financing is available can be decisive in determining whether reorganization or restructuring succeeds or fails
- ✚ Consider appropriate ways to reduce and/or otherwise reconfigure debt burden of enterprise
 - ✚ e.g., debt exchanges, debt-for-equity swaps, Dutch auctions, etc.
- ✚ In context of an SOE restructuring/privatization, labor and other social issues can truly be paramount and must be addressed directly and comprehensively
 - ✚ Need to address full range of issues related to severance, pensions, unpaid wages, job placement in privatized enterprises and elsewhere, job retraining, as well as ways in which employees can participate in upside of privatization process (e.g., preferential access to stock offerings, etc.)



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February 5-6, 2011 Astir Palace Athens, Greece
International Insolvency Institute, Committee on Extraordinary Restructuring Solutions
Colloquium on Privatization and Insolvency/Restructuring

How to Revitalize Non Profitable Business Enterprises
Necessary Precondition for Privatization

Dr. Shinjiro Takagi
Executive Senior Advisor, Nomura Securities Co.,Ltd.

My presentation is based upon Japanese experiences to turn non-viable and non-profitable business enterprises to profitable ones.

Restoring economy by restructuring nonviable business

To restore stronger national economy, it is important to select nonviable business enterprises which have been wasting important resources such as human power, money and goods and weed them out from the business world, and infuse valuable resources into viable and profitable enterprises to help them turn to profitability. Nonviable enterprises that do not have reasonable prospect for recovery, or Zombie companies, must be wiped out of the business world.

However, distress business enterprises that have reasonable prospect for recovery but are only in temporal difficulties must be rescued as soon as possible through infusing new money to renew productive facilities reducing their huge debts and maintain their business as going concern.

Speed is essence to rescue ailing companies that have reasonable prospect for recovery by minimizing deterioration of their enterprise value utilizing expedited in- and out-of-court reorganization procedures developed in the United States, the United Kingdom and Japan, such as Chapter 11, prearranged and prenegotiated Chapter 11, Section 363 sales, stalking horse biddings, DIP finances and English style prepackaged administrations, and so on.

Planned, but not realized, Local Economy Revitalization Corporation

The former Japanese government planned to establish a new quasi-governmental organization which was temporary titled “Local Economy Revitalization Corporation (LERC)” to revitalize the so-called “third sector enterprises (3rd sectors)” which are joint venture corporations created by municipality governments with participation of private sector corporations. These private sector companies purchased some portions of the shares of the joint ventures at the request of the government, but they did not participate in the operation of the 3rd sectors corporation. Most of the 3rd Sector CEOs are incumbent prefectural governors or City Mayors and their COOs are retired high rank local government officers. Most of them have no management skills and expertise. I was the chair of the preparation committee to create the LERC between 2007 and 2008 appointed by the former government, but the plan was suspended because of the objection made by the Democratic Party which is now the ruling party in Japan. According to a government report, 65% out of 6700 3rd Sector corporations are assessed to be profitable in 2005. But when I was the chair of the LERC preparation committee, I made on site research travelling all over Japan to assess the soundness of 3rd sector operations. I had an impression that nearly 90% of 3rd sector corporations were loss making and infused huge amount of subsidies and loans by the local governments, procuring money by means of municipality bonds and bank loans year after year. Today, Japanese governments bond amounts to 900 trillion Japanese Yen, municipality bonds amounts to 130 trillion Yen, and the total of both sovereign bonds amounts to 1030 trillion Yen (US\$12.5 trillion), more than twice the Japanese GDP of 525.1 trillion Yen. This raises a worry that Japan may face a severe financial crisis in the future. My suggestion for the resolution of this difficulty is very simple - privatization of 3rd sector corporations is inevitable.

Public users of 3rd sector transportation bus often complain that buses do not arrive punctually. Passengers have to wait for as long as more than half an hour, they got on a crowded bus, while next nearly empty bus arrives just after the fully-packed bus had left. When I made researches on a certain local railway, I found that only 20% increase of the fare may be enough to turn the company to profitable. Nevertheless, governor or mayor CEO and/or retired high ranked officer COO did not understand the economic logic, and the shortage was often filled by the local government subsidy every year. Introducing market mechanism may be the best and the only solution.

Experience of Industrial Revitalization Corporation

A quasi-governmental organization called the Industrial Revitalization Corporation of Japan (IRCJ), whose chair was myself, was created in 2003 and dissolved in 2007. At the time when the IRCJ was created, business restructuring practice was not very popular in Japan. Between 2003 and 2004, IRCJ helped 41 ailing corporate groups by buying their debts and infusing new money to revitalize them.

We started the process with making due diligence about the business and financial problems of the target companies undertaken by retained professional talents including lawyers, accountants and business analysts. Experienced turnaround professionals led the team including smart fresh graduates of MBO programs to obtain sufficient and accurate information.

The core businesses which were expected to generate substantial cash flow had to be maintained and the new money were infused to them to make them more competitive, and non-core businesses which were inefficient and have no reasonable prospect had to be shut down. The estimated future cash flow were discounted by referencing several certain and uncertain factors, so that the enterprise value as a going concern could be estimated. The assets had to be strictly appraised to reflect the present value based on the going concern.

The target company had to be deleveraged to a more sound level. Total debts incurring interests had to be kept less than ten times of the annual cash flow in most cases.

The business operational restructuring plan and financial restructuring plan were drafted at the same. Operational losses had to be turned to profit within three years and total assets and liabilities had to be balanced within three years.

After drafting the reorganization plan, the IRCJ negotiated with creditors to obtain their unanimous consent to the plan which provides partial debts forgiveness (haircut) and/ or debts equity swaps as well as rescheduling of the repayment date of the debts. After obtaining the acceptance of the plan by stakeholders, the IRCJ purchased debts from creditor banks and executed debts equity swaps and invested new capital.

The IRCJ then dispatched turnaround managers replacing incumbent managers. The turnaround managers trained employees intensively and changed their culture to work harder. Without changing the long-lived lazy culture, the target company might not have been able to recover, even if the plan was excellent.

In 2007, the IRCJ successfully completed its business and made exit selling (or get repaid) of its purchased debts and obtained equities (stocks).

I would like to add a note of caution that countries where market-oriented restructuring

business is well developed may not need this kind of government-initiated organization.

Dr. Shinjiro Takagi is Executive Senior Advisor to Nomura Securities since 2007. He was Chair of Industrial Revitalization Corporation of Japan and Professor of Chuo University Law School between 2003 and 2007. He was admitted to Japanese Bar in 1963 and after 25 years private practice, he sat bench of Tokyo District and High Court until 2000. He reorganized a lot of huge corporations and wrote numerous books on insolvency laws.

Preliminary Draft—January 2011

Subject to Revision

For Discussion Purposes Only

Legal Structure of the Reform of the Japanese National Railways

Hiromu Emi

1. History of the Japanese National Railways From its Establishment to Collapse and the Proposal for Reform

Before the Second World War, the railway business of Japan was owned by the national government and operated by public servants. After 1949, the railway business was owned and operated by the Japanese National Railways ("JNR"), a corporation independent from the national government, and the employees of the JNR were not considered as public servants. JNR was, however, subject to certain restrictions that were not applicable to ordinary private companies. Its management had to comply with various restrictions, which made it quite difficult for the JNR to be managed as a business entity independent from the national government (further discussed below). Although its employees were given the right to organize and/or be members of labor unions and the right to negotiate and conclude collective bargaining agreements, they were prohibited to hit a strike and any other labor dispute action, and the law expressly stated that leaders of any labor dispute action be dismissed.

The JNR had as much as approximately 600,000 employees at its inception, but the number of employees gradually decreased to become approximately 300,000 at its last stage (around 1985).

As Japan recovered from the devastation of the war and made through its sometimes-referred miraculous economic growth, its industrial structure drastically changed, with its major supporting energy source shifting from coal to petroleum. How these changes influenced the demand for railway transport can be summarized as follows. In Hokkaido and Kyushu, the two largest production centers of coal, the demand for railway transport saw an increase immediately

after the war defeat as the demand for coal increased but it subsequently followed the period of stagnation and decline. In urban areas, rapid and large-scale concentration of population resulting from the industrial growth caused a significant increase in railway demand relating to commutation and cargo transport between big cities, and the capacity of the railway transport was enhanced by improving and/or increasing railway facilities and trains. The necessary fund was mainly financed by the loan from the national treasury, and the aggregate amount of the long-term debt of JNR around 1985 reached approximately 37 trillion yen (the annual income from the transport business was approximately 2 trillion yen at that time).

The reason for getting into such a situation is attributable to the JNR management's lack of authority in making important management decisions, which the management of private companies would have ordinarily possessed. The annual budget of the JNR had to be approved by the Diet, and the JNR management was not allowed to act on its own responsibility and judgment in determining the wages of employees, the amount of investment necessary to meet the demand for railway transport taking the transport revenue into account, etc. Furthermore, especially since 1980s, exceptionally improper working morals of employees and bad employment customs started to surface in some incidents such as traffic accidents caused by drunken drivers, and the JNR has become the target of heavy public criticism by passengers and taxpayers.

Under such circumstances, the reform of the JNR became an urgent issue and the Supervisory Committee for the JNR Reconstruction (the "Supervisory Committee") was established in the Cabinet to propose specific measures of the reform.

2. Outline of the Proposed Reform

In 1985, the Supervisory Committee submitted a reform plan for the railway business that involved approximately 20,000 kilometers of railway network, which included the following measures (the Supervisory Committee also proposed that the affiliated research institution, communication business, etc., should be separated into independent entities as private companies, but these points are not described in this document):

- (i) The passenger transport division of the railway business should be divided into six companies of more manageable size (one each in Hokkaido, Shikoku and Kyushu (the “three islands”), and three in Honshu (the main island)) (while one cargo company covering the whole country), which will be operated by the assets and employees transferred from the JNR (approximately 210,000 employees in total; the necessary workforce for the business was initially estimated as approximately 180,000, but 30,000 were added for the sake of employment stability);
- (ii) The three new companies in Honshu succeed more than 20 trillion yen of the total JNR debts of 37 trillion yen in proportion to the expected revenue of each company, and each company should be repaying the debts in installments (the new companies in the three islands were not required to succeed the debts; conversely, they were to be receiving distribution of the investment profit of the management stabilization fund which was to be established by the national treasury in order to stabilize their operation);
- (iii) Among the aforementioned debts of the JNR, several trillion yen should be repaid from the proceeds of the sale of the JNR assets not transferred to the new companies, and the cost for repaying the remainder of over 10 trillion yen should be paid by the national treasury, and eventually by taxpayers; and
- (iv) Of 300,000 employees of the JNR, approximately 90,000 would be deemed redundant in excess of the necessary workforce of 210,000 in the new companies, and they should accept a voluntary resignation package (20,000 employees) or should be assisted to find new jobs as public servants or employees of private companies within three years from the privatization of the JNR.

In a nutshell, the theme of the Supervisory Committee’s proposal was such that the railway business should be operated by the newly incorporated private companies (i.e. stock corporations), into which most of the assets, liabilities and contractual relationships including executory contracts of JNR should be divided (privatization and split-up).

The assets, debts and a part of the contractual relationships to be transferred to the new companies were determined depending on such factors as location of the assets, expected

profitability of the three companies in Honshu that succeeded the debts and the place where legal effects prevail (for example, in case of a power supply agreement). The legal issues relating to such decision were not expected to be many (in case of any doubt, necessary provisions could be stipulated in laws).

3. Labor Agreements

Under the Japanese constitution and then effective private laws, including labor laws, labor agreements were handled in case of demerger or business transfer as follows. Employees are not legally obliged to enter into labor agreements contracts to become employees of the demerged company or the transferee of the business transfer against their will; conversely, they do not have any legal right to enter into employment contracts to become employees of such companies solely at their will (*i.e.* regardless of the intention of the other party). Employers may terminate employment contracts based on certain reasonable grounds, but do not have any legal right to force employees to become employees of the demerged company or the transferee without regard to their will. The above should be a common legal principle under the constitution and private laws of any democratic nation that respects the will of individuals.

When the above principle was applied to the employment contracts affected by the JNR reform, it would read as follows: the JNR employees were not legally obliged to enter into employment contracts to become employees of a specific new company against their will, while they did not have any legal right to enter into employment contracts to become employees of a specific new company solely at their will (*i.e.* regardless of the intention of the other party); meanwhile, the JNR, the employer, did not have any legal right to force the employees to enter into employment contracts with a specific new company against their will.

The above logic could be easily understood even by non-lawyers by looking at the case of the JNR reform where the number of job applicants for a specific new company exceeded the number of necessary workforce of such company determined by the Supervisory Committee.

4. Distribution of JNR Employees (Determination of the New Companies to Hire

Employees)

(1) Procedure

Under the inviolable legal principle described above that employees are not legally obliged to accept the selection by their employer against their will, while not possessing any legal right to insist on their will, the distribution of JNR employees, or determination of the new company to hire these employees, was to be determined in accordance with the following procedure:

- (i) Employees file their application for the positions at the new companies by indicating their choice of six companies with the order of preference;
- (ii) The Incorporation Preparation Committee of each new company (the "Preparation Committee") indicates the criteria concerning the qualification, etc., required for the employees of such new company (the "employment criteria");
- (iii) JNR selects employees based on their application and the employment criteria above, and prepares a list of candidates for each new company within the number of workforce determined by the Supervisory Committee; and
- (iv) The Preparation Committee determines the employees to be hired by the relevant new company.

(2) Outcomes

In accordance with the aforementioned procedure, JNR employees indicated the new companies that they desired to be hired (up to six companies), JNR submitted to the Preparation Committee the list of candidates who were selected through evaluation of their past performances in accordance with the predetermined employment criteria, and the Preparation Committee determined the employees to be hired by the relevant new company.

The number of the JNR employees, which started with approximately 300,000, was reduced down to approximately 210,000, well below the number of workforce of the new companies indicated by the Supervisory Committee, when the JNR reform was effected (April 1987). This reduction owed to the voluntary resignation of 40,000 (compared to the initially expected resignation of 20,000) and job placement of 50,000, who had or would have changed their job,

through the job placement assistance effort of the public and private sectors under the support of the national government during the reform preparation process.. In this perspective, one could have argued that the JNR reform was accomplished without causing loss of employment, which was considered as the biggest issue, in terms of the total number of employees.

However, viewed from regional perspective, in Honshu, for example, where a large number of employees accepted the voluntary resignation or changed their jobs, the number of employees of the three new companies fell short of the number of workforce determined by the Supervisory Committee by approximately 10,000 (even in such situation, those who did not meet the employment criteria were not included in the list of candidates and were not hired by the new companies). In Hokkaido and Kyushu, to the contrary, the number of the applicants to the positions at the passenger transport companies exceeded the number of workforce of these companies determined by the Supervisory Committee by approximately 10,000 in total. Furthermore, these applicants applied for only one company without indicating their second or lower preferences. Consequently, when these 10,000 employees were not accepted by their first preference, they were not hired by any other new company. Many of such employees found new jobs through the job placement assistance that was provided, in principle, up to three years or were hired by the new companies in Honshu through the additional hiring programs. However, approximately 1,000 employees refused to find new jobs through the job placement, insisting to be hired by the passenger transport company of their choice. They were finally terminated their employment upon expiration of the employment placement assistance period (three years from the effective date of the JNR reform) stipulated in the JNR reform laws.

5. Evaluation of the JNR Reform

(1) General

The JNR reform of privatization and split-up, is considered to be a successful example, that could be attributable to the following reasons and/or factors:

- (i) The strong demand for the railway transport, especially the passenger transport, had

continued mostly in urban areas, and improvement and increase of the facility had been continuously implemented even during the era of JNR in order to cope with such demand;

- (ii) Low intensity of work resulting from the overstaffed environment often caused the incidents that were heavily criticized by the people outside the JNR, which created a common sense of the need for urgent reform not only among those outside the JNR but also those inside the JNR;
- (iii) Both public and private sectors shared a responsibility of finding new jobs for the redundant JNR employees and, fortunately, the economic conditions in Japan at that time was good enough to allow them to offer such hiring opportunities;
- (iv) In the early stage of the reform, the revenue of the new companies had been sustained thanks to the continued growth of the Japanese economy; and
- (v) Both the employers and employees never forgot the miserable experience at the latest stage of JNR collapse and made their improvement efforts.

(2) Employment Issues in General

The policy of the Supervisory Committee that aimed at employing appropriate number of workforce in accordance with the business scale was realized as the result of the cooperation of both public and private sectors. It is widely understood that those who voluntarily left the railway business did so not because they were pessimistic about the future of the business, but because they fully understood the need for reform and decided to contribute to the rebuilding of the railway business by resigning by themselves, leaving the future to those who are staying with the new company.

It may not be incorrect to argue that the employment issues related to the JNR reform were resolved thanks to the spirit of self-sacrifice of those who left the railway business, coupled with the cooperation of the public and private sectors.

(3) Particular Aspects of Employment Issues

In the situation where approximately 90,000 employees had to lose their jobs and the same

number of job opportunities needed to be created, approximately 1,000 employees insisted to be engaged in the railway business at the company of their choice rather than to find jobs in another business or to be engaged in the railway business at another company, who were ultimately terminated their employment.

There might have been various reasons for choosing not to leave their place of residence, and it should be left to the choice of each individual to choose between work places and residential areas. However, the weight of the fact needs to be recognized that there were employees who had to make the hard choice of giving up either one of the two.

In conclusion, the success or failure of the JNR reform should be evaluated not simply by how the inside people such as employees were influenced but also by how the restructured railway business has been accepted by the passengers.. It may not be fair to disproportionately emphasize the fact that not all employees were fulfilled their desires.

(December 22, 2010)

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Privatization in Brazil

Thomas Benes Felsberg

Although it would be possible to discuss the various ways in which a State could reduce expenses and increase administrative efficiency, the majority of governments in countries involved in economic crises and insolvencies have opted to implement financial reforms and practice austerity in the form of reducing the public deficit. Although the Brazilian Government took steps in the tax and administration areas, the reform of the Brazilian State also included the privatization of state-owned companies, which in itself, produced important results.

Brazil's positive experience of privatization may be seen as an example of a tool to be used to reduce public deficit, control inflation and increase a Government's credibility. Indeed, considering that several state-controlled Greek companies are facing insolvency problems, the Greek Government could well contemplate the possibility of resorting to the Brazilian experience as part of the framework of its reforms designed to mitigate the effects of the global economic crisis which it started to experience in mid-2007.

Furthermore, the Greek Government's position as controller of a number of sectors of the economy, including the infrastructure sector, has resulted in a State which acts as an employer to a considerable portion of the population, a fact that, in turn, severely impairs the political aspect in negotiation toward measures aimed at austerity.

This paper will outline the general policies which were applied to privatization in Brazil and which have been an important part of the process in the reform and recovery of the State's investment and administrative capacity. It could be used as a possible example for other countries facing similar problems.

The Brazilian Economic and Political Context

The process of privatization in Brazil was formulated within the context of a desire to support macroeconomic stability and allow the resulting environment to attract direct foreign investment.

Brazil began to engage in the process of privatization in the 1970's when the former Minister of Finance, Eugenio Gudin, stated that the processes of capitalism were more controlled by the State in Brazil than in any other country except those under communism¹.

However, it was only in the mid 1980's that the question of privatization in Brazil was seriously considered given the need to stabilize an economy suffering the effects of the Oil Crisis.

At the time, Brazil was facing a growing wave of popular discontent arising from high inflation that was destroying the purchasing power of the population². Thus there was a need to reduce the funding requirements of failing State-Owned Enterprises ("SOEs"), as a means to reduce public debt.

In 1979, the 'SEST' – 'Special Secretariat of Control of State Enterprises' was created, aiming to monitor the goals and procedures that had been adopted for the SOEs, in order to control their annual accounts and capital requirements.

A major advance was accomplished by SEST through a comparative survey of all active SOEs and the establishment of objective criteria used to classify the types of businesses, their needs and overall contribution to the Brazilian economy, which included their eligibility for a privatization program. Within this context, by 1989 the National Bank of Economic and Social Development (BNDES) had absorbed six insolvent SOEs, and in so doing, an important argument against the nationalistic surge against privatization was presented.

By the 1990s, the SEST's failure to control SOEs became clear, as well as the role they played in the continuing slide of economic conditions. This led to Law Nr. 8.031 of 1990 that created the National Development Plan (PND), which envisaged, among other measures, the sale of SOEs related to sectors considered strategic (in terms of maintaining the economic control) until its enactment.

¹ PINHEIRO, Armando Castelar; FUKASAKU, Kiichiro; Privatization in Brazil: The case of public utilities, 1999, BNDES.

² PINHEIRO, Armando Castelar. GIAMBIAGI, Fabio; The Macroeconomic Background and Institutional Framework of Brazilian Privatization: 1999, BNDES.

Law Nr. 8.031, passed in 1990, contained several safeguards that encumbered the sales process involving SOEs, meaning it was almost impossible to privatize efficiently. During the sale of Usiminas, the first company to be sold, 37 lawsuits were filed to stop the privatization procedure. This maze of legal battles was one of the major difficulties that was continuously faced by the privatization program, even after it had subsequently been amended, as explained below, and led to the BNDES' creation of a legal squadron which over time successfully defended the privatization program in the courts. This was an important factor in the context of the program, considering that privatization affects conflicting interests of several entrenched groups which benefit from the status quo.

As the program evolved, several new laws and regulations had to be enacted in order to allow the privatization to succeed. Thus a law was enacted to end the government monopoly in the telecommunications sector³. The same was then implemented in the area of oil, ending the Petrobras monopoly⁴. Finally the distinction between Brazilian companies controlled by domestic and foreign stake owners was abolished, thus allowing foreign direct investment to participate fully in the Brazilian privatization program; a factor that was also to prove important in the mining and electricity generation sectors.

Net borrowing of SOEs

(% of GDP)

	1994	1995	1996	1997
Federal Companies	-1.66	-0.19	-0.12	-0.2
State and municipal enterprises	1.27	1.06	0.43	0.48
Total	-0.39	0.87	0.31	0.28

³ Constitutional Amendment Nr. 8, passed by Congress in 1995 ended the state monopoly for the operation of telecommunications services. The text approved by Congress, however, limited the amendment's immediate impact by requiring that a law should detail the role of the State and the general principles that would govern the sector. As such, Congress' passing of the General Telecoms Law (Law 9.472 of July 16, 1997) was a landmark in the change of the government's role in the telecoms sector, as the law proposed that the State should cease to be a provider of telecommunications services and become the sector regulator.

⁴ The Oil Law (Law Nr. 9,478 of August 6, 1997) flexibilized the oil and natural gas sector monopoly, up to then held by Petrobras, and opened the fuel market in Brazil.

Source: BNDES

In 1997, Law Nr. 8.031 was repealed, giving way to Law Nr. 9.491 which remains in effect until today. This law revived the privatization process, looking to clearly establish directives and set new parameters.

Within this context, Law Nr. 9.491 establishes the fundamental objectives of the PND (National Privatization Program)⁵, thus preventing privatizations which did not fall within the objectives of the Program.

The purposes of the PND are: (i) to reorganize the State's strategic position in the economy; (ii) to contribute to the economic restructuring of the public sector; (iii) to allow the reemergence of investment in businesses and activities that will be transferred to private initiative; (iv) to contribute to the economic restructuring of the private sector, especially in the modernization of the country's infrastructure and establishment of industrial parks, increasing its competitiveness and encouraging entrepreneurship, including through the provision of credit; (v) to allow Public Administration to focus its efforts on activities in which the State's presence is crucial to the continuing growth of those sectors considered to be priorities for development; and (vi) to contribute to the strengthening of capital markets, by increasing the supply of securities and the democratization of ownership of shares in companies forming part of the PND.

Under this new law, the following entities may be privatized: (i) companies, including financial institutions, directly or indirectly controlled by the Union, which are created either by law or an act of the Executive Power; (ii) companies created by the private sector which have, for whatever reason, passed into the direct or indirect control of the Union; (iii) public services subject to concession, permit or authorization; (iv) state public financial institutions that have had their capital shares expropriated; (v) movable and immovable property belonging to the Union. This law

⁵ Article 1 of Law 8,031 states the program's "main purposes": "I – To change the federal strategic approach to economic policy through the transfer of activities unduly performed by the public sector to private initiative; II – To reduce the government debt and thus help to bring relief to public finance; III – To assist in the resumption of investment in companies and activities transferred to the private sector; IV – To help modernize the Brazilian industrial complex, improving its competitiveness and strengthening the entrepreneurial capability of the several sectors of the economy; V – To free the public administration to center its efforts in areas where government action is vital in order to accomplish national priority goals; VI – To help strengthen the capital market by an increased offering of tradable securities and opening up equity ownership in the companies included in the program."

expressly excludes the 'Banco do Brasil' and 'Caixa Econômica Federal' banks, as well as certain state-owned enterprises and joint stock companies engaged in activities under the exclusive control of the Union, such as those engaged in the nuclear power industry from its field of responsibility.

Furthermore, the Brazilian law allows the following operational modalities for the implementation of privatization: (i) sale of equity interest; (ii) IPOs; (iii) capital increase by third parties, with waiver or transfer of subscription rights in whole or in part; (iv) assignment, leasing of real estate, free leases or transfer of assets and facilities; (v) dissolution of companies or partial deactivation of their development, with the consequent sale or transfer of assets; (vi) concession, permission or authorization of public services; and, (vii) special rural land arrangements.

One of the most important changes to the law was the creation of the National Privatization Council (CND), replacing the former Executive Committee. Directly subordinate to the President, the CND is the highest ranked body operating within the PND, its purpose being to provide greater agility to the privatization process. Amongst its powers, it falls to the CND to approve the operational model to be applied to each privatization (except when dealing with financial institutions - in which case the coordination lies with the Central Bank of Brazil and the National Monetary Council), determine the allocation of resources from privatization and establish payment terms applicable to the privatization of movable or immovable property belonging to the Union.

The Law also created the National Privatization Fund (FND) which is formed of stocks or shares owned by the Union that have been issued by companies included in the PND. The BNDES manages the National Privatization Management Fund, with the objective of organizing, monitoring and conducting the sale of those companies included in the PND. The CND, FND and the BNDES have given the required transparency and professional management to the Privatization program, and the set of rules and procedures adopted in the appraisal, bid proceedings and auctions related to the Program were successfully implemented and have since withstood the hundreds of court battles which have raged as a result of the privatizations.

Another important step was the approval of Law Nr. 8.897 of 1995 (Law on Concessions) that provided a legal framework for public utilities and sought to enlarge the scope of the PND, to cover not only the sale of businesses, but also the transfer of control of infrastructure projects to the private sector.

Since the establishment of the PND, 68 privatizations of state-held companies have been conducted, mostly in the steel, chemicals and petrochemicals, fertilizers and power sectors. In addition, 12 financial institutions were privatized from 1997 to 2005⁶.

The Steel and Mining Sectors

The debt crisis in the 1980's prevented investment in the modernization of industrial plants which lagged behind international standards in terms of quality, productivity and competitiveness.

In the early '90's therefore, with the opening of the Brazilian economy and the globalization of the steel industry, there was a notable increase in the competition, highlighting the structural problems inherent in the Brazilian steel industry and the huge amount of modernization needed, without which the development of Brazilian industry as a whole was in danger.

The main features of the Brazilian steel industry before privatization were, in summary: high debt; outdated industrial facilities; investment limitations; overly bureaucratic management and/or policies; trade restrictions; a low level of autonomy in planning and strategy; and a great number of environmental liabilities.

The privatization process of the Brazilian steel industry began in 1988 with the aim of solving the problems affecting the economic situation of companies. At the end of the program, all of the industry's mills had been privatized, with the total value of sales to the private sector having reached about US\$ 5.6 billion, whilst the debt which was actually transferred to the private sector stood at US\$ 8.2 billion.

Of the major gains which privatization brought to the steel industry, a number of the most important were: the beginning of a new stage of development; improvements in the administrative, financial and technological areas; the proficiency of company administration; a redirection of efforts for the obtaining of results; a strengthening of the corporate sector and business groups; participation in new investments abroad and in partnerships with customers; reductions in costs; increased

⁶ The privatization of financial institutions was encouraged by the Program for Stimulation of Restructuring and Strengthening of the National Financial System (Proer), established by means of Provisional Measure Nr. 1,179 and Resolution Nr. 2,208, both dated of 1995 as well as by the Program for the Encouragement of Reduction of the Presence of the State in Banking Activities (Proes) created by the Provisional Measure Nr. 1,514 of 1996.

productivity; access to capital markets; the development of processes and products for customer service; the definition of new investments in modernization and an upgrading in technology and environment; investment in logistics and infrastructure; autonomy for planning and action strategy; more aggressive business strategies; and an improvement of performance indicators.

Several benefits to society may also be mentioned, including social and economic development in the regions neighboring the plants, with new elements in the production chain, a rise in the taxable production and income, and increased social activities, including those resulting from partnerships with local municipalities.

The Metallurgy Sector

Another example which should be mentioned is the privatization of Vale S.A.. Before its privatization, 'Vale' was the 20th largest producer of iron ore in the world. Today, as a privately owned company, it is a global leader in the field, the 2nd largest mining company in the world and the largest private company in Latin America. The 11,000 people employed during the state-owned years has now jumped to 112,000. During the 54 years it was government owned, Vale invested USD \$ 26.47 billion, whilst over the 11 years it has been privately owned, Vale has invested USD 73.5 billion (until 2009). In addition to this, its net income totaled US\$ 10.57 billion during its 54 years in State hands and US\$ 55.39 billion whilst privately owned through until 2009. More recently, from July to September 2010, the company's net income soared to US\$ 3.89 billion, more than a third of that achieved during its entire 54 government-owned years. Adding up taxes, dividends and royalties, Vale has paid US\$ 13 billion to the Federal Government - more than 659% of the amount paid during its 54 years as a government owned company.

The Telecommunication Sector

The benefit of privatization in the case of the Telecommunication Sector⁷ is even more significant as it had a direct effect upon Brazil's low-income population. Considering the difficulty in the public sector's ability to provide the high volume of investment required, largely due to the demand

⁷ NOVAES, Ana; The Privatization of the Brazilian Telecommunications Sector: 1999, BNDES.

for increasingly sophisticated services, a scenario was designed that was conducive to the restructuring of the sector and focused on privatization and the breaking of monopolies.

In the early 1990s, the telephone services mainly served classes A and B and, as well as the difficult access to telecommunication services felt by the lower classes of the population, the competitiveness of companies located in Brazil was also compromised which ultimately had an adverse effect upon the overall competitiveness of the country.

Telebras was privatized in July 1998 through 12 consecutive auctions held at the Rio de Janeiro Stock Exchange, with the sale of control of three fixed telephony holdings, one long distance service and eight mobile phone services, establishing itself as the most extensive privatization of a controlling block in the world ever held. With the sale, the government collected a total of US\$ 22 billion, a premium of 63% over the minimum price stipulated.

In July 1998 there was a shortage in the number of fixed telephone lines considered necessary to meet the needs of the entire population, which made it a very expensive commodity and limited its access solely to the higher classes. When seen in terms of numbers, before privatization there were 14 telephones per 100 inhabitants, now this average has jumped to 124.

It is noteworthy that the greatest access to telephone lines, especially for consumers with lower purchasing power, is of great importance not only for voice communication but also in terms of the possibility for internet access. Moreover, there has also been a relevant impact on the industry since it was restructured to meet the significant increase in demand.

Before privatization, Telebras charged US\$ 1,000 per phone line and the subscriber had to wait two years for it to be installed. Nowadays, the line is free and a telephone is installed within a week. In 1998, when Telebras was privatized, the country had 24.5 million telephones, while there are now 224 million installed landlines. Furthermore, during its 25 years as a publicly owned company, Telebras invested US\$ 60 billion and, over its 11 years in private hands, it has invested US\$ 180 billion.

What is most noteworthy however, is the impact on the economy and the consequent rise in the number of jobs, the dynamics of other sectors that have been incorporated into telecommunications, the huge investments in the purchase of equipment and creation of services, and the increased

competitiveness of companies in general operating in Brazil, especially the small and medium-sized businesses which now have access to advanced telecommunications services at prices compatible with their size.

Conclusion

The fiscal motivation has, in practice, been the main source of incentive for the privatization policy, and experience has shown that this is a strategy used by governments during difficult economic periods. Privatization in Brazil brought about a significant impact in the degree of productivity and in the financial, technological and corporate strategies of companies which, as a rule, have become more profitable and efficient, with an increase in the number of jobs, taxes and GDP.

The privatization process in Brazil however, has met resistance in the form of labor issues and other special interest groups which lost privileges. In addition, the fact that many companies were sold under crisis conditions, raised questions over the prices which were obtained at the auctions and also with respect to the tax incentives which were bestowed on the acquirers. As a result, as a general political proposition, the word 'privatization' does not have great political appeal in Brazil, despite the enormous benefits it has brought to the country.

Total Privatizations in the 1990s (US \$ millions)

Sector	Number of Enterprises	Revenue	Debt Transferred	Total
Steel	8	5,562.00	2,626.00	8,188.00
Petrochemicals	27	2,698.00	1.00	3,701.00
Railroads	7	1,698.00	-	1,698.00
Mining	2	3,305.00	3,559.00	6,864.00
Telecommunications	24	26,644.00	2,125.00	28,769.00
Energy	3	3,907.00	1,670.00	5,577.00

Source: BNDES

Another positive aspect that should be emphasized, although secondary from a macroeconomic point of view, has been the establishment of competition in markets dominated by the State, resulting in higher quality services as well as a drop in prices.

The stages of privatization in Brazil can be seen in terms of decades, from the country's shy flirtation with the concept in the '80's, the implementation of sound policies which encouraged the sale of SOE's in the '90's, and the situation the country is now facing in the form of another set of challenges regarded as essential but in need of significant investment in order to continue the economic growth of recent years.

In this sense, Brazil is now in a new phase based on the search for parameters for privatization in other sectors that are intrinsic to the infrastructure, whilst noting the need for transparency in the process, the obtaining of a fair price and the dismissal of dependence on public funds.

This also shows the new challenge that lies ahead for the country that will play host to sporting events over the coming years (the FIFA World Cup of 2014 and the Olympic Games in 2016), attempting to provide a safe investment model in the infrastructure sectors, especially aviation, in which the privatization of airports is considered to be the new goal for expanding privatization.

As in any insolvency situation, finding a buyer is key to a successful restructuring. In the case of the SOE's which are generating losses in Greece, it seems that, by establishing the correct tax and financial incentives for a transparent sales process, a privatization program could be created which would attract both domestic and foreign investors and provide the sound macroeconomic and microeconomic advantages mentioned above.

Dealing with State Owned Enterprises in Distress: the Practice of Chinese Government in 1990s

Wang Weiguo*

Introduction

For a long time, debt-related distress of enterprises has been a major factor that restricts the reform and the development of Chinese State-Owned Enterprises (SOEs). In 1990s, the State Economy and Trade Commission (SETC) and other departments of the Central Government took some great measures such as liquidating inter-enterprise debts ("triangle debts"), M&A, debt for equity swap, etc, with some effects obtained. As proven by experience, it is a difficult and complicated task to relieve the enterprises from their debt-related distress. In the course of establishing and perfecting the socialist market economy in China, it is of significance for current SOE reform and economic development to search for more flexible and effective methods in restructuring distressed enterprises by combining policy tools with market means and linking governmental resources with market resources. In 1990s, some main features of SOE distress were remarkable in China. First of all, there were too much and long-existing debts stored up in the distressed enterprises. Secondly, their financial difficulties were connected with management, technology improvement, market operation, redundant personnel and social burden, and so forth. Thirdly, the resources that could be used directly by the government to relieve enterprises from distress were limited by the realistic situations of the state finance and the bank assets. Finally, since the market for capital and property transactions were just starting running, there lacked a set of mechanism and relevant systems to absorb directly from society the financial resources available for restructuring distressed enterprises. Therefore, what needed to be solved urgently include, among others, how to learn the successful experiences from abroad according to situations in China, and how to bring forth new ideas on methods and systems, which were suitable for China, for harnessing distress of enterprises.

Along with the development of deep-going enterprise reform, China has confronted with the problems of bringing forth new ideas on systems, measures, and channeled to solve the difficulties and new problems. There have been two points that need special considerations: (1) How to search out more market alternatives to solve the problems; (2) How to explore creative and new thinking,

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methods, approaches and measures to relieve enterprise distress, on condition of conforming the current laws and protecting lawful rights of all parties, especially bank creditors.

We are glad to see that, with the development of the deep-going economic reform and the socialist market economy in China, enterprises, financial section and local governments have achieved remarkable success and produced much valuable examples in taking efforts to search for creative and new ideas, methods in treating distress of enterprises by way of debt-restructuring. To sum up the practice and search for more alternative approaches should be contributory to rescuing distressed SOEs, an important theme which has been a focus for a long time, and to promoting the future economic development in China. Meanwhile, we also realize that as, a global economic problem, the issue of business distress or insolvency has been a worldwide puzzle to the governments and the international organizations, which have paid serious attentions thereto. Therefore we can make use of in the experiences of treating business distress in the foreign countries as well as the research achievements made by the international organizations.

I. Overview on Debt Problem of SOEs in 1990s

1. Situation of Assets and Liabilities of SOEs

Since 1990s, debt problem has become a conspicuous factor that restricts the reform and the development of Chinese State-Owned Enterprises (SOEs). An investigation in assets and capital SOEs (trade and financial enterprises included) made by the State Assets Administration in 1994 shows that the debt-to-assets ratio (total liabilities/total assets) of SOEs reached 75.1% at that time, about 63.9% of SOEs were in the condition of highly indebted operation (the debt-to-assets ratio was between 60-100%), and 22.5% of the SOEs were over-indebted with remarkable risk of insolvency or bankruptcy.¹

According to the statistics from another comparatively overall investigation covering 302,000 SOEs carried out in 1995, the average debt-to-assets ratio was 69.3%; if the actual losses in the guise of receivables had been deducted from the total assets, the real debt/assets ratio would be 76.1%. In comparison, the debt/assets ratio of these SOEs was just 38.7% in 1980, which was doubled in the following 15 years. There were 51,000 SOEs had the debt-to-assets ratio above 100%, meanwhile, 61,000 SOEs with debt-to-assets ratio of 100% or more had booking losses beyond the owners' equities and were *de facto* insolvent. The above distressed SOEs come to 112,000 in total, accounting for 37.1% of all the SOEs involved in the investigation.²

In the statistics from the above investigation, there are two facts remarkable: firstly, the debt-to-assets ratio after considering the factor of land assessment, was 61.3% for large-sized SOEs, 72.9% for the medium-sized, and 76.9% for the small-sized is, showing that the debt-to-assets ratio of the large-sized was lower than that of the medium & small-sized; secondly,

¹ Madam Xiaoling, Wu, Study on Debt-restructuring of State-owned Sector in China, the China Press of Finance, Janary, 1997, Page 1-2.

² Yunting, Zhang, Debt-restructuring of State-owned Enterprises, the Shanghai Press of Finance and Economics, 2000, Page 68. The statistics of the area at that time can be also referred to Liling, Lu and Shenying, Debt-treatment in Reorganizing State-owned Enterprises, the Press of Economics Science, 1997, Page 2-13; Chunling, Zhang, the Issue of debt of State-owned Enterprises, China Economics (1996), the Beijing Tianze Institution of Economics, the Shanghai People Press, 1997, Page 1.

the debt-to-assets ratio after considering the reassessment of the fixed assets and land, was 34.2% for central SOEs, and 65.8% for local SOEs, showing that the debt-to-assets ratio of the central is much lower than that of the local.³ Thus, since from the beginning the distress among the medium & small-sized and the local ones were more serious than that among the large-sized and the central ones, which were benefited of the dominant position of policy preference, resources possession, etc, inevitably the stress and difficulty of the issue in treating distress of SOEs in China would mainly focus on the medium & small-sized and local SOEs.

Because of the high indebtedness, the SOEs' ability of making profit came down year after year. According to the statistics of the related agency, the total losses of SOEs in 1995 amounted to RMB 41 billion and increased by RMB 7 billion per month compared to the last year. Loss incurred in above one-third of SOEs, and loss of the local industrial SOEs arrived at RMB 28.5 billion, accounting for 70% of the total losses.⁴ According to the calculation by the Economic Institution of the State Planning Commission, the total losses of independent accounting SOEs in 1995 increased by 48% and the growth margin increased 19% compared to the last year; the total profits of them dropped by 35% or so and the descend margin increased 25%; the losing ones covered about 60% of the SOEs and increased about 20% in compared to the last year. The Production Department of the State Commission for Economic Reform and some other agencies carried out an investigation in the SOE management in 69 cities, showing that in spite of the serious difficulties the SOEs still wished for survival. In the inspection, among the provided five choices, namely bankruptcy, merger, separation, sale by auction, and others, only 31% of them chose bankruptcy or sale by auction, while 69% chose merger, separation and others.⁵

Two more matters need to be considered in respect to the SOEs' debt problem, which would help to evaluate objectively the impact of SOEs' debt distress on national economic department. One is the comparison between the debt-to-assets ratio of SOEs with that of other kinds of enterprises; the other is the comparison between the different debt-to-assets ratios of SOEs in different scales.

Table 1-1 Comparison of the Ratio of Various Industrial Enterprises in 1995

Owner-type	Total Assets	Total Liabilities	Debt-to-assets ratio
SOEs	47472.06	31149.10	65.6 (74.2) *
Collective-Owned Enterprises	14360.07	10175.63	70.9
Stock-holding Enterprises	4382.39	2405.96	54.9
Foreign-invested Enterprises	5798.22	3162.79	54.5
Enterprises Invested by Hong Kong, Macao, and Taiwan	6258.11	3891.94	62.2
All the Enterprises	78270.85	50785.42	64.8

³ Liling, Lu and Shenyang, Debt-treatment in Reorganizing State-owned Enterprises, the Press of Economics science, 1997, Page 9-14

⁴ Liling, Lu and Shenyang, Debt-treatment in Reorganizing State-owned Enterprises, the Press of Economics science, 1997, Page 55

⁵ Guoyun, Zhang & Shongping, Li, Discussion of More Mergence, Less bankruptcy, Economics Management, the ninth, 1997.

From: the Statistic Yearbook of China (1996)

* The data in the braces is the debt-to-assets ratio which was got after the actual losses in the guise of receivables had been deducted from the total assets.

According to Table 1-1, the SOEs' assets accounted for about 60% of the total assets, and the SOEs' liabilities accounted for about 80% of the total liabilities. Therefore, in great degree, the situation of macroeconomic operation relates more to the condition of the SOEs' assets and liabilities, which indicated that it is especially prominent for the development of the economic of China to solve the problem of distress among SOEs.

Table 1-2 Numbers of SOEs and Share of Credit in 1996

Number	Total (10 thousand)	11.38
of SOEs	Including: the large-sized (%)	5.97
	the medium-sized (%)	13.18
	the small-sized (%)	80.85
Credit	Share of Credits for SOEs in Total domestic Credit (%)	81.37
Assets	Share of SOEs' Assets in Total domestic Assets (%)	58.61

From: The Statistic Yearbook of China (1996), the Financial Yearbook of China (1997)

According to Table1-2, the share of credit for SOEs in the total domestic credit was higher than that of SOEs' assets in total domestic assets, i.e., it depended on SOEs' assets accounting for about 60% of total domestic assets to keep credit for SOEs accounting for about 80% of total domestic credit. Consequently, it is very important for the quality and safety of bank assets of China to solve the problem of distress among SOEs and improve the quality of SOEs' assets.

Table1-3 Distributions of SOEs' Debt Scale in 1995

Type of SOEs	Liabilities (100 million RMB)	Share in total Liabilities (%)
The large-sized	18611.04	59.7
The medium-sized	6771.12	21.8
The small-sized	5766.94	18.5
Total	31149.10	100

From: the Statistic Yearbook of China (1996)

It can be seen from Table1-3 that, in spite of the higher debt-to-assets ratio of medium & small-sized SOEs, their liabilities only account for 30% of total Liabilities of SOEs. It is testified by international practice that the ratio of the successful restructuring of large enterprises is higher than that of the medium & small enterprises.⁶ Therefore, it is understandable why in these years

⁶ According to estimation of specialists, in USA the general ratio of the successful corporate rescue under Chapter 11 of the Bankruptcy Law is generally around 20%, while that of large companies is 80-90%; in Japan, for many years, almost all the enterprises whose recovery by restructuring successfully in application of 会社更生法 are large enterprises.

many large SOEs had been assisted and many large Enterprises-groups had been formed through reorganization and annexation, which had contributed to the alleviation of the overall tension of SOE distress, and why the economy of China kept on increasing at the serious overall situation of SOE distress.

2. Situation of Banks' Bad Assets

It is closely related between the issue of debt distress of SOEs and the condition of banks' bad assets. Since the economic reform and opening to the outside, the credit relationship between SOEs and banks, and the emergence of banks' bad assets have gone through three stages:

The first stage: before 1983

At that time when the economic reform just started, there was no concept of commercial bank. All the banks then performed as cashier of the financial department of the government. The fixed assets and current funds of SOEs relied on fiscal allocation. Only were the excess of the allocation quota and some occasional investment for fixed assets borrowed from banks. The amount of total loans for the nationwide industrial enterprises were RMB 48.7 billion in 1980, and increased to 52.7 billion in 1982. Even if in 1983, the amount were just RMB 59.7 billion, and at that time the banks had no bad assets occurred by loans for SOEs.

The second stage: from 1984 to 1990

During this period, while the market elements increasing, the credit relationship between SOEs and banks and the concept of commercial banks emerged. The so-called "shifting from allocation to credit" ("*bo-gai-dai*"), by which the investment in infrastructure construction came from bank loans rather the fiscal allocation, was one of the major measures in reform of the investment system. Since the major capital of the enterprises turned to loans from the banks, the scale of the bank credit expand rapidly, and bad loans came out. In most of the years of this stage, the ratio of the bad assets to total assets of the banks was less than 10%, and it is until the end of 1980s that the ratio arrived at about 15% (the amount of the total bad assets was less than RMB 200 billion).

The third stage: from 1991 to 1998.

It is during the period that the amount of bad assets of banks swelled dramatically. According to calculation of specialists, the amount of SOEs' bad debts increased 5 times in five years, which was in turn RMB 213.3 billion, 420.6 billion, 547.7 billion, 853.4 billion, and 1059.8 billion from 1991 to 1995. Accordingly, the amount of banks' bad assets increased about 4 times in the five years. Of the new bad assets, the amount due to the foam of real estate and stock market accounted for 32%, and the amount due to debt distress in SOEs accounted for 48%. Of the total amount due to debt distress of SOE, about one-third was due to the credit made for the sake of social stability in light of the administrative orders, about one-third amounts to the bad debts for the sake of relieving the enterprises in production accounted for, over one-sixth were written off because of some enterprises' bankruptcy, and the amount of bad debts due to the false operation and sightless loans of bank accounted for about one-sixth.⁷

According to estimation of specialists, in 1994 two-third of the total debts of SOEs owed to the banks.⁸ According to the statistics of utilizing state funds in the Financial Yearbook of China

⁷ Fangang, *ibid*, Page 102-103.

⁸ Fangang, *ibid*, Page 64.

1996, the loans for SOEs accounted for 58.73% of the total loans. Moreover, according to the Economic Yearbook of China 1996, the ratio of profit & tax to capital of the financially independent SOEs were 24.8% in 1980, 23.8% in 1985, 12.4% in 1990, and 8.01% in 1995, i.e. about 60% of bank loans had been immersed in some inefficient SOEs.

It is shown in an investigation that in the commercial banks' credit assets in 1995 the amount of bad loans came to 22.65% of the outstanding loans in the period. Of the amount of bad loans, over-due loans accounted for 13.99%, non-performing loans accounted for 6.67%, and bad debts accounted for 1.99%. However, the actual situation was more serious than those figures.⁹ According to the typical survey, there were considerable loans that were not included in bad loans, which relied on the "rolling approach" to keep operating, by which the banks lent new loans to enterprises to clear off the old loans. Furthermore, about 60% of the non-performing loans had turned into bad debts. Thus, on the basis of the calculation, the actual share of bad debts to the outstanding loans in the corresponding period would have reached 5.99%.

In 1995, China promulgated the Commercial Bank Law, providing the legal requirements to safety of bank assets. Aiming at the mess of bad assets in commercial banks that were increasing dramatically, the Central Bank strengthened the control and surveillance over the commercial banks and demanded that the ratio of all the commercial banks' bad assets should drop by 2-3% each year. It was the pressure above that made the commercial banks taking two countermeasures. The one was "rolling approach" to conceal the real bad assets artificially, which had in fact accumulated the potential of financial crisis; the other was "credit-reluctance", i.e., no loan could be made unless there was 100 per cent assurance of repayment, a practice which not only led to considerable interest losses for the more interest payment to deposits (but some of the loss was shifted to the Central Bank by increasing the bank deposit reserves), but also worsen the distress of SOEs, which would finally result in the loss of bank assets.

The large proportion of banks' bad assets was one of the major factors that caused the Asian financial storm in 1997-1998, which had stroked the economy of Thailand, Korea, Malaysia and Indonesia heavily. The financial sectors of China lucked out in the event due to some reasons such as the relatively closed financial market. However, it had inevitably borne the depression for several years. It can be seen in table 1-4 proportion of bad assets of the banks in China occupies the higher position among the Asian countries.

Table 1-4 Proportion of bad assets of bank in some countries/areas in Asia

Countries /areas	The Present Proportion (%)	The Top Proportion (%)	The ratio of top amount of bad assets to GDP (%)
Singapore	2.0	>8	9
Hong Kong	2.1	>8	13
India	17.0	15	4
Philippines	3.4	10~15	7
Malaysia	5.6	>20	28
China	20.0	>25	24
Indonesia	9.2	40	25

⁹ Liling, Lu and Shenyang, Debt-treatment in Reorganizing State-owned Enterprises, the Press of Economics science, 1997, Page 16-17.

Korea	14.0	>25	34
Thailand	18.0	>25	40

From: IMF, Goldman Sachs.¹⁰

Since there are still much various instable elements in the economy of the world at present, it is appealed by some specialists that we should not underestimate the potential of global financial turbulence, even crisis that is likely to break out in coming years. Therefore, to ensure the development of the stable and healthy economy of China in the future, it is of great significance to take efforts to solve the problem of distress of SOEs and improve the quality of banks' assets.

II. The Steps in Treating SOE Distress

Realizing the great negative impact of SOEs' high indebtedness on national economic development and institutional innovation in state-owned sector, the government determines to resolve the problems of the large bad debts and hoped to resolve three problems as debts, redundancy and the cost associated with the "social function" together through the debts-restructuring of the national economy, so as to make substantive progress in the reform of the SOEs and the financial system, achieve the strategic adjustment of state-owned sector, establish and develop the socialist market economy.

1. Liquidation of Chain Debts

In fact, it was the third quarter in 1988 when Chinese government began to make great effort to liquidate the SOEs' debts macroscopically, and as the leaders the local government and professional bank liquidated the chain debts in great scope. After 1990, the Chain Debts' Liquidation Office set up in the State Council had used many administrative methods and a great deal of the debts' liquidation fund injected by the finance and banks(the fund reached RMB 33.05 billion just in 1991) so as to undo the debt chain in turn. The organized central administrative policy of debts' liquidation gained some effects in a short term (for example, in 1991 the fund of RMB 1 could liquidate the payment in arrears of RMB 4.1yuan). However, as the complexity of the debt foundation were underestimated, the stopgap measures could not prevent the new debt chain from emerging, and the administrative liquidation of debts has turned into administrative financing in some extent. As a result, the People's Bank of China stops the "financing for debts' liquidation" in 1993. But the Liquidation of Chain Debts has aroused the attention of the people to the issue of the enterprises' debts, and it became the start of study on the issue in the level of policy and law in China. Some market organizations set up in the Chain Debts' Liquidation such as the Credit Center of Debt Exchange in Liaoning Province are still taking certain effects in debts' liquidation now.

At present, it is still very serious in our country that the SOEs are in arrears with debt each other. There are great deals of account receivable and account payable recorded in almost every SOE, which could not be received or would not be paid for a long time. It is estimated that the

¹⁰ Quote from Jiashu, lei, Safety of Finance of China---the issue on the level of system and operation, the Press of Economics Science, 2000, Page 188.

debts of the SOEs in the country defaulted with each other have reached RMB 800 billion.¹¹

2. M&A and Bankruptcy under “Capital Structure Optimization Program” (CSOP)

In fact, debt restructuring in large scales by the central government began with the CSOP applied in 18 large pilot cities in 1994. Inspired with the success of practices of annexation since 1989, the central government promulgated a series of acts and regulations to implement the CSOP, which stressed the policies that bankruptcy should be normative, merger should be encouraged, and both of them would be favored in various area. It actually utilized several approaches synthetically such as going bankruptcy, being merged, and fiscal injecting, switching from appropriate loans (which came into being in the program of shifting from the previous fiscal allocation method to bank credit method) to investment. In addition, according to the policies, enterprises that bore the relatively heavy burden of debt and weren't qualified to be merged could reduce their employees, and interests of the enterprises owing to the banks could also be decreased. At the end of 1996, the appropriate loans switched to state-owned capital amounted to about RMB ¥24.2 billion, and that of special industries such as coal industry, military industry, water and electricity industry, etc. were handled only once. The annual funds used by the central government to recuperate the loss of SOEs amounted to RMB ¥30 or 40 billion.

Since July 1, 1994, the Measure of Supplement of SOEs' Working Fund was implemented in the pilot cities. It required the SOEs to use definite taxed profits for supplementing their working funds before drawing out surplus accumulation funds. Furthermore it required the financial departments to supply 15% of total income revenue turned in by the enterprises for supplementing their working funds. In fact, even 100% of the income taxes were returned to the SOEs in many cities. However, since the measure of supplement with the fiscal fund increase was implemented itself, the satisfactory result was not achieved in fact.

Proposal for Carrying out State Enterprise Bankruptcy in Some Cities (Guo Fa 1994 No. 59), issued by the State Council in October, 1994, stipulated that normative bankruptcy to the state-owned industrial enterprises (SIEs) in 18 pilot cities should be carried out in the direction of principle that the employee of the SIEs should be arranged first before the implementation of the bankruptcy. Moreover, many problems of the SIEs going bankruptcy were stipulated concretely in the notice, for instance, disposal of right to the use of land, insolvent properties, the employees, the credit loss of banks due to the bankruptcy, and undivided take-over, reorganization of the insolvent SIEs, organization and administration of implementation. It means that the central government decided to utilize right to the use of land owned by the state and the net assets increase (even stock) of SOBs to pay for those past debt through bankruptcy of the enterprises, which included the hidden debt such as annuities, compensation to give up the qualification of employee of SOEs, and other right based on the qualification, for example, the right of obtain employment again. The approach was: (1) to use the income of the sale of right to the use of land and insolvent properties to arrange the employee; (2) to write off the loss of the banks according to bad debt reserves write-off “quota” which were controlled and used by the People Bank of China (PBC) and STEC. In November 1994, Urgent Notice regarding Problems in Enterprise Bankruptcy Cases heard in the People's Courts, issued by the Supreme People's Court, stipulated

¹¹ Yunting, zhang, Debt-restructuring of State-owned Enterprises, the Shanghai Press of Finance and Economics, 2000, Page 138.

implementation of Guo Fa, 1994 No.59.¹² Thus, a set of procedure called as “Planned Bankruptcy” was in fact created out of the bankruptcy procedure of the current law.

The approach was gradually launched in the country. The number of pilot cities increased to 56 in 1996, and 111 in 1997; the amount of bad debt reserves write-off “quota” increased from RMB ¥ 7 billion in 1995 to 20 billion in 1996, and again from 30 billion in 1997 to 40 billion in 1998.

Meanwhile, the central government promulgated a series of normative decrees to stipulate concretely “Planned Bankruptcy” in the CSOP. Notice on Some Issues Arising in the Experiment of Merger and Bankruptcy of SOEs (Guo Jing Mao Qi 1996 No. 492), issued by SETC and PBOC in July, 1996, stipulated the mechanism of “merger and Bankruptcy; Employee Reduction and efficiency Increasing”, the rescue of insolvent SOEs, the preparation to bankruptcy with the government, arrangement of the employee, writing off the bad debts, the bankruptcy of domestic-foreign trade enterprises, coordination among the department of government. Moreover, it stipulated contentiously that property under mortgage could be used to settle the employee. Supplementary Notice on Problems Pertaining to the Trial Implementation of the State-Owned Enterprise Merger and Bankruptcy and Settlement of Employees in Certain Cities (Guo Fa, 1997 No. 10), issued by the State Council in March 1997, stipulated concretely organization and administration of experimental implementation, planning, examination and approval, the preparation to bankruptcy, assets evaluation, disposal of insolvent properties, settlement of the employees, the write-off of bad debts, investigation into the responsibility of bankruptcy, lay-off and separation, reduction and exemption of interests, and so on.¹³

It is need to be noticed that according to these documents merger of enterprises was emphasized as an important measure, which could cooperate with bankruptcy or operate itself. The mergers could be favored of the policies such as suspending debt of interests, exemption of

¹² Fa Fa, 1997 No. 2, Notice Regarding Notable Issues Pertaining to Current Enterprise Bankruptcy Cases heard in the People’s Courts, issued by Supreme People’s Court, further stipulated how to carry out the related decrees issued by the State Council.

¹³ The additional documents, Cai Gong zi 1996 No. 226, the Provisional Regulations of Several financial matters on Experimental Bankruptcy of SOEs, Issued by the Ministry of Finance; Guo Jing Mao Qi, 1997 No. 257, Circular on Assignment of Pre-allocation of Reservation to Write off the Bad Debts and Planning on Merger and Bankruptcy of Enterprises and Re-Employment, Issued by the State Economy and Trade Commission; Cai Ji Zi 1997 No.15, the Several Regulations on Repayment of Debts of the Central Budget Funds for Capital Construction by SOEs in Experimental Bankruptcy, Issued by the Ministry of Finance; Cai Gong Zi 1996 No. 224, the Notice of Several financial matters on Experimental Bankruptcy of SOEs, issued by the Ministry of Finance; Lao Bu Zi 1996 No.7, Notice on Ensuring the Living Standard of Workers of distressed State-Owned Enterprises, recuing themselves by producing and distributary and arrangement of the workers, issued the Ministry of Labor; Yin Fa, 1995 No. 130, Circular on Handling Bank Loans and Interest after Better-Performing SOEs are Encouraged and Supported to Merge Money-Losing State-Owned Industrial Productive Enterprises in 18 Pilot Cities, issued by the People’s Bank of China, SETC and Ministry of Finance; Cai Kuai Zi, 1995 No. 19, Circular on Handling the Account of Bank Loans and Interest after Better-Performing SOEs Merge Money-Losing State-Owned Industrial Productive Enterprises, issued by the Ministry of Finance; Lao Bu Fa, 1995 No.43, Notice on Applying the Project of Re-Employment, Issued by the Ministry of Labor; Guo Jing Mao Qi, 1995 No.184, Opinion on Separating Enterprises from Running Social Welfare Business and Distributing the Unwanted Persons in the Several Cities, Issued by the State Economy and Trade Commission, the State Education Commission, the Ministry of Labor, the Ministry of Finance, the Ministry of Sanitation; Guo Zi Fa, 1994 No.90, Notice on Ensuring Administration of State-Owned Assets in the Course of Bankruptcy of Enterprises, issued the State Administration of State-Owned Assets; Cai Shui Zi, 1994 No.001, Notice on favorable policies of income tax of Enterprises, Issued by the Ministry of Finance and the State Revenue Headquarters; Ti Gai Jing, 1989 No.38, Provisional Measures Governing Enterprise Merger, issued jointly by the State Commission for System Reform, the State Planning Commission, the Ministry of Finance, and the State Administration of State-Owned Assets, etc.

debt of interests, repayment before the income tax, extending credit maturity. Furthermore, the enterprises in the CSOP could be favored of the preference of writing off the debt according to the amount approved. In the local practice, many approaches such as “going bankruptcy in advance, then being merged”, “combining bankruptcy with mergers” (undivided mergers), “splitting in advance, then going bankruptcy” etc. were adopted to insolvent enterprises, which led to the little performed ratio of bank claims after the liquidation of the enterprises going bankrupt. Lack of the bad debts write-off “quotas” which was allocated administratively, the bad debts of banks increased dramatically. In the condition of the commercial banks’ claims, Guo Fa 1997 No. 10, discouraged the enterprises going bankrupt through undivided mergers, and reduced the number of enterprises going bankrupt, which did not involved in mergers or did not have the qualification of writing off the bad debts. Meanwhile, the document expanded the range of the cities in the CSOP and increased the write-off “quotas”, which in fact encouraged the merger while taking efforts to restrain the shirking responsibility for creditor through going bankrupt. Based on the debt-undertaken mergers, some mergers by market means such as cash-purchasing mergers, stock-absorbing mergers, and stock-holding mergers further emerged in the practices, which promoted the debt restructuring. Meanwhile, encouraged by the Guo Fa 1994 No. 59, the approach of split was widely used to effective assets of the enterprises.¹⁴ Of course, many cases lack of real restructuring and in violation of procedures took place soon. Therefore, Article 90th of Contract Law of the People’s Republic of China effected in October, 1999 stipulates explicitly and strictly the issue of assumption of debt obligations after the separation or mergers, which actually banned in shirking the responsibility for creditor through merger or separation.¹⁵

At the beginning of 1998, the State Council proposed that three years would be spent in reforming, reorganizing, transforming, and strengthening the management of the SOEs to relieve most of the loss-maker among large & middle-sized SOEs out of the distress. In Sep. 1999, it was put forward in the resolution about some major issues on reform and development of the SOEs, which is decided at the 4th plenary meeting of the 15th Central Committee of the Chinese Communist Party, that the bad debt write-off reserve fund of the bank would be increased to support merge and bankruptcy of the large & middle-sized SOEs, and close the mines with their resources exhausted, and lay particular stress on the significant industries. As a result, bankruptcy received more attention again. However, the CSOP for 1999-2000 was changed remarkably: The write-off quota was no longer fixed and the headquarters of the Big-Four banks were able to negotiate with the SETC to decide the list of the bankruptcy enterprises. The total of the write-off in fact was RMB 18 billion in 1999, which focus on the bankruptcy cases of the large loss-making SOEs.

It is indicated in the table1-5 that from 1994 to 1996, the number of the bankruptcy cases of

¹⁴Article 8th of Guo Fa 1994 No. 59 stipulates, “If the bankruptcy have been consented by the creditor(s) whose credit amount to more than two-third of the total debts of the enterprise and approved by the government of the county municipal district, where the insolvent enterprises were located, effective assets can be separated from the enterprise going bankruptcy. The enterprises established after the separation shall assume the debts of the old enterprise according to the agreed proportion.”

¹⁵ Article 90th of Contract Law of the People’s Republic of China effected in October, 1999 stipulates, “If one party to a contract is merged after the contract has been concluded the legal person or other organization established after the merger shall exercise the contract rights and perform the contract obligations. If one party is separated after the contract has been concluded, the legal persons or other organization thus established after the separation shall exercise the contract rights or assume the contract obligations jointly and severally except that the creditor and the debtor have agreed on it.”

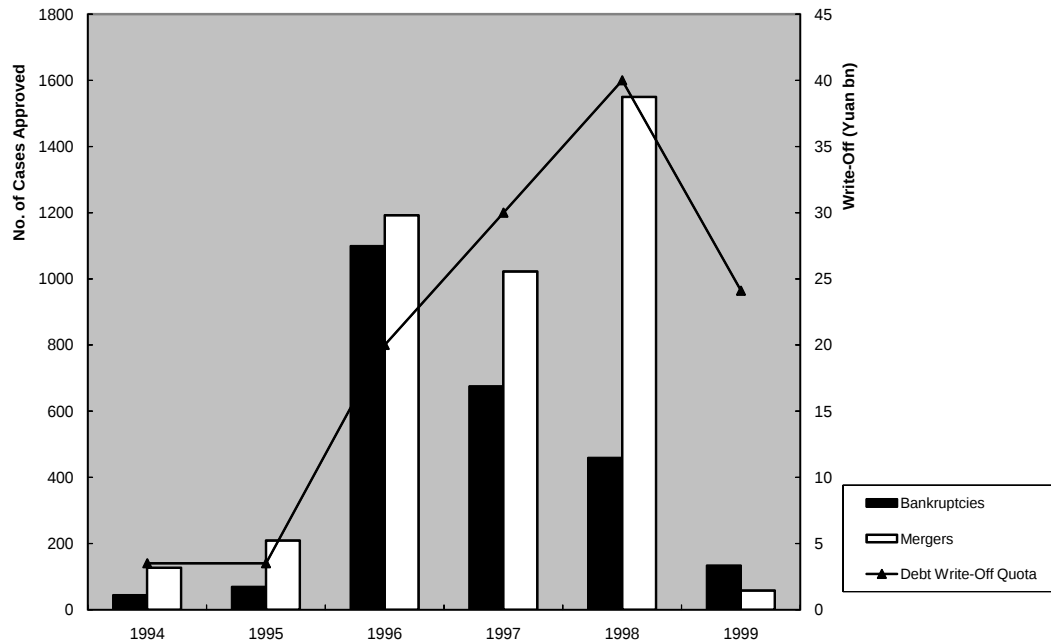
the SOEs tried in the courts all over the country increased like geometric series, while from 1997 to 1999, the number decreased in the stable aspect. The rapid growth in the first 3 years was due to the sudden deterioration of the state-owned enterprises' debts and losses at that time, while with the policy-covered pilot areas expanded, the number of the cases accepted by the courts did not increase yet in the last 3 years. It not only indicated the controlling action of "planned bankruptcy" in some degree, but also essentially indicated the limitations of the approach of bankruptcy to resolve the issue of the enterprises' debts. One of the limitations was the governmental finance's ability to write off bad debts and settle the staff and workers, and the other was the manpower and material resources that the courts could use to try the cases.

Table 1-5: Statistics of the Bankruptcy Cases Tried by the Courts All Over the Country:

Year	Number of the accepted cases	SOEs	Non-SOEs	Number of closed cases	SOEs	Non-SOEs
1989	98	—	—	36	—	—
1990	32	—	—	30	—	—
1991	117	—	—	57	—	—
1992	428	—	—	256	—	—
1993	478	171	307	—	—	—
1994	1625	635	990	1156	—	—
1995	2583	1232	1351	1938	—	—
1996	5875	3651	2224	4400	—	—
1997	5396	3060	2336	5697	3480	2217
1998	5673	3056	2517	6206	3380	2826
1999	5622	2886	2736	5313	2667	2646
2000	7219	3296	3293	5255	2654	2601
Total	35146	18617	15854	22471	12181	10290

Date from: the Statistics of the Supreme People's Court in Mar. 2001.

Table 1-6: Bankruptcies and Mergers under the CSOP 1994-99



On the basis of the data mastered by the SETC, there were 3365 SOEs all over the country from 1996 to 2000 which went bankrupt according to the CSOP, while the number of the settled bankruptcy cases of SOEs all over the country reached 12181 from 1997 to 2000. It means that more than 70% of the SOEs' bankruptcy was not implemented according to the CSOP and it is limited of the capacity of the Planned Bankruptcy in controlling the scale of the SOEs' bankruptcy.

In the process of enforcement of the Planned Bankruptcy, the system of bank has showed their discontent vigorously. In Nov. 1996, it was pointed at the joint meeting of presidents on management of financial credits in the country that according to the investigation of 145 bankruptcy cases of the state-owned enterprises of 35 provinces, the general debt-to-assets ratio were much high (it was about 165%) while the general rate of payment was very low (the average rate in name was only 9.2%), in which the state-owned banks suffered the heaviest losses. The outstanding problems reported in the meeting were that: (1) the enterprises bankruptcy had gone beyond the stipulated area, and the bankruptcy took place everywhere; (2) the local protection was so serious that it had damaged the legal right of the creditors; (3) the methods of artificially going bankruptcy and truly dodging creditors such as "splitting in advance, then going bankruptcy" and "division between the new enterprises and old ones" emerged in the enterprises bankruptcy; (4) the drain on the state-owned assets was serious; (5) the costs for the bankruptcy is too expensive. Then it was proposed at the meeting that we must explore actively a specific method of the restructuring of the enterprises' assets in which the creditors can participate out of the bankruptcy procedure, and encourage continually more merger and less bankruptcy. And it was also pointed in the meeting that it wasn't a reasonable method for the bank to pay for all the cost of the enterprises' reform and we need to research actively and seek for a new way of the finance department and the

enterprises' investors, together with the banks to pay for the cost of the enterprises' reform.¹⁶

In Mar.2001, the World Bank issued a reporter named as the Research of the Bankruptcy of State-owned Enterprises of China ---the Necessity and Way to Reform the System of Bankruptcy. The reporter analyzed the existed problems in the system of the enterprises bankruptcy in effect in our country and put forward 29 recommendations for reform. One of the recommendations is, "The legal framework for conventional *workout practices* should be strengthened to make it easier for banks to engage in rationalized debt treatment, such as maturity extensions and reductions of loan principal ("haircuts"), to help avoid the bankruptcy of potentially viable firms."

3. The Enterprises' Seeking for Approaches of Debt Restructuring

Requiring to explore approaches of debt restructuring, Guo Fa 1994 No. 59 stipulated that the government of the county or municipal district of the insolvent enterprises could restructure the enterprises with the measures of reorganizing the managers, changing the form of the operation of the assets of enterprises, guiding the adjustment of the structure of enterprises. According to the relatively common approaches, the basic idea of debt restructuring of enterprises is to start from two channels of stock adjustment and injection of increase.

At first, for adjustment of debt stock, "emphasis should be given on clearing up system related arrears through various forms of debt to equity conversion adopted within the state economy (mainly for debts due to the finance, enterprises or employees) in order to reactivate stock assets of state-owned enterprises".¹⁷ There were several main approaches in the practices such as converting the fiscal debts into equity (switching from appropriate loans to investments, converting loans arranged by municipal financial department and local taxes in arrears that enterprises owe to localities into state equity capital injected into enterprises), converting funds raised from employee into employee-hold internal stocks, converting the inter-related enterprises debts into equity, suspending repayment of certain bad debt and interests, separating non-business assets from the enterprises and entrusting them to a trustee organization, transferring the claims of banks at a discount or writing off the debts directly.

In the second, while injecting new capitals we should attach importance to establishment of new mechanism and carry out system renovation, and promote coordinated reform. There were several main approaches in the practices such as entrusting the debt, seeking for listing through reorganization of enterprises, raising State-owned Enterprise Promoting Fund, promoting actively the transfer of state property.

During the period, the local governments explored hardily and developed some additional approaches such as:

(1) Entrustment of debt. There were several practices of entrustment such as Hainan approach of the governmental trustee, Guangfayuan approach of management of the trustee of non-bank financial institutions, Xian experience of the trustee of institutions incorporated by intermediate investment organizations, Jiangxi experience that the money-losing enterprises were entrusted to

¹⁶ The Accessories of Yin Fa, 1996 No.413, Notice on issuing "the Summary of the joint meeting of presidents on management of financial credits in the country", Issued by the People Bank of China.

¹⁷ Tangjian, Types and Cases on Assets Restructuring of enterprises of China, the Press of Shicuan University, 1998, Page 160. And refer to: Study on Debt-restructuring of State-owned Sector in China, the China Press of Finance, January 1997.

better-performing SOEs in advance, then merged by the better-performing SOEs etc.¹⁸

(2) Converting debt owing to employee into employee-hold internal stocks. For example, not only the debt such as wages, welfare, bonus, funds for the welfare of employee, funds for commonweal could be converted into stocks, but also the debt of funds rose from employee, deposits for risk, and a sum of money rose from the employee to pay for the debt of the enterprises.¹⁹

(3) Freezing the debt. The government promised to use the income of assets (including the receivable income of public finance) to repay the frozen debts. It was known as the approach of Shouguan in Guangdong province in 1996, which require solidifying the debts and reconstructing the mechanism.²⁰

(4) Negotiation in the market. In the coordination of the government, multiple parties assumed the debts according to the agreed amount and manner.²¹ The case occurred in Taian, Shandong province.

(5) Transferring the claims of bank through the others. It was known as “the Return and Sale of the Mortgaged Assets” (RSMA) in the case of the factory of monosodium glutamate in Jinan, Guangdong province in 1996.²²

In the result of instruction of central government and efforts of the related parties, the debt-to-assets ratio of the SOEs declined to 64.41% in 1998 by year (The listing of some SOEs, joint investment of the non-SOEs, cooperation with non-SOEs, collectivization of SOEs, sale of the medium & small-sized SOEs contributed to the decline). However, the debt-to-assets ratio in the old industry districts remains high, the situation of the loss of the SOEs is still serious, and especially the assets of banks keep on deteriorating.

According the above, in order to settle the bad debts once for all and decrease the debt-to-assets ratio of the enterprises, most of debt restructuring in the phase in China were initiated or driven by the department of the government in charge of the enterprises, which tried their best to utilize governmental resources and policy tools to adjust the relationship of claims and debts among financial department, banks, state management company, enterprises and the employee. However, the future income and efficiency after the restructuring were not taken into account in most of the approaches, and the banks lack of the participant enthusiasm often bore the net loss of the

¹⁸ Reference to Yunting, Zhang, Debt-restructuring of State-owned Enterprises, the Shanghai Press of Finance and Economics, 2000, Page215-217; Tangjian, Types and Cases on Assets Restructuring of enterprises of China, the Press of Shicuan University,1998, Page 166; the financial institution of PBC: Debt Restructuring of SOEs and Assets Protection of Banks, the Press of Economics science, 1998, Page153.

¹⁹ Reference to Yunting, Zhang, Debt-restructuring of State-owned Enterprises, the Shanghai Press of Finance and Economics, 2000, Page140-142.

²⁰ Yousheng, Li, etc., Practices of Assets and Debt Restructuring Operation of SOEs, the Shenyang Press, 1998, Page 260-264.

²¹ Reference to Yunting, Zhang, Debt-restructuring of State-owned Enterprises, the Shanghai Press of Finance and Economics, 2000, Page237-243; Fulin,Chi, Reform of SOEs and debts, the Foreign Language Press, 1998, Page 210-212. In the case of foreign trade corporation of livestock product in Taian, Shandong, the bank , the enterprises and the government agreed to restructure the debts of the enterprises through the approach of “one part of stock assets reactivated, one part of stock assets discharged, the other part of stock assets written off”, which means that the debt of RMB ¥6 million was set on assets revived by separation, the debt of RMB ¥1.5 million was repaid through bankruptcy distribution, and the other debt of RMB ¥15 million was written off with the approval.

²² the financial institution of PBC, Debt Restructuring of SOEs and Assets Protection of Banks, the Press of Economics science, 1998, Page247-253. The RSMA is the bank transfers the effective assets to third party, who was mortgaged when the enterprise was loaned, and the third party assumes the secured debt.

restructuring passively, not only in the normative restructuring, but also in the less normative restructuring. In this period, debt restructuring of the enterprises were prone to transfer the cost of rescue to the banks. It is common that the restructuring was short of the transparency and the mechanism of negotiation with bank creditors, which was in some degree accelerated by the inimical attitude and mechanism of overdue self-protection of banks.

In short, the passive opinions of the banks to the above approaches of the restructuring of SOEs were more than the positive ones. In 1998, the financial institution of PBC cooperated with subsidiary bank in 16 provinces, and published the report of Debt Restructuring of SOEs and Assets Protection of Banks. Based on the survey of more than 100 plants, five characters of negative impact of the debt restructuring of SOEs were concluded in the report: (1) the passive position of banks in fact increased the difficulties of assets protection of banks; (2) the approaches of debt restructuring were used to suspend and shirk or default the claims of banks; (3) sometimes the debt-to-assets ratio after the restructuring remained high, and the risk of banks' assets didn't decline but increased; (4) Since the abilities of performing of some of the SOEs were not reinforced yet after the restructuring, the assets level of banks didn't increase but declined; (5) the ratio of the banks' assets performed was very little, and it led to great losses of banks. In addition, there are several advisable suggestions in the report on the policy. For instance, it advised two basic points to assist to corporation of enterprises and to protect the assets of banks; it also advised that bad loans should be assumed and transformed by government, enterprises, and banks jointly; it further proposal to expand and diversify ways of activation and transformation of the existing risks of credit assets.²³

4. The Centralized Treatment of the Bad Assets of State-Owned Banks (SOBs)

Affected by the Asian Financial Storm, the central government in 1998 began to put the stress of the Debts-restructuring on the Bank-restructuring in order to resolve the bank's bad assets which accounted for 20-25% of the bank's total assets and came into being upon implementation of reform policies. Meanwhile, with the enterprises' restructuring, a series of policies were carried out, such as promoting moderately the host bank system, debt for equity swap, etc.

In the impact of the expansionary public finance policies these years, the capacity and the structure of debt of the central government which has been shaped over short times have made people anxious. The finance recourses which can be used directly for relieving the distress enterprises and restructuring the bank are very limited, and in the binding of the law it is not as rapid and effective as before any more to dispatch the non-finance recourses through administrative measures. In 1998, the Finance Ministry issued special state-bond of RMB 260 billion in order to make up one half of the bad debts of the four commercial banks in the year. After that, Finance Ministry invested RMB 40 billion in 1999 to set up four Financial Assets Management Companies (FAMCs) to take over RMB 1396.9 billion of bad assets (in book value) stripped from related state-owned commercial banks, which was loaned before the end of 1995. The Finance Ministry hoped that the AMC could promote the reform and relief of the SOEs while reviving the bad assets. It was virtually the beginning of using the state stock assets (bank recourses) in large scale.

²³ The financial institution of PBC, Debt Restructuring of SOEs and Assets Protection of Banks, the Press of Economics Science, 1998, Page10-12.

Among the 601 enterprises recommended to the FAMC and Development Bank by SETC, there are 508 enterprises decided to carry out debt for equity swap, and the total number of the debt amounted to RMB 405 billion and accounted for 29% of the loans (worthy of RMB 1393.9 billion) stripped from the commercial banks and the Development Bank. By the end of the first half of 2001, the State Council have approved of 483 enterprises to carry out the debt for equity swap after the joint examination of SETC, Finance Ministry and the People's Bank of China. The total of the involved debt for equity swap amounted to RMB 294 billion. And there are 60 new companies among the upfront enterprises that have been registered in accordance with the law.²⁴

Due in march 2005, the four AMCs had disposed RMB 688.55 billion of the negative assets in total cumulatively, with RMB 140.89 billion of collection of cash as 20.46% of the whole disposed.

However, in the debt for equity swap which like administrative planning, it is 90% of the agreement that required the enterprises to buyback all the stock equity in 5-7 years and the local governments to promise to separate the enterprises from the function of running the social welfare business. But in fact these demands are difficult to be carried into execution. However, with the primary business goal of preserving the assets and decreasing the losses as further as possible, the FAMC made great efforts to take over and deal with the bank's bad assets with the strong support of the central government. In Nov.2000, The Rule of the Finance Assets Management Company issued by the State Council strengthened the status of the AMC in the aspects of the business scope, the preferential policies and the protection of the legal right. Moreover, the headquarters of each commercial bank had the right to decide and use the most reserve fund of the bad debts themselves with the modification of the CSOP in 1999. This stock of provisions is through tax regulations the Finance Ministry made the limitation flexible at the beginning of 2001, which was that the reserve of the bad debts must be effectively capped at 1% of the portfolio. The commercialization of the state finance creditors built up their incentives of participating in the enterprises' debt restructuring, strengthen their status in the enterprises' debt restructuring and promote the market operation of such aspects as the capital recourses of the debt restructuring, the adjustment of the debt relationship, the decreasing and sharing of the losses in the restructuring, and the dispersing the losses after the restructuring. For example, Shanghai Branch of the Bank of China set a precedent that a state-owned bank transfers its claims to a joint-stock bank when it transferred its 100 million of claims based on loan contract to Shanghai Branch of Guangdong Development Bank in August 1998. The instance of the claim auction and judicial auction of incorporated stock also took place in shanghai. At the same time, in accordance with the high growth of the citizens' income and deposit in China in the past 20 years, the central government continuously developed the capital market, encouraged the enterprises to finance directly, and let the nongovernmental capital to help the unlisted enterprises which had good benefit and potential of development but had been bothered by the high indebtedness. For example, Nanning Chemical Co. Ltd. as the first unlisted company issued 150 million convertible bonds formally in Aug.1998.

There was another question in the upfront debt for equity swap as an administrative planning that the area of application is most limited. There were more than 100 thousand SOEs all over the country, but the number of the enterprises, which could carry out the debt for equity swap, was less than 5%. Ten thousands of the middle and small-sized local enterprises would not want to

²⁴ Industrial Policy Department of SETC, the Progress in the Implementation of the Debt for Equity Swap, in Economy and Trade Guidance of China, 8th 2001, Page 12.

wait for death. The local finance resource was also limited because the local governments had no right to issue the public bond. Restricted and guided by the laws and policies, many localities had to seek for the flexible approaches to handle individual cases within the framework of the law in accordance with the debt structure of each enterprise. Enterprises and governments began to attach importance to the interests of the financial creditors and divert their attention on the capital market and title market, while emphasizing on the satisfaction of the society's claim such as the claim of the staff and workers to be settled. Some localities then were not confined to one-off settling of debts any more, and turned to seek actively for the optimization of assets, expansion of capital and long-term benefit together with the creditors. Sometimes the participants of the restructuring included the investors which were not native to the locality such as foreign businessmen and nonnative businessmen. As a result, some new approaches of debts restructuring came into being.

5. Marketized Treatment of the Distressed SOEs: Changchun Approach

Background of Changchun approach

Changchun is a major industrial city with the majority of SOEs and assets in Northeast China. For a long time, the local SOE endured their hard time because of over-weighted debt burden, redundant workers, low quality assets, inflexible management system, outdated technology and equipment. And the over-weighted debt burden is the key factor to hinder the enterprises from reorganizing assets, getting new technology and improving management system. But among their fixed assets many Changchun's SOE have profitable assets which can produce marketable goods. Only because of their over-weighted debt burden and lack of money, the SOE can do nothing but put the profitable assets aside. Thus the SOE are in insolvency, the trademarks and names of the SOE are forgotten, the market resources are lost. At the end, the unavoidable consequence is no assets, bankruptcy, unemployment, and non-discharged credits.

In 1995, Changchun began to look for methods to rescue the profitable assets in insolvent SOE. At the beginning, Changchun used administrative power to separate the profitable assets from the old enterprise with no consideration and started up a new company. But they quickly found that the profitable assets did not run out of the binding of the old enterprise's debts under Chinese law. Thus, the way was closed. In 1996, a new way, so-called "Purchase-Sale Restructuring" (PSR), came to our eyes. With the mediation of Changchun Government, some SOE negotiated with banks (the main creditors) for rescuing the profitable assets and reorganizing debts of the SOE. There were some successful cases after 1997.

In 1999, with researching and summing up the past, Changchun made three principles in assets and debt reorganization: first, commercialization of capital flow; second, assets transfer operated in accordance with to lawful process; third, negotiation with creditors constructively and protection of creditors' interests at the highest degree. Following the principles, the whole approach gradually formed. Before July 2001, there were about 40 Changchun's SOEs adopted the method to reorganize themselves and some of these were successful. Therefore, the creative practice of enterprise rescue, so-called locally "PSR" and nationally "Changchun Approach", began attracting eyes of China as well as the world. In July 2001, a team composed of scholars and specialists from Beijing and Hong Kong investigated and discussed "Changchun Approach" in Changchun City. Before this, a paper on "Changchun Approach" received attention and positive comments at an international forum in Vancouver, Canada.

The Basic Features of “Purchase-Sale Restructuring”

Based on our research of typical cases and description by Changchun Government, some banks and enterprises, we can sum up the basic points of PSR in Changchun as follows:

- The old enterprise who will adopt PSR shall be a SOE which is in insolvency but has profitable assets by which profits can produce.
- Before PSR, the government should start a new company, usually a wholly stated-owned company. The investment is often in money, sometimes plus land using right. After assets transaction, the company will gradually covert into a multiple-shareholder company.
- The new company purchases profitable assets from the old enterprise. A relatively representative transaction arrangement is that the new company and the old enterprise enter into an agreement with major creditor, usually a bank holding 3/5 of the total claims to the old enterprise. This agreement focuses on profitable assets assessment, assets purchase and debt discharge. The outline of the agreement can be illustrated in Chart 2-1. The transaction shows thereby mainly including four stages: (1) the bank provides a loan to the new company to buy the profitable assets in the old enterprise, and the quantity of the loan is almost equal to the assessment price of the profitable assets. (2) The old enterprise assigned its profitable assets to the new company at contractual price. (3)The new company gives consideration to the old enterprise by the loan provided by bank. (4) The old enterprise uses the gotten money to discharge debt to the bank.

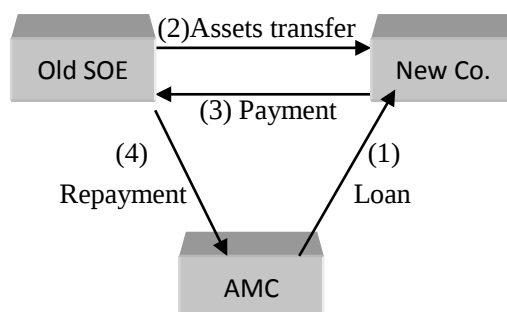


Chart 2-1 Assets Transaction Arrangement in PSR

- In the practice of the above assets transaction, the following measures usually are taken:
 - ◇ Assessing the old enterprise at every aspect, mainly at profitable assets and product market. The decided enterprise shall present a plan of reorganization. And the plan shall be discussed by some relative government departments.
 - ◇ Abiding by law strictly in assets transaction. Firstly, the assessment of profitable assets shall be done by an authorized body. And the assessment result shall get consent of the Administration of State-owned Assets and the creditor (usually the main creditor). Secondly, the plan shall get consent of the workers’ congress of the old enterprise. Thirdly, the transaction shall be done in the Center of Title Transaction. After the agreement is in effect, both parties should deliver assets and money to each other according to the list of assets assessment.

- ◇ Resolving the problems of workers' thoughts by the Communist Party of China and the Trade Union to acquire workers' back and participation.
- The majority of workers of the old enterprise turn into the workers of the new company. And labor contract between the new company and the workers should be concluded.
- The new company gets current money from various ways and uses the assigned profitable assets to produce marketable goods. Thereafter, it shall reform its property right system and convert itself into a multi-shareholder enterprise such as share-issuing enterprise, shareholding-cooperative enterprise, enterprise group, Sino-Foreign joint venture and cooperative enterprise.
- Proper disposition of the old enterprise's residual assets. To those who have no capacity of operation, bankruptcy should be conducted. To those who still have capacity of operation, they need not to meet their end. The new company may have the old enterprise to do some auxiliary work as support or reorganize it at proper time.

The Effects of "Purchase-Sale Restructuring"

We can see that Changchun's PSR has achieved "multi-win" for debtors, local government and main creditors. In general, the reorganization's effects are as follows:

- (1) The profitable assets are relieved from the debts of the old enterprise and continue to operate and earn profits. And the new company who enjoys better goodwill and financial ability can operate the profitable assets well and enlarge itself by issuing shares, achieving foreign investment, merger, etc.
- (2) The bank, as the main creditor, has new claims to the new company by issuing a loan. And the claims are believed high-class. At the same time, the bank eliminates a part of bad credits with the equal quantity to the loan by the old enterprise's discharge. Thus the bank was repaid much more than that acquired through the old enterprise's bankruptcy with its profitable assets (often 0-10% of total credits).
- (3) The employees of the old enterprise do not endure unemployment and their wages in the new company are usually higher than before.
- (4) With much less money, the government fulfills renewal of state-owned assets, maintenance of employment, social stability and can get tax from the new company.
- (5) After restructuring the old enterprises went into judicial proceedings of bankruptcy liquidation and the state capital drop out of the new companies, by the state shares assigned to the workers in return for discharging the relationship of state employment and, in addition, assigned to investors in the market.

Improved Model of "Purchase-Sale Restructuring"

In 2001-2002 the SETC organized the research to summarize the experience of SOE debt restructuring. Then the Changchun Approach was generalized nationwide.²⁵ Various improved models appeared in practice on the basis of the idea in the approach. There are some examples shown below.

Improved Model 1. The feature of "Sale-Purchase Restructuring" (PSR) in Changchun City is that the assets floating makes debts changed. Thus this model is improvable and adoptable when the main creditor is not a bank but a business or an assets management company (AMC). The

²⁵ See, Zhou Fangsheng, *The Debt Work-Out for SOEs in China*, Peking University Press, 2003.

following Chart 2-2 is an improved model that can be adopted by an AMC (or by a business creditor).

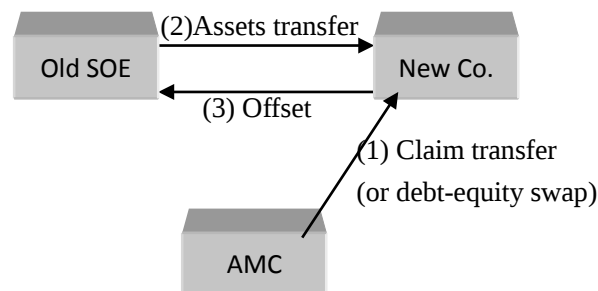


Chart 2-2 Improved scheme for PSR assets transactions (1)

The transaction showing in the above Chart mainly includes three steps: (1) The AMC transfers its claim to the old enterprise to the new company at an assessed price. And the new company will deliver part or whole payment at a future time or convert the assigned claim into equity shares. (2) The old enterprise transfers its profitable assets to the new company at a contractual price. (3) The new company makes the assigned claim and the payment to the old enterprise in assets transaction offset.

Improved Model 2. Based on Chart 3-1 and Chart 2-1, we can form Chart 3-1 as another transaction model: the bank transfers its part claim to an AMC; the AMC converts the assigned claim into equity shares of the new company according to Chart 2-3; the bank's test claim can be disposed according to the method in Chart 2-1. The advantages of this transaction arrangement are that: first, it can make a great number of profitable assets relieved; second, the bank gets a higher rate of discharged claim with less money; third, the new company has less debt burden after the transaction. This arrangement is suitable to the large and old enterprise that has a great number of profitable assets.

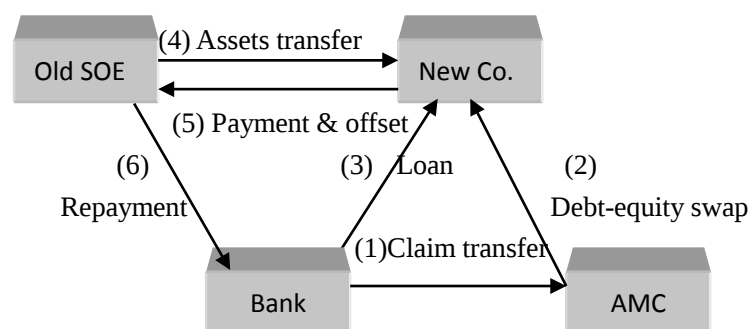


Chart 2-3 Improved scheme for PSR assets transactions (2)

Improved Model 3. Based on Chart 2-3, the old enterprise can pay the compensation of status-conversion to its employees in profitable assets, and the employees convert those profitable assets into equity shares of the new company. Thus the following Chart 2-4 is formed. This arrangement reduces the cost of assigned assets and betters the new company's financial structure. On the other hand, it protects the employees (including those who do not join the new company) and reduces the burden of government in settling workers.

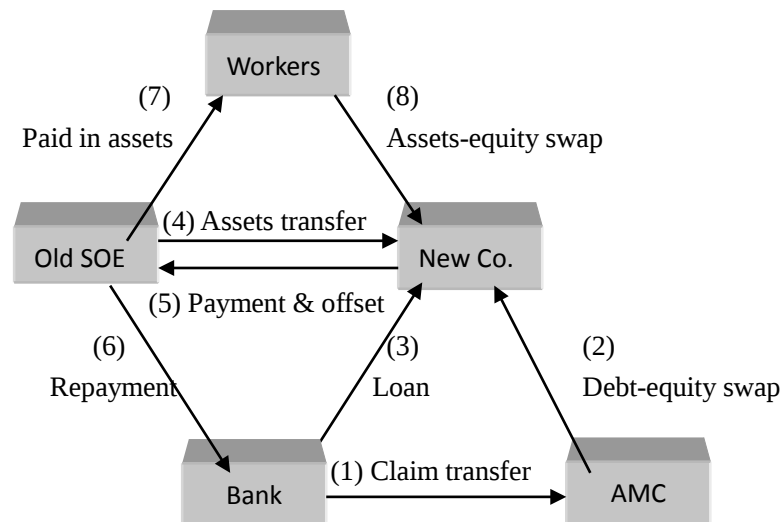


Chart 2-4 Improved scheme for PSR assets transactions (3)

Improved Model 4. If we substitute “business creditors” for “employees” in Chart 2-4, it is also practicable. If adding “business creditors”, we can get Chart 2-5.

Besides the advantages of the above three models, Model 4 has another advantage. That is that all creditors can participate in the restructuring transaction and get relatively fair treatment. Thus they all benefit from the rescue of profitable assets in the old enterprise.

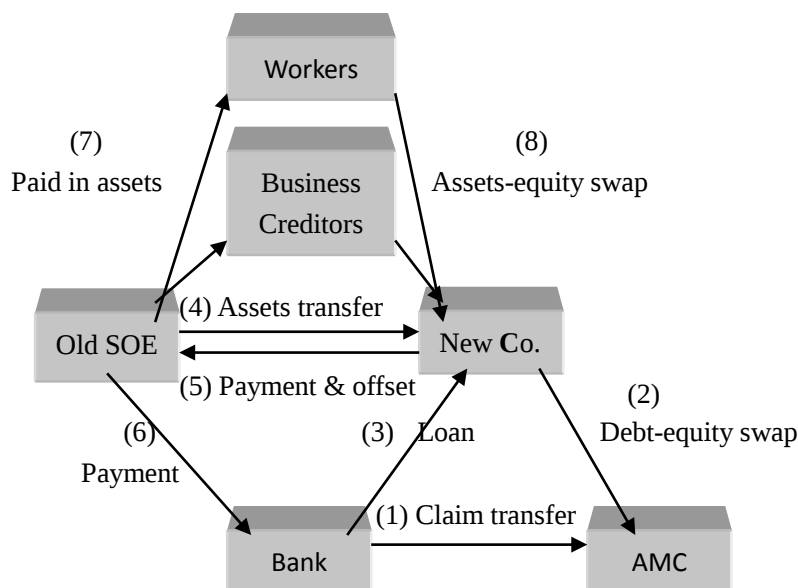


Chart 2-5 Improved scheme for PSR assets transactions (4)

Improved Model 5. When there are lots of small creditors, in order to reduce the negotiation cost and protect them in the restructuring transaction, we design a transaction arrangement showed in the following Chart 2-6.

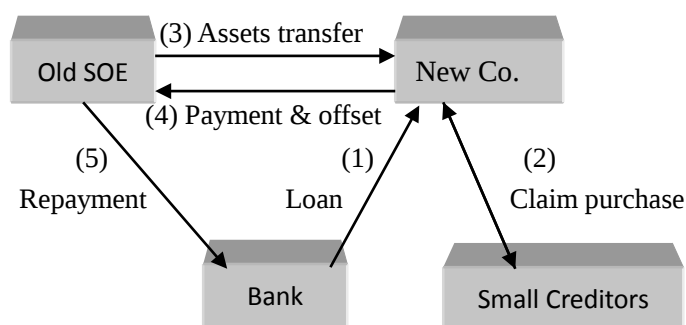


Chart 2-6 Improved scheme for PSR assets transactions (5)

In the above transaction, the bank provides two loans to the new company. One is used as a part of payment for buying the profitable assets from the old enterprise (and the latter will use this payment to discharge its debt to the bank). The other is used to buy the small creditors' claims at a discount (the discount percentage can be made according to the discharged claim rate which would gotten if the old enterprise were bankrupt). Then the new company enables those assigned claims to offset the rest part of payment for buying the profitable assets. The latter loan can be given to an intermediary institution, and then the institution allocates it among the small creditors according to their own individual percentage of the total transacted claims. For instance, if the old enterprise has profitable assets of 50,000,000, the total small claims are 20,000,000 and the discharged claim rate in bankruptcy is 15%, thus the new company will borrow two loans of 50,000,000 totally from the bank. And one loan of 47,000,000 will pay to the old enterprise (the latter will then pay it to the bank) and the other loan will pay to the small creditors. This model can be combined with Model 3 and Model 4 when used.

Improved Model 6. In the case of purchaser that usually is large-sized enterprise(s) or foreign consortium(s), the bank loans to the purchaser, and the loan and other assets are invested to form a new company that will then carry out the debt restructuring of the old enterprise according to the above arrangement. There is often advantage in decreasing the liabilities of the new company greatly and giving the new loans of the bank more reliable guarantee of repayment based on the assets of the purchaser. To the purchaser, the cost of the purchase will be much less than that of the direct merger. The picture 2-7 is an arrangement of trade improved on the basis of the fifth improved model, and the same change can also apply to the other models.

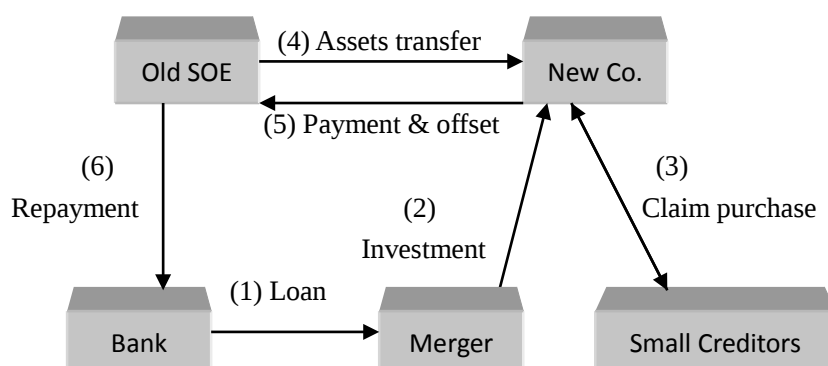


图 2-5 Improved scheme for PSR assets transactions (6)

Other Addible Factors. The following factors might be added to the above models:

- The government's investment of money and land using right.
- The government obtains the profitable assets from the old SOE as repayment financial loans and converts them into investment in the new company.
- Claim transfer among creditors.
- The new company rents some of the surplus assets from the old SOE with the grant of right of preemption.
- The new company leases the government-invested land use right to the old SOE and use the rental as the means to set off the consideration for renting the latter's assets.
- The third person's participation in restructuring transactions by purchasing claims to the old SOE.
- The third person's participation in restructuring transactions by purchasing claims or share rights to the new company.

Furthermore, some steps shown in the above Charts can be omitted or modified. For instance, if sufficient profitable assets can transfer to the new company by virtue of "claim→assets→equity" method and all of bank claims are disposed by AMC according to Chart 3-1, thus the starting step by a loan from bank can be omitted in "sale-purchase" transaction.

The Application of Trust System. The Trust Law of the People's Republic of China issued recently will take into effect on October 1, 2001. Trust system established by the Law proposes new approaches of the enterprises' debt restructuring in suspending the claims, exercising the rights of creditors collectively, and separating the effective assets. Concretely, there are at least approaches as following:

- *Assets trust of and claim trust in the restructuring transactions.* Based on the unanimity or majority resolution of the creditors, the enterprise debtor can entrust the effective assets to a trustee and appoints the creditors the beneficiary, while the creditor can entrust the credits to another trustee appointing itself as the beneficiary. Managers or the new team of managers of the old enterprise will run the effective assets as the trustee or the employee hired by the trustee. For the effective assets have the independent status of trust estate and have been distinguished from the other assets and civil liability of the trustor i.e. the old enterprise, the effective assets will never be the objectives of individual recourse and enforcement of the creditor. And in the meantime the credits will also be out of the control of the trustor and the creditor after the claims are entrusted to the trustee so that the creditors can't exercise the rights individually. Thus, a system of collective payment will come into being and the unfair payment led to the preemptive strategy of individual creditor can be avoided.
- *Trust of rights in the Restructuring negotiation.* During the negotiation of the Restructuring (whatever the model adopted in the end), the medium and small-sized creditors may entrust their claims to an intermediary institution that will independently participate in the negotiation, decide the concession, and sign on the agreement. There is often advantage to the medium and small-sized creditors in reducing the cost of the negotiation and strengthening the position of their negotiation. Meanwhile, it also facilitates the dialogue between the debtor and the major and medium and small-sized creditors, increase the efficiency of the workout process. This approach usually comprises of part of the above trust of the claims, and sometimes can be also exercises itself. The participants of the trust may not be the whole or majority of the creditors and

it can also be applied in the case of one or more creditors included in the trust. Additionally, the owner of the enterprise may entrust the enterprise to a company or intermediary institution that will take over the assets and the liabilities and negotiate with the creditors based upon that.

- *The method of trust can also be flexibly applied to the above models.* For instance, the equity of the employee in the picture 3-3 and 3-4 can be entrusted to the trustee, and the approach of trust can also apply to the trade of the purchase of small claims in the picture 3-5 and 3-6, which means that the small creditor entrusts to the trustee and the trustee negotiates with the new company and distributes the money paid for the transfer of claims according to the related share.

III. Comparison of Different Approaches

The Chinese approaches to debt restructuring in 1990s may be categorized into three types. The first is based on reduction of debts, the second is based on injection of assets and the third is based on transactions of assets.

1. The restructuring mode focused on reduction of debts

The restructuring mode focused on the debt pay attention to the existing debt of the enterprise, and it try to make the enterprise revive by decreasing or clearing up the debt. The main methods of this approach include administrative pay-off, put in assets to write off the debt, debt transformation and bankruptcy liquidation.

Administrative pay-off. It refers to that the administrative organ of the each level encourage the special banks and state own enterprises concentrate on clear up the inter-enterprises debts and the debts between the banks and the enterprises with plan and organization, step by step, in a certain period. The most typical method was the clearing up the triangle debts of China in the end of the 1980's and in the early of the 1990's. Although this method can quickly clear up a series of debts with a concentrated effort in a certain period of time, it may relax the restriction of the enterprise budget. And it may make the enterprise develop the idea that it is good to be in arrears and it is a loss to pay the debt, and the tendency to depend on the public finance. As a result, it led to a new large scale of debt accumulation.

Putting in fund to write off the debts. It refers to that the public finance and banks use the state inventory capital to share the accumulated debts. For example, the state bank draws the reserve for bad debts and doubtful debts to write off the bad debts; the government returns the taxes that the enterprise turned over to replenish the debt repayment fund. These methods have some help to resolve the question of the enterprise debt in a particle scope, but the utilities are limited. Firstly, the amount of the bank reserve for bad debt and doubtful debts is small. It must be used to cope with the bad debt caused by the bankruptcy of the enterprise at first. With a lot of enterprises bankruptcy, the bank has no sufficient assets to actively discharge the enterprise debt. Secondly, the room of the financial input is very small, for the

reason that most local finance is income falling short of expenditure. And many enterprises in distress are at a loss and stop producing for a long time, so there aren't taxes to be returned. Moreover, too many financial in-put may be cause the question of soften restriction.

Debt transformation. It includes "debt-equity swap" and "debt-debt swap".

There are four methods of debt trading, as follows:

(1) The bank debt is changed into stock .The four financial assets management corporations have begin to do this job from 1999;

(2) The inter-enterprises debts are changed into stock. This is a debt disposal method adopting the market principle, and it has a full development potential. Now, the case of adopting this method to resolve the inter-enterprises debts is a few.

(3) Changing the debt of the insider workers and staff into stock. Change the wages that enterprise owed the workers and staff, and the composition for changing the statue of the state own enterprise permanent staff, into stock, and the insider workers and staff hold stock. It is the measure taken by the enterprises in difficulties to decrease the debts, when the enterprises go in for transformation into joint-stock system.

(4) Changing "changing allocation of funds into loans" into "changing loans into investment". It is take the special measure to the debt forming in special form and in a special period. There is in a strict limitation to adopt the method.²⁶ In fact, "debt-debt swap" is the debt transfer in the Contract Law. It is changing the body to bear the debt. For example, transferring the debt, which was formed when the enterprise was engaged in the community affairs, into the financial debt; the low level enterprise bears the debt of the high level or on the contrary.

Debt trading changes the bad claims into stock rights, and it leads to the increase of the total amount of the enterprise shares. At the same time, the value of each share reduces. Therefore, in fact, the original investors also contribute to it .Then, it realize the assignment of the risk of management failure and loss between stock-investors and the credit -investors. The advantages of it as follows:

- Changing the book assets situation of the enterprise, benefiting improving the credit of the enterprise, and enhancing the enterprise financing capacity.
- Decrease the financial cost (the interest of loan), increase the profit in the enterprise benefit of the period (or decrease the loss of the period).Nevertheless, debt trading hasn't put in incremental assets such as currency or material. It is only a temporary measure. To have the substantial effect, it must join with the other measures of improving the assets situation.

Bankruptcy liquidation. It is the most through method to clear up the debts. Bankruptcy liquidation at the cost of the enterprise legal entity die out, and it isn't the method to rescue

²⁶ "Changing allocation of funds into loan" means that in the early of the 1980's, to change the situation of the unified state revenue and expenditure and the enterprise share the state financial "big pot meals", in the planned economy, the state changed the allocated funds for the enterprise into the loan from the bank. As a result, some of the state own enterprise are established only with loan investment, but no input capital funds. These enterprises beard heavy debts.

"Changing loan into investment" means that in the middle of the 1990, to resolve the debts of the enterprises without capital funds , the state changed the book investment loan for the capital construction and all kinds of financial borrowing of the enterprise into state investment, so that it can decrease the debt rate . To the end of 1996, the state had changed the principle loan and interest, which were changing from the allocated funds, amount to RMB242 billion of the 131 enterprises into the state capital funds.

the enterprise. Bankruptcy also leads to the value of the assets run off and the increase of unemployment and other passivity results. Certainly, it can be seen as rescuing the enterprise base on the assets to wholesale the assets of the bankruptcy enterprise in the bankruptcy liquidation. Nevertheless, this method is always abused in China. It damaged the interests of the banks. So it was defined as “fraudulent bankruptcy, but actually dodging debts” by the No.10 file of the State Council in 1997. According to this file, only when the bankruptcy enterprise really stopped producing and closed (deprive its title of legal person); the land use right and property were realized; the workers and staff were settled down, then it is a qualified bankruptcy. If this is the case, it is impossible to rescue the enterprise in the purely meaning of assets.

2. The restructuring mode based on injection of assets

The restructuring mode based on the assets pay attention to the inventory assets of the enterprise .It try to make the enterprise revive by the way of make the profitable assets active. The main methods of this mode are loan, increase assets, merge, tax reduction and exemption or retune the tax.

Loan and increase assets. It means to directly put the incremental fund in an enterprise. This method may resolve the present fund difficulties of the enterprise and improve the producing situation and financial situation of the enterprise. However, the increase of the loan led to the increase of the debt .On the one hand, to an enterprise in distress, this method although could improve the producing situation of the enterprise for a short time; it’s no use improving the financial situation. Moreover, it’s difficult for an enterprise in distress to loan from bank. On the other hand, in spite of the increase fund may improve the financial situation of the enterprise; in essence, it couldn’t decrease the debt burden of the enterprise. When an enterprise is in a lot of debts, the investor seldom has motive to invest. The law doesn’t allow some enterprise, such as the listed company, increasing the fund, when it is at a loss. So this method usually is adopted when the enterprise is in the early stage of the distress and the distress is not serious, and the prospect of the management is bright.

M&A. It means merger and acquisition. It is the property right transaction of one enterprise general bears the assets and debts of the other. In China, as a method to realize the state own enterprise get away from the distress, merger means the enterprise, the assets and management of which in good situation, purchase the enterprise in distress. It is an important measure, which is leading by the government, to rescue the enterprise in distress for a long time. The main methods, as follows: bearing the debts, purchasing, absorbing share and holding share. In recent years, there are purchasing shell to list in a stock exchange, lever purchasing and other merger and acquisition means.

The merger method of bearing debts is the main method for the enterprise to get away from the distress, which is leading by the government, covering 70% of the total amount of the merger and acquisition.²⁷ The two parties in the merger always are the state own enterprises under the same authority department. The adopted method maybe government allocation for funds gratuitously, or purchase nil assets, that is, the purchaser get all assets and

²⁷ *The Debt Restructuring of the State Own Enterprise*, written by ZhangYun-ting, Financial and Economic University of Shanghai Press, 2000 edition, page 138.

the management right of the objective enterprise on the price of bearing the debts of it. In all these merging methods, the purchaser not only bear the book debts of the objective enterprise, but also bear the hidden debts, that is, settling down the workers and staff and social security liabilities. In fact, the good enterprise merger with the enterprise in difficulties always make the former bear the heavy debt burden of the later. Although the State Council provided in 1997 that the enterprise which is at a loss for three continuous years could be remitted the interest of original loan owed by the merged enterprise, and the principal may be amortized in five years (if there is any difficulties may be prolonged for one or two years). However, it couldn't remarkably improve the financial situation and credit of the merged enterprise, and it also couldn't prevent the non-banking creditors from continually collecting their claims and therefore the assets of the enterprise still fettered by the heavy debts. In practice some enterprises were not only unable to get away from distress, but pulled their purchaser who used to be healthy ones in difficulties because of the heavy debts and lawsuits.

Tax deduction/exemption and tax return. In fact, it is such a practice that the local government uses financial revenue (such as local taxes and the cession fund for the land) to subsidize the enterprise. When rescuing the enterprise in distress, these methods may use as the auxiliary methods to improve the quality of the assets of enterprise. Nevertheless, as the amount reduced, exempted and returned is limited, it is not enough to resolve the distress of the enterprise solely in this way.

3. The restructuring mode based on transactions of assets

Firstly, the Purchase Approach to Debt Restructuring differs from the debt restructuring mode based on the debt. It isn't pay attention to the existing enterprise debts, but to the existing assets of the enterprise. And it is different with the usual repayment approach to the debt restructuring, which keep the profitable assets stay in the old enterprise, and try decreasing the debts on these assets. As proof by experience, when the enterprises bear too many debts, the cost to decrease the debts is much and it is difficult to do it. The local government and enterprise adopting this restructuring approach strive for the financial resource to reduce debt by every possible means, but it is usually in vain or gets half the result with twice the effort. The approach of Changchun is put a lot of the debts aside, but rescuing the productivity (profitable assets and human source/labor) from the heavy debts by the purchase approach.

Although the government has some financial resource, it must to consider two different choices that is shifting assets or shifting debts. When the existing debt much more than the existing assets, the cost of the shifting assets obviously less than the shifting debts. On the basis of the data in table 2-9, if adopting the approach of put in funds to pay off the debt, the cost to make the average debt to profitable assets ratio of the six enterprises decline to 60%, that need deduct the RMB1 billion debt of every enterprise, is more than four times of that in purchase approach to debt restructuring.

In fact, if adopt the method of shifting debt, it must be attempt nothing and accomplish nothing, because of the shortage of the fund. And the outcome is, on one hand, the debt can't be paid off, on the other hand, the productivity and the value of the profitable assets loss gradually in the long-time leaving unused.

Secondly, compare with the other restructuring approaches based on the assets, the characters of the Purchase Approach to Debt Restructuring of Changchun are that it realized splitting the profitable assets off the debt of the enterprise and also off the unprofitable assets. It lighten the debt burden of the assets and deduced the operating cost of the assets (such as the expenditure to maintain the unprofitable assets). So the difference of the Purchase Approach to Debt Restructuring with the approaches of put in fund and merger is that the split off profitable assets have powerful capital expansionary capacity. Sometimes, they may become the object of the enterprise merger. Since these assets have no heavy debt burden and relative unprofitable assets, the efficiency of merging these assets remarkably better than that of merging the whole old enterprise.

In the past practice, there was an approach of partly merger upon consideration. There some common points between this approach and the Purchase Approach to Debt Restructuring of Changchun. In this kind of merger the purchaser only bear part of the debts, and gain part of the assets and the whole management right, with providing technology and management. The objective corporation is still the legal entity, which is independent accounting and assumes sole responsibility for its profit and losses. But, the difference is that this kind of approach actually binds the benefit of the merged assets with the other assets and debts of the objective corporation. Therefore, although the property right is split off, the management body is still the original entity. Then neither the merged assets can be made full use to gain management benefit without the fetter of the other asset, nor it can solely joint with the outside assets by joint investment, transform into joint-stock system, or other means. The split off profitable assets in Purchase Approach to Debt Restructuring of Changchun is completely independent. So it can not only independently be made full use to gain management benefit, but also joint investment or co-operate with the outside assets.

IV. Conclusions

According to the analysis above, the success of debt restructuring of SOEs of China can be theoretically summed up as follows.

1. Following the philosophy that “anyone who doing something must avoid doing something else”, China took “*Seize the big and free the small*” as a strategic guideline of SOE reform from 1999. This guideline requires the government to focus on the restructuring of major enterprises and leave minor ones to fend for themselves. As the result China has turned out a number of large and extra-large SOEs by reorganizing some strategic planning with the practice of debt restructuring included. On the other hand, while the “big” was invigorated, the “small” was freed to the market and revived through the course of privatization in a large number.
2. Exactly, the contribution of the practice of debt restructuring is not merely offering some kind of approaches for reference, but proved a simple and profound principle that to rescue the SOEs we should *exploring market methods and market resources* rather than simply relying on the policy tools and governmental resources. Therefore it should be bear in mind that either assets of enterprises or claims of creditors is negotiable and the

negotiability of them should be well utilized. The *market transaction of assets and that of claims* are important concepts in using market means and resources to rescue the distressed SOEs.

3. Of course, *governmental functions and State-owned Economic resources* are also very important. As regard to the function of government, *function of owner and function of coordinator* are the most primary. The goal of function of owner is to put assets of the enterprises into market. The course of assets transactions in the debt restructuring is in some degree the course of putting state-owned assets into market. It is impossible to put the issues such as debt of SOEs and settlement of SOEs workers into market unless the state-owned assets were put into market. The primary significance of function of coordinator lies in promoting the workout of related parties and eliminating sorts of obstacles and resistance from the bureaucratic system. In order to carry out these functions more effectively, it is considerable to establish a kind of *special government agency*. To avoid repeating the old manner of running the whole show, it is needed to clarify the tasks and functions of such a special agency by virtue of laws and regulations.
4. As to the resources of State-owned economy, there are two main parts that need to be paid attention to in the course of debt restructuring: *existing resources and incremental resources*. There are two most important kinds of existing resources. One is aggregative working assets, including all kinds of economic resources such as tangible and intangible, monetary and real, material and human, in and out of the capital account, contributory to profits of enterprise directly and indirectly. The other is right to use land. Meanwhile, incremental resources comprise of two parts. One is paid-up financial revenue, and the other is receivable financial revenue. The paid-up is invested mainly in the way of directly or indirectly financial funding or financing, while the receivable is invested in the main form of reduction, postponement and exemption of chargeable taxes, remuneration for assignment of the right to use land etc. Other than that, the financial policy, industrial policy, basic infrastructure construction, financing technical innovation, and funding social insurances made by the State should provide favorable conditions for rehabilitation of SOEs.
5. The assessment of assets and business anticipation before restructuring of an enterprise is of great impact for the success of restructuring. It should be pay attention to that the assessment mustn't go along only with the financial statement or the achievement in the produce and sale. In the assessment of assets and business anticipation, the comparison of the going-concern value with the liquidation value should be pay attention to, and the ability of produce, possession of market, competition, profit, technique exploitation, investment drawing should be assessed synthetically.
6. Arrangement of restructuring is a result of workout of multi-parties. The disclosure of information during the restructuring is one of the most important conditions needed to get the assistance of the creditors. Arrangement of restructuring should be approved by multi-parties such as the workers, the governmental department in charge and the creditors. The arrangement should be an all-around workout by kinds of approaches, which is agreed on the basis of equality and voluntariness using market ideas and means as possible as they could.

7. It is especially important for restructuring and recovery of SOEs to respect the democratic right of workers and rights and interests for labors well enough. It is not because of the special position of workers of SOEs based on the historical and legal reasons,²⁸ but because of the special contribution of their technique, organization, discipline, and perfect character to the intangible assets of the enterprises.
8. Concession of creditors and investment of assets increase are two conditions indispensable to successful restructure and rescue of enterprises. Creditors should ascertain their boundaries of concession contrasted with the rate of repayment in the case of bankruptcy liquidation. Overemphasis on the interest of themselves and persistence in no concession is in fact irresponsible for the interest of themselves. To rescue their interests at the same time of rescuing the enterprises, the creditors should do the best one can to inject blood into the enterprises in all kinds of ways. Meanwhile, it is great feasible to introduce the investment from third party or parties in many ways.
9. It is only the beginning of recovery of the enterprises to ameliorate the financial position through debt restructuring. To gain the survival and development for long, the enterprises should carry out their recapitalization and technique alteration, optimize their mechanism of operation and strengthen their position in the market continuously. The recapitalization of the enterprises can go along with the transformation of SOEs in line with the stock system. In fact, the recapitalization usually means some sort of privatization. In some of the cases the state capital may drop out while in some others it may keep stay as one of the shareholders in accordance with the principle of “Seize the big and free the small”.
10. Since before the restructuring the old enterprises has been insolvent and part of the assets have been ineffective, the depreciation of creditor's rights will be an accomplished fact that is inevitable and cannot be eliminated. Therefore, one of the tasks is to distribute the loss of the creditor's rights impartially. One form of the distribution is to dispose of the creditor's rights in discount in the trade. The other is to extinguish the claims after the bankruptcy liquidation of the old enterprises.
11. The principle that participant will benefit from the debt restructuring is a kind of more efficient institutional arrangement, which is propitious to encourage constructive assets transfer and active concession of creditor's rights, and to save the cost of the negotiation. It should be paid attention to that all the creditors should be given the equal opportunities to participate the restructuring.
12. In short, coordination of multi-goals should be achieved in the debt restructuring of enterprises. Three goals are surrounded in the various debts restructuring of enterprises hitherto: the first is to relieve the distressed enterprises (or at least rescue the effective assets of the distressed enterprises); the second is to keep employment and settle the workers; the third is to protect the rights of financial creditors, especially the rights of bank creditors. All the goals are the social issues that bring great pressure to the government at present. However, few people place the achievement of fair repayment in

²⁸ The Article 9 of the Law on Industrial Enterprises Owned by the Whole People of China that is still effective stipulates: “The state safeguards the owner position of workers, and the lawful rights and interests of workers are protected by the law.” The 10th Article of it stipulates: “Democratic management is implemented in the form of workers’ representative assembly and other forms.”

the creditors on the prominent or relatively important position. The issue of the achievement of fair repayment may is not urgent to the government, but for a long run it should be paid great attention to because fairness and good faith are great vital to establish a healthy and efficient market.

Labor and Privatization

Aharon S. Schorr

Introduction

Labor's distrust of privatization is founded on the fear that privatization inevitably leads to reduction in the workforce and threatens pension and other labor rights. Fearing job loss and wage reduction, workers and unions are often the most vocal opponents of privatization.¹ The frequent allegation of union leaders is that cost-cutting measures by new private owners fall disproportionately and unfairly on workers. Labor leaders argue that poor management and poor government policies are the root causes of the financially troubled state of public firms, but it is labor that pays the price of reform.² Dealing with labor is particularly thorny in a harsh economic environment when it is difficult for displaced workers to find replacement jobs in the private sector. Greece, like most of the world, is currently facing economic downturn. On August 13, Eurostat reported the Greek economy contracting during April-June by a preliminary 3.5% year-on-year, and in May, the unemployment rate rose to a record 12.0% with nearly one in three people aged 15-24 not having jobs.³

Privatization may not only reduce the size of the labor force, but may also adversely impact salary levels and structure, working conditions, and accrued pension rights.⁴

Privatization often leads to less security of tenure, increased use of nonunionized contract labor,

¹ L. Gray Cowan, *The Labor Factor in Privatization*, in Public Enterprises: Restructuring and Privatization, Jack L. Upper & George B. Baldwin eds. 1995, p 205

² Nancy Birdsall and John Nellis, *Winners and Losers: Assessing the Distributional Impact of Privatization*, World Development Vol. 31, No. 10, pp. 1617–1633, 1622 (2003)

³ Greece: Autumn of Discontent May Lie Ahead, Oxford Analytica Daily Brief Service, Aug 17, 2010. pg. 1

⁴ Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 6, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=880595##.

fewer benefits, and longer hours, and larger wage differentials. After Argentina privatized telecommunications and electricity companies, the workweek increased from 35 hours to 40 hours, wages became more closely linked to productivity, and certain types of overtime and leave were eliminated.⁵

A byproduct of privatization is it often leaves workers feeling a sense of betrayal that may result in a decrease in morale and productivity.⁶ A survey of public employees in companies that privatized through contracting services to private hands found that workers who expected to see their positions privatized deliberately slowed down, cut quality, or even engaged in sabotage.⁷ For example, thefts and sabotage multiplied at Mexican railroads as the privatization date became closer.⁸ Even workers who were not to be laid off also "let down" and reduced output in sympathy with friends and colleagues who were being let go because a private firm was taking over.⁹ Workers alleged that output was down even in work areas not directly affected by privatization and continued long after the private contractors began to function—sort of a continuing lag in morale and productivity by survivors.¹⁰

This can be explained through the principal–agent paradigm. Such relationships are susceptible to problems of opportunism and moral hazard, as agents pursue their own self-interests, and may take advantage of opportunities or circumstances with little regard for the

⁵ *Id.* (citing Shaikh, Hafeez, and Manuel Angel Abdala, 1996, Argentina Privatization Program: A Review of Five Cases (Washington: World Bank)).

⁶ Timmins, William M., *Impacts of Privatization Upon Career Public Employees*, Public Administration Quarterly; Spring86, Vol. 10 Issue 1, p50-59, 50-51.

⁷ *Id.* at 52

⁸ Luis F. López-Calva1, *Private Participation in Infrastructure and Labor Issues: The Privatization of Mexican Railroads*, November 2001 p. 15 available at http://siteresources.worldbank.org/INTRAILWAYS/Resources/514687-1119277885757/mex_study.pdf.

⁹ Timmins, William M., *Impacts of Privatization Upon Career Public Employees*, Public Administration Quarterly; Spring86, Vol. 10 Issue 1, p50-59, 50-51.

¹⁰ *Id.*

interests of the principal.¹¹ Factors such as trust and reciprocity can play a significant role in the principal–agent relationships that exist within the firm. As agents, employees enter a firm with certain needs, and the ability of the firm and its management—the principal—to provide an environment in which they can satisfy these needs determines employee commitment and subsequent behavior.¹² When employees feel that the firm is maintaining or improving their work environment, they perceive a moral obligation to reciprocate through greater levels of commitment and citizenship behavior, such as increased work effort and improved disposition to colleagues. On the other hand, where employees feel the firm has failed to provide a beneficial work environment in exchange for their effort, it can be expected that employees will reduce their level of commitment and citizenship behavior.¹³ By focusing firm objectives on profitability and competitiveness, privatization can have a significant impact on management’s strategy. Changes in firm strategy can take the form of rationalization aimed at reducing excess labor costs, or changes in employee work patterns aimed at improving labor performance. In effect, features traditionally associated with public sector employment, such as job security, promotion based on length of tenure and a stable work environment, no longer prevail in the more commercial environment associated with private ownership. Such changes can be expected to increase employee turnover and have a negative impact on employee commitment

¹¹ Dermot McCarthy, Eoin Reeves and Tom Turner, *The impact of privatization and employee share ownership on employee commitment and citizen behavior*, *Economic and Industrial Democracy* 31(3) 307–326, 308 (2010) available at <http://eid.sagepub.com/content/31/3/307>. (citing Williamson OE, Wachter ML, and Harris JE (1975) *Understanding the employment relation: The analysis of idiosyncratic exchange*. *Bell Journal of Economics* 6(1): 250–279.).

¹² *Id.* at 309 (citing Mowday RT, Porter LW, and Steers RM (1982) *Employee–Organization Linkages: The Psychology and Commitment, Absenteeism, and Turnover*, London: Academic Press).

¹³ *Id.* (citing Coyle-Shapiro J, Kessler I (2000), *Consequences of the psychological contract for the employment relationship: A large scale survey*, *Journal of Management Studies* 37(7): 903–931; Coyle-Shapiro J, Kessler I (2002) *Exploring reciprocity through the lens of the psychological contract: Employee and employer perspectives*, *European Journal of Work and Organizational Psychology* 11(1): 69–86.).

and citizen behavior.¹⁴ Thus, protecting labor's morale and expectations throughout the privatization process is an important aspect of a privatization plan.

While experience has shown that in many instances privatization does lead to reduction of the labor force since over-employment is chronic in SOEs—for example, one survey of 308 privatized firms shows post-sale labor reduction in 78.4% of cases, with no change or job gains in only 21.6%¹⁵—the generalization about privatization adversely affecting labor is subject to many exceptions that reduce its validity both for the long and short term.¹⁶ Most importantly, privatization is not the cause of job losses. Many SOEs are inefficiently operated, employing more workers than necessary; any attempt to successfully rehabilitate the SOE likely requires reduction in labor force. Thus, the problem of unemployment is no more avoidable in rehabilitating the enterprise even were the enterprise to remain under state ownership.¹⁷

Additionally, reduction in labor force because of privatization depends to a large degree on the composition of the laborers. Where the work force is composed of unskilled labor, there is a much greater chance of job loss, since productivity can be increased by giving greater incentives to fewer workers. Loss of jobs due to privatization will be minimal where the labor force is composed of skilled workers whose services cannot be duplicated or dispensed with.¹⁸ For example, the privatization of the National Bank of Jamaica meant little loss of employment to workers highly trained in banking operations, and the scientists in Costa Rican fertilizer plants

¹⁴ *Id.* at 309-10.

¹⁵ Nancy Birdsall and John Nellis, *Winners and Losers: Assessing the Distributional Impact of Privatization*, World Development Vol. 31, No. 10, pp. 1617-1633, 1625 (2003) (citing Chong, A., & Lopez-de-Silanes, F. (2002). *Privatization and labor force restructuring around the world*. Unpublished paper issued by Inter-American Development Bank and Yale University).

¹⁶ L. Gray Cowan, *The Labor Factor in Privatization*, in Public Enterprises: Restructuring and Privatization, Jack L. Upper & George B. Baldwin eds. 1995, p 205

¹⁷ *Id.* at 206

¹⁸ *Id.* at 205

were told they would automatically be retained after privatization.¹⁹ Moreover, whether the SOE was part of a competitive environment or had budget constraints will affect the extent of employee downsizing when privatization occurs. If a state enterprise had already been exposed to competition and faced a hard budget constraint, initial overstaffing is less likely and privatization would add little to the existing incentives for the enterprise to improve efficiency by downsizing the workforce.²⁰

Finally, privatization can be an instrument for increasing the workforce over time. If a privatized firm is put on a more efficient and profitable basis, it can be assumed that business will increase over time and that wages and job opportunities will also increase.²¹ Additionally, new ownership and management may lead to an expansion of activities resulting in an increase in the work force.²² After the privatization of British Airway, there was an initial drop in employment with employment increasing as business improved under private management.²³ A comparative study of the pre- and post-privatization performance of sixty-one companies in eighteen countries, six developing and twelve industrial, sold through public share offerings showed that almost two-thirds of the firms increased employment after privatization, by an average of 6 percent.²⁴ A 1994 study examining the costs and benefits of privatization in twelve enterprises in Chile, Malaysia, Mexico, and the United Kingdom found that workers gained in

¹⁹ Id.

²⁰ Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 5, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=880595##.

²¹ L. Gray Cowan, *The Labor Factor in Privatization*, in *Public Enterprises: Restructuring and Privatization*, Jack L. Upper & George B. Baldwin eds. 1995, p 206.

²² Sanjeev Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 4, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=880595##.

²³ L. Gray Cowan, *The Labor Factor in Privatization*, in *Public Enterprises: Restructuring and Privatization*, Jack L. Upper & George B. Baldwin eds. 1995 at 207

²⁴ Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 8, available at <http://info.worldbank.org/etools/docs/library/74184/winter2002/proceedings/pdfpapers/mod4sk.pdf>, (citing Mathieson, John, Ophelia Yeung, and John Normand. 1994, *Mitigating the Social Impact of Privatization*, Research paper prepared for USAID under the Privatization and Development(PAD) Project. Stanford Research Institute International, International Policy Center.).

ten of the twelve cases through the retention and expansion of jobs.²⁵ Equally important, the study found that even laid off workers did not suffer a welfare loss because the amount of severance pay they obtained was larger than the wages they lost during the time between losing their old job and finding a new one, and because of the allocation of valuable shares at discounted prices.²⁶ A study of 79 firms in 21 countries found that for the period 1980-92, employment increased by 10 percent or more for 60 percent of the privatized firms.²⁷ In a study of firms in the Czech Republic, Hungary, Poland, and the Slovak Republic, it was found that as the transition progressed, the elasticity of employment with respect to sales increased.²⁸ These studies suggest that over the three periods of privatization—the pre-privatization period, the privatization period, and the post-privatization period—the level of employment in the firm could follow a U-curve: declining during the first two periods and increasing at some point during the third.²⁹ Nevertheless, some enterprises may be viable in the long run only with a permanently reduced workforce. To deal with the job losses from permanent downsizing, privatization should be accompanied by sound macroeconomic and structural policies that promote employment generation and provide social safety nets in the short run.³⁰

Privatization has significant political undertones, and lowering public anxiety about the process is an integral part of a successful privatization. Governments should run a general education campaign on the implications of privatization on society as a whole. Part of this

²⁵ *Id.* (citing Galal, Ahmed, Leroy Jones, Pankaj Tandon, and Ingo Vogelsang. 1994. *Welfare Consequences of Selling Public Enterprises: An Empirical Analysis*. World Bank. New York.: Oxford University Press).

²⁶ *Id.*

²⁷ Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 4, (citing Boubakri, Narjess, and Jean-Claude Cosset, 1998, *The Financial and Operating Performance of Newly Privatized Firms: Evidence from Developing Countries*, *Journal of Finance*, Vol. 53 (June), pp. 1081-1110).

²⁸ *Id.* at 5 (citing Estrin, Saul, and Jan Svejnar, *The Effects of Output, Ownership, and Legal Form on Employment and Wages in Central European Firms*, in *Enterprise Restructuring and Unemployment in Models of Transition*, ed. by Simon Commander (World Bank) (1998)).

²⁹ *Id.*

³⁰ *Id.*

campaign can be directed specifically at answering the fears of labor, providing answers to labor's objection to privatization in order to preempt initiation of an opposition campaign by labor. The government's motives for privatization should be publicly disclosed, pointing out the long-term advantages to privatization without glossing over the short-term problems it will create.³¹ Labor must be assured that their interests are fairly represented and that their sacrifices will be balanced with measures to allow workers to share in the benefits of privatization.³² More specifically, this involves early efforts to enhance labor's understanding of the timing and method of privatization. In many cases labor unions recognize that the time for change has come but their opposition stems from lack of information about the government's plans for privatization.³³ Governments should describe the incentives and social safety net measures being put in place to protect workers.

Privatization's benefit to workers who remain at the enterprise should be noted. In Argentina, the real wages and salaries of employees of Entel and the Buenos Aires water concession increased by 45 percent in the three years following privatization.³⁴ In Chile, the new owners of the electricity companies increased wages and introduced profit-sharing schemes.³⁵ Malaysia's Port Kelang workers who remained with the partly privatized company received compensation increases averaging 12 percent.³⁶ In Mexico wages in a sample of privatized firms increased far in excess of rates elsewhere in the economy, with the mean annual wage rising from N\$14,925 before privatization to N\$26,348 in 1993, with larger gains for blue

³¹ L. Gray Cowan, *The Labor Factor in Privatization, in Public Enterprises: Restructuring and Privatization*, Jack L. Upper & George B. Baldwin eds. 1995, p 208

³² Sunita Kikeri, *Labor Redundancies and Privatization: What should governments do?* Public Policy for the Public Sector, Note No. 174, Jan. 1999 (World Bank) p. 20

³³ *Id.*

³⁴ *Id.* at 7

³⁵ *Id.*

³⁶ *Id.*

collar workers than for white-collar workers.³⁷ And in Ghana salary levels in privatized textiles and printing companies increased to 10-15 percent above industry standards.³⁸

Countries with strong and active labor unions have gone a step further and given unions a direct role in implementation of privatization.³⁹ For example, labor unions have been part of committees established to oversee the privatization process and were closely involved in negotiations on restructuring methods, severance options, and retraining arrangements. Such arrangements can have their costs: they can significantly complicate and lengthen the privatization process, and may provide labor access to information that favors them in the bidding process. Nevertheless, the benefits of having labor support and moving ahead on privatization can outweigh the costs.⁴⁰

I. Methods of Privatization

Before beginning a discussion on how governments can protect labor throughout the privatization process, it is important to note that the method used to privatize an enterprise will, to some extent, determine the impact on employment.⁴¹ Each method of privatization has benefits and detriments—for example, a method that maximizes sales revenue for a government may also have a more detrimental effect on labor—and a government must determine their exact goals of privatization and use a method that best matches those goals.

Some methods produce larger revenue gains for the government than others, and these gains can be used to finance social programs during the adjustment period. In cases where the government has the administrative capacity, it may make sense to maximize its revenue gains

³⁷ *Id.* (citing La Porta, Rafael, and Florencio López-de-Silanes. 1997. “The Benefits of Privatization—Evidence from Mexico.” FPD Note 117. World Bank, Finance, Private Sector, and Infrastructure Network, Private Sector Development Department, Washington, D.C.)

³⁸ *Id.*

³⁹ *Id.* at 20-21

⁴⁰ *Id.*

⁴¹ Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 12.

through public sales and mitigate the resulting social impact through social safety nets.⁴²

However, public sales can also be expected to have the largest adverse social impact. To some extent, the government has to balance the social costs of different methods of privatization against the benefits of maximizing privatization proceeds. A number of factors enter this cost-benefit analysis: the most prominent are the administrative capacity of the government to run cost-effective social safety net programs, and the social and political circumstances at the time of privatization.⁴³

Generally, when enterprises are privatized through public sales and auctions, including initial public offerings, sales of shares of already corporatized or publicly traded enterprises, or public auctions, the government maximizes the sale proceeds of privatization. But to make the price worthwhile, the new owner must undertake a broad and rapid restructuring; hence, under this method, the impact on workers can be large.⁴⁴ However, as the enterprises also benefit from an infusion of fresh capital—and, in many cases, new ideas—chances are also best for a speedy restructuring and an eventual increase in employment, and compensation.⁴⁵

In contrast to public auctions and sales, negotiated sales enable a government to influence the divestiture to achieve its social objectives by placing constraints, such as employment guarantees, on the buyer in order to protect labor.⁴⁶ However, these constraints can lead to a lower sale price, reducing the revenues that the government can use to finance social safety nets. In addition, once the employment guarantees expire, the government has little leverage for protecting workers. Other disadvantages of this method are the risk of under-pricing the SOE, as the State may be less able than the buyer to assess its true market value, causing a negative effect

⁴² *Id.* at 23

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.* at 12-13

⁴⁶ *Id.* at 13

on the budget through reduced privatization proceeds,⁴⁷ or political opposition due to concerns about possible corruption and favoritism.⁴⁸

Management/Employee Buyouts (MEBOS), offer the greatest chance of minimizing the adverse impact on employment.⁴⁹ The major attraction is that by giving employees a personal stake in the company they are motivated to find ways to cut costs, improve productivity, and operate more efficiently.⁵⁰ Such schemes can also help win employee support for privatization. However, under MEBOs, there is neither an infusion of fresh capital nor new ideas, and it may mean that the benefits of privatization are delayed. Additionally, employee-controlled firms tend to favor labor hoarding.⁵¹ The record of labor-managed firms suggests that they may grant excessive wage increases and maintain excessively high employment, resulting in the same labor inefficiencies that plague SOEs.⁵² The final disadvantage is that MEBOs have more limited opportunities to raise external funds: the core problem being the risk to investors that their funds will be used to sustain existing levels of labor rather than to undertake modernizing investment.⁵³

Under management or lease contracts, the government retains ownership of the enterprise but delegates the management functions. Thus, there is no transfer of assets to the private sector. Instead, private sector technology and skills are provided for an agreed time and for a fee.⁵⁴ Under a management contract, the private company earns a fee for managing the enterprise and the government keeps the profits. Under a lease contract, the private company pays a rent to the

⁴⁷ *Id.*

⁴⁸ Comparative Experiences with Privatization: Policy Insights and Lessons Learned, U.N. Conference on Trade and Development (1995), pg 90-91

⁴⁹ Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 13.

⁵⁰ Comparative Experiences with Privatization: Policy Insights and Lessons Learned, U.N. Conference on Trade and Development (1995) pg 92-93.

⁵¹ Paul Hare & Alexander Muravyev, *Privatization in Russia*, in International Handbook on Privatization, David Parker & David Saal eds., (2003) pg 349

⁵² Cosmo Graham, *Methods of Privatization*, in International Handbook on Privatization, David Parker & David Saal eds., (2003) pg 98.

⁵³ Paul Hare & Alexander Muravyev, *Privatization in Russia*, in International Handbook on Privatization, David Parker & David Saal eds., (2003) pg 358

⁵⁴ Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 13.

government and assumes full commercial risk.⁵⁵ Management or lease contracts are more likely than MEBOs to impact employment and workers' compensation, but not as much as by negotiated sales.⁵⁶ The respective impact on labor between management and lease contracts can differ. Management contracts typically provide for cost-plus payments to the manager; hence, so long as the managers earn the fee, there is little motivation to cut the workforce.⁵⁷ In the case of lease contracts, lessors have an incentive cut the workforce, since they can keep all extra proceeds net of the lease payment.⁵⁸

Granting a percentage of shares to employees can be used to provide incentives to the work force by granting them a share of the enterprise. This can be done through employee stock ownership plans (ESOPs), reserving a specific percentage of shares for employees, or through gifting shares to employee. An ESOP fund is created by borrowing from banks, and the fund acquires the enterprises stock. Each employee participant receives an allocation of stock, and as the ESOP loan is repaid, the plans trustee allocates to each employee his share of the total.⁵⁹ By creating employee shareholders, an ESOP can align the objectives of employees and management, thereby facilitating greater employee understanding of the changes in conditions of employment, and can counterbalance the principal-agent problems created by privatization.⁶⁰ Where employees receive shares free of charge or at a discounted price, an ESOP can also be viewed as a form of financial compensation in light of these reforms. Furthermore, the ESOP may allow employees and their representatives to oppose adverse changes in conditions of

⁵⁵ *Id.* at 14. Lease contracts are relatively rare in industrialized countries, but common in developing countries. See *id.*

⁵⁶ *Id.* at 18

⁵⁷ *Id.* at 14

⁵⁸ *Id.*

⁵⁹ L. Gray Cowan, *The Labor Factor in Privatization*, in Public Enterprises: Restructuring and Privatization, Jack L. Upper & George B. Baldwin eds. 1995, p 211.

⁶⁰ Dermot McCarthy, Eoin Reeves and Tom Turner, *The impact of privatization and employee share ownership on employee commitment and citizen behavior*, Economic and Industrial Democracy 31(3) 307–326, 311 (2010)

employment.⁶¹ By providing employees and their representatives with ownership rights, including voting rights and board-level representation, an ESOP may place management under pressure to refrain from the introduction of measures that have a negative impact on employee welfare.⁶² Additionally, where an ESOP is representative in nature it provides trade unions with a new role within the firm as the representatives of not only employees but also shareholders. As a result, the establishment of an ESOP can offset the loss of union bargaining strength associated with privatization and provide employees with a greater sense of participation in firm decision-making, particularly at the firm level.⁶³

A wide variety of incentives has been used to raise employee interest in shareholding. For example, a specific percentage of an offering, usually between 5 and 10 percent, can be reserved for employees.⁶⁴ Shares can be made available at a discount from the offering price ranging from 5% at the time of sale to 20% if the shares are held for at least two years. In many cases, loan arrangements are made at low rates for employee purchases, or payment can be arranged over a time through direct withdrawals from wages.⁶⁵ Another option is the outright gifting of shares to employees, or granting free shares tied to the purchase of additional shares. This may cost revenue in the short term, but it may encourage labor to support later privatizations.⁶⁶

II. Restructuring Labor

It is important for government to be involved in the restructuring of labor, whether during pre-privatization restructuring or post-privatization layoffs. Attempts to leave labor restructuring

⁶¹ *Id.* at 311

⁶² *Id.*

⁶³ *Id.* at 312

⁶⁴ L. Gray Cowan, *The Labor Factor in Privatization*, in Public Enterprises: Restructuring and Privatization, Jack L. Upper & George B. Baldwin eds. 1995, p 211.

⁶⁵ *Id.*

⁶⁶ *Id.* at 212.

to the private sector on the grounds that private investors are better equipped than the government to judge the level and kind of skills needed and have greater incentives to minimize severance costs have proved risky.⁶⁷ Where union opposition is high, private investors, wary of taking on the political burden of carrying out large-scale layoffs, are reluctant to bid and the process slows down. Moreover, when investors have to absorb large labor liabilities, they discount the sale price accordingly, leading to lower sale revenues and potential public allegations that assets are being sold cheaply.⁶⁸ Alternatively, they demand government subsidies to cover the cost of the liabilities, thus subverting one of the original goals of privatization.⁶⁹ Leaving large-scale downsizing to new private owners may also create social problems, particularly where weak severance laws and social safety nets reduce protection for workers and where, in the absence of alternative job opportunities, redundant workers take months or even years to get new jobs.⁷⁰

It is heavily debated whether governments should restructure the workforce of an enterprise prior to privatization. Early advice from the World Bank was that governments should operationally restructure SOEs prior to divestment, since governments are better able to cushion the financial blow to any displaced workers by using unemployment or pension payments. Government-led restructuring can thus provide a private buyer of the SOE with a “clean slate.”⁷¹ Another reason for prior restructuring is to increase the attractiveness and value of firms,

⁶⁷ Sunita Kikeri, *Labor Redundancies and Privatization: What should governments do?*, Public Policy for the Public Sector, Note No. 174, Jan. 1999 (World Bank) p. 2.

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ William L. Megginson and Jeffrey M. Netter, *From State To Market: A Survey Of Empirical Studies On Privatization*, Journal of Economic Literature (June 2001), p 19(citing Nellis, John and Sunita Kikeri. 1989. *Public Enterprise Reform: Privatization and the World Bank*, World Devel., 17, pp. 659-672.

although such increases might be marginal.⁷² A study on privatization prices in the second phase of Mexico's privatization program found that pre-sale reductions in the labor force raised sale prices by 6 percent over the mean predicted price. Conversely, transferring contingent labor liabilities to new private owners lowered sale prices by 3 percent, while even greater price reductions, up to 18%, resulted from strikes in an enterprise before privatization.⁷³ On the other hand, one study found pre-privatization restructuring through voluntary departure programs does not improve the sales price. A survey of 308 privatizations comprising 84 countries for the period 1982-2000 found that voluntary downsizing is associated with about a 12 percent decrease in privatization prices.⁷⁴ This may be a result of adverse selection, as workers with the best outside prospects accept the severance package and those with the worst outside perspectives remain. This deteriorates the human capital of the firm and is reflected in the privatization price.⁷⁵ However, the study did find that skill-based downsizing⁷⁶ is effective and may increase prices by 22 percent.⁷⁷

There have been many arguments against restructuring pre-privatization. First, some argue that public unions can influence the future of politicians, effectively reducing the government's bargaining power in restructuring.⁷⁸ It has also been argued that it is not worth spending resources in restructuring the labor force before privatization, as governments may not

⁷² Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 13

⁷³ *Id.* (citing López-de-Silanes, Florencio. 1996, *Determinants of Privatization Prices*, Working Paper 5494. National Bureau of Economic Research, Cambridge, Massachusetts).

⁷⁴ Alberto Chong Freeman and Florencio López -de-Silanes, *Privatization and Labor Force Restructuring around the World*, World Bank Policy Research Working Paper 2884, September 2002 pg. 12.

⁷⁵ *Id.*

⁷⁶ Skill-biased downsizing includes any labor cut that uses any test or certification to measure skills or occupational ability as a retrenchment reference. A typical case is to test workers on general or particular labor skills in order to decide whether to keep them. For example, the Peruvian Tax Administration required all workers to pass a written test to keep their jobs. *Id.* at 6.

⁷⁷ *Id.* at 12-13.

⁷⁸ *Id.* at 3 (citing Freeman, Richard (1986). *Unionism Comes to the Public Sector*, Journal of Economic Literature 24: 41-86.; López-de-Silanes, Florencio, Andrei Shleifer, and Robert Vishny (1997). *Privatization in the United States*, Rand Journal of Economics 28(Autumn)).

be able to distinguish the particular workers that should be retained and risk retrenching the wrong personnel.⁷⁹ This may result in the loss of know-how that, at a minimum, may help solve short-run post-privatization efficiency problems and, at worst may be linked with permanent damage to the productive structure of the firm.⁸⁰

The World Bank had become more nuanced in their recommendation on pre-privatization restructuring. A 2001 report suggested that small and medium-sized SOEs “should be sold as is at the best price possible, as quickly as possible.”⁸¹ Another report suggested that by companies with minimal to modest levels of overstaffing, restructuring can and should be left to the private investors. But large-scale redundancies are usually best handled by governments prior to sale to minimize labor resistance, enhance the likelihood that a social safety net will be provided, and increase the value of the firm.⁸²

Sometimes, countries in urgent need of privatization have taken a mixed approach. In Argentina, part of the restructuring was done by the government prior to sale and part was left to the new private investors.⁸³ In the case of Entel (telecommunications), 17 percent of the 20 percent reduction in employment took place after privatization, while in Segba (power) the work force was reduced by 22 percent prior to privatization and by a further 29 percent after privatization.⁸⁴ By contrast, in GDE (gas company) employee restructuring was left entirely to the new owners. Investors were allowed to select their labor force from the restructured labor

⁷⁹ *Id.* (citing Haltiwanger, John, and Manisha Singh (1999), *Cross-Country Evidence on Public Sector Retrenchment*, World Bank Economic Review 13(1): 23-66).

⁸⁰ *Id.*

⁸¹ William L. Megginson and Jeffry M. Netter, *From State To Market: A Survey Of Empirical Studies On Privatization*, Journal of Economic Literature (June 2001), p 19 (citing Kikeri, Sunita, John Nellis, and Mary Shirley. 1992. *Privatization: The Lessons of Experience*, Washington, D.C.: World Bank, pg 54.).

⁸² Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p x.

⁸³ *Id.* at 13.

⁸⁴ *Id.* (citing Shaikh, Hafeez. 1996. *Argentina Privatization Program: A Review of Five Cases*. World Bank, Private Sector Development Department, Washington, D.C.).

pool according to need, while the government provided other incentives and constructed a social safety net for displaced workers. By December 1993, employment had been reduced by 32 percent. Similarly, in the case of OSN (water and sewerage services in Buenos Aires), no labor retrenchment took place before privatization, although the government entered into a cost-sharing agreement with the private concessionaires in financing severance.

III. Protecting Labor

Policymakers have four principal options for alleviating the adverse impact of privatization on workers. First, the downsizing can be carried out in a way that minimizes the adverse impact on labor. Second, the government can engage in passive labor market policies, such as severance payments and public works programs, to support the displaced workers during unemployment. Third, the government can help the unemployed find new jobs by running retraining and other programs. Finally, job creation in the private sector can be encouraged through sound macroeconomic and structural policies.⁸⁵

A. Minimizing Downsizing Impact on Employees

Gradual labor force attrition can be used to ease the effects of privatization on labor. An appropriate net attrition rate can help to balance the rate at which jobs are lost with the rate at which the economy can absorb it, since those leaving under this approach only do so if they have a better opportunity.⁸⁶ In many cases, the labor redundancy problem at SOEs is too serious to permit a gradual solution. These cases have led to the development of more aggressive labor redundancy adjustment programs. These include promoting early retirement through a 3-5 year reduction in the age at which unreduced or only mildly reduced, retirement benefits can be paid. One concern with early retirement programs is it accelerates pension liabilities and can aggravate

⁸⁵ Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 13.

⁸⁶ Louis S. Thompson, *Changing railway structure and ownership: is anything working?*, Transport Reviews, 2003, VOL. 23, NO. 3, 311–355, 321

the financial strains on pension systems and other components of the social security system.⁸⁷ A study on Brazilian privatization showed that the savings deriving from the downsizing were lessened because the pension benefits granted to the workers increased the long-term liabilities of the federal government. As a result of the implicit transfer of obligations, budget savings were 15 to 25 percent lower than they appear at first glance.⁸⁸

Another option is to include employment guarantees in the sale of an enterprise. One potential advantage of employment guarantees is that by the time the guarantees expire, a more favorable macroeconomic environment may emerge.⁸⁹ The danger is that by complicating the process of privatization and limiting the discretion of the new owners, employment guarantees can lead to lower sale prices and decrease the revenues available to finance safety net programs. When investors have to absorb large amounts of surplus labor and thus the cost of severance payments, they discount the sale price accordingly, which leads to lower sale revenues and public allegations that state assets are being sold cheaply.⁹⁰ A survey found employment guarantees are associated with a 22% decrease in sales price.⁹¹ Furthermore, guarantees can perpetuate the existing inefficient labor practices and delay the desired gains in productivity and efficiency.⁹² Additionally, when used in early privatizations, employment guarantees set a dangerous precedent for future, more complicated privatizations.⁹³ Guarantees can deter investor

⁸⁷ Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 18.

⁸⁸ Juan Jose Diaz, *Public Sector Downsizing*, in *Analyzing the Distributional Impact of Reforms*, Vol. 2, p. 232, World Bank, available at <http://go.worldbank.org/PK2BO4YJI0>.

⁸⁹ Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 15.

⁹⁰ Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 12.

⁹¹ Alberto Chong Freeman and Florencio López -de-Silanes, *Privatization and Labor Force Restructuring around the World*, World Bank Policy Research Working Paper 2884, September 2002 pg.11.

⁹² Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 15.

⁹³ Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 12. However, setting precedent is not always problematic. It was not a serious problem for Malaysia since many of its state enterprises were relatively efficient to begin with. But such arrangements have created serious problems in Sri Lanka and other countries where overstaffing is rampant. See *id.*

interest and delay privatization in overstaffed companies, as in Mexico's Mexicana Airlines where no buyers could be found in the first attempts to sell the company because the terms and conditions of sale prohibited worker layoffs.⁹⁴

In the former East Germany, Malaysia, and Pakistan most privatization contracts contained a special clause guaranteeing employment levels for a specified period, with penalties for noncompliance. In Pakistan and Sri Lanka, employment was assured for one and two years, respectively, after privatization.⁹⁵ In Malaysia, workers were guaranteed continued employment with the new company for at least five years. These contractual guarantees have usually been limited to situations where overstaffing was limited, and is not a solution in countries or enterprises with severe overstaffing.⁹⁶

B. Passive Labor Market Policies

One means of providing income support to displaced workers is to provide cash support through severance payment as part voluntary or involuntary departure programs, preferential allocations of shares, or unemployment insurance schemes.⁹⁷

Providing cash to displaced workers is a politically attractive way to reduce the size of the labor—whether through voluntary or involuntary programs. Voluntary retirement programs can be helpful, but in overstaffed enterprises with immediate need for privatization, attrition

⁹⁴ *Id.*

⁹⁵ Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 15; see also Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 8, (citing Galal, Ahmed, Leroy Jones, Pankaj Tandon, and Ingo Vogelsang. *Welfare Consequences of Selling Public Enterprises: An Empirical Analysis*. (1994)); Comparative Experiences with Privatization: Policy Insights and Lessons Learned, U.N. Conference on Trade and Development (1995) pg 234-35. Both sources provide a more in-depth discussion on the particulars of each country; see also L. Gray Cowan, The Labor Factor in Privatization, in *Public Enterprises: Restructuring and Privatization*, Jack L. Upper & George B. Baldwin eds. 1995, p 209-11.

⁹⁶ Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 11.

⁹⁷ Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 17.

alone will usually be insufficient.⁹⁸ If it is sufficiently generous, severance pay can reduce labor opposition to privatization. However, the fiscal cost for severance payments can be large. In Mali, generous severance payments—two years' pay, plus up to two years' salary to establish new businesses—led the government to halt privatization.⁹⁹

The size of the payments has varied widely between countries and within countries between enterprises in different sectors, depending on legal and contractual obligations and the strength of labor unions.¹⁰⁰ The main challenge with incentive-based voluntary options lies in devising a severance policy that is both attractive for workers and financially feasible in the short run.¹⁰¹ Compensation should not be so generous as to induce massive departure from the privatized enterprise.¹⁰² Overpayment can be minimized by having a clear severance policy that offers severance only to predetermined redundant workers or certain categories of workers where overstaffing is the highest, and that tailors severance packages to worker characteristics and the benefits they obtain from public employment.¹⁰³ Non-cash supplements can be provided, as in Zambia where, because generous cash offers were not feasible, elements such as shares in companies, land, houses, vehicles, and equipment were included as part of the severance package.¹⁰⁴

Usually, severance plans are based on a multiple of years of service and salary, taking

⁹⁸ Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 8.

⁹⁹ *Id.*

¹⁰⁰ *Id.* at 14.

¹⁰¹ *Id.* at 15.

¹⁰² *Comparative Experiences with Privatization: Policy Insights and Lessons Learned*, U.N. Conference on Trade and Development (1995), pg 289-90.

¹⁰³ Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 17.

¹⁰⁴ *Id.*

into account legal or contractual severance obligations.¹⁰⁵ Severance formulas have generally ranged from 1 to 3 months of salary per year of service, with a typical average payment of 1.5 months per year of service.¹⁰⁶ A typical example is the severance package in Mexico where laid off railroad employees were given four months of salary, plus 30 days for each year of service.¹⁰⁷ Monthly salaries were calculated by including many factors, such as base salary, Christmas bonus, payment for vacations, incentive payment for attendance and punctuality, and tenure bonus.¹⁰⁸

The advantage of a standard severance formula is that it is simple to understand and implement. It is attractive to unions because they can negotiate a formula for a class of workers, and it is attractive to government because it can set a single formula as part of a uniform approach. The disadvantage is that it may lead to adverse selection with the best workers leaving the enterprise. Adverse selection can be limited by offering early retirement and voluntary separation packages only to redundant staff and within predetermined limits.¹⁰⁹ In addition, attempts can be made to retain skilled workers by establishing eligibility criteria for accepting voluntary departure severance, raising the retirement age for essential employees, and developing performance-based compensation schemes to minimize the incentive to leave. Still, even where such features might be difficult to put into practice, the costs of adverse selection are generally outweighed by the broader economic and social benefits of reducing the size of the overall workforce and of completing privatization.¹¹⁰

¹⁰⁵ William Morrison, *Labor Issues in Public Enterprise Restructuring*, Asian Development Bank, December 2006 p. 15

¹⁰⁶ *Id.*

¹⁰⁷ Luis F. López-Calva, *Private Participation in Infrastructure and Labor Issues: The Privatization of Mexican Railroads*, November 2001 p. 26.

¹⁰⁸ *Id.*

¹⁰⁹ Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 18.

¹¹⁰ *Id.*

A recent World Bank study of 41 public sector retrenchments shows that moving away from standardized severance packages linked to wage and past years of service to packages more closely linked to the future earnings potential of workers can reduce costs by 20 percent or more.¹¹¹ This approach takes account of the factors that influence individuals' likelihood of gaining income after severance. For example, if better-educated workers are more likely to return to higher-paid employment after separation, the formula will reduce their severance payment. If women workers are more likely to have difficulty in finding a job, the formula will increase their severance payment.¹¹² Loss-based severance uses estimations of future earnings based on data from national household statistics, and compares workers' existing incomes with alternative private sector income sources.¹¹³ The calculation also include earnings lost while a worker searches for another job, estimated losses of tangible benefits (for example, transportation to work, food and housing subsidies, and medical benefits), and estimated losses of intangible benefits (for example, job security, flexible working times, opportunity for bribes, access to equipment, and facilities for private use).¹¹⁴

The advantages of loss-based severance is that the compensation that each employee receives is more fair—those who stand to lose most will receive the most, and reduces the risk of overpayment, which has plagued severance programs worldwide.¹¹⁵ This approach may also minimize adverse selection because workers with higher prospects of finding jobs will receive lower severance compensation and have less incentive to accept severance. Loss-based

¹¹¹ Sunita Kikeri, *Labor Redundancies and Privatization: What should governments do?* Public Policy for the Public Sector, Note No. 174, Jan. 1999 (World Bank) p. 3.

¹¹² *Labor Issues in Infrastructure Reform—A Toolkit*, World Bank' Investment Climate Department, available at <http://rru.worldbank.org/documents/toolkits/labor/toolkit/index.html>.

¹¹³ William Morrison, *Labor Issues in Public Enterprise Restructuring*, Asian Development Bank, December 2006 p. 16

¹¹⁴ *Labor Issues in Infrastructure Reform—A Toolkit*, World Bank' Investment Climate Department, available at <http://rru.worldbank.org/documents/toolkits/labor/toolkit/index.html>.

¹¹⁵ *Id.*

severance does have some drawbacks. It is subject to legislation or existing labor contracts that may preclude discriminative treatment of workers according to factors such as age, gender, ethnicity, and location. And it potentially adds time to the work force restructuring process because of the need to conduct econometric analyses, and it as a formula whose derivation is difficult to explain to policymakers and unions when seeking their support.¹¹⁶ Finally, while loss-based severance has been pilot-tested by the World Bank in Guinea-Bissau, Madagascar, and Tanzania, it has not yet been implemented beyond pilot plans.¹¹⁷

Three approaches have developed on the timing of when severance programs are offered.¹¹⁸ Argentina made the pre-announced benefits available only after the worker had not accepted, or not been offered, a job with the new companies. Brazil partially reduced the labor force prior to concessioning, requiring the concessionaire to assume a stated labor force level, and then allowing the new operator to reduce the force later using the government safety net provisions. Mexico paid all workers a calculated benefit based on their wages and length of service at the outset and then allowed the new operators and the labor force to negotiate freely on future employment at the privatized enterprise.¹¹⁹

Each approach has advantages and disadvantages. Argentina's had the advantage of ensuring that the good workers did not take their package and leave before negotiating with the new employers, but it also kept paying the total labor force somewhat longer. Brazil's approach reduced the budgetary drain earlier, but permitted some of the better workers to leave early and, by requiring the investor to take on a labor force larger than needed, reduced the initial price paid for the concession. The third approach ended the government role quickly but entailed payment

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ Louis S. Thompson, *Changing railway structure and ownership: is anything working?*, Transport Reviews, 2003, Vol. 23, No. 3, 311–355, 321.

¹¹⁹ *Id.* at 323.

of benefits to all workers and not just those who were terminated.¹²⁰

Governments can finance severance pay in a variety of ways. Privatization proceeds can be sequestered for severance payments, as in Turkey and Tunisia.¹²¹ In low-income countries, however, this option is limited because proceeds from sales are often not sufficient to cover severance costs. Additionally, whether privatization proceeds should be earmarked to finance social safety nets is questioned.¹²² Technically, earmarking is unnecessary because budgetary resources are essentially fungible. In fact, if the proceeds are used to, say, reduce public debt, and therefore reduce future interest payments, the resources freed could be used to finance social safety nets. This option may prove more efficient than earmarking the proceeds. Moreover, earmarking can make fiscal management inflexible. By tying up resources, earmarking makes it more difficult for outlays to be reassigned in response to changes in priorities or circumstances.¹²³

Another option is sequencing privatization candidates to ensure phased retrenchments and minimize cash-flow problems.¹²⁴ Malaysia sold shares of profitable enterprises first to generate proceeds that could subsequently be used for financing severance in future transactions.¹²⁵ Governments can also set aside budgetary funds, as in Argentina and Peru where the World Bank tied the release of loan funds to the designation of budgetary funds for paying severance.¹²⁶ Finally, governments can issue government bonds to finance the costs.¹²⁷ Many

¹²⁰ *Id.*

¹²¹ Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 17.

¹²² Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 12.

¹²³ *Id.*

¹²⁴ Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 17.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ William Morrison, *Labor Issues in Public Enterprise Restructuring*, Asian Development Bank, December 2006 p. 17.

governments, however, look to loans or grants from multilateral institutions and bilateral donors as potential sources of funds.¹²⁸

Often governments share the burden with the new buyers, as in Argentina and Pakistan where the costs of the voluntary departure schemes were split between the government and the new private buyers.¹²⁹ Whether the enterprise or the new owner pays the severance has no material importance, because the cost is reflected in the sale price. Ultimately, the government finances the severance payment, through either the direct provision or a reduced sale price.¹³⁰

Ensuring prompt payment of full severance packages is crucial to labor restructuring, especially in high inflation environments. In some cases, inadequate funds have forced governments to delay severance payments, which in addition to imposing social difficulties and reducing the value of severance, have seriously eroded government credibility and threatened a backlash to reform. One of labor's main concerns is credibility—that is, whether the government, in the midst of a severe fiscal crisis, will be able to pay the generous amounts it had promised to pay. In the case of Argentinean privatization in midst of economic troubles, World Bank participation in the financing of severance packages brought credibility to the process and ensured that commitments were honored.

The financial and economic returns on severance payments are high. A study of labor redundancy in transport-related state enterprises found that the programs pay for themselves within two to four years—and sometimes less, since the costs of one-time severance pay and accumulated pension obligations are outweighed by the fiscal benefits resulting from savings in

¹²⁸ *Id.* For a more in-depth discussion on funding, see part IV.

¹²⁹ Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 17.

¹³⁰ *Id.* at 14

reduced wages and subsidies.¹³¹ In the case of Brazil Railways, for example, the cost of cutting 20,000 employees over three years is estimated at about \$350 million, but these reductions reduced the wage bill by about \$250 million a year. By the privatization of Mexico's railroads, the total estimated cost of the severance packages was 521.9 million dollars.¹³² On the other hand, the company had incurred a deficit of about 400 million dollars a year, on average. That means that it would take less than five years for the federal government to recover in net present value the amount invested in restructuring and even less if one considers the fact that the new companies would start paying taxes on profits.¹³³ One study on 16 programs found that the average break-even period was two years and four months, and it exceeded four years in less than 10 percent of the cases.¹³⁴ The economic rate of return—defined as the net increases in marginal productivity of redundant staff that is redeployed to another productive activity, and the marginal gain from avoided labor related costs—is also high, averaging 45 percent in the six countries covered by the transport study.¹³⁵ Returns are particularly high if there are other opportunities for employment and redundant workers are likely to find jobs in the labor market.

Even after a voluntary departure program, there may be redundant staff that need to be involuntarily laid off. Though politically the most difficult of all restructuring options, retrenchment of workers who do not accept the voluntary program have sometimes been

¹³¹ *Id.* at 15 (citing Svejnar, Jan and Katherine Terrell. 1991, *Reducing Labor Redundancy in the State-Owned Enterprises*, Research Working Paper 792. World Bank, Infrastructure and Urban Development Department, Washington, D.C.).

¹³² Luis F. López-Calva, *Private Participation in Infrastructure and Labor Issues: The Privatization of Mexican Railroads*, November 2001 p. 26, available at http://siteresources.worldbank.org/INTRAILWAYS/Resources/514687-1119277885757/mex_study.pdf.

¹³³ *Id.* at 27.

¹³⁴ Juan Jose Diaz, *Public Sector Downsizing* in *Analyzing the Distributional Impact of Reforms*, Vol. 2, p. 225, World Bank, available at <http://go.worldbank.org/PK2BO4YJI0> (citing Haltiwanger, J., and M. Singh. 1999. "Cross-Country Evidence on Public Sector Retrenchment." *World Bank Economic Review* 13 (1): 23–66.)

¹³⁵ Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 17.

necessary in the last phase of restructuring.¹³⁶ Retrenched workers should be offered some compensation, but to induce acceptance of voluntary separation it should be lower than the voluntary program. In Argentina railways, the last 5,000-6,000 workers who did not accept voluntary retirement were declared redundant based on performance and laid off. About 3,000 additional workers were sent home with 50 percent of their salaries.¹³⁷ In Brazil Railways, laid off workers were given legal entitlements plus a separation package equivalent to 80 percent of the incentive offered under the voluntary program. The employees were selected based on performance, attendance record, frequency of penalties or suspensions, and family situation.¹³⁸

Unemployment benefits can assist displaced workers only if unemployment insurance schemes already exist. Unemployment benefits should not be set too high, in order to preserve fiscal stability and encourage the unemployed to reenter the labor market.¹³⁹ In 1998, the Chinese government started to deal with the bloated payrolls of SOEs. Over a five year period, 36% of the entire state workforce was laid off.¹⁴⁰ China introduced unemployment insurance in 1992, starting with creating a security fund for laid off workers. This was superseded by two funds, one providing unemployment insurance for two years, and the other providing an allowance for furloughed workers who were laid off but retained links with the SOEs.¹⁴¹ Additionally, enterprises were required to establish unemployment centers, funded with the help of public funds.¹⁴²

An alternative means of providing income support is through public works programs,

¹³⁶ *Id.* at 19.

¹³⁷ *Id.*

¹³⁸ *Id.* at 19-20.

¹³⁹ Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 22.

¹⁴⁰ Shahid Yusuf et al, *Under New Ownership: Privatizing China's State-Owned Enterprises* (2006) p. 79 citing Dorothy J. Solinger (2002). *Labour Market Reform and the Plight of the Laid-off Proletariat*. The China Quarterly, 170, pp 304-26. One estimate puts the numbers at 24 million workers. *Id.* at 30 n. 18.

¹⁴¹ *Id.*

¹⁴² *Id.*

which have been successfully used, for example, in Chile, although not in the context of privatization-related job losses.¹⁴³ Tunisia created jobs for workers through a program implemented to tide workers over for a temporary period while they sought reentry into the labor market.¹⁴⁴ In general, a critical decision in these programs is the level of wages. Wages should be kept low so as not to discourage the unemployed from entering the labor market.¹⁴⁵

C. Active Labor Market Policies

Active labor market policies are aimed at helping the unemployed return to work and decrease the duration of unemployment. Policies include job counseling and job search assistance, assistance and training for self-employment, and retraining. When labor demand picks up, these policies ensure that there is a supply of appropriately skilled labor to meet it.¹⁴⁶

The Philippines and Tunisia established funds for the purpose of providing retraining or entrepreneurial development.¹⁴⁷ These funds are often helped by loans from a multilateral financial institution. In developed countries, such as Austria, Germany, and Sweden, a wide variety of training programs are offered to interested employees. The costs are covered by the enterprises or the State, either in form of direct payments or tax deductions or a combination of both.¹⁴⁸ In Jamaica, the privatized enterprise is usually responsible for running retraining programs.

In Tunisia, particular attention has been accorded to the redeployment of the excess personnel who have acquired experience beneficial for the economic development of the

¹⁴³ *Id.*

¹⁴⁴ L. Gray Cowan, *The Labor Factor in Privatization, in Public Enterprises: Restructuring and Privatization*, Jack L. Upper & George B. Baldwin eds. 1995, p 209.

¹⁴⁵ Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 17.

¹⁴⁶ *Id.*

¹⁴⁷ *Comparative Experiences with Privatization: Policy Insights and Lessons Learned*, U.N. Conference on Trade and Development (1995) pg 241.

¹⁴⁸ *Id.*

country.¹⁴⁹ Thus, in addition to the payment of indemnities, the released employees are given help and the necessary institutional support to set up small businesses that can themselves generate employment. However, such programs must be accompanied by the creation of an enabling environment for the development of entrepreneurial capacity;¹⁵⁰ failure to do so may lead to unsuccessful performance by the new businesses. For example, Gambia gave displaced SOE employees soft loans as start-up capital for private ventures. Lack of management skills deterred many of them from actually starting a business or made them give up after a short period.¹⁵¹ Consequently, training programs should cover a broad range of activities, for example, developing knowledge and skills in operational areas such as marketing, bookkeeping, production techniques and product development, as well as in dealing with problems like finding new customers, suppliers, and collaborators, obtaining better prices, and reducing material costs.¹⁵²

While retraining is commonly included in the social safety net package, studies examining the cost-effectiveness of training programs are limited, making definitive conclusions difficult.¹⁵³ The few existing evaluations for industrial economies show mixed results. A review of twenty retraining programs in OECD countries covering both displaced workers and the long-term unemployed found that for displaced workers retraining programs resulted in modest gains

¹⁴⁹ *Id.*

¹⁵⁰ Examples of macroeconomic and structural policies that should be adopted are discussed in the next section of this paper.

¹⁵¹ *Id.* at 242.

¹⁵² Business Development Services for SMEs: Preliminary Guidelines for Donor-Funded Interventions, Summary of the Report to the Donor Committee for Small Enterprise Development, World Bank, pg 12, *available at* <http://www.edgegrowth.com/Portals/0/Documents/Seminal%20Docs/World%20Bank%20-%20SME%20BDS%20-%20World%20Bank%20Best%20guidelines.pdf>. This report focuses on general guidelines for small business development and does not discuss training in the privatization context. Nevertheless, these principles should apply be privatization.

¹⁵³ Sunita Kikeri, Privatization and labor: what happens to workers when Governments Divest, World Bank Technical Paper, The World Bank, 1997, p 25.

in reemployment probabilities, but wage changes were negligible or negative.¹⁵⁴ The same review also found that the costs of retraining appear to be two to four times higher, though no more effective, than job search assistance.¹⁵⁵ As a result, a World Bank paper suggests that focusing on labor market policies that eliminate obstacles to private job creation is a better approach than retraining.¹⁵⁶ Yet, political and social circumstances may necessitate instituting retraining programs. In such circumstances, a first step is to carry out an assessment of the scale and nature of layoffs, the demand for retraining services, existing labor market conditions, and the ability of the existing training infrastructure to deliver services.¹⁵⁷

The problem with retraining programs is that careful planning is required so that the workers are retrained for jobs for which there is some prospective need.¹⁵⁸ Often, the tendency is to train for jobs already in surplus simply because the training facilities and personnel are available, resulting in supply based, and not demand based, retraining.¹⁵⁹ The usefulness of training programs can be increased by forming demand-driven programs that target retraining on specific groups for whom it is most cost-effective.¹⁶⁰ This involves taking into account workers' employment profiles—including age, education, and skill level—and local labor market needs. In general, younger workers with basic educational levels and skills are most likely to improve their labor market outcomes from retraining. On the other hand, retraining programs are of limited applicability for older workers, where early retirement schemes combined with the

¹⁵⁴*Id.* (citing *Evaluations of Retraining Programs in OECD Countries: Implications for Economies in Transition*, Internal Discussion Paper 156. World Bank, Office of the Vice President, Europe and Central Asia Region, Washington, D.C.(1995)).

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at 23

¹⁵⁷ *Id.* at 26

¹⁵⁸ L. Gray Cowan, *The Labor Factor in Privatization, in Public Enterprises: Restructuring and Privatization*, Jack L. Upper & George B. Baldwin eds. 1995, p 209.

¹⁵⁹ *Id.*

¹⁶⁰ Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p 26.

provision of basic social services are key.¹⁶¹

Providing vouchers to private employers to provide on-the-job training is one way to ensure that training is market oriented.¹⁶² Cape Verde has successfully worked out arrangements where private employers are given subsidies to provide on-the-job training for employees retrenched as a result of privatization. Private employers are reimbursed 40 percent of the salary of a retrenched worker up to a period of six months. At the end of the six months, the private employer is expected to confirm the job and assume the full salary costs of the retrained employees.¹⁶³ Giving workers a choice between obtaining training or getting the equivalent amount in cash as part of severance pay, or as a voucher to select their own training programs, also ensures that training is demand driven.¹⁶⁴

Alternatives to retraining, such as counseling and job search assistance, appear to be more promising options. Experience from industrial countries shows that counseling can be crucial in helping individual workers obtain information about education, training, and alternative job opportunities, in making other employment services more demand-oriented, and in better targeting expenditures for other employment services.¹⁶⁵ Provision of job search assistance or placement services that provide information on labor markets and job openings, and include registration of job seekers, selection and referral of job applicants, and follow-up with employers after referral help enhance labor mobility. Moreover, counseling is far more cost-effective: evidence from industrial and developing countries shows that it is at least twice as

¹⁶¹ *Id.* at 27

¹⁶² *Id.* at 28.

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Id.* (citing Fretwell, David, and Susan Goldberg. *Developing Effective Employment Services*, World Bank Discussion Paper 208. World Bank, Human Resources Operations Division, Washington, D.C.(1993)).

cost-effective in assisting displaced workers compared to retraining.¹⁶⁶

. Another way to minimize labor redundancies is to contract activities previously carried out within the enterprise to private cooperatives formed by former state enterprise employees.¹⁶⁷ This arrangement has been used in a variety of countries and sectors. In Argentina, the oil company YPF entered into service contracts with 210 companies formed by 5,300 former employees. Similarly, the railways company rented out workshops performing rolling stock repairs to worker cooperatives that compete with the private sector.¹⁶⁸ In Congo, railroad workers have subcontracted with the railways company to manage activities that have been privatized, including marketing merchandise, handling baggage and package, and maintaining tracks, equipment, and buildings. In Peru, some 20 percent of laid off state employees became subcontractors; small companies created by former state employees were formed in all sectors, including transport, water, mining, ports, and electricity.¹⁶⁹ Ensuring that employees can compete effectively with other service providers requires the provision of support services, including training for business start-up, access to initial working capital, and technical support in preparing bids and contracts.¹⁷⁰ Such support should be temporary to ensure that competition is not crowded out.

D. Sound Macroeconomic and Structural Policies

Privatization does not take place in a vacuum; it is usually one element of a larger program of macroeconomic and structural adjustment. The more effective the program is in

¹⁶⁶ *Id.* (citing Dar, Amit, and Indermit Gill, *Evaluations of Retraining Programs in OECD Countries: Implications for Economies in Transition*, Internal Discussion Paper 156. World Bank, Office of the Vice President, Europe and Central Asia Region, Washington, D.C (1995); Fretwell, David, and Susan Goldberg, *Developing Effective Employment Services*, World Bank Discussion Paper 208. World Bank, Human Resources Operations Division, Country Department II, Washington, D.C. (1993)).

¹⁶⁷ *Id.* at 19.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ Sunita Kikeri, *Labor Redundancies and Privatization: What should governments do?* Public Policy for the Public Sector, Note No. 174, Jan. 1999 (World Bank) p. 3-4.

fostering a dynamic private sector, the easier it will be for displaced workers to find new employment and the less the need for social safety nets.¹⁷¹ Particularly in the case of large loss-makers and infrastructure firms, rapid privatization and a focus on creating jobs through the private sector—rather than on preserving jobs in less efficient areas—are needed to secure economy-wide gains.¹⁷² Hence, policymakers need to complement privatization with macroeconomic and structural policies that are conducive to growth and private sector development. Reforms that promote flexibility of labor markets and enable entrepreneurial capacity, particularly in small and medium enterprises, are especially important.¹⁷³ Government policies may strengthen the viability of such enterprises by addressing regulatory and fiscal issues, and facilitating access to finance, technology, market information, and advisory services.¹⁷⁴ Eliminating obstacles to private sector job creation—such as restrictions on hiring and firing, and excessive payroll taxes—facilitates the restructuring process and smoothes the movement of workers to private employment.¹⁷⁵

Governments should also involve small and medium sized enterprises in government procurement, marketing and distribution channels, and export promotion programs.¹⁷⁶ The national policy framework of India and Korea for small enterprises incorporates specific concessions for the growth and development of export capacity and exports through export development companies.¹⁷⁷ Additionally, business associations of small and medium sized

¹⁷¹ Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 17

¹⁷² Sunita Kikeri, *Privatization and labor: what happens to workers when Governments Divest*, World Bank Technical Paper, The World Bank, 1997, p x.

¹⁷³ *Comparative Experiences with Privatization: Policy Insights and Lessons Learned*, U.N. Conference on Trade and Development (1995) pg 242.

¹⁷⁴ *Id.* For further information on policies for small enterprise development, it cites a book I was unable to locate, Neck, Philip A. and Nelson, Robert, *Small Enterprise Development: Policies and Programmes*, Geneva; ILO (1987)

¹⁷⁵ Gupta et al, *Privatization, Social Impact, and Social Safety Nets*, IMF Working Paper (1999) p. 17

¹⁷⁶ *Comparative Experiences with Privatization: Policy Insights and Lessons Learned*, U.N. Conference on Trade and Development (1995) pg 242.

¹⁷⁷ *Id.*

enterprises, like the Handwerkskammer (craft chambers) in Germany, can play an important role in providing guidance and training to new businesses.¹⁷⁸ They also represent the interests of the small business sector with the government and, consequently, can influence policies and regulation concerning small enterprises.¹⁷⁹

IV. Pensions

Governments must address the question of what to do about pension benefits. Retirement benefits represent a large percentage of public employees' benefit packages in most jurisdictions. The prospect of having to forfeit their pension benefits will induce many public employees to strongly resist privatization.¹⁸⁰ Additionally, many pension programs are operated on a largely unfunded or "pay-as-you-go" basis, in which obligations are treated as a current operating expense rather than paid from reserves or asset pools to which payment is made at the time a future obligation is incurred.¹⁸¹ As a result, many firms have a large liability for future benefits that are not accounted for and for which funds have not been set aside. Unfunded pension liabilities and other pension issues present a significant challenge on privatization. Such liabilities can be substantial and investors may be reluctant to take over an entity until those liabilities are resolved. Investors considering purchasing SOEs have balked at the accumulated costs of pension and other rights provided by labor codes, forcing the government to either assume this burden as part of the sales agreement or substantially reduce the sales price of the SOE.¹⁸²

There are three potential approaches to dealing with pension liabilities with many

¹⁷⁸ *Id.* at 242-43

¹⁷⁹ *Id.* at 243

¹⁸⁰ William D. Eggers, *Overcoming public employee opposition to privatization*, Business Forum, Winter-Spring, 1994, pg 2, available at http://findarticles.com/p/articles/mi_hb3355/is_n1-2_v19/ai_n28646336/

¹⁸¹ William Morrison, *Labor Issues in Public Enterprise Restructuring*, Asian Development Bank, December 2006 p. 6.

¹⁸² *Id.*

variations and combinations possible.¹⁸³ The first option is to renegotiate or modify the past pension obligation to bring the liability to a manageable level. Second, governments can freeze the past obligations and establish a means either to set aside funds to meet the obligation or to transfer the obligation and associated risk to another entity. Finally, governments can establish a viable approach to resolve the past liability by setting aside assets or scheduling the payment of contributions in arrears on a schedule that is sustainable for the enterprise as a going concern.

The lowest-cost approach to resolving past pension liabilities is to reduce the magnitude of the liability. The viability of this approach is likely to be determined by a combination of legal constraints and the assessment of potential consequences to labor or government relationships.¹⁸⁴ Prior pension obligations can be reduced through a retrospective modification of the benefit formulas, including steps such as reducing the proportion of wages replaced for each year of covered work and increasing the age at which retirement is permitted. Workers in public infrastructure entities, especially those included in civil servants' schemes are likely to represent powerful political constituencies and strongly resist such steps.¹⁸⁵

An intermediate approach to addressing past obligations is to freeze the existing obligation at its current level and take steps to address it in a manner that is viable for the future. In this approach, the past pension obligations are honored, but additional benefits do not continue to accrue or they accrue at a different level or in a form more affordable with the anticipated needs of the future.

Alternatives for resolving liabilities include development of a schedule for amortizing any shortfall over a period that matches a projected future funding stream, paying lump-sum

¹⁸³ *Labor Issues in Infrastructure Reform—A Toolkit*, Module 5, World Bank' Investment Climate Department, available at <http://rru.worldbank.org/documents/toolkits/labor/toolkit/index.html>.

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

settlements to affected workers in exchange for the settlement of the obligation, "laying off" the liability through a contract with a life annuity provider, or in some cases even permitting a public entity to take over the pension obligation in exchange for an agreed-on fee or future series of payments.¹⁸⁶ In cases where there is considerable uncertainty regarding the capacity of an enterprise to fulfill future obligations and remain a viable concern, workers may be willing to accept one-time cash payments of lesser present value than the benefits they forgo in the settlement of future pension rights.¹⁸⁷

The least controversial method of resolving existing pension obligations is simply to pay their full cost on a present-value basis. If this is financially viable, it may be financed in a variety of ways. Proceeds from the sale of assets belonging to an enterprise can fund the pension liabilities. These assets may be rolled into a separate fund that combines existing liabilities with future ones.¹⁸⁸ An example of the separation and isolation of pension assets and liabilities is Tanzania Telecommunications Company. As part of privatization, unfunded liabilities were removed from the company's balance sheet and transferred to a newly created company, Simu 2000 Ltd. It took over the unfunded pension liabilities and was required to ensure that the future pension obligations from these older pension plans were met. Simu 2000 Ltd. took over existing assets of the previous pension company plus noncore assets of the telecommunications company in exchange for also taking over future pension liabilities. The privatization committee provided an initial advance to cover the first three months of the pension payments and the initial administrative cost of setting up Simu 2000 Ltd.¹⁸⁹ Similarly, a special purpose entity was

¹⁸⁶ *Id.*

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

established to take over pension funds in the privatization of the Nigerian electricity sector.¹⁹⁰

Privatization proceeds can finance pension obligations. Some countries have first sequenced the sale of valuable enterprises to build up adequate funds to finance the labor adjustment, including pension costs. Proceeds can either be monetary transfers, or transfers of government shareholdings in public enterprises into private pension plans. If the investor is willing to take on pension liabilities, but in return, reducing the purchase price, that discount is effectively the same as the forgone privatization proceeds.

For example, in 1981 management and employees bought the National Freight Corporation in one of Britain's first privatizations. Sale revenue of £60 million was reduced to £9 million after the government paid for pension obligations.¹⁹¹ Bolivia's 1994 privatization is a unique example of a combined privatization and pension system reform program.¹⁹² Major state enterprises, including gas, telecommunications, railways, airlines, and electricity generation and transmission, were privatized through a competitive bidding process with private investors purchasing up to 50 percent of the companies' shares. Government transferred the remaining 50 percent of the shares into two new privately managed pension plans. This approach meant that there were no privatization proceeds left for the state budget, but that the investment went directly into these infrastructure assets. At the same time, the utilization of pension plans helped provide for development of the local capital market and meet the social protection needs of the population.¹⁹³

Donor loans and grants through large sector reform and structural adjustment lending

¹⁹⁰ Neil Ford, *Nigeria power to be privatized*, African Business; Sep. 2002, Issue 279, p 32.

¹⁹¹ Madsen Pirie, *Policymaking and Privatization: Ten Lessons from Experience*, Economic Reform Today, Number One 1998, p. 29-30, available at http://www.cipe.org/publications/ert/e27/E27_08.pdf.

¹⁹² *Labor Issues in Infrastructure Reform—A Toolkit*, Module 5, World Bank' Investment Climate Department, (citing Guislain, Pierre. 1997. *The Privatization Challenge: A Strategic, Legal, and Institutional Analysis of International Experience*. Washington, D.C.: World Bank.)

¹⁹³ *Id.*

programs are a potential source for funding. For example, World Bank loans financed severance packages for redundant workers, including pension liabilities payments, in the restructuring of the Polish and Brazilian rail sectors and the privatization of Togo's telecommunications sector.¹⁹⁴ The International Finance Corporation, the private sector arm of the World Bank, helped the Kenyan government arrange US\$81 million in financing to fund the privatization of the telecommunications company.¹⁹⁵ The loan helped fund the restructuring of the company's balance sheet so that it could be privatized free of major government liabilities, including government debts and pension deficits.¹⁹⁶

The final way to finance pension liabilities is through rescheduled liabilities that are paid later from the profits of the privatized enterprise.¹⁹⁷ Sometimes, this rescheduling may include the negotiated write-off of some debts, the government raising funds through government bonds and securities, or by the privatized enterprise issuing corporate bonds. An example is the Moroccan Railways Corporation, which agreed with the government of the Kingdom of Morocco to finance unfunded pension provisions by issuing bonds over a five-year period.¹⁹⁸ Chile relied on government bonds to finance debts owed to workers, with revenues collected from the tax system paying off the bonds.¹⁹⁹

In Mexico, prior to privatization, Ferrocarriles Nacionales de México (FNM, a railroad company) had a pay-as-you-go pension scheme directly attached to the operational accounting of

¹⁹⁴ *Id.*

¹⁹⁵ *Kenya: Telkom Kenya*, Infrastructure Advisory Success Stories, International Finance Corporation, p. 2, available at

[http://www.ifc.org/ifcext/psa.nsf/AttachmentsByTitle/PPPseries_TelkomKenyaS/\\$FILE/SuccessStories_Telkom.pdf](http://www.ifc.org/ifcext/psa.nsf/AttachmentsByTitle/PPPseries_TelkomKenyaS/$FILE/SuccessStories_Telkom.pdf)

¹⁹⁶ *Id.*

¹⁹⁷ *Labor Issues in Infrastructure Reform—A Toolkit*, Module 5, World Bank' Investment Climate Department, available at <http://rru.worldbank.org/documents/toolkits/labor/toolkit/index.html>

¹⁹⁸ *Id.*

¹⁹⁹ Jenkins, Glenn P, 1992. *Privatization and Pension Reform in Transition Economies*, Public Finance, vol. 47(Supplement), pages 141-51

the firm.²⁰⁰ There was no special fund for retirement of workers. As part of privatization, a trust fund to finance retirement benefits was created. The fund only paid the pension of people who decided on retirement before dissolving FNM, and did not cover the pension of workers who could have been hired by concessionaries.²⁰¹ In fact, the trade union negotiated independently with concessionaries so they would receive life insurance and pension schemes under a new agreement with each concessionaire. The federal government contributed 1.64 billion dollars from privatization proceeds and started the trust fund with the state-owned Bank Nacional Financiera as the fiduciary institution.

²⁰⁰ Luis F. López-Calva¹, *Private Participation in Infrastructure and Labor Issues: The Privatization of Mexican Railroads*, November 2001 p 24.

²⁰¹ *Id.*

Summary note on the main labor issues in case of privatization with a look also at insolvency



***Presentation by Alexios Papastavrou
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- At a first glance, four main issues need to be discussed:
 - o Changes in the size of the workforce
 - o Modification of the employment terms and conditions
 - o Social security matters
 - o Privatization within the framework of insolvency proceedings

- o Insofar as the **size of the workforce** is concerned, privatization may be achieved in two ways:
 - o In case of **transfer of shares**, the identity of the employer is not affected and as such the common restrictions imposed on redundancies for financial and technical reasons shall apply (i.e. collective redundancies' limits and procedures, protection of trade unions BoD members, and of pregnant women, etc)
 - o In case of **transfer of business (in the ECJ sense) or undertaking**, the presidential decree 178/2002 (that implemented Directive 98/50/EC of the Council) imposes further restrictions:
 - Article 5 para 1: *The transfer of the undertaking, business or part of the undertaking or business does not in itself constitute grounds for employees' dismissal. This provision does not impede dismissals that may take place for economic, technical or organizational reasons entailing changes in the workforce always in compliance with the relevant redundancy provisions.*

PLEASE NOTE: the transferee is required to notify and consult with the employees' representatives prior to the transfer.

- Article 5 para 2: *If the employment agreement or the employment relationship is terminated because the transfer results to a substantial change in working conditions to the detriment of the employee, the employer shall be regarded as having been responsible for the termination of the employment agreement or of the employment relationship.*

PLEASE NOTE: such claims are likely to be invoked and the employer must be expected to be held liable for severance payments as per ordinary law

- ADDITIONAL COMMENT: Even if provided by Law, it cannot be ruled out that personnel transfers from the legal entity under privatization (or even soon to be privatized) to some legal entities of the public sector may be found by some Court to be problematic in terms of the Greek Constitution (article 103).

In addition, such transfers are currently deemed to be hiring of workforce. Thus, the principle “*1 hire (= transfer) for every 5 departures*” shall apply.

Therefore, there is a strong likelihood that the only means effectively able to achieve a true reduction of workforce would be the termination of employment agreements, whether voluntary (i.e. through a voluntary redundancy scheme) or not.

- Insofar as **employment terms and conditions** are concerned

oLaw

- In case of transfer of shares, the legal identity of the employer is not affected and, consequently, working terms and conditions remain unchanged, employer's and employees' rights and obligations remain the same.
- In case of transfer of business or undertaking, the presidential decree 178/02 (that implemented Directive 98/50/EC of the Council) shall apply:

- ✓ Article 4 para 1: *As of the date of the transfer, the transferor's rights and obligations arising from an employment agreement or from an employment relationship shall, by reason of such transfer, be transferred to the transferee. Even after the transfer is effected, the transferor and the transferee shall be jointly and severally liable in respect of obligations which arose from the employment agreement or from the employment relationship up to the time that the transferee undertakes his obligations.*

PLEASE NOTE: The individual shall be held personally liable in view of all debts of the privatized legal entity against the employees and which arose the previous years namely, prior to the transfer (privatization).

- o Consequences (regarding the possible impact of privatization on employment terms and conditions)
 - If employment terms and conditions are provided by Law, a Law is required to amend them.

- ✓ Article 4 para 2: *Without prejudice to the next paragraph, following the transfer, the transferee shall continue to observe the terms and conditions agreed in any collective labor agreement, arbitral award, regulation or individual employment agreement.*
 - ✓ Article 4 para 3: It provides for the right of termination or amendment of any group insurance contract etc
-
- If employment terms and conditions are provided by collective labor agreement(s) and / or arbitral award(s) and / or Employment (Internal) Regulation(s), they may be amended (even to the employee's detriment) solely by a new collective labor agreement or arbitral award, otherwise termination (of the CLAs etc) is required. Nevertheless in the case of termination, all those hired up to six months following the termination will benefit from the previously terminated instruments.

PLEASE NOTE:

If the collective labor agreement has been ratified by Law, a new Law must provide as well (along with the new collective labor agreement) for any possible amendment.

One cannot rule out the possibility that the abolition of a collective labor agreement by Law may be found by some Court to be problematic in terms of the Greek Constitution.

- If employment terms and conditions are provided by an individual employment agreement, any amendment is possible only when provided by a new individual employment agreement.

PLEASE NOTE:

One cannot rule out the possibility that the abolition of an individual employment agreement by Law may be found by some Court to be problematic in terms of the Greek Constitution.

- If employment terms and conditions result from business practice(s), according to the prevailing view each individual employment agreement is implicitly amended by the business practice(s) and, as such, one must treat the matter as mentioned hereabove regarding the amendment of the individual employment agreement.

- o Conclusion

- Successful HR management of a privatized business is likely to require the conclusion of individual and collective labor agreements.
- One cannot rule out the possibility that some Court finds the resolution of such matters by Law to be contrary to the Constitution.

- Insofar as **social security** is concerned:
 - o Problem: if employees' main or auxiliary Social Security Funds before and after privatization differ.
 - o Solution: only by Law.
 - o Current laws on “successive” social security are not adequate.

- Insofar as the **privatization within the framework of insolvency proceedings** is concerned
 - o Law
 - Article 34 para 1: *Employment agreement is not terminated by the declaration of insolvency*
 - Article 34 para 2 of Insolvency Code facilitates the termination of the employment agreements; most crucially, the liquidator may invoke the insolvency as cause for termination of term employment agreements; employment agreements may also be terminated by the liquidator but, under Greek law, those do not require the invocation of cause. In addition, termination upon insolvency of agreements of indefinite duration is valid even if the employer fails to pay termination compensation. This may be crucial from the perspective of limiting the accumulation of debt for insolvent debtors.
 - Article 34 para 3: If the liquidator's report of article 70 foresees to the viability of the business and the company seeks reorganization, the liquidator, the debtor and the creditors' committee can each one of them separately or jointly request from the rapporteur the preservation of the necessary personnel until the ratification or rejection of the reorganization plan of art 107 *et seq.* by the Insolvency Court.

oConclusion

- A company in the process of privatization that is in financial distress may find the declaration of insolvency of assistance to the restructuring of its labor force while being able, at the same time, to maintain the enterprise in operation.

Reforming SOEs: The need to assess all parameters

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The reform of state owned enterprises has consistently been on the agenda of the Greek administration over the past decades. Successive governments have overseen various programmes of reform in the state sector. However, it gradually became apparent that to efficiently address the ubiquitous problems of degenerating SOEs, policy action on a broad front is required.

A defining feature of SOEs reform is that it has to take place within the wider context of economic, legislative and organisational reform. Either on account of the commitments that Greece has undertaken in recent times and in any case by virtue of the necessity to find an exit route from the current odious financial conditions, the time is ripe for the state to delve into the overhauling reform of SOEs.

Various economic and legal doctrines have been developed on the rehabilitation and restructuring of SOEs, with the abundant literature providing both theoretical and empirical justification. These range from commercialization¹, through alternative forms of management such as Public Private Partnerships (PPP), organizational changes, to partial or full privatization. What emerges as a common denominator of all models is that, any reform is a systematic project, requiring to clearly determine from the outset the priorities of the changes that need to be instituted. However, much of the effort to alter existing policies and to effect the measures of choice will be fruitless unless the reform objectives are considered in light of the particular parameters pertaining to SOEs under review.

It is relatively easy to distinguish between poorly managed, inefficient and wasteful state-owned enterprises. Although, this may not prove to be an inexpensive and timely task, depending on the available information and the quality of the datasets depicting the performance of the relevant entities. In any case, it is more than likely that most SOEs will be deemed dysfunctional when considered purely under the prism of economic orthodoxy. Nevertheless, the challenges associated with the reform of certain SOEs

present a particular conundrum. In most cases, this relates to the economic and social affairs, directly linked with the role and operations of state owned enterprises. This is particularly true for SOEs that ensure universal access to essential services for all citizens, especially when the enterprise has been established to provide public goods and services that are likely to be under-provided by private companies acting purely on market incentives.

In fact, services of general economic interest are portrayed as fundamental elements in the European model of society, with Article 16 of the EC Treaty confirming their place among the shared values of the European Union². At the same time, special consideration may also be required in the case of SOEs operating in specific industries. A typical example is the case of armaments, where performance and profitability indexes may not necessarily be the most suitable yardstick to determine the role of such SOEs.

The nature of the services provided by certain SOEs does not negate the necessity for reform. It merely sets the parameters that will need to be examined when selecting the model that will be applied in reforming these. Therefore, liquidations, mergers and privatization may be suitable for some less essential SOEs, but not appropriate for others that could benefit more from extensive organizational restructuring and measures that would inculcate public services ethos and would motivate employees and lax management.

On this premise, it is impossible to suggest that a single model is unconditionally the best for the scale and scope of reform under consideration, on account that one option may not be fully consistent with the particularities of each SOEs. However, a hybrid model that would amalgamate case specific parts of the above reform options may prove helpful in removing the functions that the government considers to no longer be the business of the State, freeing this way resources to improve the performance of other, more essential SOEs, whilst at the same time effecting the changes dictated by other models to ensure that the entities

remaining under state ownership are structured to deliver their services as efficiently and effectively as possible.

Once a reform model is formulated, it will be essential to ensure that progress is monitored during all phases of the implementation process. The establishment of monitoring agencies from the outset is one of the main pillars of the reform process. The experience of auditing companies and insolvency experts is pivotal in this direction. In fact, the stigma attached to the word insolvency is grossly misleading, given that a great deal of work in this field entails the rehabilitation and rescue of corporate entities in financial distress. Monitoring mechanisms will assist the flow and quality of information throughout the stage of instituting changes. At the same time it will guarantee the transparency of the procedure, which is paramount for the success of any efforts in this direction. The necessity of transparency is further magnified in reform models requiring equity divestitures. This is due to the fact that the process of privatization has traditionally attracted criticism for lack of transparency, fueling concerns of nepotism and political patronage. This could potentially give rise to serious shortfalls in the reform process, under the suspicion that unfavorable conditions were attached to the sales.

At the same time, transparency is also crucial in building public confidence on the necessity of the institutional changes and most importantly on the way these are designed and implemented. A reform of the purported scale will not be accepted unquestioningly. A significant level of protest and disquiet should be expected. Nevertheless, the experience of SOEs reforms in other jurisdictions shows that the support of the business community plays a significant and proactive role in the reform process. Transparency in many of these cases was a key element in securing active supporters (like for example the chamber of commerce or the various professional associations and federations of enterprises) to publicly advocate reform.

The timing for implementing changes is also crucial. Rigid deadlines dictated by exogenous factors could prove ominous for reform. It is important that the timetable for implementation allows for contingencies that are bound to arise, as well as for the establishment of new systems before the old ones are removed.

Despite the merits of having a strict timeframe for instituting changes, this may also have an unwanted impact on the value of SoEs. For example in case the reform process is largely geared towards privatisation, the outcome of the sale could be less than expected if this has to be effected within a short period of time.

In any case, a “fire sale” of a substantial number of state owned assets, especially within a set deadline, may create the impression that the state is selling out the “family silver”³. There is justification to suggest that this could be disconcerting to the society and detrimental to the image of the state and its prospects of recovery, especially if the proceeds are destined to reduce external debt and are not injected to the economy in pursuit of economic development and growth.

Apart from the various models on reform, Greek legal order also provides legislative tools that could be put at use, under qualifications, to assist the process of rehabilitation and the restructuring of SoEs. For example, the amended Greek insolvency code may provide readily available solutions, in some cases, without the need for regulatory or legislative amendments. These could be in the form of liquidation or reorganization proceedings, if this solution is promoted.

However, concerns have been voiced in that the insolvency code should not be the predominant legislative framework to effect reform of SoEs. Particularly in the case of privatization, arguments have been put forward that the sale of state owned enterprises should not be effected under the aegis of insolvency legislation. If this is the case, then arguably the insolvency code should be also used where the state wishes to acquire ownership of a private business entity. Lessons of the past have shown that this is an extremely problematic route.

The selection and implementation of the appropriate model for reform is a matter of policy and without a doubt a political decision. However, this does not necessarily mean that the reform of SoEs is a purely political matter but perhaps a national matter of utmost significance. It is true that the momentum of socioeconomic dynamics in Greece, traditionally called for the state to bailout ailing SoEs, predominantly

instigating a social protection strategy to mitigate the calamity of job losses. Nevertheless, this is not an option any longer. However, the process of reform is not necessarily a dilemma between ideological correctness and economic viability, as evidenced by the breadth of the available options⁴. Careful strategic planning, rigid monitoring and transparency throughout the process could ensure that the state attains the goals that it sets, in the best possible way.

¹ *Subjecting the operation of public firms to market-related management disciplines through a range of different contractual forms, hard budget constraints and where possible competition, with the state retaining ownership. This purports to capture the benefits of private ownership without the loss of public assets, see Communication from the Commission to the Council and the European Parliament, "The Reform of State-Owned Enterprises in Developing Countries with focus on public utilities: The Need to Assess All the Options", COM(2003) 326 final, p. 7.*

² Without prejudice to Articles 73, 86 and 87, and given the place occupied by services of general economic interest in the shared values of the Union as well as their role in promoting social and territorial cohesion, the Community and the Member States, each within their respective powers and within the scope of application of this Treaty, shall take care that such services operate on the basis of principles and conditions which enable them to fulfil their missions. Also see Communication from the Commission to the Council and the European Parliament, "The Reform of State-Owned Enterprises in Developing Countries with focus on public utilities: The Need to Assess All the Options", COM(2003) 326 final, p. 15.

³ Ha-Joon Chang, "State owned enterprises reform", *National Development Strategies, Policy Notes*, United Nations Department for Economic and Social Affairs (UNDESA), 2007, p.20

⁴ See also, Georges Enderle, "Ethical guidelines for the reform of state owned enterprises in China", *UPenn Journal of International Economic Law*, Volume 18, p.1177 et seq.