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IS THERE A NICHE FOR THE STATE IN CORPORATE GOVERNANCE? SECURITIZATION OF STATE-OWNED ENTERPRISES AND NEW FORMS OF STATE OWNERSHIP

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I. INTRODUCTION

The failure of socialism in Russia and Eastern Europe does not discredit the institution of state ownership. The phenomenon of state property is more than a temporary episode in human history. State property existed in the past and continues to exist in a broad variety of societies all around the world. Indeed, the economic concept of privatization is not an innovation of the post-socialist epoch; it can be found in the writings of Adam Smith as early as 1776.¹ Since that time, however, privatization has usually been regarded as the opposite of the process of nationalization. It is often believed that the privatization of state enterprises reflects the predominance of capitalist thinking, whereas nationalization is considered to be a sign of socialist development. In my view, however, the attempt to contrast the underlying ideologies of nationalization and privatization is misguided. There is no more socialist thinking in the proposal to grant some government control over certain sectors

1. Cf. ADAM SMITH, THE WEALTH OF NATIONS 7-16 (E. Cannan ed., Modern Library 1937) (discussing division of labor and freedom of trade in terms of market efficiency).

of the national economy than there is in support for government taxation, zoning, licensing, condemnation, trade quotas, anti-trust restrictions, securities regulation, and other forms of government interference in the "private business" of its citizens. Generally, from any ideological perspective, even the most libertarian, there is no question that the government should maintain some control of and impose some burdens upon the members of society; otherwise the state and society simply could not exist, being constantly riven by the anarchic behavior of citizens in conflict with each other. Even most conservative libertarian writers recognize the necessity of government coercion and of the existence of public property as essential prerequisites for the performance of government functions. On the other hand, no longer do positivists and socialists insist on absolute unlimited government power. Therefore, nationalization and privatization are nothing but reverse movements along the continuum of property rights. Neither abolishes the state's presence in the economy and neither abrogates the property interests of private owners.

Each society has its own special reasons and objectives for privatization. The nature of the government's objectives have a determinative effect on the shape of its privatization program. The length and scope of the privatization process will primarily be determined by the current socio-political atmosphere in the country, by the level of prior socialization of property, by distorted economic factors, by the stage of the development of the economic and legal institutions, and by the costs and effects of the options proposed.

For various political and social reasons, governments of some countries might want to retain some control over the privatized enterprises. For example, the preservation of government control is desirable in the spheres of national defense and public services, such as has been the practice in many countries (not all socialist) around the world. In certain situations, the government might also want to retain some control over privatized enterprises in order to prevent the closing of important strategic businesses, preserve production lines of enterprises representing the national heritage, protect employees from mass layoffs and so on. However, a government need not *fully* own an enterprise to accomplish its specific objectives. In order to maintain some control over former state-owned

enterprises in the process of being securitized and privatized, a government might employ various methods.

In certain situations, a government might determine that, for the sake of the national interest, it should not divest itself of majority holding in the enterprises that are of strategic importance nor in those that are determined to need government control for different public reasons. In other situations, a government might resort to alternative privatization techniques, such as the "golden share," which enable the government to retain veto power over key decisions by the new owners and management regarding the operation of a privatized enterprise after the state has become a minority shareholder or even after a total buy-out of the enterprise from the state.

A government might lock in its control over an enterprise during privatization through a covenant with the new owners and managers of the enterprise. After all, considering the low prices of most of the privatized state enterprises in some Eastern European countries and the former Soviet Union, the government is in a good bargaining position to demand some conditions and limitations on the future operation of the privatized enterprise.

Finally, a government might choose to let the enterprises be fully privatized and effectuate its control over them by regulatory means, such as: establishing certain mandatory requirements for the bylaws of the enterprises and their corporate charters; government licensing of particular industrial and entrepreneurial activities; requiring mandatory registration of the enterprises by local or central government authorities; restricting the activity of private joint-stock companies through various types of securities and antitrust acts; establishing limitations on foreign shareholding; institutionalizing government auditing and inspection services; imposing taxes and various exactions upon private enterprises; strictly enforcing labor and social security laws; resolving conflicts and disputes between enterprises through a state arbitration system; and instituting other state regulations on private enterprises that might be justified for reasons of public interest and national sovereignty. Moreover, in pursuing goals of public interest, the government's liability rules are not the only means to which it might have recourse to punish undesired corporate behavior. The goal of monitoring certain corporate activities might also be effectively achieved by enacting a system of government incen-

tives and privilèges aimed at encouraging a certain socially desirable functioning of the companies.

While these techniques are not a surrogate for government superintendence over the management and everyday operation of the enterprises, they provide the government with quite effective legal instruments to protect the national interest and to ensure that certain major decisions affecting the operation of the enterprises are consistent with its policies. This article will deal with some of the problems of implementing these legal techniques.

II. GOVERNMENT EQUITY SHARE IN THE PRIVATIZED ENTERPRISES

A. *Securitization of State Enterprises*

Generally, in corporate finance, "securitization" refers to a process of financial engineering by which an illiquid financial asset that has no secondary market is converted into a tradable security with an active secondary market.² This technique was first developed through the efforts of banks and financial institutions to repackage their mortgage loans into pools of similar loans in which ownership interests are then issued and traded on the securities markets as debt security.³ By pooling their loans and selling interests in them, banks improve their capital ratios and avoid regulatory requirements that otherwise would have forced them to maintain certain reserves on their own balance sheets equal to some proportion of the transferred loans.⁴

In contrast, "securitization" as it relates to the first phase of the privatization of state enterprises in the former socialist countries has nothing to do with the sale of collateralized interests to investors. The term "securitization" in this context refers exclusively to the legal and financial restructuring of state-owned enterprises through their conversion into joint-stock companies.⁵ As such, "securitization" generally refers to

2. See Joseph C. Shenker & Anthony J. Coletta, *Asset Securitization: Evolution, Current Issues, and New Frontiers*, 69 TEX. L. REV. 1369, 1373 (1991).

3. *Id.* at 1372.

4. *Id.* at 1391-92.

5. Such a conversion of legal form and financial restructuring of the state enterprises is also known in the former socialist countries under the terms "corporatization" and "commercialization." See, e.g., Polozhenie o

corporatization of an enterprise through issuance of *stocks* rather than general securities.

However, initially securitization was considered more broadly. In China, a pioneer among socialist countries in this area, the experiment of securitization started in the northeastern province of Liaoning in the early 1980s with the primary purpose of raising funds for collective enterprises.⁶ After establishing joint-stock companies (*gufen gongshi*), the shares were primarily distributed only to the employees of the enterprises, and had to be gradually redeemed from the enterprises' profits.⁷ These shares were mainly bonds and debentures that were not transferable and did not confer ownership rights.⁸

The term "securitization" is more narrow than the concept of "privatization" since the former does not necessarily involve the process of selling stock *to the public*. Indeed, in some former socialist countries, such as China, an overwhelming majority of the shares after securitization (*gufenhua*) is often retained by the state in order "to maintain the principle of socialist public ownership."⁹ The Chinese law expressly recognizes a category of "state shares," which are the shares purchased by government departments in exchange for the privatized state assets.¹⁰ Such shares are generally held by a specially-established state entity that acts as an agent, similar to an ordinary shareholder, without interfering in the daily management of the enterprise.¹¹

Arguably, the issuance of shares does not necessarily presume a subsequent public distribution of such shares. In theory, it is possible to create a system where the state remains the sole shareholder of all shares of the state enterprises while it delegates its monitoring functions to mutual funds which would

Kommertsializatsii Gosudarstvennikh Predpriatii S Odnovremennim Preobrazovaniem v Aktsionernii Obshestva Otkritovo Tipa [Position about the Commercialization of State Enterprises with a Simultaneous Transformation to Open Joint-Stock Companies], PRIVATIZATSIIA GOSUDARSTVENNIKH I MUNIZIPALNIKH PREDPRIATII V ROSSII 90-113 (1992).

6. Jianfu Chen, *Securitization of State-Owned Enterprises and the Ownership Controversy in the PRC*, 15 SYDNEY L. REV. 59, 60-61 (1993).

7. *Id.* at 60-61.

8. *Id.* at 61.

9. *Id.* at 59.

10. Matthew D. Bersani, *Privatization and The Creation of Stock Companies in China*, 3 COLUM. BUS. L. REV. 301, 314 (1993).

11. *Id.*

operate according to normal market conditions.¹² In this example one must assume that everyone else would have to buy stocks only through mutual funds. In my view, this system would eliminate most of the problems with the monitoring of state enterprises by imposing a "hard budget constraint" and market competition on them while preserving all characteristics of state ownership. The scheme would not preclude the development of new private businesses, and would allow the possibility for bankruptcy and the takeover of the weakest state businesses.

While securitization and sale of private businesses is probably the most common means for restructuring a state enterprise, these techniques may have other purposes as well. For example, the securitization technique might be used for mixed-ownership types of enterprises, such as the Chinese "stockholding-cooperative system," which is based on James Meade's model of a "labor-capital partnership."¹³ The Chinese experiment, which was first approved in the early 1980s, tends to harmonize the interests of workers with the other members of the same rural community.¹⁴ This type of Chinese rural enterprise has both *labor shares* and *capital shares*. If labor shares are distributed to all employees pro rata to their individual earnings, the capital shares are mainly collective, legally belonging to the whole community.¹⁵

Thus, securitization does not always lead to privatization, just as not all privatization methods presuppose securitization. In Russia, securitization (*commercializatsiya*) was considered the first stage of the process of privatizing large enterprises (those with more than 1000 employees or a book value of over fifty million rubles), while small state enterprises have been sold as

12. See *Privatization: Selling the State*, ECONOMIST, Aug. 21, 1993, at 20.

13. James Meade, *Forms of Share Economy*, in 2 COLLECTIVE PAPERS OF JAMES MEADE 235-45 (Susan Houson ed., 1988).

14. See Zhiyuan Cui, *China's Rural Industrialization: Flexible Specialization, Moebius-Strip Ownership and Proudhonian Socialism* 186-87 (1994) (on file with the author).

15. See *id.* at 187-88; JAMES MEADE, *ALTERNATIVE SYSTEMS OF BUSINESS ORGANIZATION AND OF WORKER'S REMUNERATION* 116-17 (1986). In the United States, employees under Employee Stock Option Plans (ESOPs) participate in their company's fortunes only to the extent that their past pay was deducted in the form of compulsory savings. *Id.* at 117. Whereas labor shares in a labor-capital partnership "depend directly upon the employee's current labor contribution without any reference to past compulsory savings." *Id.*

going concerns without preliminary securitization.¹⁶ Moreover, even some large state enterprises in Russia have been transferred to their employees without securitization, through a lease contract with a condition of buy-out (*arenda*),¹⁷ or sold as going concerns at a public auction (*aukzion*) or through a competitive bid of managerial projects (*konkurs*).¹⁸

According to some authors, there are at least fifty-seven varieties of privatization,¹⁹ predetermined by the specific socio-political atmosphere of the country in which the privatization is taking place and the goals of its government.²⁰ Among the most common types of privatization are the following: (i) sale of enterprise assets (instead of shares); (ii) reorganization of large enterprises into separate entities (or one holding company and

16. See Gosudarstvennaia Programma Privatizatsii Gosudarstvennikh i Munizipal'nikh Predpriatii v Rossiiskoi Federatsii na 1992 [State Program of State and Municipal Enterprises' Privatization in the Russian Federation for 1992], art. 5(2), PRIVATIZATSIIA GOSUDARSTVENNIKH I MUNIZIPAL'NIKH PREDPRIATII V ROSSII 53-54 (1992); see generally ROMAN FRYDMAN ET AL., THE PRIVATIZATION PROCESS IN RUSSIA, UKRAINE AND THE BALTIC STATES (1993) (discussing the role of securitization in the initial steps of privatization).

17. See Osnovi Zakonodatel'stva Soiuza SSSR i Soiuznikh Respublik ob Arende [The Foundations of the Soviet Union's and Union Republic's legislation about leases], art. 9, VSIIO PRIVATIZATSII 105 (1991). The workers' right to buy out the leased enterprises was limited to enterprises which had been contracted out by the state prior to the enactment of the Russian Law on Privatization of State and Municipal Enterprises (that is, prior to July 3, 1991). Regulation of Leasehold Relations and Privatization of Leased Property of State and Municipal Enterprises, RF President's Edict No. 1230, Oct. 14, 1992, translated in RusData Dialine RusLegisLine, available in LEXIS, World Library, SOVLEG File, at *2; Zakon RSFSR o Privatizatsii Gosudarstvennikh i Munizipal'nikh Predpriatii v Rossiiskoi Federatsii [Law of the RSFSR on Privatization of State and Municipal Enterprises of the Russian Federation], art. 15(1), PRIVATIZATSIIA GOSUDARSTVENNIKH I MUNIZIPAL'NIKH PREDPRIATII V ROSSII 5 (1992). Thus, privatization through lease was allowed for state enterprises that entered into a lease contract with the state in the period from December 1, 1989 to July 3, 1991. Up until July 1, 1993, 19,438 state enterprises in Russia (about 10 percent of all state enterprises) were on lease. *Obzor Investitsii i Privatizatsii* [Survey of Investment and Privatization], KOMMERSANT, July 5-11, 1993, at 17.

18. See Zakon RSFSR O Privatizatsii Gosudarstvennikh i Munizipal'nikh Predpriatii v Rossiiskoi Federatsii [Law of the RSFSR on Privatization of State and Municipal Enterprises of Russian Federation], art. 15(1), PRIVATIZATSIIA GOSUDARSTVENNIKH I MUNIZIPAL'NIKH PREDPRIATII ROSSII 22-23 (1992).

19. *Privatisation: Selling the State*, supra note 12, at 18.

20. See CHARLES VUYLSTEKE, TECHNIQUES OF PRIVATIZATION OF STATE-OWNED ENTERPRISES xi-xii (World Bank Technical Paper No. 88, 1988); D. HEALD, PUBLIC EXPENDITURE ch. 13 (1987).

several subsidiaries);²¹ (iii) new private investment in state enterprises (dilution of government's equity position instead of distribution of shares); (iv) acquisition by the workforce of controlling interest in the state enterprises;²² (v) leveraged management buy-out (LMBO); (vi) leases and management contracts; (vii) public offering of shares;²³ (viii) private sale of shares (over-the-counter);²⁴ (ix) contracting out of public services by the government;²⁵ (x) denationalization (the return of property to its previous owners); (xi) introduction of competitive features into state-owned enterprises (such as performance-related incentives); (xii) liberalization and demonopolization of certain activities;²⁶ (xiii) increased private sector financing by switching the source of financing for the supply of government services from taxation to user charges;²⁷ (xiv) revenue partici-

21. See Dennis A. Rondinelli, *Policy and Management Requirements for Privatization*, 19 BUS. FORUM 20, 23 (Winter/Spring, 1994). "Governments in Indonesia, Russia, China, and Bolivia quickly discovered that they must reform or restructure state-owned enterprises before private investors are willing to purchase shares or take over their operations." *Id.* Russia's giant Tupolev aviation complex was re-formed into eight separate managed divisions. See, e.g., *Tupolev Plant Privatized*, AVIATION EUR., Jan. 28, 1993, at 5.

22. See, e.g., Phillippe Sarraillhe, *Privatization in France in 1993*, 7 INT'L L. PRACTICUM 28, 29-30 (1994). According to The Privatization Act of 1993, the shares of a privatized enterprise *must* be offered to the present and former salaried employees with substantial preferences, such as discounts and payment extensions. *Id.* at 29-30.

23. *Id.* at 30.

24. *Id.* at 29.

25. VUYLSTEKE, *supra* note 20, at 10. For instance, the President's Commission on Privatization in the U.S.A. has recommended that "[t]he Federal government should rely on the private sector for provision of commercial goods and services. Because contracting provides a means to procure the same level of services at reduced cost, it is not in the public interest for the government to perform functions in competition with the private sector." PRESIDENT'S COMMISSION ON PRIVATIZATION, PRIVATIZATION: TOWARD MORE EFFECTIVE GOVERNMENT 130-31 (1988).

26. VUYLSTEKE, *supra* note 20, at 8-9. For instance, the Ivory Coast decided to permit private operators to provide public transportation in Abidjan and Rabat *together* with the state enterprise that is in charge of handling such urban transportation. *Id.*

27. VUYLSTEKE, *supra* note 20, at 9. The state-owned North-South Highway in Malaysia began to be financed by toll revenues as a result of privatization. *Id.* In Malaysia, after the privatization of Perbadanan Khidmat Korporat (PKK), this enterprise continues to be run by the Federal Land Development Authority (Felda), which is qualified and experienced in running it, but the new relations are now on a contractual basis. See David Ong-Yeoh, *Malaysia: Felda Settlers*

pation certificates or revenue bonds issued by the state or by state bodies;²⁸ (xv) privatization by "attrition" (gradually permitting the private sector to invest in enterprises and ultimately take over all or part of the enterprise's operation);²⁹ and (xvi) "build, own and operate contracts" (BOT contracts).³⁰

The classic example of a privatization scheme involving securitization is the public sale of shares, which includes distribution to the general public of all or part of the shares in a privatized state enterprise.³¹ The main objective of a public offering is widespread ownership, allowing the targeting of broader resources of investments.³² The sale of shares to the general public is normally characterized by openness, transparency, and democracy, which might be more acceptable politically.³³ In Russia and other former socialist countries, this method of privatization is also desirable for the reason that in socialist societies the citizens rather than the state were considered the actual owners of state property. The idea of bringing in the general population as a central actor gave rise to the state policy of "voucher privatization," according to which every citizen in the country received a privatization voucher which

to *Get Shares in Firm*, BUS. TIMES (Malaysia), Oct. 6, 1994, available in LEXIS, World Library, BUSTMS File, at *1. Commentators suggest that it was "just ownership" that was transferred, while managerial functions remain with the state. *Id.*

28. VUYLSTEKE, *supra* note 20, at 9. For instance, such bonds were issued for the Bosphorus Bridge and the Keban Dam in Turkey. Unusual privatization bonds were issued by the Moscow government in November 1994. See *Russia's Post-Voucher Privatization Policies*, PRIVATISATION INT'L, Nov. 1994, available in WESTLAW, PRVINT Database, 1994 WL 2788362, at *1. According to the indentures, if a lease holder (of state property) buys such bonds that are equal to the rented property's value, they will be entitled to own the property (in addition to the bonds). *Id.* at *2.

29. See Sarraïhe, *supra* note 22, at 29. The increase of capital without the state exercising its preferential right of subscription is partially used in France. *Id.*

30. VUYLSTEKE, *supra* note 20, at 9 n.7. There is an increasing trend for the private sector to provide management, acquire equity, or otherwise to participate in new infrastructure projects which were traditionally public sector undertakings only. "Build, own and operate contracts" (BOT contracts) provide for transfer of ownership to the state after a given period. Examples are found in the United States, Great Britain, Spain, Hong Kong, Singapore, Turkey, and Australia. *Id.*

31. See *id.* at 11-12.

32. *Id.* at 13.

33. *Id.*

could be used to acquire shares in the state enterprises without any additional compensation.³⁴ Nonetheless, under conditions of undeveloped capital markets, absence of liquidity, monopoly of information, deficiency of legal rules and institutions capable of protecting public investors, this scheme might not be as efficient as it tends to be in the developed industrial countries.

In order to distribute the stocks of a state enterprise, it must be preliminarily restructured and securitized.³⁵ Evaluating assets and pricing shares requires special care in order to ensure that adequate value is received. For example, as a result of a ridiculous evaluation, the market value of all the privatized industries in Russia in October 1994 was about \$7 billion, roughly comparable to the value that Wall Street currently places on a single American retailer, the K-mart Corporation.³⁶ The market values of Russia's large energy, natural resource, and telecommunications companies were about one to forty percent of what they would be in Western markets.³⁷

Moreover, to be eligible for a public offering, the privatized enterprises must comply with certain registration and disclosure requirements, governed by the applicable securities laws of the offering country.³⁸ However, these requirements generally apply only to securities, which are defined differently in different countries. From a legal perspective, though not every method of privatization involves the actual issuance of shares, some of these schemes still might be considered securitization in its broad meaning: as a process of issuing *securities*. For instance, under U.S. law, employee stock, private placement of shares, limited partnership, leasing programs, and other legal arrangements might be considered securities.³⁹

34. See generally Anthony V. Raftopol, *Russian Roulette: A Theoretical Analysis of Voucher Privatization in Russia*, 11 B.U. INT'L L.J. 435 (1993) (analyzing the efforts to institute mass-based industrial privatization in Russia).

35. See VUYLSTEKE, *supra* note 20, at 13-14.

36. See Richard W. Stevenson, *Foreign Capitalists Brush Aside Risks to Invest in Russia*, N.Y. TIMES, Oct. 11, 1994, at D6.

37. *Id.*

38. See A.V. MAIFAT & B.A. TATIANNIKOV, *TSENNIE BUMAGI: PRAKTICHESKIE VOPROSY I KOMMENTARIK ZAKONODATEL'STVU* 22-27 (1993). See generally Karl Viehe et al., *The Russian Federation Law on Regulation of the Securities Markets*, 6 TRANSNAT'L LAW 81 (1993) (for the most complete overview of Russian securities law in English).

39. See generally THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 22-41 (2d ed. 1990) (an overview of securities as general investment vehicles).

B. Government as a Controlling Shareholder

1. Partial Privatization

Privatization does not necessarily result in a complete transfer of ownership from the state to the public. Mixed state-public property enterprises are a worldwide phenomenon of our day.⁴⁰ For example, in 1991 the French government approved the partial privatization of certain state-owned enterprises (Total, Elf Aquitaine, and Rhone-Poulenc)⁴¹ through the sale of minority interests to the public. This process was not limited to the sale of shares in the privatized enterprises, but also included the transfer of certain activities to a subsidiary and the issuance of various financial instruments, such as non-voting shares, investment certificates, equity loans, and subordinated securities.⁴²

Governments still have ample control of strategic industries in energy, telecommunications, defense, transport, and other sectors of national priority. Many governments retain equity shares in electricity, gas, coal, and oil production enterprises.⁴³ For instance, a survey of the electricity industry in several developed countries reveals that more than seventy-five percent of equity stock belongs to the state in Austria, France, Norway, Switzerland, Britain, the Netherlands, New Zealand, Australia, and Canada; and between twenty-five and seventy-five percent of equity is government owned in Italy, Denmark, Germany, Sweden, Spain, Belgium, and the United States.⁴⁴ More than seventy-five percent of equity in gas production enterprises belongs to the state in Austria, France, Italy, Switzerland, Denmark, Germany, and Sweden.⁴⁵ According to my research, the government has some equity in various types of enterprises

40. See Anthony E. Boardman & Aidan R. Vining, *The Behavior of Mixed Enterprises*, 14 RES. IN L. & ECON. 223 (1991). "Mixed enterprises (MEs) are corporations where some percentage of the shares are held by private shareholders and some percentage by national or sub-national governments." *Id.* at 224.

41. See Sarraillhe, *supra* note 22, at 28.

42. *Id.*

43. See Dennis C. Stickley, *New Forces in International Energy Law: A Discussion of Political, Economic, and Environmental Forces within the Current International Energy Market*, 1 TULSA J. COMP. & INT'L L. 95, 99-100 (1993).

44. *Id.*

45. *Id.*

in the following countries: Australia, Austria, Argentina, Brazil, Belgium, Canada, Denmark, France, Germany, Great Britain, Israel, Italy, Ireland, Malaysia, Mexico, the Netherlands, Nigeria, New Zealand, Norway, the Philippines, Portugal, Spain, Sweden, Switzerland, Turkey, the United States, Venezuela, Zambia, and the former socialist countries.

There are four constructive reasons why governments would want to retain some equity in privatized enterprises. First, the state retains public ownership of the "commanding heights" of the economy for reasons of social policy and the national interest.⁴⁶ The governments of many countries are anxious about the possibility of a foreign takeover, as occurred when Britain privatized British Petroleum in the 1980s, enabling Kuwaiti investors to acquire a large stake in it, then prompting London to force a buy-back of the Kuwaiti shares.⁴⁷ Some countries, such as Italy, where national emotions and a heritage of national unity go back to the days of Fascist authoritarianism, generally favor a policy of national economic self-reliance and government control of the economy.⁴⁸ Yet, in other countries, such as Russia and other former socialist countries, the presence of some government control might be necessary for political reasons, such as curbing corruption and preserving the values of community, democracy, solidarity, equal opportunity, and social justice.⁴⁹

Second, in certain situations, government would retain a substantial equity share if a privatized enterprise were to participate in any future increase in the enterprises value.⁵⁰

46. *Id.* at 97. "The formation of . . . state-owned enterprises was a result of the assertion of national sovereignty over energy resources in combination with centralized economic planning." *Id.*

47. See John Tagliabue, *Privatization is Crucial for Italy's ENI*, N.Y. TIMES, Jan. 17, 1995, at D4.

48. *Id.*

49. See generally Roswell B. Perkins & William W. Jarosz, *Western Investors Weigh Strategies for Entering Russian Privatization Process*, RUSSIA AND COMMONWEALTH BUS. L. REP., Aug. 23, 1993, available in LEXIS, World Library, RCBLR File (discussing political tensions in Russia around the question of privatization). See also Tagliabue, *supra* note 47, at D4 (concerning the wave of corruption scandals in Italy during the 1992 privatization).

50. See *Back-End Tender To Maximise Proceeds From UK Generators*, PRIVATISATION INT'L, Feb. 1, 1991, available in WESTLAW, PRVINT Database, 1991 WL 2715857, at *1. In 1991, the British government sold only 60% of Britain's regional electricity companies (RECs) in order "to try and maximize

Indeed, if a state enterprise performs well and generates substantial profit, there is no logical reason why it should be privatized. In my view, it is significantly more important to develop new private businesses than to destroy the well-established businesses of state enterprises which can still operate on a self-functioning basis. As long as the state enterprises operate on a hard budget constraint, there is no material burden on the state to maintain such businesses, while profit from them might be more than nominal. Such profit, received as dividends, would be a substantial source of revenue for the state.

A third reason why government might want to retain an equity stake in privatized enterprises is to preserve a state monopoly on certain commercial and industrial activities in order to facilitate government intervention and the imposition of restrictive regulations.⁵¹ Areas of the state monopoly might include the energy sector, nuclear industry, gold mining, extraction and processing of radio-active and rare-earth elements, development and production of weapons systems and ammunition, rocket launching, and military research and design.⁵²

Finally, a government might want control over a privatized enterprise to provide public goods and services. Indeed, by definition the private market is not generally conducive to the production of public goods, which are of public value though typically unattractive to private investors because of their unprofitability. A prime example of an enterprise that provides such public goods is the post office, which offers the same services at the same rates over an entire national territory. Analogously, in order to make public goods accessible at moderate prices, socialists, who have a strong influence within the governments of many countries, insist that essential services such as water, gas, electricity, and transportation should be publicly owned and run solely in the public interest.⁵³

proceeds for the taxpayers over time." *Id.*

51. Stickley, *supra* note 43, at 97.

52. See Industrial Policy in the Privatization of State Enterprises, RF President's Edict No. 1392, Nov. 16, 1992, translated in RusData Dialine-RusLegisLine, available in LEXIS, World Library, SOVLEG File, at *1 [hereinafter Industrial Policy].

53. See, e.g., Peter Kellner, *New Labor May Deny It, But The Party Wants to Nationalize*, SUNDAY TIMES, Jan. 15, 1995, available in LEXIS, World Library, TTIMES File, at *1 (concerning Tony Blower's "alternative version of socialism"). See also Simon Jenkins, *An Unnecessary Rout*, TIMES, Jan. 11, 1995, available

In Russia, a core of the defense industry has remained under state ownership, including 454 enterprises and scientific organizations which were identified as being "vital to the nation's defence capability."⁵⁴ For example, "[t]he sectors with the largest state holdings [include] the conventional munitions, missile-space, and radio industries."⁵⁵ But the remaining 1500 enterprises and organizations of Goskomoboronprom (The State Committee on Defense Industries) are scheduled to be privatized. In some of these cases, the state will retain an ownership stake plus a single "golden share"⁵⁶ for an initial three-year period.⁵⁷ By the spring of 1994, 700 defense enterprises had been already converted into joint-stock companies.⁵⁸

In some capitalist countries the process of privatization did not require creation of special organs that would hold state shares in partially privatized enterprises. For instance, in Brazil such a role is fulfilled by the Ministries,⁵⁹ in Italy by the Treasury or relevant local bodies,⁶⁰ and in Turkey by the Public Participation Agency (PPA).⁶¹ Other capitalist countries established special holding companies or property funds, which were designed to hold the state's shares in the privatized enterprises.⁶²

in LEXIS, World Library, TTIMES File, at *1 (concerning the Labor Party's "1995 agenda" in Great Britain and the dispute over whether the public utilities should remain in public ownership).

54. Julian Cooper, *Transformation of the Russian Defence Industry*, JANE'S INTELLIGENCE REV., Oct. 1, 1994, available in LEXIS, World Library, ALLWLD File, at *4.

55. *Id.*

56. The notion of a "golden share" will be discussed extensively later in the text. See *infra* Section III.

57. Cooper, *supra* note 54, at *4.

58. *Id.*

59. See, e.g., *Brazil: Committee Sets Date for Embraer Privatisation*, GAZETA MERCANTIL, Nov. 8, 1994, at 26, available in LEXIS, World Library, ALLWLD File (reporting that the golden share in the privatized aircraft manufacturer Embraer was held by the Aeronautics Ministry).

60. See, e.g., Tagliabue, *supra* note 47, at D4 (reporting that the golden voting share remained in the hands of the Italian Treasury); *Italy: Government Seeks To Privatize Spas*, IL MONDO, Oct. 3, 1994, available in LEXIS, World Library, ALLWLD File, at *1 (concerning plans for relevant local bodies to hold shares in partially privatized spas).

61. John Murray Brown, *Turkey Sells Cement Companies*, PRIVATISATION INT'L, Dec. 1, 1992, available in WESTLAW, PRVINT Database, 1992 WL 2748358, at *1 [hereinafter *Cement*].

62. See, e.g., *Elf Offer "A Great Popular Success,"* PRIVATISATION INT'L, Mar.

Privatization in the former socialist countries not only transformed the ownership of state enterprises, but also changed the role of the state from a tutelary to an ordinary participant in the equity of the mixed-ownership enterprises. Clearly the former central bureaucratic ministries could not perform the new role of monitor. To realize their monitoring power as shareholders, the governments of the former socialist countries established special state organs or government holding companies.⁶³

The securitization of the state enterprises raised the issue of how the state would institutionalize its shareholders' rights, especially in the case of a mixed-ownership corporate enterprise. In my view, one of the models that can be considered is a system of state mutual funds. I perceive that under this model the state can create several mutual funds that, together with private mutual funds, would compete among each other. The state mutual funds should be mixed-ownership companies themselves. They should issue their own shares to the public, as well as transfer a certain number of their own shares to the government in exchange for the government's shares of the privatized enterprises.

The state mutual funds scheme can give some internal incentives to the managers of the state enterprises, while preserving state ownership of some of the profitable state companies. On the one hand, being large institutional shareholders, the state mutual funds would possess a significant decision-making power over the management of the enterprises. On the other hand, the market for the shares of the state mutual funds would be a valuable indicator of their own performance.

In my view, the mutual funds should be allowed to sell the controlling interest in any partially-privatized enterprise, as well as divest the state ownership interest in their own invest-

1, 1994, available in WESTLAW, PRVINT Database, 1994 WL 2547381, at *2 (concerning the French holding company Erap).

63. See, e.g., Virginia Marsh, *Romania: Privatization - Romania's Private Sector Resurrector*, EUROMONEY CENTRAL EUR., Sept. 1, 1993, at 29 (stating that in Romania, the National Agency of Privatization, State Ownership Fund and Private Ownership Fund was established); *Paks Nuclear Power Station to Remain in State Ownership*, MTI ECONNEWS, Jan. 25, 1995, available in LEXIS, World Library, MTI File, at *1 [hereinafter *Paks*] (stating that in Hungary, the State Property Agency (SPA) was established).

ment portfolio. The state representatives on the board of a state mutual fund might be appointed by the state's Central Bank or by the Minister of Finance. Certainly, there should be nongovernment representatives on the board and the number of government representatives should be restricted by law.

This model might be applicable to the situation when the government wants to retain a substantial equity share in privatized enterprises in order to participate in any future increase of their value. In such a case, the profit of the state mutual funds, received as dividends, would be a substantial source of revenue for the state. However, if the state mutual funds do not operate well, the state might want to sell the shares of such mutual funds and reinvest the money into other more valuable projects. In turn, in order to operate well, the state mutual funds would have to closely monitor managers of the state companies or sell the shares of such companies. However, the most important rule for an effective functioning of such a system should be the policy not to impose social objectives on such enterprises directly through external requirements, such as taxation and regulation.

2. *Controlling Size of the Government Share*

An important practical issue that arises during partial privatization is the determination of the maximum size of the government share which would lead to the maximization of social objectives while remaining compatible with efficient management of the mixed-ownership corporation.⁶⁴ Certainly, the size of this share will depend upon government objectives. If the government seeks to pursue profit from the stock in the company, it might want to retain more equity stock in the enterprise. However, if the government retains a controlling share in order to maintain the ability to access corporate information, the power to appoint, advise and influence managers, and the right to monitor corporate affairs on an interim

64. Boardman & Vining, *supra* note 40, at 225-27. Boardman and Vining analyzed how the behavior of mixed enterprises depends on the "low," "medium" and "high" government proportion of total ownership when private share ownership is dichotomized into "concentrated" and "dispersed." *Id.* at 226.

and ex post basis,⁶⁵ then it does not ordinarily need a large equity stake in the enterprise.⁶⁶

As a general rule, the controlling share of a large public corporation is well below fifty-one percent.⁶⁷ Moreover, if the firm has dual class shares, the controlling block can amount to a tiny minority of equity. For instance, some Dutch companies developed a share structure where the voting priority shares carry one percent of the equity rights and the non-voting certificates carry ninety-nine percent of the equity.⁶⁸ In other countries, where a minimum ratio of voting shares is required, fifty percent of the voting power can be held by investors limited to ten percent of equity each.⁶⁹

In practice, in order to retain control over the national oil company, the Polish government abandoned the idea of the golden share and retained fifty-one percent of the ordinary shares in the Polska Kampania Naftoway.⁷⁰ The Portuguese government, in a case involving the privatization of the steel company, Siderurgia Nacional, retained a twenty-five percent golden share in the company,⁷¹ but in other cases involving the national oil company and the gas supply consortium, the government held only a ten percent golden share.⁷² In Hungary, the government in the case of non-nuclear state electricity

65. In a corporate setting, a controlling share usually gives the holder at least these rights. See Theodor Baums, *The German Banking System and Its Impact on Corporate Finance and Governance* 37 (Feb. 1993) (on file with the author).

66. *E.g.*, *Lisbon Embraces Popular Capitalism*, PRIVATISATION INT'L, May 1, 1994, available in WESTLAW, PRVINT Database, 1994 WL 2547275, at *2 [hereinafter *Lisbon*].

67. *E.g.*, Yana Mirontseva, *Russia's Gold Reserve is to Expand by the Year 2000*, KOMMERSANT, Aug. 10, 1994, translated in RusData DiaLine-BizEkon News, available in LEXIS, World Library, SBE File, at *1.

68. See generally *Cable TV Sale in Netherlands*, PRIVATISATION INT'L, June 1, 1995, available in WESTLAW, PRVINT Database, 1995 WL 8379976 (stating that the Amsterdam City Council sold its 100% equity in a cable TV company, but would continue to influence the company through a golden share).

69. VUYLSTEKE, *supra* note 20, at 123-24.

70. *Poles Seek Leeway for Refining Sector Reform*, E. EUR. ENERGY REP., July 27, 1994, available in LEXIS, World Library, EEENR File, at *2.

71. *SN For Sale*, PRIVATISATION INT'L, Feb. 1, 1991, available in WESTLAW, PRVINT Database, 1991 WL 2715910.

72. *Plot to Gain Control of Petrogal*, PRIVATISATION INT'L, Apr. 1, 1993, available in WESTLAW, PRVINT Database, 1993 WL 2787826, at *1; *New Gas Project in Portugal*, PRIVATISATION INT'L, June 1, 1993, available in WESTLAW, PRVINT Database, 1993 WL 2787629, at *1.

companies decided to keep twenty-five percent and the golden share, while in the case of the privatization of the gas distribution companies the government retained only the golden share, which was considered enough to exercise control over certain strategic decisions of the company.⁷³ In Russia, during the privatization of the national gold industry, the government retained thirty-eight to fifty-one percent of the equity stock in the twenty-five companies, while in seventeen cases the government retained only the golden share.⁷⁴ Indeed, as a general rule, just a golden share provides the government with substantial powers to veto management decisions regardless of the percentage of the equity the government holds in the enterprise.⁷⁵ Certainly there is no hard and fast universal rule regarding the required percentage for control; rather the problem must be decided on a case-by-case basis.

However, the question of the size of a controlling share takes on a special legal significance in Russia. Under Russian law, the federal government may hold a three-year *controlling block* of shares only in the following types of enterprises: communications; generation and supply of electric power; extraction, refining, and sale of oil and natural gas; extraction and processing of precious metals, precious stones, radioactive, and rare-earth elements; development and production of weapons systems and ammunition; production of alcoholic beverages; rail, water, and air transportation; research and design enterprises; specialized enterprises in building and operation of facilities designed for ensuring national security; and wholesale trade enterprises making purchases for the state.⁷⁶ Outside these categories of enterprises the government is not allowed to hold a controlling share.⁷⁷ Moreover, the government is prohibited from retaining a controlling share even in these specified enterprises after expiration of the three-year period.⁷⁸

73. *Energy Market Report: Natural Gas*, ENERGY ECONOMIST, Dec. 22, 1994, available in LEXIS, Patent Library, ENRECO File, at *2 [hereinafter *Natural Gas*].

74. Mirontseva, *supra* note 67, at *1. See also *Tupolev Plant Privatized*, *supra* note 21, at 5 (concerning the privatization of Russia's Tupolev aviation complex, where the government retained a golden share).

75. *E.g.*, *Lisbon*, *supra* note 66, at *2.

76. *Industrial Policy*, *supra* note 52, at *1.

77. *Id.*

78. *Id.* at *1-2.

Thus, there is an issue as to what the minimal size of a "non-controlling block" of shares that the government is allowed to hold in enterprises after expiration of the three-year period.⁷⁹ Russian law defines a "controlling block of shares" as "any form of participation in the capital of an enterprise giving *unconditional* right to accept or reject certain decisions at general meetings of members (shareholders, stakeholders) and of its management bodies (including the issue of a golden share, the right of veto, the right of direct appointment of executives, etc.)."⁸⁰ Therefore, for the answer to the question of what percentage of equity is necessary in order to be qualified as a controlling shareholder under the Russian law, one must look first to the articles of incorporation. For example, in Russia the charter and bylaws of the newly-privatized enterprises often specify the ownership percentage needed to effect significant changes in corporate structure or organization.⁸¹

III. THE "GOLDEN SHARE"

The concept of the "golden share" originated during the British privatization of the 1980s,⁸² when the then state-held firms, such as Britoil and Jaguar, were sold off by Prime Minister Margaret Thatcher's conservative government.⁸³ The British Government retained a so-called "golden share" in both these enterprises, which allowed the government to outvote all shareholders regardless of the number of equity shares held by the government.⁸⁴ The French privatization law provides for the use of this technique (*action spécifique*) for the purpose of protecting the national interest (e.g., in areas of defense, ener-

79. This provision of Russian law refers to equity stake in the enterprise. *See id.* at *4. However, the government can effectuate its control over an enterprise through other important monitoring mechanisms, such as the bankruptcy provisions, money lending schemes, antitrust and securities regulations, corporate law, and the establishment of rules of fiduciary duties of majority shareholders and managers.

80. Industrial Policy, *supra* note 52, at *4.

81. Perkins & Jarosz, *supra* note 49, at *4.

82. *Id.* at *5.

83. *See Britoil Says Assets Worth 55% More Than BP Offers*, LOS ANGELES TIMES, Jan. 20, 1988, Business Section at 4, [hereinafter *Britoil*]; Jim Mateja, *Ford Steps up Pursuit of Jaguar*, CHI. TRIB., Oct. 25, 1989, Business Section at 1.

84. *See Britoil*, *supra* note 83, at 4.

gy, public transportation, and media).⁸⁵ Italian law requires the bylaws of companies that operate in the fields of defense, transport, telecommunications, energy sources, and other public services to contain "golden share" clauses granting special powers to the Ministry of Treasury.⁸⁶ Due to their "strategic significance," this technique was also used during the privatization of the Turkish companies Turk Hava Yollari (the Turkish Airlines), Usas (an airline caterer), Petrol Ofisi (an oil distribution firm), and Teletas (a telecom manufacturer).⁸⁷ Israel's government employed this method in privatizing Zim Israel (a shipping company) and Bezeq (the state telecommunications company).⁸⁸ A special share was retained by the Malaysian government in the privatization of Malaysian Airlines System, Malaysian International Shipping Corporation and the Naval Dockyard.⁸⁹ The Belgian government, advised by its privatization commission, has chosen to retain a golden share in Belgium's Distrigaz and Sabena Belgium World Airlines.⁹⁰ In Portugal,

85. See Sarraillhe, *supra* note 22, at 29; Barbara Casassus, *Balladur's Hit List*, PRIVATISATION INT'L, June 1, 1993, available in WESTLAW, PRIVINT Database, 1993 WL 2787564, at *2.

86. *Italy: The 1995 Guide to Italy—Privatization—A Special Report (2 of 2)*, EUROMONEY SUPPLEMENT, Jan. 23, 1995, available in LEXIS, World Library, ALLWLD File, at *2.

87. John Barham, *Framework Law to Set Aims for Turkey*, PRIVATISATION INT'L, Nov. 1, 1994, available in WESTLAW, PRIVINT Database, 1994 WL 2788354, at *1-2; John Murray Brown, *Turkish Court Suspends PTT Sale*, PRIVATISATION INT'L, Nov. 1, 1994, available in WESTLAW, PRIVINT Database, 1994 WL 2787182, at *2; *Cement*, *supra* note 61, at *3; *Turkey: Draft Schedule for Main Privatization Deals in 1995*, MIDDLE E. ECON. DIG., Dec. 5, 1994, available in LEXIS, World Library, ALLWLD File, at *2.

88. *Private Sales in Israel*, PRIVATISATION INT'L, Dec. 1, 1994, available in WESTLAW, PRIVINT Database, 1994 WL 2788393, at *1-2; *Israel: Excessive Bourse*, EUROMONEY, Sept. 30, 1994, available in LEXIS, World Library, ALLWLD File, at *3.

89. VUYLSTEKE, *supra* note 20, at 165; *Malaysia*, PRIVATISATION INT'L, July 1, 1994, available in WESTLAW, PRIVINT Database, 1994 WL 2547079; Kartini Abd. Kadir, *Malaysia: Independent Party to Decide Naval Dockyard's Price*, BUS. TIMES (Malaysia), Oct. 12, 1994, available in LEXIS, World Library, BUSTMS File, at *2.

90. *Home Team for Belgium's Distrigas*, PRIVATISATION INT'L, Feb. 1, 1994, available in WESTLAW, PRIVINT Database, 1994 WL 2547634, at *1; *Belgium's Di Rupo Says Swissair Plans Eventual Majority Stake in Sabena*, AFX NEWS, Jan. 23, 1995, available in LEXIS, World Library, EXTAFX File; *Belgium to Raise BFr25 Billion*, PRIVATISATION INT'L, Dec. 1, 1992, available in WESTLAW, PRIVINT Database, 1992 WL 2748355.

the government holds a golden share in Petrogal (the Portuguese oil company), the Siderurgia Nacional Produtos Londos (a steel company), and Transgas (the natural gas utility).⁹¹ The golden share technique was similarly used in the privatization of Brazil's Embraer (an aircraft manufacturer),⁹² Air New Zealand,⁹³ the Venezuelan airline Aeropostal,⁹⁴ Irish Life (an Irish insurance company),⁹⁵ Zambia's copper mines,⁹⁶ and various Filipino companies.⁹⁷ The new Spanish privatization program allows the state to retain a golden share in part-state-owned companies.⁹⁸

In addition, this technique was introduced during the post-socialist privatization in Hungary, which reduced the state's participation to one golden share in the nine privatized electric power companies and five distribution companies.⁹⁹ In Russia, by the beginning of 1994, golden shares had been issued to the government by 125 joint-stock companies.¹⁰⁰

91. *Doubts Over Petrogal*, PRIVATISATION INT'L, Aug. 1, 1991, available in WESTLAW, PRIVINT Database, 1991 WL 2715832; *SN For Sale*, supra note 71; *Portugal's Transgas Seeks Private Partners*, PRIVATISATION INT'L, Aug. 1, 1994, available in WESTLAW, PRIVINT Database, 1994 WL 2546995, at *1.

92. *Brazil: Committee Sets Date For Embraer Privatization*, supra note 59, at 26.

93. Ian Thomas, *Australia: Qantas Seeks Revamp of Secret Air NZ Deal*, AUSTR. FIN. REV., Oct. 20, 1994, at 25.

94. *Venezuela*, PRIVATISATION INT'L, Oct. 1, 1993, available in WESTLAW, PRIVINT Database, 1993 WL 2787332; *Ann Charters, Aeropostal On Runaway*, PRIVATISATION INT'L, Oct. 1, 1993, available in WESTLAW, PRIVINT Database, 1993 WL 2787366, at *2.

95. *Ireland*, PRIVATISATION INT'L, Apr. 1, 1991, available in WESTLAW, PRIVINT Database, 1991 WL 2716040.

96. See generally, Tony Hawkins, *Zambia's Copper Mines in Catch 22*, PRIVATISATION INT'L, Dec. 1, 1994, available in WESTLAW, PRIVINT Database, 1994 WL 2788390, at *3 (stating that retention of a golden share would be "common sense").

97. See generally *Napocor Gets Set for the 'Infernal' Voyage to Privatisation*, POWER ASIA, Nov. 28, 1994, available in LEXIS, World Library, PASIA File, at *4 [hereinafter *Napocor*] (stating that retention of a golden share is likely).

98. *Spain Enacts Golden Share Law In Privatization Program*, GLOBAL FIN. MARKETS, Oct. 24, 1994, available in LEXIS, World Library, ALLWLD File. The Spanish government plans, for the first time, to use the golden share technique in the privatization of Repsol. Paul Farrow, *Golden Shares Set for Spanish Sales*, PRIVATISATION INT'L, Sept. 1, 1994, available in WESTLAW, PRIVINT Database, 1994 WL 2547841, at *1.

99. *Hungary To Speed Up Energy Sector Privatization*, REUTER EUR. BUS. REP., Jan. 24, 1995, available in LEXIS, World Library, REUEUB File.

100. *Privatizatsiia v Zifrahk [Privatization in Figures]*, ROSSIYSKAYA GAZETA,

What is the magic that has produced such worldwide popularity for the golden share? In short, it offers the government power over important industries without a ban on private ownership. Through the mechanism of the golden share, "[c]apitalism can be kept at bay, and profit regulated."¹⁰¹ As characterized by the British Industry and Trade Minister, Gerard Lonquet, the mechanism aims "to reassure both those who wanted a state presence and those who feared it."¹⁰²

A. *Special Characteristics of the "Golden Share"*

A "golden share" bears no relationship whatsoever to gold as a commodity, to gold material, to the gold standard, or to other commercial qualities of gold. Rather the word "golden" in the term expresses the great value or quality of this type of share, which is also called a "special share."¹⁰³ The provisions regarding the "golden share" enable a government to exercise a certain control over privatized enterprises after the state has become a minority shareholder or even after total privatization.¹⁰⁴ Thus, a "golden share" empowers the state with control which is disproportionate to the state's equity in the enterprise. This "authority-giving" quality of the share makes it "golden" in the eyes of ordinary shareholders.

Generally, the golden share is designed to provide the government, *inter alia*, with the power to *veto* (or *approve*) certain major decisions affecting the operation of an enterprise.¹⁰⁵ The special character of the "golden share" might be illustrated by the following comparison of its distinguishing characteristics, which can vary from state to state, with ordinary common and preferred shares.

1. Subject to certain exceptions for close corporations, shareholders generally have no right to exercise direct management

Jan. 27, 1994, at 4, translated in BBC Summary of World Broadcasts, Feb. 4, 1994, available in LEXIS, News Library, BCSWB File, at *2 (text of a report by The Russian Federal Property Fund's Consolidated Analysis Department).

101. Jenkins, *supra* note 53, at *3.

102. *Elf May Be Sold In Single Tranche*, PRIVATISATION INT'L, Jan. 1, 1994, available in WESTLAW, PRVINT Database, 1994 WL 2547742, at *1.

103. Alice Pezard, *The Golden Share of Privatized Companies*, 21 BROOK. J. INT'L L. 85, 85 (1995).

104. *Id.* at 85-86.

105. Cheryl W. Gray et al., *Hungarian Legal Reform for the Private Sector*, 26 GEO. WASH. J. INT'L L. & ECON. 294, 326 (1992).

or control over the *ordinary business* of a corporation,¹⁰⁶ while a "golden share" gives a "*special shareholder*" the right to interfere not only in a broad spectrum of corporate affairs, but also in determining the company's line of business.¹⁰⁷ For instance, the golden share can require a company to preserve the existing line of business, maintain its contractual relations with particular business partners, undertake certain business projects, and prevent the dismissal of employees, among other powers.¹⁰⁸

2. The golden share is comprised of *negative* and *affirmative* powers.¹⁰⁹ The negative powers are exercised through the right to veto various corporate actions, such as dissolution of the company, disposal of certain major assets, mergers and changes in voting control, limitations on shareholdings, or changes in the line of business.¹¹⁰ The affirmative powers include the right to compel the corporation to undertake certain business activities and to maintain social programs, to appoint directors and the chief executive officer of the corporation, and so on.¹¹¹

3. Convened under most statutes, common shareholders have *the right to vote* (at regular or special meetings) for the election and removal of directors and on "major corporate actions" or certain "fundamental changes," such as (i) amending the certificate of incorporation, (ii) corporate mergers, (iii) the sale of most of the corporation's assets, and (iv) the liquidation of the corporation.¹¹² As to the holders of preferred shares, though they normally do not have voting rights, they will typically be granted these rights if preferred dividends have not been paid for an extended period of time.¹¹³ On the contrary, although the "special shareholders" are entitled to receive notice of all shareholders meetings and are allowed to attend these meetings, as well as speak at them, they cannot vote at such meetings.¹¹⁴

106. See, e.g., ROBERT W. HAMILTON, *CORPORATIONS* 528-43 (3d ed. 1986).

107. See, e.g., Cosmo Graham & Tony Prosser, *Golden Shares: Industrial Policy by Stealth?*, 1988 PUB. L. 413, 415.

108. See *id.*

109. See *id.*; VUYLSTEKE, *supra* note 20, at 165-67.

110. See VUYLSTEKE, *supra* note 20, at 165-67.

111. See Graham & Prosser, *supra* note 107, at 415.

112. WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE* 118 (2d ed. 1986).

113. STEPHEN A. ROSS ET AL., *CORPORATE FINANCE* 403 (3d ed. 1993).

114. See, e.g., VUYLSTEKE, *supra* note 20, at 166 (quoting the British Telecom

4. Although the general rule is that the payment of *dividends* to shareholders of corporations is a matter within the business judgment of the board of directors and the shareholders ordinarily have no *subjective* right to dividends even if funds are available, the shareholders still have an *objective* right to participate in the capital or profits of the corporation.¹¹⁵ By contrast, the “golden share” generally confers no right to participate in the capital or profits of the company.¹¹⁶

5. As a rule, the articles of incorporation can be *amended* if the changes are approved by the board of directors and a majority of shareholders.¹¹⁷ However, the “golden share” provision substantially complicates the process of amending the corporation’s articles. The amendment of the articles of incorporation cannot be effectuated without consent of the special shareholder, who holds the “golden share.”¹¹⁸

6. Unless the corporation’s articles provide otherwise, a shareholder who is entitled to vote has one vote for each share

Perspectus).

115. See KLEIN & COFFEE, *supra* note 112, at 118, 179. Civil law traditionally recognizes two categories of rights: “objective rights” and “subjective rights.” See JOHN H. MERRYMAN ET AL., *THE CIVIL LAW TRADITION* 70 (2d ed. 1985). According to John Henry Merryman’s explanation, “objective law is the rule to which the individual must make his conduct conform; subjective right is the power of the individual that is derived from the norm.” What this really means is that an “objective right” indicates a scope of permissible behavior, while a “subjective right” actually furnishes the power to insist on certain behavior from others. See *id.* 70–71. In order for a proclaimed “objective right” to give rise to a subjective right of an individual, some *dispositive facts* must occur. See *id.* at 70.

Applying this theory to American corporate law, we can see that the shareholders in a public corporation have the right to participate in sharing the profit of the corporation, *if* the board of directors decide so, or *if* the board’s refusal to declare dividends is in bad faith or so unreasonable as to amount to an abuse of discretion. See *Dodge v. Ford Motor Co.*, 170 N.W. 668, 682 (Mich. 1919). Accordingly, “the board’s decision” and “the board’s abuse of discretion” are dispositive facts that when they occur give rise to the subjective right of shareholders to have the dividends be paid. *Id.* Without the occurrence of such dispositive facts, the shareholders would not have the right to demand payment of the dividends. *Id.*

116. *E.g.*, VUYLSTEKE, *supra* note 20, at 166 (quoting the British Telecom Prospectus).

117. *E.g.*, ERNEST L. FOLK, III ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 242 (3d ed. 1992). Nonetheless, the articles may legitimately require a higher percentage of shareholder approval for any proposed amendment than would otherwise be required by the statute. *Id.* § 216.

118. See Perkins & Jarosz, *supra* note 49, at *6.

held.¹¹⁹ Unlike ordinary shares, the “golden share” empowers its holder with super-majority control which is *disproportionate* to the equity in the enterprise that this share represents.¹²⁰ The special shareholder’s power to veto or approve certain strategic decisions affecting the operation of the enterprise does not depend on the number of shares held by the special shareholder.¹²¹

7. Because of its extraordinary powers and the goal it tends to achieve, the “golden share” is usually held by the *government*.¹²² For instance, according to the British Telecom Prospectus, “[t]he Special Share may only be held by or transferred to the Secretary of State or another Minister of the Crown or any person acting on behalf of the crown.”¹²³ This requirement restricts the transferability of the golden share, which is not tradable on the secondary markets and not consignable to non-government entities.¹²⁴ In addition, restrictions on the transfer of a “golden share” do not have to satisfy the *reasonableness* test, which is required by common law and by the statutes of most jurisdictions.¹²⁵

Although these characteristics of the golden share might vary from state to state, they provide a general outline of the idea of a special share and reveal the legal regime of its regulation. It should be noted, however, that the technique of the “golden share” is not a surrogate for conclusive government control over the management and affairs of privatized enterprises. Where government wants to retain the rights of an ordinary

119. KLEIN & COFFEE, *supra* note 112, at 117.

120. See Britoil, *supra* note 83, at 4; Graham & Prosser, *supra* note 107, at 415.

121. See Gray et al., *supra* note 105, at 326; Graham & Prosser, *supra* note 107, at 415.

122. Gray et al., *supra* note 105, at 326; Graham & Prosser, *supra* note 107, at 414.

123. VUYLSTEKE, *supra* note 20, at 166 (quoting the British Telecom Prospectus).

124. See *id.*

125. See, e.g., *Coleman v. Coleman*, 191 So. 2d 460, 469 (Fla. Dist. Ct. App. 1966). To be valid at common law, a restriction on the transfer of shares must be “reasonable” in view of the needs of the particular corporation and shareholders involved. See *id.* Some statutes simply codify the common law rule, authorizing “reasonable restrictions” on the transfer of shares. See CAL. CORP. CODE § 204(b) (West 1990). Others deal with such restrictions in more detail. See FOLK ET AL., *supra* note 117, § 202. Restrictions on the transfer of the golden share are established by edict. *E.g.*, Industrial Policy, *supra* note 52, at *2.

shareholder, including the right to participate in profits of the company, it should retain majority shares in the enterprise which would provide it with adequate majority control.

In summary, the technique of the golden share provides governments with an alternative legal mechanism of control over privatized enterprises. Applying this technique, governments can effectively monitor privatized enterprises without retaining a controlling equity stake in them. Contrary to conventional shares, the golden share provides governments with the power to monitor the ordinary *commercial* activity of a corporation in addition to the standard power of corporate governance. In contrast to the ordinary normative corporate regulations, which apply universally, the technique of the golden share can be implemented differently within specific enterprises. Indeed, normative government laws and regulations are not agile enough to achieve the same effect as a golden share, since the spectrum of powers of a golden share may vary depending on the specificity of a particular company and the distinctive government objectives for monitoring this company. Moreover, because the fact that the government retains the golden share is presumably disclosed to the investors, the price of the ordinary shares of a company should reflect the existing risk of the government's future meddling in corporate business.¹²⁶

Corporate laws, particularly in Russia and other former Soviet republics, are often vague, overbroad, and subject to frequent amendments. If applied to the case of the special shareholder, the laws would not define in detail the scope of government authority in relation to each particular corporation, but, probably, would provide the government with overbroad arbitrary power to dictate its conditions to all companies. Finally, contrary to the government's almost unlimited powers to regulate social affairs when acting in its sovereign capacity, the state as a special shareholder presumably would owe fiduciary duties to other shareholders of the corporation.

126. Cf. COSMO GRAHAM & TONY PROSSER, *PRIVATIZING PUBLIC ENTERPRISES* 144-48 (1991) (stating how the market responded by marking up shares when British Prime Minister gave initial response of *non-interference* regarding bid by British Petroleum to purchase substantial shareholding in Britoil, in which the Government held a golden share).

B. Definition of the "Golden Share"

In spite of the word "share," it is uncertain whether the golden share can be considered as either an ordinary share or a security. Because these problems are generally unresolved in the national laws of the countries that have introduced this technique, I would like to approach this issue from a purely theoretical perspective.

From the definition of the "golden share," it follows that it is an equity stock, rather than an obligation. However, in a certain sense, the golden share contains elements of both *stocks* and *bonds*.

The basic difference between stocks and bonds is that the former represents the stockholder's proprietary interest in a corporation, or *equity*, and the latter represents *debt*.¹²⁷ By definition, a bond is a promise by the borrower to repay a specified amount (*par value*) on a specified day (*maturity date*), together with fixed interest at regular intervals (*coupon rate*), on the terms and subject to the conditions (*covenants*) spelled out in a governing agreement (*indenture*).¹²⁸ By contrast, a stock's usual characteristics include (i) the right to receive dividends contingent upon an apportionment of profit;¹²⁹ (ii) negotiability;¹³⁰ (iii) the conferring of voting rights in proportion to the number of shares owned;¹³¹ and (iv) the capacity to appreciate in value.¹³²

127. HAMILTON, *supra* note 106, at 274. There are several major differences between debt and equity. *Id.* Unlike equity, debt is not an ownership interest in the firm, and it does not entitle one to vote. *Id.* Unpaid debt is a liability of the firm which might cause its liquidation or bankruptcy. KLEIN & COFFEE, *supra* note 112, at 201. There is also a difference in the tax treatment of equity and debt. *Id.* at 185, 287 (stating that while the corporation's payment of interest on debt is considered part of the cost of doing business and it is fully tax deductible, dividends on common and preferred stocks are paid to shareholders only after tax liability has been determined).

128. KLEIN & COFFEE, *supra* note 112, at 199-200.

129. *Id.* at 214. Contrary to the common law, Russian shareholders have an *absolute* right to receive dividends regardless of the "business judgment" of managers as to how to allocate the profit. For comments of Russian legal scholars on this subject, see, e.g., A.V. MAJFAT, B.A. TATIJANNIKOV, *supra* note 31, at 30-31.

130. See KLEIN & COFFEE, *supra* note 112, at 134.

131. *Id.* at 117.

132. *Id.* at 216-17.

Unlike normal stocks, a golden share does not necessarily represent equity in an enterprise.¹³³ As such, a plain golden share (which does not involve equity) does not pay dividends and does not confer voting power. Moreover, as a rule, golden shares are not negotiable and cannot be pledged or hypothecated.¹³⁴ Yet, if the golden share represents an equity stock, it confers voting powers disproportional to the number of shares owned. Finally, a golden share normally does not appreciate in value. In most situations it has only a nominal value,¹³⁵ although the government might capture an appreciation when it reconverts the golden share into an ordinary share.¹³⁶

Furthermore, a golden share possesses some similarities with bonds. A bond generally represents a contract for borrowing money between a corporation and a bondholder.¹³⁷ Because bondholders, unlike shareholders, normally do not have voting powers, they use the indenture as a device to protect themselves through the business covenants.¹³⁸ The general function of the covenants may be considered as protection or enhancement of the lender's equity cushion.¹³⁹ Accordingly, such covenants might incorporate broad rights of control over the strategic decisions and activities of the corporation and its managers.¹⁴⁰

Indeed, the lenders and debtholders, like special shareholders, might have some degree of control over the determination of the goals and strategies of the firm. Among the covenants

133. See *Natural Gas*, *supra* note 73, at *2. In Hungary, the government plans to fully privatize several enterprises while retaining only a naked golden share without any represented equity. *Id.*

134. See *Industrial Policy*, *supra* note 52, at *2. Yet, in one particular case the Russian government acquired \$10 billion in long-term bonds as Western assistance which were collateralized by the golden shares held by the government in the privatized Russian enterprises. See *Financing the Russian Safety Net*, BANKER, Oct. 1993, available in LEXIS, World Library, BANKER File, at *1.

135. *E.g.*, Dominic Maclaine, *UK: The Beginning Of The End?—Take-Over Bids For Regional Electricity Companies?*, ELECTRICAL REV., Jan. 6, 1995, available in LEXIS, World Library, ALLWLD File, at *1.

136. See, *e.g.*, Sarrailhe, *supra* note 22, at 29, 31.

137. See KLEIN & COFFEE, *supra* note 112, at 199–201.

138. *Id.*

139. See *id.*

140. See generally Churchill Rogers, *The Corporate Trust Indenture Project*, 20 BUS. LAW 551, 552–58 (1965) (discussing the history of the development of the terms and protective provisions in indentures).

which may limit the freedom of action of the corporate managers are the following: (i) requirement of maintenance of property in good condition; (ii) restrictions on the freedom to pay dividends; and (iii) maintenance of specified level of liquid assets.¹⁴¹ As such, the provisions of a "golden share" are very similar to the legal framework of bonds and debentures.¹⁴²

Moreover, as a rule, the special shareholder may require the enterprise to redeem the golden share at its nominal amount or convert it into ordinary shares at any time.¹⁴³ The ordinary shares of a corporation do not represent a promise to pay the value of the shares to their holders and cannot be cashed in at the shareholders' demand.¹⁴⁴ They can be redeemed by the corporation only as a matter of right (not as an obligation) and only if it is expressly provided in the corporation's articles or bylaws.¹⁴⁵ Thus, in the case of ordinary shares, the right to redeem, if any, belongs to the corporation. Contrary to ordinary shares, the special shareholder can redeem his golden share at his own option at any time at the preliminarily specified amount.¹⁴⁶ Although this right is typically described in the articles of incorporation, it is not restricted by the prerequisites of availability of funds, specified date of redemption, or similar provisions.¹⁴⁷ As such, the redemption right offered by the golden share is more reminiscent of such "hybrid" securities as *convertible bonds* and *pre-paid mortgage bonds*.

To a certain extent, the golden share, much like a bond, sets out a promise of payment to its holder.¹⁴⁸ Convertible bonds, like golden shares, can be changed at the holder's option into a specified number of shares of the issuer's common stock.¹⁴⁹ Although convertible bonds normally cannot be repaid

141. See KLEIN & COFFEE, *supra* note 112, at 200.

142. On the special functions of a golden share, see the discussion *infra* part C.

143. VUYLSTEKE, *supra* note 20, at 166 (quoting the British Telecom Prospectus); Sarrailhe, *supra* note 22, at 29. See *Industrial Policy*, *supra* note 52, at *2.

144. See KLEIN & COFFEE, *supra* note 112, at 229.

145. See ALEXANDER H. FREY ET AL., *CASES AND MATERIALS ON CORPORATIONS* 1098-143 (2d ed. 1977).

146. See GRAHAM & PROSSER, *supra* note 107, at 414-15.

147. See FREY ET AL., *supra* note 145, at 1098-143.

148. See generally VICTOR BRUDNEY & MARVIN A. CHIRELSTEIN, *CORPORATE FINANCE* 82-173 (1979) (discussing bonds and bondholders' rights).

149. *Id.* at 246-47.

before the specified time, mortgage bonds might be terminated earlier at the holder's request with some prepayment penalty.¹⁵⁰ Moreover, like an ordinary bond, a golden share has a priority of repayment in the case of liquidation, in spite of its proprietary nature.¹⁵¹ Like a bond or a debenture, it does not raise legal issues of *fiduciary duty* to the shareholders.¹⁵²

Nonetheless, this comparison of the golden share with bonds is simply conditional, and made for comparative purposes. Obviously, the golden share does not involve debt, which usually is entailed by bonds and debentures. Unlike a typical payment of interest at an established coupon rate for bonds, a corporation does not pay interest on the capital investment that is represented by a golden share.¹⁵³ In contrast to a bondholder, the special shareholder is usually concerned with the decision-making process of the corporation and the preservation of the present operation of the enterprise, not for reasons of protecting or enhancing the lender's equity cushion, but because of considerations of protecting the state's national interest and other public policy reasons.¹⁵⁴ As such, in certain situations the golden share remains in the permanent ownership of the state for an indefinite life.¹⁵⁵

Although the distinction between debt and equity is meaningful for tax purposes, it certainly loses its pertinence with respect to the golden share, which belongs to the state and entails a special tax treatment.¹⁵⁶ Nonetheless, the distinction among stocks, bonds, and golden shares is very important for academic purposes, particularly in civil law countries given their

150. See, e.g., Michael Quint, *A Mortgage Penalty, or Plus?*, N.Y. TIMES, Oct. 25, 1994, at D1 (discussing prepayment clauses and penalties in mortgage contracts). On mortgage bonds in general, see BRUDNEY & CHIRELSTEIN, *supra* note 148, at 113-15.

151. E.g., VUYLSTEKE, *supra* note 20, at 166 (quoting the British Telecom Prospectus). Note as well that *preferred* stocks also have priority over common stock as to dividends and liquidation rights but not over the claims of debtholders and creditors. See KLEIN & COFFEE, *supra* note 112, at 227-29.

152. See generally *Katz v. Oak Indus., Inc.*, 508 A.2d 873, 879 n.7 (Del. Ch. 1986) (noting that directors do not have a fiduciary duty to the bondholders).

153. See Leonard Hyman, *Privatization: The Hows and Whys*, 131 PUB. UTIL. FORT. 18, 20 (1993).

154. See Sarrailhe, *supra* note 22, at 29, 31-32.

155. See *Paks*, *supra* note 63; France, PRIVATISATION INT'L, June 1, 1993, available in WESTLAW, PRVINT Database, 1993 WL 2787596.

156. Hyman, *supra* note 153, at 20.

tendency toward "conceptual jurisprudence" and legal labeling.¹⁵⁷ Such a comparative analysis helps us to understand the essence of the golden share and the legal regime of its regulation. Moreover, according to the conventional principles of legal science, an inquiry into the character of the distinctions facilitates the development of legislation.¹⁵⁸ The comparison of different securities with the provisions of the golden share are particularly important for the former socialist countries, which face the problem of creating a new national corporate law together with the ongoing process of privatizing the state enterprises. The institution of the golden share serves to distinguish a special role of the state over the corporatized enterprises. The golden share does not make the state an ordinary shareholder or bondholder, but a special shareholder with special rights.

C. *National Interests and the Functions of the Golden Share*

The areas of national interest, which the golden share has been designed to protect, are described very broadly by various national laws. Generally, the spheres of applicability of a golden share can be divided into three categories: (i) industries "strategic" to the national economy, (ii) "politically sensitive" spheres of the economy, and (iii) industries of "symbolic" national importance.

1. *Strategic Industries*

The notion of retaining government control over strategic industries is based on the widely-held perception of national independence, economic self-sufficiency, and the state's capacity to preserve its political sovereignty.¹⁵⁹ It is assumed that the state must maintain such industrial potential, which would preclude the possibility of national colonization and foreign influence over internal state affairs.

The strategic industries usually include defense, energy, transportation, communications, mining and scientific R&D (research and development) enterprises, and particularly those

157. See MERRYMAN, *supra* note 115, at 63-64.

158. See ALBERT KOCOUREK, AN INTRODUCTION TO THE SCIENCE OF LAW 171 (1982).

159. See Pezard, *supra* note 103, at 85-87.

industries that serve the state military complex.¹⁶⁰ Golden shares are retained by governments in aerospace and military ammunition factories, defense facilities, shipping and airline industries, oil and natural gas extraction and refining industries, energy power stations, the nuclear industry, gold mines, and other industries.¹⁶¹ Moreover, the governments of some countries have retained golden shares in the banking industry, considering it another sphere of crucial state autonomy.¹⁶² For the same reasons the Italian government retained a golden share in the privatized telecommunications enterprises.¹⁶³ In these cases, through the technique of the golden share, governments aim to achieve the following goals: (i) to preserve the national residence of the enterprises; (ii) to maintain the existing line of production; (iii) to prevent foreign takeover; or (iv) to undertake certain programs or projects necessary to national interests.¹⁶⁴

In Israel, the government, through a golden share, imposed on the new owners of some privatized industries an obligation not to relocate the headquarters of these companies outside of Israel; not to close down the plants; and, in the case of mining, not to cease supplying raw materials to Israel's manufacturers.¹⁶⁵ By retaining a golden share in shipping or airline companies, governments mean to ensure, among other things, that the carriers will not change their national flag status due to unfavorable labor, tax, or tariff rules, or other economic condi-

160. See Industrial Policy, *supra* note 52, at *1; see also Sarrailhe, *supra* note 22, at 31 (describing the concept of protecting the national interest under French law).

161. See Pezard, *supra* note 103, at 85-87; Industrial Policy, *supra* note 52, at *1; *Security Bill and Flights on Sabbath Key to El Al*, PRIVATISATION INT'L, July 1, 1994, available in WESTLAW, PRVINT Database, 1994 WL 2547120 [hereinafter *Security Bill*].

162. See Tomasz Janowski, *Underwriters Help Privatize Poland's BPH Bank*, REUTER EUR. BUS. REP., Jan. 14, 1995, available in LEXIS, World Library, REUEUB File.

163. *Italy: Telecommunications Experts Ask Key Questions Concerning Stet Privatization* [sic], IL SOLE - 24 ORE, Dec. 6, 1994, at 31, available in LEXIS, World Library, ILSOLE File.

164. See Pezard, *supra* note 103, at 85-87; Industrial Policy, *supra* note 52, at *1; Alexander Marquardt & Ellen H. Clark, *French Privatizations and International Capital Markets*, 15 J. INT'L L. BUS. 408, 418 (1994).

165. David Krivine, *Privatize or Bust*, JERUSALEM POST, Sept. 19, 1990, available in LEXIS, World Library, ALLWLD File.

tions that prevail in the country.¹⁶⁶ By requiring carriers to remain under the national flag, the government secures its ability to call them into requisition in case of a national emergency.¹⁶⁷ Moreover, carriers are sometimes required not to cease their transport operation into and out of the country. For example, the Israeli government retained a golden share in the privatized national airlines, El Al, in order to require the company to keep flying in and out of Israel even if other airlines suspend their flights. During the Gulf War, El Al was for a time the only airline company to maintain services to Israel.¹⁶⁸

Golden shares are also used to maintain the existing lines of production of privatized enterprises.¹⁶⁹ According to Russian law, a golden share gives the state, for a period of up to three years, the right to *veto* key decisions, such as: those made at shareholders' meetings regarding the reorganization or liquidation of the enterprise; amendments and addenda to the charter and bylaws of the corporation; mergers, acquisitions, or participation in other enterprises or associations; and mortgages, leases, sales, or other forms of alienation of assets whose structure is determined by the enterprise's privatization plan.¹⁷⁰ In Russia, golden shares in the defense enterprises are retained by the government to prevent the undesirable "withdrawal from all military work."¹⁷¹ The Brazilian government retained a golden share in the aircraft manufacturer Embraer, allowing the Aeronautics Ministry to veto any attempts by future controlling shareholders to change Embraer's production line or military aviation programs.¹⁷² Under French law, the powers and rights attached to the golden share are broader than mere veto power. The golden (special) share conveys to the government, among other things, the power to appoint one or two representatives of the state (without any voting rights) to the board of directors of a privatized company.¹⁷³ In many situations, politicians see in the golden share the means to

166. See, e.g., Charters, *supra* note 94, at *2.

167. VUYLSTEKE, *supra* note 20, at 167.

168. *Security Bill*, *supra* note 161.

169. Industrial Policy, *supra* note 52, at *1.

170. *Id.* at *2.

171. See, e.g., Cooper, *supra* note 54, at 445.

172. *Brazil: Committee Sets Date for Embraer Privatization*, *supra* note 59.

173. Sarrailhe, *supra* note 22, at 31.

prevent foreign takeover of the strategic military enterprises. According to the French privatization law, the golden share can be used to limit foreign participation in enterprises crucial for national defense to twenty percent. Moreover, by holding a golden share, the French government can control the subsequent sale of more than ten percent of the share capital to any investor.¹⁷⁴ The French Privatization Law of 1993 empowers the state, as a special shareholder, with the right to require the prior approval of the Minister of Economy when investors, acting individually or in concert, exceed one or several stipulated thresholds of equity ownership in the company.¹⁷⁵ A similar limitation on the amount of equity stock that might be acquired by an individual investor exists in the provisions governing golden shares in Britain, Spain, Italy, and elsewhere.¹⁷⁶

Finally, the technique of the golden share can be used to require the managers of privatized enterprises to undertake certain programs or projects necessary to national interests.¹⁷⁷ For instance, during the privatization of the Warsaw steelworks, the Polish government retained a golden share in order to commit the new owners to the 150 million European Currency Unit modernization program, which called for cutting costs while raising production output to one million tons of steel a year from the present of 300,000 tons.¹⁷⁸ The Malaysian government retained a golden share in the Naval Dockyard project in order to direct the new owners to undertake the RM4 billion Offshore Petrol Vessel project which was found "necessary to national interests."¹⁷⁹

174. *Id.* at 30. However, the threshold of 20% does not apply to EC investors. *Id.*

175. *Id.*

176. See Eric Reguly, *Golden Share in Northern to Stay*, *TIMES*, Dec. 16, 1994, available in LEXIS, World Library, TTIMES File; *Spain Enacts Golden Share Law in Privatization Program*, *GLOBAL FIN. MARKETS*, Oct. 24, 1994, available in LEXIS, World Library, ALLWLD File; *Italy: The 1995 Guide to Italy—Privatization—A Special Report*, *supra* note 86, at *2.

177. Kadir, *supra* note 89, at *2.

178. *Compromise Offer in Polish Strike: A Dispute Between Warsaw Steelworkers and Italian Employers*, *FIN. TIMES*, July 18, 1994, at 2, available in LEXIS, World Library, ALLWLD File.

179. Kadir, *supra* note 89, at *1.

2. Politically Sensitive Interests

In some cases, the policy of retaining a golden share in enterprises involves "politically sensitive" spheres of the economy, privatization of which provokes government concern about social instability and political volatility.¹⁸⁰ This might involve issues of preserving the existing employment status at privatized enterprises, maintaining inexpensive public services, providing citizens with equal access to information, or various other political concerns.¹⁸¹ For instance, in Russia the reason for government concern over the necessity of the right of veto is obvious: the current economic recession may induce enterprises to shift their profile and free themselves of superfluous assets. According to the government of the Russian Federation, "it is impossible to allow, for the sake of momentary benefits, industrial capacities with special [e.g., strategic] purposes, which were created at the expense of the State and in the interests of the State, to be lost."¹⁸²

In such cases, the government can use the golden share to impose certain obligations on the new owners and managers, as well as eliminate or restrict ownership by certain undesirable investors, such as rich foreigners, corrupt individuals, or other "politically inappropriate" participants. For instance, during Israel's privatization, although Palestinian investors were not banned from participating in acquiring equity in the privatized companies, the government retained a golden share so as to protect the "sensitive interests" of Israelis.¹⁸³ Similarly, the Filipino government retained a golden share during the privatization of state enterprises in order to preclude the possibility of the sector's "drift[ing] into oligopolistic hands."¹⁸⁴ The Italian government imposed golden share limitations on the privatized electricity enterprises so as to prevent "colonialization" of Italy's infrastructure.¹⁸⁵

180. See *New Russian Privatization Program Expands Rights of Foreign Investors, Adds to List of Restricted Industries*, RUSSIA AND COMMONWEALTH BUS. L. REP., Mar. 7, 1994, available in LEXIS, World Library, RCBLR File, at *1.

181. *Id.*

182. *Preobrazobat' giganti [To Transform Giants]*, TRUD, July 31, 1992, at 3.

183. *Israel Plans Foreign Offers in 1994*, PRIVATISATION INT'L, Dec. 1, 1993, available in WESTLAW, PRVINT Database, 1993 WL 2787141.

184. *Napocor*, *supra* note 97, at 43.

185. *Enel and UK Power Firms Vie For Market Slot*, PRIVATISATION INT'L,

For the protection of workers, a government, through the mechanism of the golden share, can impose on the new employers an obligation not to terminate the workers' employment.¹⁸⁶ Indeed, the hostility of workers to the new private owners may be contained by ensuring that fair wage and working conditions are provided by private companies that take over enterprises from the state.¹⁸⁷ Thus, in Israel and Hungary, the state's golden share precludes the managers of the privatized enterprises from reducing the work force without the government's consent.¹⁸⁸

For political reasons in part, golden shares were retained by governments in water supply and sewerage companies in England and Wales,¹⁸⁹ media and printing companies in Russia and Hungary,¹⁹⁰ the building industry in Russia,¹⁹¹ and telecommunications companies in Italy.¹⁹² While these enterprises do not necessarily affect national security, the technique of the golden share was used by these governments to further certain public policies such as precluding extraordinary changes in the rates or conditions of public services,¹⁹³ preventing the closing of newspapers,¹⁹⁴ avoiding monopolization and maintaining competition in a particular area,¹⁹⁵ and maintaining

July 1, 1994, available in WESTLAW, PRIVINT Database, 1994 WL 2547045.

186. Krivine, *supra* note 165, at *4.

187. *Id.*

188. *Id.*; Virginia Marsh, *Hungary Sells Porcelain Producer*, FIN. TIMES, Oct. 4, 1994, at 29.

189. Robin Stoddart, *Market Forces: Sell-Off Shares Looking Stronger After a Hard Year*, GUARDIAN, Dec. 17, 1994, at 28, available in LEXIS, World Library, GUARDN File, at *2; Haig Simonian, *Tide of Interest Faces Many Locks—Why Takeover Talk in The Water Industry is Tinged With Caution*, FIN. TIMES, Dec. 30, 1994, at 16, available in LEXIS, World Library, FINTIME File, at *1.

190. *Hungary: Axel Springer Tries Backdoor Privatization*, HETI VILAGGAZDASAG, Nov. 12, 1994, at 17, available in LEXIS, World Library, ALLWLD File; N. Samoilova, *Russia: Printing Enterprises Await Privatization*, NOVECON, Oct. 11, 1994, at 2, available in LEXIS, World Library, ALLWLD File.

191. "Golden Shares" to Be Issued in Moscow's Privatized Building Sector, BBC Summary of World Broadcasts, Apr. 30, 1993, available in LEXIS, News Library, TBBCSW File.

192. *See Italy: Telecommunications Experts Ask Key Questions Concerning Stet Privatization* [sic], *supra* note 163.

193. Stickley, *supra* note 43, at 99.

194. *Hungary: Axel Splinger Tries Backdoor Privatization*, *supra* note 190, at 17.

195. Charles Miller, *Stall GEC Bid for VSEL, Demands Labor*, PRESS ASS'N NEWSFILE, Nov. 8, 1994, available in LEXIS, World Library, PANNEWS File.

employment, with the aim of "ensur[ing] that any decision made will be in line with government's policies."¹⁹⁶ In Senegal, the technique of the golden share ("*action speciale*") has even been used by the government as a protection device for ensuring that the privatized enterprises would repay government loans or government guaranteed loans.¹⁹⁷

3. Industries of "Symbolic" National Importance

All countries have their own cultural relics and heritages which have been protected by national governments for centuries. Certain enterprises are well recognized in the world and are associated with particular countries.¹⁹⁸ These enterprises are associated with national pride, cultural distinctions, and civil unity. It is certainly in the public interest to preserve these aspects of national culture for the sake of future generations. Nonetheless, the task of maintaining industrial enterprises is very different from preserving cultural sites, historic buildings, and museums. Indeed, it is more important to ensure that an enterprise operates and competes on the product market than to preserve an "enterprise-museum." In these situations, privatization with a government golden share might be the best alternative for the state.

During the privatization of Zsolnay Porcelangyar, one of Hungary's oldest and best-known companies, the state decided to retain a golden share which, among other things, requires the proprietors to continue the production of porcelain, which the company has been producing for 150 years, and to keep the Zsolnay name.¹⁹⁹ The privatization of Plzenske Prazdroj, the brewery that makes the internationally known Pilsner Urquell brand, has been controversial in the Czech Republic because the beer is so much a part of the people's daily life. Indeed, the national breweries have been regarded as "part of the country's cultural and historic heritage."²⁰⁰ As a solution to the problem,

196. Ong-Yeoh, *supra* note 27, at *1.

197. VUYLSTEKE, *supra* note 20, at 167.

198. See *Czechs Lose Their Bottle over Cultural Icons*, PRIVATISATION INT'L, Feb. 1, 1994, available in WESTLAW, PRVINT Database, 1994 WL 2547714; *Italy: Government Seeks to Privatize Spas*, *supra* note 60, at *1.

199. Marsh, *supra* note 188, at 29.

200. *Czechs Lose Their Bottle over Cultural Icons*, *supra* note 198; *Czechs' Output, Not Intake, of Beer May Slow*, CHI. TRIB., Aug. 22, 1993, at 8.

the Czech government retained a golden share in the privatized breweries, which will allow it to influence the appointment of management board members and to veto decisions it might regard as harmful for the industry. Apparently for the same reasons, the Russian government decided to retain golden shares in the vodka distillery enterprises.²⁰¹ In Italy, the government and the local municipalities retained golden shares in the thirteen spa companies, which were also regarded as part of the national heritage.²⁰² The Kazakhstan and the Uzbekistan governments have retained golden shares in the privatized tobacco factories.²⁰³ For reasons of "symbolic importance" as well, the Brazilian government retained golden shares in the National Steel Company, once the flagship of Brazilian industry.²⁰⁴

IV. PRIVATE (OVER-THE-COUNTER) PLACEMENT OF SHARES

A. *General Procedure*

Under this method, the state sells all or part of its shares in a joint-stock company (which is a securitized state-owned enterprise) to a preliminarily identified single purchaser or specific group of investors, selected by the government.²⁰⁵ The transaction can take various forms, such as a direct (friendly) acquisition by another corporation or a private placement aimed at institutional investors.²⁰⁶ While a private sale of shares normally implies that the enterprise would be sold as a going concern with all its assets and liabilities, some legal and financial restructuring (securitization, segregation of the large enterprises into separate units, alleviation of liabilities and deregulation) may be carried out prior to offering the shares to investors.²⁰⁷

201. See Industrial Policy, *supra* note 52, at *1.

202. See *Italy: Government Seeks to Privatize Spas*, *supra* note 60, at *1.

203. See *Uzbekistan's Tobacco Industry Taken Over by BAT*, BBC Summary of World Broadcasts, Dec. 9, 1994, available in LEXIS, News Library, BBCSWB File; *US Tobacco Group Lifts Kazakhstan Interest*, FIN. TIMES, Jan. 1, 1994, at 9, available in LEXIS, World Library, FINTME File.

204. *Franco Plans Slower Pace in Brazil*, PRIVATISATION INT'L, Nov. 1, 1992, available in WESTLAW, PRIVINT Database, 1992 WL 2748506. According to Antonio Barros de Castro, the head of the Brazilian privatization program, even thinking of privatizing some enterprises would be a "cultural violation." *Id.*

205. VUYLSTEKE, *supra* note 20, at 16.

206. *Id.*

207. See *id.* at 19-20. Yet, although as a rule the private placement of shares

The purpose of selling a stake over-the-counter is to secure a stable core of shareholders to control the company.²⁰⁸ For instance, according to the French Privatization Act of 1993, the Minister of Economy, with the consent of the Commission, may select "hard-core" groups (*noyaux durs groups*) of shareholders, who are then supposed to maintain a long-term stake in privatized firms.²⁰⁹ Commentators underscore some advantages for the government in employing the private placement scheme, including the ability of the government to select the investors and a chance to actually negotiate the transfer of the shares or securities to new owners, enhancing the possibility that some commitments from the investors may be obtained (such as an obligation that the investors will not resell the acquired shares within a certain period of time).²¹⁰ Therefore, the main advantage of a private sale is an ability of the government to attract strong owners, who may give the state something other than the market value of the enterprise.²¹¹

Thus, the private placement of shares may be used when government needs to secure certain national interests, such as preserving the functional operation of an enterprise, maintaining the national place of incorporation or national flag (for shipping companies), guaranteeing workers' employment after

is not strictly a sale of *securities* (as compared to an offering to the general public), the private sale of shares to pre-identified investors might be considered by the courts as *such*, requiring a certain disclosure procedure. In many situations, such a determination might depend on the character of the investor's activity. For instance, in the United States, courts are more likely to recognize a security in a directly negotiated two-party transaction if it is doubtful that the new investors would operate the purchased business; but if the investors are capable of active involvement, this factor would militate against finding a security. See *Tanenbaum v. Agri-Capital, Inc.*, 885 F.2d 464 (8th Cir. 1989). The determination also depends on the percentage of stock transferred, the number of purchasers, and what provisions for voting and veto rights were agreed upon by the parties. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 696 (1985). U.S. courts are split on the issue of whether the "sale of business" might be construed as the sale of securities. See RICHARD W. JENNINGS ET AL., *supra* note 3, at 299-302.

208. See Sarrailhe, *supra* note 22, at 29-30.

209. *Id.* at 31. However, the technique of *noyaux durs groups* existed in French law before the new Privatization Act of 1993. *France Prepares Bills, PRIVATISATION INT'L*, May 1, 1993, available in WESTLAW, PRVINT Database, 1993 WL 2787664, at *1. It was commonly used in the 1986-1988 privatization in France (during the conservatives' two-year term). *Id.*

210. See Sarrailhe, *supra* note 22, at 31.

211. VUYLSTEKE, *supra* note 20, at 18-19.

privatization, or controlling the secondary allocation of shares. As such, this strategy attains the same goals as the technique of the "golden share," which is to provide a government with a mechanism for retaining some influence over the new owners of the privatized enterprises.²¹² But contrary to the golden share, over-the-counter privatization utilizes a *contractual* mechanism as opposed to the *property* claim of a special shareholder, creating a difference of available legal remedies and liability procedures for violation of the established provisions (in the contract or articles of incorporation).²¹³ For instance, according to the French Privatization Act, if the shares of a privatized company (representing more than five percent of the company's equity) have been transferred without preliminary approval of the Minister of Economy, a violation of the "golden share" provision, the holders of the shares (even *bona fide* ones) cannot exercise their voting rights and are obliged to sell the shares within a specified period. If, however, the securities remain unsold, a *forced sale* of the shares will be executed.²¹⁴ Certainly, in a case of breach of contract, in most countries, a different procedure would be used.

However, in applying the technique of over-the-counter placement, the government may not only prescribe the covenants and conditions of the future operation of an enterprise, but also select the desired shareholders, as well as their number, and eliminate the participation of objectionable investors.²¹⁵ The latter result cannot be fully effected by a special shareholder because of different national rules against restrictions on alienation.²¹⁶

Privatization through over-the-counter placement can be full or partial, with the latter resulting in mixed ownership enterprises, but a controlling share has to be possessed by the stable

212. Compare Sarrailhe, *supra* note 22, at 31 (stating that over-the-counter sales of shares may be tied to additional obligations and restrictions such as an agreement prohibiting the selling of such shares for a specified time period) with *New Privatization Wave Sweeps Across Europe*, DEUTSCHE BANK RES. BULL., Oct. 22, 1993, available in LEXIS, World Library, ALLWLD File, at *31 (stating that golden shares allow a government to influence major decisions).

213. Sarrailhe, *supra* note 22, at 31.

214. *Id.* at 32.

215. See Sarrailhe, *supra* note 22, at 31.

216. *Id.* at 30.

core shareholders (alone or together with the state).²¹⁷ Depending on the particular goals and necessities of the specific case, in various situations the private placement mechanism may be applied together with that of the golden share or without it. For example, in Hungary, five regional gas distribution companies were scheduled to be fully privatized by selling 100% of their stocks minus a "golden share" to be retained by the government. According to the plan, fifty percent plus one vote was to go to strategic investors through an international tender offer, while the rest would be publicly sold.²¹⁸ In the privatization of Elf-Aquitaine, only ten percent of the shares have been sold to such hard-core investors, which was enough to retain control over the enterprise.²¹⁹ According to the proposed privatization plan of the Eredi Iron and Steelworks enterprise, which is one of the most profitable companies in the Turkish domestic sector, a core investor was sought for technological input and international marketing expertise, while the government was to retain a golden share in order to assure all investors against possible conflicts between the hard-core shareholder, the ordinary shareholders, and the state.²²⁰ The private sale of shares to foreign "strategic investors" has been taking place in Russia as well, but the percentage of shares to be owned by the foreign investors must be negotiated with the enterprise's management and its workers, and, if the agreement is concluded, the plan must be approved by the appropriate government branch of GKI (*Goskomimushestvo*).²²¹ Although this multilevel bureaucratic procedure creates obvious obstacles, it is considered by Western commentators as the most orderly and efficient method of investing in Russian equity.²²² In a competitive tender in 1993, the Swiss firm Pan Transit AG purchased eleven percent of the shares of Plastpoliten, a Russian firm which produces plastic products, while fifty-one percent of the firm's shares have been acquired by Plastpoliten's workers.²²³

217. *Id.*; *Natural Gas*, *supra* note 73, at *2.

218. *Natural Gas*, *supra* note 73, at *2.

219. See John Ridding, *10% of Elf Core Investors*, FIN. TIMES, Jan. 7, 1994, available in LEXIS, World Library, FINTME File, at *1.

220. *Turkey: Draft Schedule for Main Privatization Deals in 1995*, *supra* note 87, at *1.

221. Perkins & Jarosz, *supra* note 49, at *11.

222. *Id.*

223. *Id.*

B. Efficiency of Private Placement Procedures

Generally, over-the-counter placement of shares might be advisable for poorly performing enterprises which can be sold as going concerns under conditions of undeveloped capital markets, when the size of an enterprise does not justify a public offering, or when the state needs special commitments from the purchaser, or particular nonpecuniary benefits which cannot be provided by others. Moreover, a partial private sale may sometimes be a necessary first phase of full privatization because it draws in a new leveraged participant who is able to turn the company around, enabling it to become attractive to general investors.²²⁴ Certainly, the efficiency of this technique depends on the purposes of its implementation in particular socio-economic conditions.

The private placement of government shares in privatized enterprises is generally administered in two ways: (i) through the competitive process with preliminary qualification of bidders; and (ii) through direct negotiation with specific investors.²²⁵ The process of selecting the shareholders is not always complicated. In some situations, as in the case of a mixed enterprise, the government might simply sell shares to the existing shareholders. As such, the selling process may involve a gradual disposal of equity, rather than a bulk sale of all available shares.²²⁶ However, in the majority of situations the government exercises significant discretion in the selection of purchasers.²²⁷ In most countries this discretion is given to the specially formed privatization committees.²²⁸

224. Sunita Kikeri et al., *Privatization: Lessons from Market Economies*, WORLD BANK RES. OBSERVER, July 1994, available in LEXIS, World Library, ALLWLD File, at *15-16 (giving examples from companies in Malaysia, Indonesia, and Japan where productivity generally improved after a partial sale).

225. VUYLSTEKE, *supra* note 20, at 17. For instance, while Senegal's privatization program requires a competitive process, Argentina's law with respect to some manufacturing enterprises and petrochemical concerns requires individual calls for bids which are often directed at companies with the *same* line of business or having some other *special* interest. *Id.*

226. Krivine, *supra* note 165, at *5.

227. Perkins & Jarosz, *supra* note 49, at *9.

228. See VUYLSTEKE, *supra* note 20, at 16-18. For example, in France the Privatization Commission consists of seven independent experts (in economics, finance, and law) who are appointed by the Prime Minister. Sarrailhe, *supra* note 22, at 31. The members of the Commission are instructed by the Minister of

Questions arise as to how well a government can perform its function of selecting investors. How long can a government exercise these functions without becoming corrupt and unduly prejudicial? How far can a government's discretion extend without being arbitrary and capricious? How efficient and successful can a government's selection be? How well can the authorized government's agent (privatization committees) protect the public interest without being influenced by various lobbying groups and political movements? What standards of preference, if any, should be applied to successful bidders? What judicial review, if any, should be provided for others?

Indeed, as one commentator remarked, "discretionary procedures carry the danger of lack of transparency."²²⁹ The standards that are usually applied in such procedures are vague and overinclusive, which makes the decision-making process unduly arbitrary. For instance, in the case of the Philippines, the Operating Guidelines of the Asset Privatization Trust provide minimal standards for bidding and private negotiations.²³⁰ The guidelines state that privately negotiated offers (as opposed to competitive bids) might be accomplished *only* if bidding is considered *unsatisfactory, impractical, or inappropriate*.²³¹ Argentina provides such evaluation standards for new shareholders as "general business reputation," "financial strength," "record of performance," "special interest in the company," and the like, while inherently presuming a discretionary power of interpretation.²³² Yet, even if more precise standards are established, the discretion involved in the decisions is obvious.

Certainly the unlimited discretionary power of government agents creates conditions that promote rent-seeking, logrolling, corruption, bribery, and the enrichment of organized criminal groups, which are evidently part of the atmosphere of privatization in Russia.²³³ As a consequence of the authoritarian privatization process in Russia, state property has been torn apart

Economy for each privatization transaction. *Id.* In certain situations, the decisions of the Commission have to be approved by the Conseil d'Etat. *Id.*

229. VUYLSTEKE, *supra* note 20, at 17.

230. *Id.* at 18.

231. *Id.*

232. *Id.* at 17.

233. Y. Mirkina & I. Medina, *Doveriat' li Trastu? [Whether to Entrust the Trust?]*, EKON. I ZH., Feb. 1994, at 17.

and pilfered by bureaucrats, managers, and those who were situated close to the governing party clique.²³⁴ The state has continued to lose almost all of its powers to influence the development of the enterprises, while such powers accumulate in the hands of select circles. Many Russian scholars and the intelligentsia have issued warnings that the contractual forms of privatization will bring "sensational lawsuits regarding fraud of the population and quiet gratuitous dispensation of state property for pay-offs and bribes, up to the full exhaustion of the property."²³⁵

One solution for preventing the negative effects of the discretionary process of private negotiation and over-the-counter sale of the government property would be to provide bidders with an independent judicial review and to make information about the privatization public. However, these observations are not striking to the legislators. Even in France, with its substantial experience with privatization, the question of judicial review is not completely resolved, in spite of scholars' suggestions that decisions regarding the choice of investors and the terms and conditions of the private offers made by the Minister of Economy should imperatively be subject to judicial review.²³⁶ In Russia, the disputes between legal entities regarding the issues of privatization are still subject to the State Arbitration Court (*Arbitrazh*), which cannot be considered an independent court.²³⁷ The judges of the Russian Arbitrazh are traditionally government appointees. Both jury's and people's assessors (*Narodnii Zasedateli*), present in Citizens' Courts (*Narodnii Sudi*), are absent in the Arbitration Courts.²³⁸

Another problem with private placement of shares in privatized state enterprises is lack of sufficient information about potential bidders even though there often are guidelines and procedures in place to curb this problem.²³⁹ The preliminary

234. *Id.*

235. *Id.*

236. See Sarrailhe, *supra* note 22, at 31.

237. See *Zakon RSFSR o Privatizatsii Gosudarstvennikh i Munizipal'nikh Predpriatii v Rosshskoi Feeratsii* [Law of the RSFSR on Privatization of State and Municipal Enterprises of the Russian Federation], art. 30(3), PRIVATIZATSIIA GOSUDARSTVENNIKH I MUNIZIPAL'NIKH PREDPRIITI V ROSSII 35 (1992).

238. See, e.g., R.V. Nasirov, *Ob Arbitrazhnikh Komissiiakh 1922-1931* [About the Arbitration Commissions of 1922-1931], in *TEORIJA I PRAKTIKA SOVSHENSTVOVANIIA ZAKONODATEL'STVA NA SOVREMENNOM ETAPE 7-10* (1993).

239. See generally VUYLSTEKE, *supra* note 20, at 14 (stating that, in order to

qualification of bidders (*cum prequalification*) in Argentina and Brazil requires compliance with numerous guidelines and procedures.²⁴⁰ The country of Togo requires preparation of a *dossier* and a *brochure* for each enterprise which are broadly distributed to the public.²⁴¹ After a field visit of interested parties to the enterprise, the Ministry and then the Interministerial Commission each review the proposals by evaluating the bidders' qualifications and their propositions.²⁴² The Russian approach of screening investors' proposals in the case of a competitive bid (*konkurs*) is also quite elaborate. The contenders are required to present their strategic plans for developing the enterprise, including proposals for technical re-equipment and structural reorganization of the production process, expansion in the output of production and improvement of the quality of goods and services, and reduction of production costs and increase in profitability.²⁴³

Yet the supply of information regarding the performance of companies in Russia is mainly controlled by their managers, who, as a result of "spontaneous" and uncontrolled privatization, have been able to use the legislative vacuum for "stripping the enterprise's assets."²⁴⁴ In the absence of strict disclosure requirements, the managers do not feel obliged to provide objective information about the performance of their enterprise to the general public, especially when specific news might affect their social status or their substantial equity stake in the enterprise.²⁴⁵ In certain situations, the managers might want to intentionally misrepresent the value of an enterprise or its

ensure the protection of governmental and public interests, prequalification of potential bidders is desirable).

240. See *id.* at 18.

241. *Id.*

242. *Id.*

243. See, e.g., V. Koshkin & Y. Sichev, *Konzeptual'nie Osnovi Kommertsializatsii Gosudarstvennikh Predpriatii na Baze Konkursa Predprinimatel'skikh Proektov (Kontraknaia Sistema Predprinimatel'stva [The Conceptual Foundation of the Commercialization of State Enterprises on the Basis of Competition of Entrepreneur Projects (the Contract System of Free Enterprise)]*, EKON. I ZH. Jan. 1994, at 7.

244. Simon Johnson & Heidi Kroll, *Managerial Strategies for Spontaneous Privatization*, 7 SOVIET ECON. 281 (1991).

245. See generally Perkins & Jarosz, *supra* note 49, at *5 (stating that there is little reason to believe that the stated value of a Russian company will have any connection to its actual value).

business plans in order to avoid a takeover or to frighten off undesired investors. The employees of the enterprise, who have a considerable stake in its equity, also refrain from airing dirty laundry in public.²⁴⁶ Primitive accounting, absence of credit records, and undeveloped audit services facilitate the managers' arbitrariness and render them practically unpunishable.²⁴⁷ The archaic noncomputerized records system, limited communication abilities, shortage of publications, and relatively restricted freedom of the press do not enhance the exchange of information. Finally, undeveloped capital and product markets do not provide adequate price information.²⁴⁸

Thus, the private over-the-counter sale of shares in the securitized state enterprises is not the most desirable method of privatization in Russia, at least for the purpose of retaining government control over the management of enterprises. In the present socio-economic situation in Russia, this procedure will only contribute to the unpunishable embezzlement of state property and further concentration of wealth in the country.

V. CONTROL THROUGH GOVERNMENT REGULATION

Privatization does not mean *privatism*, nor does it refer only to property or property-related rights.²⁴⁹ Privatization does not mean "self-governing" either.²⁵⁰ In a certain sense, privatization is nothing but a process of cutting back the range of government's supervision over *private affairs*, but it does not presume the abolition of this supervision nor that everything becomes completely private.²⁵¹ Privatization gives one private property, it does not necessarily offer freedom from all social regulations in a way that would allow one to produce public ills in the domain of one's detached privacy. Privatization is initiat-

246. See *id.* at *2.

247. See generally *id.* at *5 (stating that the Sukhoi Design Bureau even refused to disclose the number of its employees).

248. *Id.*

249. See JACQUES V. DINAVO, *PRIVATIZATION IN DEVELOPING COUNTRIES* 1-5 (1995).

250. See *id.*

251. See ROMAN FRYDMAN & ANDRZEJ RAPACZYNSKI, *PRIVATIZATION IN EASTERN EUROPE: IS THE STATE WITHERING AWAY?* 171 (1994); Robert D. Cooter, *Organizational Property and Privatization in Russia*, in *LAW AND DEMOCRACY IN THE NEW RUSSIA* 55 (Bruce L. R. Smith & Gennady M. Danilenko eds., 1993).

ed by the government and supported by it.²⁵² Government not only carries out the process of its own deregulation, but also establishes new legal rules for the post-privatization society and guards against their violation.²⁵³ Government realizes its control over the *macro* and *microeconomic* processes of the country through rules and regulations.²⁵⁴

A. *Reducing the Burden of Government Regulation*

The current wave of international privatization, which has involved more than seventy countries, had its roots in the period of deregulation in the United States and Canada in the late 1970s, and in the movement toward restructuring public transport and utility companies in Britain and Germany in the early 1980s.²⁵⁵ However, the scope and methods of privatization in the various countries are not identical, but depend on the particular goals pursued by their governments.

When business was undertaken by the state and when personal affairs were related to state policy, as in the former socialist countries, privatization for these countries meant liberalization and deregulation, and not simply property redistribution.²⁵⁶ As such, privatization can be *broadly* defined as "the [consecutive] transfer of *function, activity, or organization* from the public to the [emerging] private sector,"²⁵⁷ rather than as the mere reorganization of an existing property rights system by transferring the title on state property to new private owners. This notion is particularly important for resolving the current problems which the former socialist countries face on their way to a market-oriented economy. Addressing the issue of stabilizing the economy in the socialist countries, Keith Hartley and David Parker stressed that privatization embraces not only denationalization and the selling-off of state-owned assets, but also liberalization of the whole economy, including deregulation of the everyday activity of producers and the establishment of competitive tendering, as well as the introduc-

252. Rondinelli, *supra* note 21, at *2.

253. See FRYDMAN & RAPACZYNSKI, *supra* note 251, at 170.

254. SAUL ESTRIN, *PRIVATIZATION IN CENTRAL EUROPE* 3-10 (1994).

255. Rondinelli, *supra* note 21, at *1.

256. See *id.*; FRYDMAN & RAPACZYNSKI, *supra* note 251, at 10; Cooter, *supra* note 251, at 69.

257. L. GRAY COWAN, *PRIVATIZATION IN THE DEVELOPING WORLD* 6 (1990).

tion of venture markets and other arrangements for developing private ownership in socialist states.²⁵⁸ Indeed, the privatization reforms in post-socialist countries involve the processes of decentralizing and democratizing the entire economy and socio-political atmosphere in these countries.²⁵⁹ It involves the process of demonopolization of government monopolies, deintegration of the center-oriented state industrial complex, conversion of the clumsy military-defense system, securitization and privatization of state-owned enterprises, development of capital and venture markets, land reforms, creation of democratic political institutions, and the formation of new legal systems.²⁶⁰

These responsibilities are carried out by the state, which manages the privatization process. As such, the success of these reforms, or their failure, largely depends on the state. Moreover, in countries where economic risks and political uncertainty are high, the ability of privatized companies to survive and expand depends more on government supervision than in countries where markets already operate efficiently.²⁶¹ The role of government supervision is twofold: to establish state privatization policies and to assist in their implementation.²⁶²

As a policy maker, a government controls complex measures of (i) economic stabilization (deficit reduction, debt rescheduling, control over the money supply, reduction of subsidies); (ii) structural adjustment policies (financial liberalization, reduction of price controls, mechanisms of market development); (iii) trade and investment reform policies (taxes, quotas, tariffs, and exchange rate adjustment); (iv) private sector development programs (venture market support); and (v) democratization of political procedures.²⁶³ A government adopted privatization

258. Keith Hartley & David Parker, *Privatization: A Conceptual Framework*, in PRIVATIZATION AND ECONOMICAL EFFICIENCY: A COMPARATIVE ANALYSIS OF DEVELOPED AND DEVELOPING COUNTRIES 11 (Attiat F. Ott & Keith Hartley eds., 1991).

259. See FRYDMAN & RAPACZYNSKI, *supra* note 251, at 142.

260. See *id.* at 14–16; Cooper, *supra* note 54, at *2–4; Gianmaria Ajani et al., *Introduction*, in PRIVATIZATION AND ENTREPRENEURSHIP IN POST-SOCIALIST COUNTRIES (Ajani et al. eds., 1992).

261. See Marek Dabrowski, *The Role of the Government in Postcommunist Economies*, in PRIVATIZATION, LIBERALIZATION AND DECONSTRUCTION: RECREATING THE MARKET IN CENTRAL AND EASTERN EUROPE (Laszlo Csaba ed., 1994).

262. See *id.*

263. Rondinelli, *supra* note 21, at 21.

plan,²⁶⁴ usually identifies the objectives and methods of privatization, creates a privatization agency, illustrates various techniques of privatization, describes assessment and valuation methods, establishes the legal requirements for bidding and contractual procedures, provides legal guarantees to employees of the privatized enterprises, among other things.²⁶⁵

Furthermore, as a policymaker, government decides questions concerning the utilization of privatization revenues, which has turned out to be an important area of policy.²⁶⁶ In my view, the capital from privatization should not go to the state budget to finance the government's usual expenses, as this would reduce the amount of savings available to private enterprises.²⁶⁷ Rather the revenues from privatization should go to finance new private businesses, instead of being consumed by an inflated government budget.²⁶⁸

264. *E.g.*, Gosudarstuennaia Programma Privitazatsii Gosudarstuennikh u Munizipal'nikh Predpriatii v Rossiikoi Federatsii na 1992 [State Program of State and Municipal Enterprises Privatization in the Russian Federation for 1992] PRIVATIZATSIIA GOSUDARSTVENNIKHI I MUNIZIPAL'NIKH PREDPRIATII V ROSSII 40-77 (1992); Gosudarstuennaia Programma Privitazatsii Gosudarstuennikh u Munizipal'nikh Predpriatii v Rossiikoi Federatsii [State Program of State and Municipal Enterprises Privatization in the Russian Federation] PRIVATIZATSIIA GOSUDARSTVENNIKHI I MUNIZIPAL'NIKH PREDPRIATII V ROSSII 7-82 (1994).

265. Rondinelli, *supra* note 21, at *4.

266. *See, e.g.*, SPA Gets Cabinet "Heavy Hitter," PRIVATISATION INT'L, Feb. 1992, available in LEXIS, World Library, ALLWLD File, at *1.

267. The total revenue from privatization in Russia accounted for 2.5 trillion rubles in 1994, 65% of which went to the federal budget instead of being available as credit for the private sector. *Metodicheskie Rekomendatsii po Primeneniiu Osnovnikh Polozhenii Gosudarstvennoi Programmi Privitazatsii Gosudarstvennikh i Munizipal'nikh Predpriatii v Rossiikoi Federatsii Posle 1 Iiulia 1994, Utuershdennikh ukazom Prezidenta Rossiikoi Federatsii ot 22 Iiulia 1994, No. 1535* [Systematic Recommendations for the Application of the Basic Conditions of State Programs of Privatization of State and Municipal Enterprises in the Russian Federation after July 1, 1994, Affirmed by edict of the President of the Russian Federation from July 22, 1994, No. 1535], EKONOMICHESKAA GAZETA 16 (1994); Alexander Privalov, *V GKI Bsie po Starom u. Ili po Novomu*, [Is Everything in the State Committee on Property According to the Old, or According to the New], 46 KOMMERSANT 14, 16 (1994).

268. Russian legislators might want to analyze the new Turkish privatization law, which requires that privatization revenues be set aside for the rehabilitation or restructuring of existing state enterprises prior to their sale, together with repayment of their outstanding debts. *See* Jim Bodgener, *Turkey: Stakes Mount in Turkish Sell Off*, MIDDLE E. ECON. DIG., Dec. 9, 1994, available in LEXIS, World Library, ALLWLD File.

As a reform-supervisor, government should only enforce its legal rules, resolve judicial disputes, and impose liabilities. Supervision is the area where government authority is substantially reduced by ongoing privatization.²⁶⁹ It is important for Russian socialists to realize that, in a market-oriented system, government cannot operate efficiently by simply utilizing the old administrative directives and command. Yet, some absurd situations of government authority over privatized enterprises still persist in Russia, where government arbitrarily (without representation) imposes various price control mechanisms and licensing requirements.²⁷⁰ For instance, after privatization, the Russian company Emerald Mines of the Urals still had to market its emeralds through the government agency, Malyshevo Mining Administration (MMA), which took one-third of the company's profit. The company's legal action against the MMA was rejected by the court, which held that since the company extracted strategic raw materials it had to sell its output through MMA, which holds an appropriate government license.²⁷¹ This is an example of ineffective privatization, where private ownership did not change the administrative character of the business. As such, why bother to privatize? It should be well-established that government regulations are justified only when they are based on law.

B. Government Regulations and Role of Corporate Law

According to one well-known concept of the corporation which has dominated our thinking about public business entities over the last century, a corporation is not strictly private but rather "is tinged with a public purpose."²⁷² The proponents of this theory insist that the corporation comes into being and continues as a legal entity only with the concurrence of government, which "grants a corporation its juridical personality, its

269. See Rondinelli, *supra* note 21, at *2-3.

270. Cf. *Gas Firms Head Energy Sell-Off*, INT'L GAS REP., available in LEXIS, World Library, IGASR File (describing government price controls on oil and gas in Hungary).

271. *Emerald Mine Fails to Overturn Its Privatisation*, KOMMERSANT DEYLI, Oct. 28, 1994, at 14, translated in BBC Summary of World Broadcasts, Nov. 2, 1994, available in LEXIS, World Library, BBCSWB File.

272. William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 265 (1992).

characteristic limited liability, and its perpetual life."²⁷³ United States Senator Nelson expressed this concept of the social purpose of the public corporation as follows:

The corporation is a human invention to serve human, social needs. In theory, it is subservient both to the State that creates it and the market in which it competes. If the corporation does not fulfill its social obligations, under the theory, the State can amend or even *revoke* its charter. If it lapses in economic efficiency, its market competitors will force it to improve—or force it out.²⁷⁴

Thus, a question arises as to whether it is efficient for society to grant the state the right to revoke the charter of a corporation when the corporation does not fulfill its obligations, which have been defined by the state. This issue is very closely related to one of the fundamental questions of corporate law: what is the role of corporate law? Shall corporate law requirements be mandatory or “catch-all” provisions? To what extent should the state be allowed to infringe the contractual rights of incorporators?

The ardent supporters of the “contractarian paradigm” insist that corporate law is justified only when it reduces the cost of drafting corporate contracts by providing a set of default rules that firms can adopt or reject at *their option*.²⁷⁵ Such an “advisory” role for the state is partially explained by *skepticism* that the state, as the primary source of corporate law, has sufficient incentives to provide such corporate law as would promote social wealth, rather than engaging in a race to the bottom in a competition to attract more corporations to reside within its borders.²⁷⁶

Nonetheless, even the proponents of contractual theory agree that corporate law should provide mandatory rules when

273. *Id.*

274. *The Role of Giant Corporations in the American and World Economies: Corporate Security: Overviews, Hearing Before the Subcomm. on Monopoly of the Senate Select Comm. on Small Business, 92d Cong., 1st Sess., (1971), cited in HAMILTON, supra note 106, at 520.*

275. Michael Klausner, *Corporations, Corporate Law, and Network Contracts*, 81 VA. L. REV. 757, 771, 825 (1995).

276. *Id.* at 826; see William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 698 (1974).

doing so would reduce the adverse effects of externalities or imperfect information.²⁷⁷ Due to the imperfect supply of information in Russia, the unequal bargaining positions of the parties, the absence of market institutions capable of reducing negative externalities of unequal negotiations, and the lack of an established judicial precedent system, the *rule-bound mandatory* system might be currently better than the general advisory “gap-filling” system. To preserve the freedom of private negotiations, government might give the incorporators some regulatory clearance by providing a set of optional terms (“menus”) from which corporations could select the terms that suit them best, rather than establishing one mandatory requirement for all.²⁷⁸ Companies then would be able to customize their own terms, while the “menu” would facilitate coordination, provide predictability, restrict managerial authority and corruption, and reduce the economic risk and political tension in society.

C. Incentive Methods of Government Regulation

In pursuing its social goals, government does not always have to apply mandatory rules of restrictions and limitations. In certain situations, methods of encouraging specific behavior through a system of economic incentives might serve the same purposes as liability rules.²⁷⁹ Certainly the regulations designed to deter particular undesired corporate behavior cannot stimulate desired forms of positive conduct. As such, government can influence certain strategic corporate decisions by establishing systems of direct or indirect subsidies, tax incentives, low interest rates, free economic or industrial zones, and technical or educational assistance; by offering relief from international trade tariffs or quotas; and by providing monopoly licenses or other privileges.²⁸⁰

Different types of bonus and incentive zoning are known in many countries. In a sense, this technique is “a sophisticated form of barter, designed as a means of achieving both developer profit and municipal amenity.”²⁸¹ A local municipality, through

277. Klausner, *supra* note 275, at 835–36.

278. For more on a system of standards, see *id.* at 839–41.

279. See Rondinelli, *supra* note 21, at *8.

280. See generally PRESIDENT'S COMMISSION ON PRIVATIZATION, *supra* note 25 (giving an overview of legislative options).

281. DAVID L. CALLIES & ROBERT H. FREILICH, LAND USE 695 (1986).

its zoning ordinances, may offer economic incentives to developers by relaxing various restrictions and zoning requirements applicable to the developing area in exchange for the development of desired types of projects.²⁸² For the same purpose, tax abatement or other financial privileges might be granted.

For example, in New York City, in order to encourage private developers to build low-cost cooperative housing, the municipality of New York provided the developers with long-term, low interest mortgage loans along with substantial tax exemptions.²⁸³ In return for such benefits, the developers had to agree to have the city approve virtually every step in the development of the cooperative.²⁸⁴ One such condition was that developers agree to operate the facility on a nonprofit basis and lease apartments only to tenants whose incomes fall below a certain level and who have been preliminarily approved by the city.²⁸⁵ Thus, the city accomplished its purpose of providing the low-cost housing and maintaining substantial control over the enterprise by granting developers certain pecuniary privileges which could not be obtained by liability rules or other methods.

The government might play an important role in *municipal land management* programs, as it does for the *industrial parks* in the Modena region of Italy.²⁸⁶ Under the municipal land management program in Modena, the municipal authorities have the power to expropriate large areas of land for industrial parks.²⁸⁷ By acting as an agent for a large group of artisans and small businesses, the municipality buys the agricultural property for an industrial park.²⁸⁸ Therefore, by removing the speculative element in land prices, the municipality has been able to substantially reduce the price of land for individual arti-

282. *Id.* at 691.

283. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 840-41 (1975).

284. *Id.* at 841.

285. *Id.* at 842-43. Moreover, the tenants of Co-op City also were restricted in their ability to transfer the shares (which represented their ownership in the apartments) to nontenants, and they could not resell the apartments for a profit. *Id.*

286. *See, e.g.*, MICHAEL H. BEST, *THE NEW COMPETITION: THE INSTITUTIONS OF INDUSTRIAL RESTRUCTURING* 211-14 (1990).

287. *Id.* at 212.

288. *Id.*

sans.²⁸⁹ In addition, by organizing firms according to productive activity, the municipality was able to customize the building construction and achieve economies of scale in the provision of common infrastructural services.²⁹⁰ By statute, the municipality can sell a maximum of fifty percent of the lots obtained within industrial estates and has to offer the other half for surface rights leases for a minimum of sixty years while retaining ownership. A firm can receive the benefits of the industrial park by leasing surface rights, which cannot be resold on the open market and are returned to the municipality to be leased at the original price to another firm. By the control of leases the municipality retains control over the use of the industrial parks.²⁹¹ Having later turned over the management of the construction and operation of the industrial parks to a construction company, the municipality still retains influence through a clause in the contract which includes the proviso that the construction company sell exclusively to purchasers approved by the municipal authorities.²⁹² As a result, by organizing users and the building industry, the municipality has been able to promote the development of small firms located in specialized facilities but without the burden of operating the industrial parks themselves.²⁹³

VI. CONCLUSION

Privatization in Russia and other former socialist countries has not completely demolished the public sector of the economy. The state enterprises existed, they continue to exist, and they will exist for an indefinite future. Privatization does not aim to abolish all means of government influence over the enterprises, but rather it is conceived as a method of eradicating absolute state supervision over the enterprises which derived from the state's exclusive ownership interest in it. Privatization is aimed at giving enterprises their own life and independence by slackening the umbilical cord connecting the enterprises and the state; however, it should not attempt to completely sever the

289. *Id.*

290. *Id.* at 213.

291. *Id.*

292. *Id.*

293. *Id.*

enterprise from the state, a process which brings social pain and suffering, for the sake of ideological de-socialization.

Indeed, capital intensive enterprises can operate effectively only in conditions of the free flow of capital, which can be provided through the system of capital markets.²⁹⁴ However, it is inevitable that governments will want to exercise more control over certain enterprises that are essential for national security as well as for other public policy reasons. Putting these enterprises on a hard budget constraint or diluting ownership in them might be partial solutions to the monitoring problem. Other ways of providing the state with the desired control over privatized enterprises are for it to retain a golden share or to enter into a covenant agreement with the new owners. The government can also achieve its objectives through the institutions of corporate law, as opposed to retaining equity in the enterprises.

Nonetheless, I do not see why it would be impermissible to allow the state to participate in the equity of any enterprise as an ordinary shareholder. The state should not be prohibited from buying and selling stocks on the market, provided that the government carries the same liabilities as an ordinary shareholder or manager, including fiduciary duties to minority shareholders, disclosure requirements, prohibition on insider trading, and so on. In order to preserve the minority stake in an enterprise, some limitations on state equity interest may be established. Certainly the government should exercise its authoritative powers through the specially established state organs or holding companies. The State's monitoring functions may also be contracted out to private investment or management firms. Yet, the state should be entitled to participate in dividends from its investments. If such investments are recognized, it makes little sense to continue distinguishing between the processes of privatization and nationalization. To conclude, privatization should not be regarded as a magic cure for the aches and pains of socialism. Privatization is not a panacea, nor is government control a deadly disease. The real cure may be the simple prohibition on subsidizing state enterprises from the state budget. The threat of bankruptcy then will be the lash, while the product market will be the compass. In my view, what is

294. See Rondinelli, *supra* note 21, at *2.

significantly more important for restructuring centralized socialist economies is the establishment of a system of diversified property rights and the creation of conditions for developing *new* private businesses. This can be achieved through securitization of former state enterprises and the ability to trade the shares freely on the market. The state, if it wants, can also be a player in this market. But three conditions should necessarily be fulfilled: capital markets should exist; the rules of the market should be established; and all participants in the market (including the state) should play fair. This is a model not only for Russia, but for everywhere. This is the true antidote for both the dictatorship of the state and market anarchy, which are equally deleterious.

