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LEASE PRIVATIZATION AS A NONSTANDARD CONTRACT

The process of ownership transformations takes the form of transactions. Contractual relations in the transition from state-dominated property rights to private property are of various character. The privatization contract proceeds according to the following sequence: 1) preparation of a privatization contract, 2) conclusion of the contract for the transfer of property rights, 3) implementation of the contract. The features of the privatization contract, particularly the limited rationality of participants in the contract, uncertainty resulting from the opportunism of participants in the contract, and the specificity of the subject-matter of the contract, determine the results of the implementation of a privatization contract. In lease privatization, which incorporates features of a nonstandard contract, the results of the implementation of a contract may be as follows:

1. Failure to fulfil the contract, in which case the process of the transfer of property rights in the economic sense does not take place;
2. Fulfilment of the contract, which entails the establishment of a private entity or an employee-owned company.

1. INTRODUCTION

The process of ownership transformations may be treated as organizational innovations that impact on the development of an entity that undergoes privatization. The analysis of the privatization process in terms of transaction costs means focusing on privatization contracts, and in particular on their qualitative and quantitative features. As the analyzed economic phenomena are quite complex, the analysis of the privatization contract presented below is not conclusive. It is merely an attempt to highlight some aspects that in my opinion are of importance, an understanding of which can be obtained using the instruments of the new institutional economics.

The subject-matter of this paper is the privatization contract and the effects of its implementation in a situation of a transition from state-dominated property rights to private property. After discussing the main features of the privatization contract, I will try to point out the changes in the structure of property rights that are the result of the implementation of contracts in the process of lease privatization.

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2. DESCRIPTION OF THE PRIVATIZATION CONTRACT IN TERMS OF TRANSACTION COST ECONOMICS

As a result of the implementation of a privatization contract two qualitatively different situations may develop. One situation is where as a result of the implementation of a privatization contract the formal owner actually controls business activities. There is a coincidence of property rights and control over business activities. In such a case the fulfilment of the privatization contract results in privatization as the transition of property rights to natural or legal persons results in the constitution of private property.

The other situation is connected with the fact that property rights and control over business activities do not always coincide. The formal owner is in fact unable to control a business. In such a case the changes caused by the privatization contract may be defined precisely on the basis of the logic of the behaviour of persons who actually control business activities. Thus, the implementation of the privatization contract will not result in an actual transfer of a state enterprise from the public sector to the private sector. With regard to the second situation, i.e. the situation where property rights and control over business activities do not coincide, we will use the term "ownership transformation".

Ownership transformation of a privatization nature is a process that takes place according to the following sequence: \Rightarrow preparation of a privatization contract \Rightarrow conclusion of the contract for the transfer of property rights \Rightarrow implementation of the contract.

The following features characteristic of the privatization contract may be enumerated:

- 1) limited rationality of the participants in a contract;
- 2) uncertainty:
 - fortuitous,
 - behavioural, resulting from opportunism of the participants in a contract;
- 3) specificity of the subject-matter of a transaction;
- 4) uniqueness of the circumstances of each transaction;
- 5) possibility of renegotiation of the terms of the contract.

The limited rationality of participants in a contract results from the fact that individuals have limited ability to collect and process information. It is not possible to establish a detailed strategy of the privatization contract due to limited rationality on the one hand and opportunism on the other hand. According to F. von Hayek (1945, p. 254), interesting economic problems of an organization are connected with uncertainty, as the main economic problem of a

society consists of adaptations to changes in the circumstances of a particular time and place.

The long-term nature of the privatization contract increases uncertainty. This is due to the fact that not all future circumstances may be anticipated. Adjustment to new circumstances that arise during the implementation of a contract can be limited. An increase of uncertainty as a consequence of open-end contracts may and does cause a higher degree of adjustment. Privatization contracts are organized in various manners. The reasons that justify the various organizations of privatization contracts may be explained using the categories of transaction cost economics, in particular such characteristics as the specificity of resources, uncertainty, and frequency. The complex nature of the empirical analysis of the privatization contract results from the specificity of physical resources and the specificity of human resources. As pointed out by O. E. Williamson (1985, p. 62), specific transactions are more often related to human resources, which evolve during the period of the implementation of a contract. This is illustrated by specialized training and learning by doing.

Due to the unpredictableness of circumstances in the privatization process, the terms of privatization contracts are rather general and flexible and equip the parties to such contracts with special tools for the negotiation and renegotiation of the terms. A question should be posed whether privatization contracts implemented under the liquidation method are conducive to the establishment of large numbers of independently operating businesses controlled by clearly defined owners and what forms of ownership the state enterprises privatized by means of the liquidation method will assume.

The privatization contract may be a basis for the establishment of private property rights. Due to its features the privatization contract proceeds through three interdependent stages.

In the first stage, a privatization method is selected and the enterprise is prepared for the conclusion of a privatization contract under the selected method. At this stage the participants that co-decide about the privatization are: the employees' council, the enterprise's managers (agents), and a representative of the owner – the State Treasury (the founding organ – principal). In the liquidation method the powers of the employees, i.e. the employees' council, and of the managers are of essential importance with respect to the decision on the ultimate form of privatization. Those powers are derived from employment in the given enterprise. Thus, it can be concluded that the employees participate in the first stage of privatization by participating in making the privatization decision, which has labouristic justification. The employees' participation is manifested in making choices

and justifying them to the founding organ with respect to the following issues:

- the target type of company: private limited company or public limited company;
- the rules regarding the allocation of shares to employees;
- principles concerning the transfer of shares;
- employees' participation in the management board and the supervisory board;
- powers of the management board with regard to employment.

The selection of the future form of ownership of the enterprise is of utmost importance for the implementation of the privatization contract under the liquidation method. The forms of ownership correspond to legal models defined in the Commercial Code. The choice can be made between two possibilities: the private limited company and the public limited company. The choice of the legal model is determined by the features of the privatization contract, in particular by limited rationality, uncertainty, and specificity of the subject-matter of the transaction. The selection of the public limited company option is tantamount to the adoption of a strategy of openness to new shareholders who could reinforce the company's capital. The choice of the private limited company option means the exclusion of the possibility of raising capital through increasing the number of shareholders. The satisfaction of financial needs will require borrowing. When comparing the two options it should be noted that the selection of the public limited company offers the possibility of limiting the employees' interests, whereas the selection of the private limited company is conducive to the petrification of the ownership and employment structures.

The adopted rules of the allocation of shares to employees determine the scope of the decision-making powers of managers and other employees at the stage of the implementation of a privatization contract. At the beginning of the process different situations are possible, which in conjunction with principles concerning transfer of shares may have a decisive impact on the target ownership structure and on the motivations of managers. The adopted rules for the allocation of shares constitute in fact an informal contract between the employees and the managers for the implementation of ownership transformation by means of the liquidation method.

The unpredictableness of circumstances in the ownership transformation process is the reason why the terms of privatization contracts are rather general and flexible and equip the parties to such contracts with special tools for negotiation which cannot constitute a legal framework. The implementation of the contract is both formal and informal in character. According to the letter of the law (Dziennik Ustaw 1990) a commercial-law company is established. Property rights could not be acquired individually by a manager in the manner provided for in Art. 39 of the

State Enterprises Privatization Act. Thus, the implementation of the contract has features of circumstantial approximation to the law in the sense of C. Summers (Williamson 1985, p. 9). The opportunism of participants in the contract brings benefits to the agent (manager), in the form of a reduction in transaction costs, and to the principal, in the form of, for instance, the fulfilment of political objectives (quantitative results of privatization – a formal reduction in the number of state enterprises).

The general principle of trade in shares should be the transferability of employee shares. By employee shares I understand shares in the public limited company or the private limited company acquired by individual employees on preferential terms. Employee shares may exist only in enterprises that have the legal form of companies. In Poland employee shares may be created in stock companies and in limited liability companies. This form of ownership is close to classical private equity ownership as it is based on individual shares that have market value. Such shares are owned by persons who as a result of the acquisition of the shares acquire specified property, income, and decision rights. It should be emphasized, however, that there exist significant differences between employee ownership and classical equity ownership. The differences relate first of all to the principles and manner of acquisition and transfer of employee shares. The transferability of employee shares is limited due to, among others, limited rationality and behavioural uncertainty resulting from the opportunism of participants in a contract, as a result of which, in conjunction with the uniqueness of the circumstances of each transaction (relating to the parties, the subject-matter, the time, and the place), the transferability of shares is subject to:

- time limitations;
- limitations concerning persons entitled to acquire shares;
- limitations concerning the existence of pre-emptive rights with regard to the shares to be transferred.

Generally, the transferability of employee shares depends on the legal form of the entity in which employees hold employee shares. The Commercial Code provides for full and unlimited transferability of shares (both inscribed and bearer shares) in stock companies. In limited liability companies, however, each transfer of shares requires the consent of the management board and must be recorded in the commercial register. In privatization lease the possibility of opportunistic behaviour of the parties to a privatization contract may lead to the limitation of transferability of shares. Two options are possible with regard to the transfer of shares. Priority with regard to the transfer of shares is given to employees. This limitation is most often formulated explicitly in the articles of association.

Under one option, companies issue inscribed shares. The limitation imposed on the transfer of such shares is that the company has pre-emptive rights with regard to the shares. Share transfer transactions between employees are also subject to limitations, as they require the company's consent. In such a case inscribed employee shares are not subject to market valuation.

Under the other option, trade in the company's shares is not restricted to the employees. In such a company part of the shares are inscribed shares and the remainder are bearer shares and are traded on the stock exchange. Unrestricted transfer of shares makes possible market valuation of those shares and, indirectly, of registered employee shares. Rafako is an example of such a company. Accepting the behavioural assumption about opportunism and in particular Williamson's statement (Williamson 1985, p. 31) that some people are opportunistic from time to time, the analysis of companies' articles of association proves that efforts are made in order to create *ex ante* rather than *ex post* security. The next factor conducive to opportunistic behaviour of participants in privatization contracts is the degree in which shares are paid for with employees' own funds and the scope of privileges, reliefs, and exemptions offered to employees. Privatization activities that have been carried out so far show clearly that in enterprises privatized by means of the liquidation method various privileges are granted with respect to the purchase of employee shares and the transfer of such shares is subject to temporal and personal limitations.

Employees' financial participation means that employees take shares in a company for cash contributions, the obvious result of which is that they hold property rights to a specified part of the company's assets and the right to income generated by the company's assets. An employee who is the owner of such a share, depending on the type of the share, has the right to participate in the company's decisions, is entitled to benefits, but at the same time assumes risks connected with the company's economic performance. The purchase of individuated shares by employees in enterprises that are privatized by means of the liquidation method is supported by various types of facilities. The nature and scope of such facilities that may be offered to employees in the process of the privatization of enterprises have been specified in statutory regulations (Art. 24 of the State Enterprises Privatization Act). They may relate to: the number and price of shares and the terms of payment in consideration of purchased shares.

The financial condition for the conclusion of a privatization contract by the State Treasury is the accumulation by the company of funds equal to 20% of the combined founding fund and enterprise fund of the state enterprise. The requirement of financial contribution from the employees acquiring shares is supported by a system of financial facilities. Employees who acquire shares can

take advantage of loans, discounts, payment by instalments, partial forgiveness of payment as well as tax exemptions and allowances.

Certain features of circumstantial approximation to law are shown by the funding of loans to finance the acquisition of shares by employees from Ownership Transformation Foundations, to which contributions are made out of the profits and other funds of state enterprises transformed by the lease privatization method. Those foundations gave low-interest or interest-free loans exclusively to employees of those enterprises for the purchase of employee shares. Subsequently the foundations forgave the loans, which in fact were grants. (For example, the Poznań Private Ownership Foundation 'Sami Sobie' [We for Ourselves] received donations from various state enterprises undergoing privatization, used the donated funds to make loans to employees for the purchase of shares, and immediately wrote them off. The enterprise Winstal contributed 5 bn zlotys out of its 1990 profit to the Ownership Transformation Foundation, which made loans to the enterprise's employees at 5% per annum. The owners' equity of the company Winstal was 5.5 billion zl ("Gazeta Wyborcza" no. 54, 5 March 1993).

Uncertainty on the one hand and opportunism on the other reduce employees' willingness to subordinate operating decisions to strategic ones. Their operating decisions concern privileges with respect to the acquisition and transfer of shares, and thus in view of the source of funding for the acquisition of shares during the implementation of the privatization contract employees become residual claimants. Therefore they may be willing to use their property rights in order to maximize profits. Who the ultimate owners of a privatized enterprise will be depends on the long-term make-up of the group of residual claimants. It usually comprises managers. Managers are interested in acquiring shares from other enterprises. In state enterprises implementing privatization contracts under the liquidation method, an internal quasi capital market is created. The fact that individuals hold specific equity interests in the form of employee shares means that the structure of the owner's rights is changed. Employee shares give rise to property, income, and decision rights of their owner. Using the methodological hints of the Property Rights School we can characterize the bundle of property rights of an enterprise transformed through lease privatization by reference to the attributes of property rights, exclusiveness and completeness, bearing in mind that free transferability is a prerequisite for the realization of the exclusiveness attribute. The lack of exclusiveness means that free transferability of component property rights does not exist. The completeness of property rights means that all enumerable component rights exist. In the case under consideration the subjects of the transactions are state enterprises and companies. Incomplete and nonexclusive property rights are

transferred into other incomplete and nonexclusive property rights. It should be stressed that individual privatization contracts concerning lease privatization differ from one another in terms of the principles of acquisition and disposition of equity shares, the scope of the rights of employees-shareholders, the degree of financial risk involved in the holding of shares. In reality, the privatization contract brings about changes in actual rights to such an extent that managers (agents) enjoy exclusive property rights (Table 1).

Table 1

Property right attributes in state enterprises and in enterprises in the lease period

Property right attributes	State enterprise	Enterprise in the lease period
	Person	Person
Ius utendi	managers	managers
Ius fruendi	State Treasury, employees no residual claimants	State Treasury, employees residual claimants occur
Ius abutendi	founding organ, managers	owners – employees, managers
Ius disponendi	founding organ, employees	owners

Source: own research.

The management's authority regarding employment is an important element of the privatization contract. Two alternatives are possible: the management's autonomy as regards dismissing and hiring employees or employment guarantees for employees-shareholders. Either option is possible in both the private and the public limited company; however, the public limited company, where shares can be traded, offers greater freedom in employment policies than the private limited company.

3. CONCLUSIONS

To sum up, it can be said that the choice of the corporate form of organization is essential for the fulfilment of the privatization contract, while the other elements are important for the efficiency of the contract, as they have an effect on the managers' motivation and their ability to act in the multifaceted restructuring of the enterprise and repayment of lease obligations to the owner (Table 2). The private limited company is the predominant legal form of company established for the purpose of taking over assets leased by the State Treasury. The Commercial Code imposes restrictions on the transfer of interests

in limited liability companies. Such transfers are restricted in that, firstly, such interests are personal and, secondly, any transfer requires the consent of the management board or is temporarily prohibited. An analysis of the legal form of companies leasing State Treasury-owned assets has shown that where the public limited company form was selected, an open nature of the company was envisaged, with a view to attracting external investors.

Table 2
Comparison of privatization options

Conditions of privatization contract	Public limited company		Limited liability company
	Inscribed shares	Bearer shares	
Managers' motivation relating to increase of his interest	strong	medium	weak
Possibility of securing additional capital	medium	strong	weak
Borrowing requirements	medium	weak	strong
Possibility of restructuring employment	medium	strong	weak
Possibility of managers' opportunistic behaviour	weak	medium	strong
Role of employee ownership after completion of the privatization process	weak	Weak	strong

Source: own research.

The privatization contract, which takes place in the case of lease privatization, is not an institution characteristic of the perfect market and has features of a relational contract. However, certain privatization contracts can be described as neoclassical contracts, whose principal characteristic is that effective adaptations are provided for to achieve the fulfilment of the original agreement. Privatization contracts relating to leasing proceed in such a way that some of them can be and actually are conformable to the original agreements, while others need not be and actually are not conformable to the original agreements. In contrast to the classical contract, in the relational contract contractual terms and conditions are not fixed *ex ante*. The open-endedness of the contract means that the parties agree on a procedure that will result in future changes of the provisions of the contract

as it was not possible to make them sufficiently specific at the time of concluding the contract. The existing legal order is insufficient to overcome opportunistic behaviour, and because of informational asymmetry the parties to the contract have limited rationality. J. R. Macneil (1978, pp. 854–906) describes relational contracts as contracts relating to recurring nonstandard transactions. The transactions are bilateral and described as managed by unified management structures.

“On the one hand, both parties have an incentive to sustain the relationship rather than to permit it to unravel, the object being to avoid the sacrifice of valued transaction-specific economies. On the other hand, each party appropriates a separate profit stream and cannot be expected to accede readily to any proposal to adapt the contract. What is needed, evidently, is some way for declaring admissible dimensions for adjustment such that flexibility is provided under terms in which both parties have confidence. This can be accomplished partly by (1) recognizing that the hazards of opportunism vary with the type of adaptation proposed and (2) restricting adjustments to those where the hazards are least.” (Williamson 1985, p. 76). Transactions in privatization contracts concern specific resources that are sold to buyers who offer contractual security. In such cases Williamson (1985, p. 38) recognizes justification for price discrimination. The buyer obtains a premium in the form of a lower price.

The adoption of a decision to privatize an enterprise, and in the case under consideration specifically to lease out its assets, means that there will be various transaction costs. In particular, E. G. Furbuton and R. Richter (1991) distinguish contract preparation costs, contract conclusion costs, and contract monitoring and strengthening costs. Certain costs of agreeing the terms and conditions of ownership transformations are incurred before the terms of exchange are fixed. Transaction costs in this case can be described as the costs of guaranteeing property rights. Particularly important for the implementation phase of a privatization contract based on lease is the occurrence of the cost of management and the cost of monitoring the obligations of exchange participants.

The equity structures of companies resulting from the implementation of a privatization contract are closed to their own evolution, which gives rise to the surmise that the privatization process is not finished as soon as strong private property appears. The conclusion of a lease contract with the owner does not create such guarantees. The implementation of a privatization contract may result in the establishment of:

1. a company with an active owner, where the latter role can be assumed by:
 - a) the company’s managers,
 - b) investors external to the company,

2. an employee-owned company with an active manager.

In the former case ownership transformations involve a reduction of employee interests, in the latter employee interests are not affected. As can be seen in Table 2, a company with an active owner is more likely to be formed under the stock company option, and an employee-owned company under the private limited company option.

The accomplishment of ownership transformations by means of the lease method depends not only on the elements of the privatization decision discussed above but also on many circumstances of the economic activity of the enterprise that condition its fulfilment of obligations towards the owner.

A company that takes State Treasury-owned assets on lease obtains freedom to use those assets in exchange for payments. Financial responsibility remains with the owner. (This situation is illustrated by the privatization of the enterprise Wodrol. In 1991 the assets of the state enterprise were taken on lease for a six-year term (1991–1997) by a company. In May 1994 the company stopped paying principal instalments and other charges to the Provincial Office and was declared bankrupt on 30 November 1995. Under the agreement concluded by the provincial governor, representing the State Treasury, and the company Wodrol S.A., if the agreement is for some reason terminated before all principal instalments have been paid, the Provincial Office must refund to the company all principal instalments that have been paid (Rybak 1996; NCE...1996). In such cases the effect of the implementation of the privatization contract is the transfer of state property to private ownership.

Summing up, the implementation of the privatization contract, which is a process of the creation of private property, can hypothetically lead to the following results:

1. The lessee fails to discharge its obligations under the contract. The State Treasury remains the owner of the leased assets of the state enterprise. The privatization contract is not fulfilled. Property rights are not transferred in the economic sense as a result of the failure to make payments in respect of the use of State Treasury-owned assets.

2. The lessee pays up the amount due for the use State Treasury-owned assets. The privatization contract is fulfilled. An employee-owned or a private company can be set up.

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