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# Privatization Laws

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Privatization is a transaction or series of transactions by which governments sell off all or part of an interest in a state owned asset. It is often used in the context of state-owned businesses, which are first converted into corporations and undertake financial and operational restructuring to prepare them for sale. Privatization is therefore different from PPP as it is anticipated that public involvement in that particular business will cease or be diminished, as opposed to PPP where the government role continues throughout the PPP and in most cases the asset returns to government control on expiry or termination of the PPP.

## Legal Foundations for Privatization Laws

Privatization laws provide authority to government agencies and clarify the rights of investors, both domestic and foreign, to participate. These laws are supported by elements of the wider legal framework such as corporations and capital markets laws. This page provides analyses of legal issues arising in the course of privatization, as well as illustrative examples of good practice privatization laws.

The objective here is to provide guidance to policy makers in addressing legal issues likely to arise once a governmental decision has been made to proceed with a program for the privatization of state assets or enterprises. Such a program may entail the privatization of substantially all state enterprises in the tradeable sectors of a country, sectoral privatization or the privatization of selected medium or large enterprises. These guidelines do not, however, discuss small-scale privatization of the retail or service sectors or mass privatization programs involving the distribution to the general public of vouchers or similar instruments.

A "privatization transaction" for the purposes of these guidelines is one in which ownership or control of a public body (state, government, ministry, department, enterprise or corporation) or its major assets or shares held by a public body in a company representing a controlling interest are to be transferred from the government or a government-controlled entity to the private sector.

"Private sector" would exclude an entity which is owned or controlled, directly or indirectly, by a public body. So the sale of an enterprise to a public body, whether of the host state or another state, is not a privatization for the purposes of these guidelines.

A privatization law serves a valuable purpose in defining the legal authority for a country's privatization program, the key principles on which it will be based, and the institutional arrangements for policy making and implementation. Other supporting laws provide for the legal steps in preparation for privatization and to consummate the transaction, as well as forming part of the business environment in which the newly-privatized enterprises will operate.

## **Key Legal Frameworks Supporting Privatization**

The choice of whether or not to enact a privatization law depends upon the constitutional and legal circumstances of the country concerned. Typically in the case of countries with constitutions derived from the French legal tradition, a privatization law to authorize the sale of state assets will be a constitutional requirement. Even if a separate privatization law is not mandatory, such a law can serve a variety of purposes, such as to:

- define the government's objectives and establish commitment to the privatization process;
- make amendments to existing laws which otherwise would be an obstacle to privatization, e.g. laws preventing private sector participation in what were previously thought of as "strategic" activities;
- create institutions with the authority to implement privatization;
- avoid the "vacuum of authority" which can lead to spontaneous or unauthorized privatization;
- allow for the financial restructuring of enterprises prior to sale and permit liabilities to be cancelled, deferred or swapped for equity;
- define the methods of privatization and any limitations on potential bidders; and
- provide for the allocation of sale proceeds.

A principal function of a privatization law is to define the scope of the program and any exclusions of specific sectors or enterprises. Though the law may list the enterprises to be privatized, the disadvantage of doing so is that the listing becomes inflexible, with the resulting difficulty of either removing or adding enterprises as the program evolves. Other alternatives are to:

(a) adopt a "negative list" approach, so that all state enterprises are eligible for privatization other than named exceptions; or

(b) require a high-level political decision on a case-by-case or sectoral basis to transfer an enterprise to the privatization agency for disposal.

## **Supporting Legal Frameworks**

The legal framework of the country should support privatization in two respects: first, laws may be required to govern the process of preparing enterprises for privatization and undertaking the transactions; and second, the overall legal environment must be one in which the newly-privatized businesses can obtain access to land and credit, enter into enforceable contracts for their inputs and outputs, and compete on a basis of equality with one another and with the residual state sector.

The conversion of enterprises into corporations under a modern corporations law is an effective prelude to privatization. Corporatization enables the assets and liabilities of the business to be identified; allows for the appointment of a transitional board of directors to oversee the management; and provides for the issue of shares to the government, allowing flexibility in the sale of partial interests if required. The corporations law should also include procedures for the liquidation or dissolution of enterprises, thereby releasing the assets of insolvent state entities for sale to the private sector.

Prior to the sale of certain heavy polluting enterprises, an environmental audit should be performed to determine the requirements for environmental and occupational health cleanup. This audit can be performed in accordance with existing domestic or international environmental and occupational health standards. Based on that audit, the seller can decide whether to absorb the costs of existing environmental degradation, while requiring the buyer to meet future environmental liabilities.

Labor restructuring is commonly required before privatization to reflect the change from a government agency to a profit-oriented enterprise. Labor laws should define the entitlement of redundant employees to severance or other benefits, while recognizing the right of the employer to reorganize the labor force to meet changing needs.

Privatized enterprises are most likely to operate efficiently when they are exposed to competitive forces. A competition law is desirable to:

- allow for the review of the potential cartel effects of purchase of state enterprises or their assets by domestic or foreign entities with market power in the same or related sectors;
- prohibit restrictive or unfair trade practices.

If the enterprise is a public utility, a regulatory regime should be created by law so that the regulator can protect the public interest in output pricing and the quality of services and support future entry by competitors.

If foreign investors are expected to participate in the privatization program, the laws of the country should guarantee fair and equitable treatment to those investments according to generally acceptable international standards.

## **Institutional Arrangements and Transparency**

Privatization requires institutional arrangements to manage the program so as to ensure transparency and consistency in implementation.

Yet the conduct of privatization transactions differs from traditional bureaucratic activities, in that:

- the process must be as open as possible;
- privatization cuts across existing areas of influence and political and bureaucratic control;
- the agency controlling privatization must itself operate in a professional manner, as it will be dealing with private domestic and foreign buyers and with investment banks and other professional advisers.

These factors suggest the need for a central unit or agency responsible for overall guidance of the privatization program. The agency should have a single mandate: to sell the assets and enterprises in accordance with the policy principles on which the program is based. Clear authority to control program implementation, as well as the ability to recruit quality staff and outside advisers are also vital to success. Responsibility for managing the ongoing business activities of the enterprises prior to sale should however rest with the governing board of the enterprise.

The agency should desirably be given sole authority to:

- recommend to the appropriate political decision-maker the enterprises or classes of enterprise to be included in the privatization program;
- decide upon any necessary financial restructuring of the enterprise prior to sale;
- determine the timing and method of sale;
- control the preparation and issue of bid invitations and the pre-qualification of bidders, if required;
- require government-appointed members of the governing board of each enterprise to resign at or prior to settlement of the sale; and
- recommend the acceptance of the winning bid.

While a single central agency is the most desirable means of ensuring effective policy formulation and focused control of the process, the preparation and implementation of individual transactions should be decentralized to the maximum possible extent. Regional, sectoral, municipal or enterprise-specific groups can be set up to implement transactions in accordance with guidelines set by the central agency. Those groups should ideally include representatives of the major stakeholders, to improve the prospects for local commitment to the transaction, and should be assisted by investment banks, lawyers or other professional advisers as required.

### **Ensuring Transparency and Accountability**

A primary goal of any privatization program should be to ensure that transparency is maintained in every transaction. This can be done at two levels. First, the laws and regulations supporting the program should require the maximum publicity and openness in the workings of the privatization agencies consistent with normal requirements of commercial confidentiality. Second, individual transactions should be conducted under well-publicized competitive bidding procedures, encouraging the widest possible range of domestic and foreign investors to participate. Competitive bidding should maximize sales proceeds while maintaining public confidence in the integrity of the process.

### **Methods of Privatization and Allocation of Proceeds**

The principal methods of privatization through competitive bidding are the sale of assets or shares through public auction or tender, and the public offering of shares through a stock exchange. Except in the case of pre-existing contractual rights such as pre-emptive options to purchase held by existing private shareholders, a direct negotiated sale to a single buyer should be avoided.

Commonly, employees of an enterprise will be given a preferential right to buy a small proportion (normally not more than 10 per cent) of the shares of the enterprise. Payment may be deferred for a limited period, with transfer of ownership of the shares delayed until payment has been made. Employee consortia should also be eligible to participate in the bidding process on a basis of parity with other bidders.

Even within the same transaction, a variety of methods may be used: for example, sale of a tranche of shares to employees, followed by the sale of a core shareholding to a long-term investor, and finally a public offering of the balance of the shares.

### **Public Auction and Public Tender**

Public auctions are used to sell individual assets, and more rarely parcels of shares or a business as a going concern. The items to be sold are advertised along with the location of the auction. The terms and conditions of sale are fixed and require that the items to be auctioned are sold to the highest bidder. A minimum price may be set in advance so that if that price is not reached in the bidding, the seller has the option of either withdrawing the items from sale or negotiating a sale after the auction at a lower price to the highest unsuccessful bidder.

A public tender is suitable for the sale of larger or more complex businesses where there is not likely to be wide public participation. The availability of the enterprise for sale will be advertised and interested parties may be pre-qualified if the seller wishes to establish in advance their financial capacity or to review their operational or investment plans. Bidders may be required to negotiate the transfer agreement before submitting their bids and to accompany their bids with a signed copy of the agreement. In this way, the seller avoids the risk of a post-tender negotiation on issues not addressed in the tender document.

The general principles for a public tendering process are:

(a) the tender notice should be widely publicized and should provide summary information on the assets, should fix the date of bidding and should invite prospective bidders to obtain the tender document;

(b) interested parties who request the tender document should have the opportunity to carry out a due diligence evaluation of the enterprise and for that purpose should be permitted to inspect the books of account, examine the physical assets and interview senior management. To preserve confidentiality, prospective bidders can be required to sign an undertaking not to disclose or to use sensitive commercial information, and may be asked to post a bond in support of that undertaking;

(c) bids should be sought on a cash basis, accompanied by a deposit;

(d) bids should remain valid for a period after the closing date to allow careful evaluation and possible negotiation with the top bidder; and

(e) the privatization agency should have the right to reject any bids which do not conform to the general bidding guidelines, or to reject all bids if none are adequate.

The criteria for evaluating the tenders received could differ from one case to another. Desirably, tenders would be evaluated solely on the basis of price, i.e., the cash and other financial aspects of the bid (such as the assumption of liabilities by the bidder) would be assessed on a net present value basis, using a standard and consistent discount rate. The highest value bid would be selected.

The inclusion of non-price criteria in bid evaluation can be justified in certain cases, though the bid evaluation process is made more complex and transparency may suffer. Instead, non-price criteria should so far as possible be dealt with in the pre-qualification process to avoid the need to attribute financial "weights" to these factors.

When factors such as investment or employment maintenance promises are included as tender criteria, rather than simply pre-qualification assurances, legally-binding terms to give effect to these promises would be included in the contract with the successful bidder. The privatization agency would then need to maintain an effective monitoring and enforcement capacity during the post-privatization period.

### **Public Offering of Shares**

A public offering of shares requires as complete a disclosure as possible of relevant financial and business information concerning the assets and liabilities of the enterprise, its profitability history, business activities and future prospects. This disclosure should be in the form of an offering document or prospectus containing a description of the new shares and the terms on which they will be allocated. The offering document is prepared by the management of the enterprise and approved by the board of directors. It is then registered with the relevant capital markets authority and is a public document open to inspection.

Since investors will take up shares in reliance on the offering document, the responsibility for any errors or omissions in the document should rest with the board of directors which approved its issue.

### **Allocation of Proceeds**

When state assets are sold, the general budget law may determine how the sales proceeds are to be dealt with. If the existing laws do not do so, the privatization law itself should specify that proceeds should be applied:

- first, to meet the costs of sale, which may include a fixed percentage of the proceeds as a contribution to the operating costs of the privatization agency;
- second, towards liabilities of the enterprise retained by the state;
- third, towards outlays which benefit the economy at large or large segments of the population.

Since the restructuring of enterprises for privatization can frequently lead to one-time labor costs for the severance and retraining of redundant labor, a fixed proportion of the amounts remaining after payment of sale costs and enterprise liabilities may be applied to a special fund set up for this purpose.

### **The Privatization Transaction**

In addition to the broad legal issues having application across the entire privatization program, individual privatization transactions will give rise to a variety of legal issues needing to be dealt with on a case-by-case basis in reliance upon legal advice.

Specific transactional legal issues are most readily resolved in the context of a clear and consistent set of publicly announced guidelines for each step of the process, from evaluation through implementation. These guidelines should include the following principles:

(a) Market structure should be considered before privatization. If a state enterprise is dominant in any sector, either the enterprise should be broken-up before sale or restrictions on new entry should be removed or minimized. Any monopoly rights granted to a privatized enterprise should be time-bound and phased out as quickly as possible. In the tradeable sectors, the reduction or removal of tariff barriers will foster competition from imports. The review of market structure should also identify special privileges such as preferential access to credit to be abolished once the enterprise has been sold.

(b) For enterprises in the utilities sectors, the regulatory regimes to be responsible for tariff policy, service standards and new entry and the regulatory agencies required to implement those policies should be created or defined.

(c) In cases where the government retains a minority shareholding, it should not be entitled to any special or extraordinary voting or control rights, except in the case of "strategic" enterprises such as national airlines, where a golden share could be retained. Such a golden share could permit the government to veto the resale of a controlling interest if that would not be in the interests of the country.

(d) Domestic and foreign investors should have the same rights to participate in the privatization process. The government may however decide, as an exception, to reserve a tranche of shares for domestic investors only.

### **Examples of Privatization Laws**

#### **French - Civil law systems**

- [Algeria](#)
- [Morocco](#)
- [Tunisia](#)

#### **Middle East**

- [Jordan](#)
- [Oman](#)

## Central Europe

- [Bulgaria](#)
- [Turkey](#)
- [Latvia](#)

## Further Reading

[Businesses Of The State \(BOS\) and Private Sector Development Toolkit](#) - The WB Private Sector toolkit presents a full spectrum of policy options. It explores how the private sector can play a stronger role in sectors with state participation, ranging from corporate governance reforms, restructuring, regulatory reforms, management contracts up to full or partial privatization.

[Beyond privatization: A fresh approach and new tools for state-owned enterprise reform](#) - To support governments in navigating the complexities of SOE reform, the World Bank has introduced two innovative tools: A new taxonomy to distinguish the type of sectors and rationale for state ownership and A new toolkit to design and sequence SOE reforms toward private-sector-led growth.

### Related Content

- [Laws and Regulations](#)
- [PPP Legal Foundations - Further Reading](#)
- [Legislation and Laws - General and Sector Specific](#)
- [Regulatory Systems and Sector Overview](#)
- [Country Profiles](#)

### Additional Resources

- [PPP Reference Guide](#)
- [World Bank Guidance on PPP Legal Frameworks](#)

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