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Treuhandanstalt and investment acquisitions: How to ensure that contracts are kept?

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**TREUHANDANSTALT AND INVESTMENT ACQUISITIONS:
HOW TO ENSURE THAT CONTRACTS ARE KEPT?**

by
Klaus-Dieter Schmidt

May 1994



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Abstract

The process of selling a state-owned company in former centrally planned economies (CPEs) differs greatly from that of buying a private company in western market economies. While a private seller is normally interested in selling his portfolio expensively, a privatizing agency in CPEs has additional goals: she intends to ensure, e.g., that the purchaser continues the company, makes certain investments or maintains a certain number of jobs. Consequently, these concerns are a potential source of conflict.

This paper gives an overview of how the German Treuhandanstalt (THA) copes with the problem. It investigates

- first what the THA has done in establishing a contractual framework reflecting her social goals and
- second how effective this framework has been in realizing them.

The results are mixed: the THA has been very successful in putting an investor on the chain. However, she has invested a lot of money. Time must tell whether the results make all these efforts worthwhile.

I Introduction¹

Joint ventures (JV) between domestic and foreign corporations are considered as a key element for a successful economic transformation of the formerly centrally planned economies (CPEs) into market economies. Massive inflow of fixed capital, technologies and managerial skills over many years to come is regarded as essential for overcoming the transformation crisis.

JV are, nevertheless, a hotly and controversially debated issue in CPEs. The opposition stems not only from those who reject foreign capital penetration for ideological reasons still thinking in terms of Marxist theories and regard JV as an instrument of neo-colonialism designed for political and economic exploitation. It is also often provoked by vested interests of governments, business and trade unions in the CPEs. These interests, e.g. in respect to product profile, investment strategy or wage and employment policy often differ widely from the intentions of a foreign investor. Finally, it comes from many citizens who are also afraid that foreign investors will steal the property which belongs to the people.

Although governments and companies in the CPEs do the best they can to realize their goals, the results often look disappointing. The market for JV is, by far, no seller market. Foreign investors, well assisted by experienced investment bankers and attorneys, understand their job. They put money into a business only if it promises to become a success. They spare no effort to fix a contract which is in their own interest.

In a JV the foreign investor is mostly the party which sets the tone, frequently he is even the majority shareholder. Then he is able to revise a contract sooner or later. Sometimes he would not dream of holding what he initially promised. The most spectacular case is perhaps the decision of Volkswagen to cut the investment budget for Skoda substantially. Volkswagen may have had good arguments in its defence: the world markets for automotive products have become depressed and under those circumstances it would not make sense to enlarge capacities. Nevertheless, the decision has been disastrous. The Czech government, the press and the people on the streets have demonstrated deep dissatisfaction. The government has been accused of having poorly negotiated the deal.

In normal business this is not even worth talking about. There exists an acquisition contract concluded between the seller and the purchaser. The contract, mostly elaborated by versed

¹ The paper was presented at the ACE-Workshop "Joint Ventures in Transformation Countries in the Context of Overall Investment Strategies of Their Partners" in Budapest on 10 - 12 June 1994. I am indebted to my colleagues Birgit Sander and Uwe Siegmund and Hans-Jörg Schaal (Treuhandanstalt) for valuable assistance and comments.

attorneys, is litigable. And the purchaser will hold what he has promised. He will not dare to be threatened permanently with litigations. He will clarify the essentials of the contract before it is signed. However, the process of buying a company in the CPEs differs greatly from that of buying a private company in western market economies. It means to deal not only with a state-owned company but also with a government or a privatization agency, an omnipotent superseller, whose motives are often quite different from those of a private seller. While a private seller is normally interested in selling his portfolio expensively and in putting himself out of business and responsibility as soon as possible, a government or a privatization agency has her own goals. She has not (or not only) an interest "to take the money and run" (Dodds and Wächter, 1993). She looks additionally that her social goals are reached: she intends to ensure, e.g., that the purchaser will continue the company, make a certain investment or maintain a certain number of jobs - although the companies are often heavily overstaffed.² These concerns are basically alien to a private investors. Consequently, they are a potential source for conflicts.

The purpose of the paper is to give an overview of how the German Treuhandanstalt (THA) copes with the problem. Altogether, the THA has now more than 30 000 investors under contract. She is actually in the process of installing a contract management and controlling. For years on end a special agency (with a permanent staff of about 500 lawyers, accountants and consultants) will act as a watch-guard that the contracts are fulfilled.

Table 1 - Foreign Investor's Participation in Privatizing Eastern German Enterprises (End of 1993)

	Privatized enterprises (number) (a)	Promised investment (bill. DM)	Promised employ- ment (1 000 persons)
Total	13 572	183.9	1 506
of which:			
Foreign investors	806	20.0	144
(in p.c. of total)	5.9	10.8	9.6

(a) Including parts of enterprises.

Source: Treuhandanstalt.

The paper is written in particular for businessmen and policy makers in CPEs who may learn from the THA's experiences. The THA is the leader in the privatization process. She is completing her job with remarkable speed. Within 3 ½ years she has privatized about 6 500 complete enterprises and 7 000 parts of enterprises. Foreign investors acquired 800 (or 6 p.c.) of

² "What is important to the government in dealing with these foreign companies, first and foremost, is employment. ... we constantly are told that many of these factories have 20 % overemployment, but we are not letting the foreign buyers or investors to fire these people ... we are demanding that they keep the people employed" (Bakal, 1992).

them; their shares in promised investment and employment were even higher, reaching 11 p.c. and 10. p.c. respectively (Sander, 1992; Table 1).

II. Privatization Strategy

1 THA Contracts

The assignment of the THA is to transfer as many as possible of the former GDR state-run companies into private ownership. That does not mean that the THA is willing to sell to everybody who offers a reasonable price. Her ultimate goal is to create the groundwork for healthy, competitive companies able to survive in the market. Consequently, an investor who is interested in acquiring a THA-company has to present a business plan (Unternehmenskonzept). This plan must provide detailed information on

- the whole scale of business activities (e.g. research and development, production and sales, technology, marketing, administration, management),
- the revenue situation (e.g. turnover and structure of sales, orders on hand, market share),
- the cost position (e.g. material, wage and overhead costs, staffing plan),
- the financial budget (e.g. cash flow, investments, depreciations) and
- the intentions for restructuring and privatization (Vogelsang, 1992; Annex 1).

The business plan and its assessment by the THA are the basis for negotiations. Without the potential investor presenting a convincing concept the THA does not enter any dialogue. The THA investigates first what the investor can offer in terms of operating the enterprise successfully: is he able to overlook the market situation? Are his products competitive? Is he sufficiently experienced to undertake research work? The business plan serves as the yardstick for assessing all these issues.

With the business plan being the A and O the negotiations between the THA and the potential investors are often lengthy and complicated. In contrast to normal acquisition contracts the crucial matter is generally not the selling price: the THA is an institution with "deep pockets". She does not need to maximize revenues, she can afford to make losses and sell companies even at negative prices. Bidders are always requested to present a business plan which takes into account the THA's social goals. According to the advice of two insiders bidders should behave accordingly: "Check the merchandise thoroughly, push hard on the few points that matter and aim for the quickest closing possible, before getting leap-frogged by someone who knows the ropes and accept the process for what it is. There are terrific bargains to be had,

but they do not come with ribbons and bows Make an offer degree of comfort as of the deadline and if that fails, move quickly onto the next deal, using what was learned in the last one" (Dodds and Wächter, 1993, p. 10).

Though the negotiations may be time consuming and uncomfortable, THA's acquisition contracts are considered as lean by international standards. The contracts comprise only those issues which really matter: clauses regarding the continuation of the company, investment and employment guaranties, revaluation of assets, restitutional claims and other risks - and the purchase price. Most of these clauses are not customary in normal acquisition contracts.

2 Parallel Contracts

The THA is the legal owner of her companies. Although she is not a holding company, she takes responsibility for them. She has the exclusive right of sale. The companies are not allowed to negotiate with potential investors on their own. Insofar, the case of parallel contracts should not exist.

A temporary problem, however, have been preliminary contracts concluded between companies and investors in the early stage of the THA. At that time things were often topsy-turvy. Immediately after the fall of the Berlin wall a large number of eastern German companies were "occupied" by western investors by "co-operation or partnership agreements". The large Interhotel group, a holding of more than thirty first-class hotels, e.g., was sold by its former top manager to a western German hotel group obviously for a song. In nearly all cases the THA was able to declare such contracts invalid, only in few cases the matter had to be settled in court.

III Acquisition Clauses

1 Investment

The THA plays a key role in the process of rebuilding the eastern German economy. Therefore, she must be interested in high investments to be undertaken there. For the THA investments are "an anchor cast into the future" (Dodds and Wächter, 1993, p. 15). They give rise to hope that a company will be able to survive.

Before negotiations are started the potential investor has to present an investment plan. The THA carefully scrutinizes all proposed details. "The potential investor is asked how large the company is to become and whether production will take place at one or several locations ... The potential investor must state the volume of investments envisaged and the time in which

these are implemented: Assurances have to be given on both figures and the date." (Rexrodt, 1992).

The intention of negotiating investment clauses is twofold:

- First, they should assure that fresh money flows into the company and
- second, they should assign an adequate share in the risk to the investor (Küpper, 1993).

Indeed, one can assume that an investor who risks his own money will be interested in a positive rate of return.

Investment clauses may have different forms: normally, only the amount of investment and the time horizon are fixed. In other respects, however, they may be defined widely or narrowly:

- In the wide definition an investor may be able to determine the specific types of investments and their timing on this own.
- In the narrow definition most of the details of the procedure (types of investment, timing and financing) are fixed.

In order to promote enforcement of the contract sanction clauses are agreed upon: if the promised investment is not made, a penalty, often equal to one third of the contracted investment volume, has to be paid.

Until the end of 1993 the volume of promised investment contained in sales contracts had been totalling 150 bill. DM (Table 1), however, the THA hopes that in the end she can mobilize even more.

2 Employment

Given the high rate of structural unemployment the THA must be very interested in maintaining or creating jobs. But as the companies to be privatized have been heavily overstaffed, trimming down workforce numbers is the first step in privatizing them. This is normally a source of conflicts.

It should be mentioned that an investor is not free in scaling down workforce numbers. The German Labour Law establishes important obstacles which intend to protect workers in several ways. Individual and collective employment protection is a complicated matter and cannot be described here in detail (for a comprehensive description see Bayerreuther, 1992). For some groups of persons dismissals are not possible at all (e.g. for disabled persons, persons in

military services, persons working on a work council), for others it is possible only after official authorization which is often difficult to obtain. This makes it easier for the THA to secure a maximum of jobs, but it makes it often difficult to sell a company properly.

As in the case of investment clauses the THA tries to fix a certain number of jobs for a certain period of time. Normally, a stepwise reduction of jobs, sometimes also an increase, is agreed. In principle, the number of jobs is negotiable but, in fact, the THA is interested in maximizing them. In negotiations the THA normally starts with a certain target which is mostly out of reach for the prospective investor. If this actually is the case, the purchaser price will be increased. For the THA exists a trade-off between the number of jobs to be maintained and the purchase price to be agreed.

Normally, the number of job guarantees is strictly fixed. As in the case of investment plans investors have to pay a penalty if they fail to fulfill the contract. The penalty should be an equivalent for keeping an employee on staff for the agreed time, but in fact it is lower: 24 000 DM on the average (Küpper, 1993). Sometimes it may be cheaper for an investor to pay the penalty.

For the THA it is important to establish clear-cut provisions in the contracts. "Investors will normally make little progress when they try to build up loopholes into employment clauses by inserting broad 'conditions beyond the purchaser's control' language. The Treuhand generally expects that the penalties for failure to maintain agreed employment levels will be paid regardless of the reasons for the failure. Especially unwelcome will be buyer-proposed language which attempts to make unexpected market conditions a trigger to escape. The world of market risks is, after all, the jungle in which entrepreneurs make their gains" (Dodds and Wächter, 1993, p. 14).

Until the end of 1993 a total of 1.6 mill. jobs had been agreed (Table 1). According to the THA the majority of investors even surpassed the targets; however, a significant minority also fell short of them.

3 Business Continuation

A crucial matter in the negotiation process is to enforce an investor's commitment with regard to keep the company running. The THA has an outstanding interest in the company's continuation. "The trauma to be avoided is the destruction of a company by a purchaser who wants to tear out the surplus value lying within ..." (Dodds and Wächter, 1993, p. 12). In certain cases, if a company is obviously more worth dead than alive, the THA tries to contract business continuation clauses. The investor has to pay a penalty - possibly decreasing in stages for a certain period, say five years - if he fails. However, it goes without saying that the

THA has to work hard to negotiate such clauses which are absolutely unusual in normal acquisition contracts.

4 Speculation and "Asset Stripping"

Anti-speculation clauses overlap with business continuation clauses. They should avoid that an investor purchases a company for speculative reasons. Frequently, a potential investor may only be interested in real estate as a company's only valuable asset. He may intend to shut down the plant and resale estate and premises.³ In the case of any resale, leasing or use contrary to the contract within a certain period of time a revaluation takes place. This period can be long, sometimes much longer than in normal contracts. In the region of Berlin, a fast-booming place where the market for real estate is a seller market, e.g., it can reach 10 years. In extreme cases the investor has to concede to the THA an option for repurchasing (Vorkaufsrecht) which makes it impossible for him to realize the gains. Speculation profits have to be paid up to 100 p.c. to the THA.

Speculation clauses must not be confused with revaluation clauses. The first ones are an integral part of all contracts, the second ones can be found only in about two fifths of them.⁴ Revaluation clauses should prevent big "windfall profits" due to unforeseeable developments in the real estate market: this market is still unbalanced in eastern Germany and, frequently, the true value of an object cannot be calculated. In contrast to speculation clauses revaluation clauses are devices to share the gains between the investor and the THA. The crucial problem with revaluation profits is that they are often only in the books. Sharing them is often the only solution because a full repay to the THA could take away too much liquidity from the company.

However, the criteria for distinguishing between speculation and revaluation gains are vague. "Purchasers seek to have 'speculation' defined narrowly enough so that the revaluation right of the THA may only be invoked where there is a clear failure to fulfil the contract purpose. The Treuhand seeks to define 'speculation' broadly enough to provide it with real protections against clever evasion" (Dodds and Wächter, 1993, p. 13). In practise, such clauses are difficult to handle. Recently, the THA has negotiated more and more contracts without them.

³ Normally, the THA does not sell the real estate not necessary for operating the company. By this, she considerably discourages speculation

⁴ The share was higher in earlier contracts, e.g. 54 p.c. in the 1st half year 1991 in contrast to 28 p.c. in the 2nd half year 1992.

5 Restitutional Claims

One has to keep in mind that frequently investors are objectively handicapped in fulfilling their commitment. Such a handicap are restitution claims arising from the peculiarities of the Unification Act. The normal legal position is "restitution before compensation" - and this has proved to be an immense obstacle to investments. Nobody can hope that an investor puts money into a business before restitutional claims are cleared up.

There are different methods to lift the ban on sale. Normally, a piece of property can only be sold by the THA if the local property office (Vermögensamt) has signalled that no restitutional claims are announced. Otherwise the THA must obtain a so-called Investment Preference Decision (Investitionsvorrangentscheidung) which may set aside the ban on sales. However, restitutional claims legally give the right to protest such a decision in the courts. This can postpone investments for some years.

In order to reduce uncertainty for investors the THA offers a special restitution clause which takes effect if a restitution claim succeeds after the property transfer has been completed. In this case the THA is willing to repay the investor the current book value of the property reclaimed or - if it is lower than the initial purchase price - to void the contract. A precondition is that the investor has carried out his investment promises.

6 Ecological Damage

The typical THA contract will include some other "safe harbour clauses" which reduce the risk for an investor - and may encourage him to pursue the THA's social goals. The most important are perhaps ecological damage clauses. These clauses release investors - partly - from clean-up responsibilities. Often they are used to encumber the investor with a fixed amount of the cleaning-up costs; the exceeding amount is shared between the investor and the THA up to a certain limit and the remainder is paid by the THA alone (Küpper, 1993). It should be added that the environmental clauses do not allow for a "luxury clean-up". The THA must be interested in avoiding unjustifiable expansions which may cost a lot of her money.

7 Other Safe Harbour Clauses

The THA is willing to contract "safe harbour clauses" for other unknown risks. The balance sheet of the former GDR companies frequently contains hidden liabilities which may only become known after years. But normally the THA does not insure a purchaser of a company against usual business risks. She expects that he will do his best to win the battle. Only in

special cases she is willing to share the risk by paying the losses of running the company for a limited period of time.

8 Purchase Price

Finally, the standard contract with the THA includes that a purchaser has to pay the agreed price without delay. After signing the contract it is rather pointless to ask for easy terms or a moratorium. In order to reduce the risk of the THA the purchaser has to bring by the guarantee of a well reputed bank. For outstanding payments, also for contracted payments in instalments, market interests are charged. In case of inability to pay an immediate execution of the whole property of the purchaser can be initiated.

IV Contract Management and Controlling

No doubt, the THA has been very innovative in establishing a contractual framework reflecting her social goals. But the question arises how effective this framework has been in realizing them. It is always an open question how many investors will be willing or able to stick to what they promised. At present it is too early for a final judgement. The period of validity of the contracts is often several years. This means that the investors are free with respect to timing: they may find it useful to fulfil their obligations immediately or they may prefer to do so later. According to the THA's statistics the overwhelming majority of investors is fully in line with their contracts. But a significant minority is obviously falling behind and asking for revision. The acid test will already come in the near future - when more and more investors must recognize that the avenue adopted has not led them to their goal.

The THA intends to close down her privatization shop at the end of 1994, but that does not yet mean the definite closure. She is now forced to open up some other shops. She is building up, inter alia, a so-called contract management and controlling. She has recognized that she must take care of "her" companies for a long time, even after their privatization has been concluded. And she has to ensure that the contracts are kept.

1 Aims and Means

The THA's contract management and controlling has three main aims:

- First, registering all contracts in a specific computer-aided system,
- second, examining the fulfilment of the contracts and, if necessary, imposing penalties and

third, revising or cancelling those contracts getting in serious difficulties.

An adequate registering is conditional for efficient controlling, and a permanent controlling, on the other hand, is conditional for efficient contract management. Initially, the THA regarded the registration and examination as her most important task. Now she has realized that it is necessary to focus on the field of the contract management because a large number of contracts are potential candidates for re-negotiations. Consequently, she has learnt to consider the task of contract management in a broader sense: as a permanent evaluation of the risks involved in the contracts. The THA will make sure that an investor is able to fulfil the clauses of the contract. By this, she minimizes her own risks, too.

In the case of an infringement the THA can bring a charge against the investor, but normally she hesitates to bring up her big guns. Only if worst comes to worst she is willing to take a defaulting investor to court. The THA's main concern is a healthy future of the company. This is not promoted if the investor is condemned to pay a fine - and, as a consequence, the company goes bankrupt. One of the spectacular cases is that of the Märkische Faser AG, one of the largest producers of synthetic fibre in the GDR. The company was sold to a Swiss investor who presented a business concept which was obviously convincing. This concept was mainly based on delivery contracts with an Ukrainian customer. But the customer got in serious trouble and from one day to another the Märkische Faser lost its main market. Consequently, the new owner has asked for re-negotiations in order to give back the company. The THA has rejected this demand; she is afraid to establish a precedent. On the other hand, she is pressurised by the government of the Land Brandenburg because the company is the only main employer in the region. Until now the case has been unresolved. The Märkische Faser AG is still in the ownership of the Alcor Chemie AG. But the Swiss company and the THA are negotiating with the Rostextil, a group of 300 Russian textile producing companies which is obviously interested in buying the shares.

But there are not only investors in difficulties which do not keep their promises. Sometimes financially healthy investors do so, too. Another spectacular example is the deal between the THA and a consortium of the French oil multinational Elf Aquitaine and the German commercial house Thyssen Handelsonion. The consortium was very keen on buying the Minol company which in the GDR was the only supplier of gasoline with a network of 670 stations. However, the price for the stations demanded by the THA was high: the consortium was committed to build up a new refinery in Leuna with a guaranteed investment of 3.6 bill. DM. The refinery should be the nucleus for revitalizing a whole region which is traditionally a center of the German chemical industry. Meanwhile, Elf Aquitaine changed its mind. The European oil producing industry suffers from excess capacities and it is very doubtful whether a new refinery could be profitable enough: it is obviously cheaper to carry finished products to Leuna

instead of crude oil for processing there. First of all, the strategy of the THA was to force Elf Aquitaine to keep the refinery contract - by threatening to cancel the contracts concerning the profitable gasoline stations. In this case Elf Aquitaine had to fear that the stations would be newly divided among its competitors. In addition, the THA could have prosecuted the company; it is said that a penalty of 1.6 bill. DM has been contracted. This, however, could have easily caused political quarrels which are not in the interest of the governments in Bonn and Paris.⁵

Meanwhile a new arrangement has been negotiated with the following results: Elf Aquitaine will reduce its share in the refinery project by 24 p.c. from 67 p.c. to 43 p.c. The 24 p.c. will be sold to Rosneft - a large Russian holding company in the oil industry. Rosneft will pay the shares by oil supply. Thyssen Handelsunion which holds a share of 33 p.c. (with an option to sell it to Elf Aquitaine in 1997) will then sell it to Buna GmbH. The Buna GmbH, which is owned mainly by the THA and partially by Thyssen and Gazprom (Russia), will get in return one third of the profitable Minol gasoline network. By this the THA hopes to raise Buna's chance to become fully privatized.

2 Results

In examining the THA's contract management one has to call to mind that a clever investor is always able to shape the contract in his favour. The THA does not sell enterprises but, in fact, buys investors (Schmidt, 1993). As mentioned above, this leads to a complicated negotiation process which is unlike any other. The THA has "deep pockets". She is able to grant price concessions for investments and employment guaranties. Insofar it does not seem too risky to commit oneself to an issue - if the bill has been paid in advance.

a) Performance

Meanwhile the THA has started examining the contracts. "The first results", so a spokesman of the THA, "give grounds for optimism" (Frankfurter Allgemeine Zeitung, February 8, 1994): in 1993 about 2 800 of 10 000 contracts which have been in the sample were examined. 7 600 are still in examination. In 2 200 (78.8 p.c.) cases the employment targets were realized or even surpassed. 152 000 jobs were maintained or created instead of 110 000 which

⁵ Ironically enough, Elf Aquitaine is still a state-owned company and the French government is preparing its privatization. Obviously, the government will not overburden the new owners with responsibility for a doubtful investment.

were guaranteed. But 600 investors failed their targets significantly: they provided only two thirds of the jobs they promised (Table 2).

Table 2 - THA-Contracts under Examination 1993

	Number of Contracts	Number of Jobs	
		Targets	Realization (p.c.)
Contracts examined	2 846	157 621	157 371 (99.8)
of which:			
Target realized	2 242	109 524	141 881 (129.5)
Target failed	604	48 097	15 490 (32.2)

Source: THA.

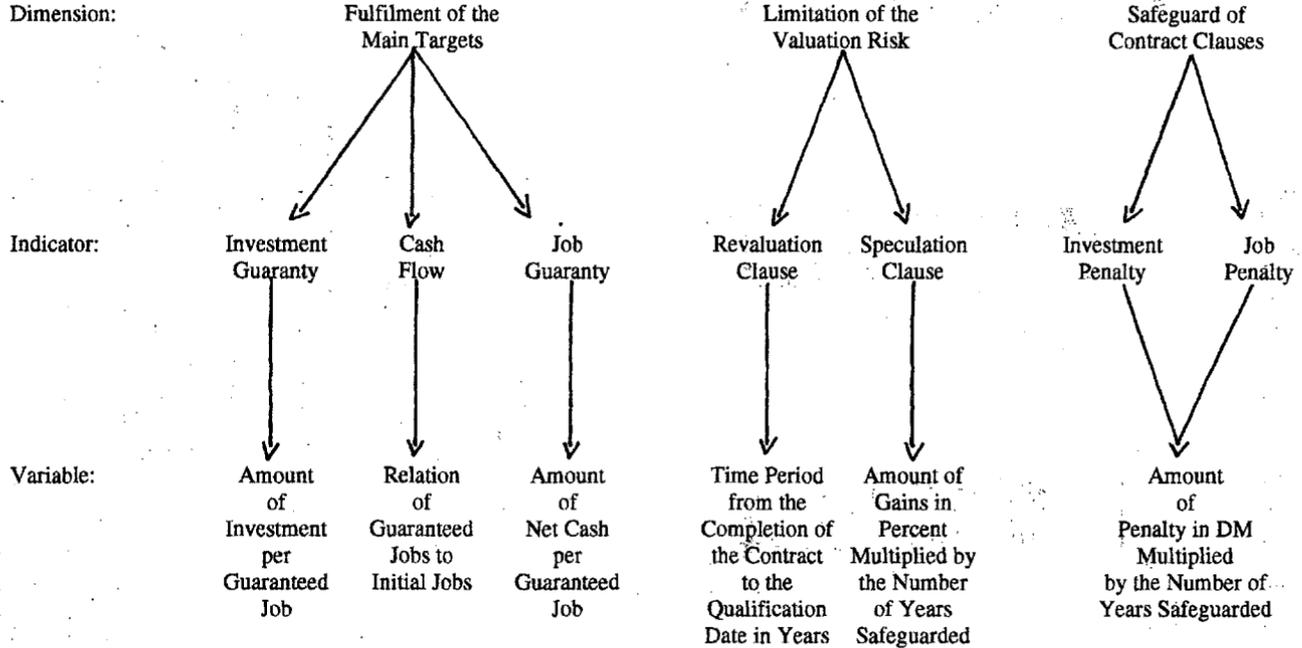
At present no data on realized or failed investment guaranties are available because the deadline has not yet passed. According to information from the THA the overwhelming majority of investors has outstripped their targets. In roughly 1 000 cases, among them 150 "serious" missings, the THA is in negotiations because the promised investments were not realized.

As it has been mentioned it is too simple to measure the performance of the THA by comparing targets and their realization only. A meaningful performance indicator must take into account the manifold feedbacks between contract-shaping and contract-realization. In order to do this, Küpper (1993) has calculated a series of indices: Chart 1 describes the dimensions, indicators and variables measured in the test. Three dimensions inter alia - fulfilment of the THA's main targets, limitation of the valuation risk and safeguard of contract clauses - have been picked up. For each dimension the average value and the maximum value are compared. The maximum value is assumed to be 1; the deviation of the calculated average values from 1 can be interpreted as a measure for performance.

As Chart 2 shows the indices are in the range between 0.3 and 0.4. It is the highest in respect to the limitation of the valuation risk and the lowest in respect to shaping the contracts. In all cases the performance has improved remarkably over time: it has been much better in the period up from summer 1992 than in the period before. The THA has steadily made progress in negotiating, controlling and managing her contracts: particularly quality with respect to safeguard clauses could be increased considerably.

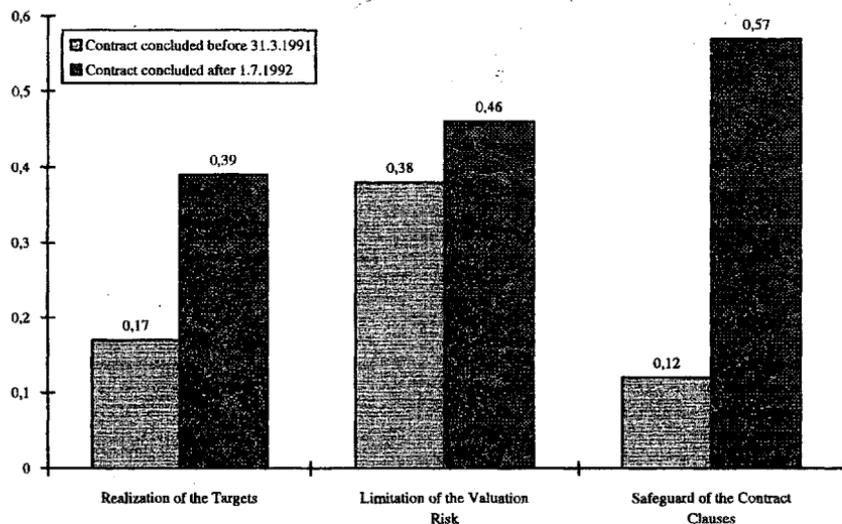
Unfortunately, no separate data for foreign investors are available. In principle, the THA makes no difference between German investors and investors from abroad. But obviously she has more difficulties with foreign investors than with German ones in pushing through curbing contract clauses. Especially penalty clauses are often rejected by them.

Chart 1 - Cornerstones of the THA's Contract Management and Controlling



Source: Küpper (1993).

Chart 2 - The THA's Performance in Reaching her Targets



Source: Küpper (1993).

b) *Adjustment and Revisions*

The THA cannot force an investor to keep to the contract whatever the costs may be. She is, in principle, ready to re-negotiate. In such a case an investor must bring arguments to bear. One argument that normally counts is the existence of unclear contract clauses. Particularly in the early stages of the privatization process the quality of the contracts left a great deal to be desired. Then as a rule the THA agrees to re-negotiate in order to clarify the issue. But it is rather pointless to try to wring the THA out of additional concessions.

The THA is very restrained with regard to investors who ask for re-negotiation because of financial difficulties. She argues that her basic method to sell companies does not include risk sharing with the purchaser. She is willing to pump a lot of money into the company before selling it, but afterwards the purchaser has to run his company on his own. Nevertheless, even on this point the THA is always open to discussion. In many cases the result will be that additional support is granted - e.g. more time is given to pay the purchase price, to create the promised jobs or to make the guaranteed investment volume.

Although the THA has focused her sales strategy on finding investors able to give the company a secure future, inevitably a great part of them fails. According to a new study about

50 percent of the 25 000 companies which were privatized by management-buy-out (MBO) are facing severe financial troubles (Handelsblatt, 4th February, 1994). In most cases the business concept proved to be unable to carry the load. The new owners often miscalculated their possibilities to run their company successfully. They overestimated the cash flow and, accordingly, the net asset value of the company. Mostly, these difficulties have a strong connection with the collapse of exports to the former RGW-countries. Initially, west German and foreign investors expected to get rapid access to the eastern markets by purchasing a THA-company but this strategy did not work out. Investors who failed their targets will hardly be able to pay a penalty.⁶

Frequently, problems arise with proper calculation of the equity to be provided. The THA has normally relieved companies of their debts by taking on old loans and has permitted special items (equalization claims and liabilities) and special reserves to clear up the balance sheets. This equity provided should be sufficient for the reorganization period of the company. In fact, though, it has often proved to be too small.

Assessing the virtual demand for re-negotiation is very crude. According to estimates of a THA-expert about 10 p.c. of all contracts are expected to be revised. But finally the share might be somewhat higher. The majority of the privatized companies will be put to the test only in the years to come.

c) *Penalties*

The THA puts special emphasize on clauses to safeguard contractually guaranteed investments and jobs. Experience has shown that by and large the penalties laid down in the contracts for non-adherence by the investor are a valuable instrument to achieve the objective of safeguarding. But their importance should not be overestimated. Penalties can work by the same principle as traffic regulations: they should take care that the necessary steps are taken. Only a minority breaks the regulations. By threat of punishment the THA hopes to hold the number of offenders low.

Nevertheless, the THA feels rather unhappy with applying this instrument: until now she has only taken 42 investors to court (Frankfurter Allgemeine Zeitung, February 8, 1994). Not to forget that penalties cut both ways. "On the practical side it has become apparent that fixing

⁶ In the German legal literature there is a discussion whether a vital change in circumstances assumed by the parties at the time the contract was concluded (Wegfall der Geschäftsgrundlage) could be an argument for renegotiating the contracts. In this case a reduction of the purchase price or the penalty is considered as recoverable, but not a repurchase by the THA (Wächter, 1994).

the level of such penalties is rather like walking a tightrope: a balancing act between the economic benefits to be gained thereby and the danger of frightening off potential investors" (Baumgarten, 1992, p. 286). In fact, the typical THA contract with its specific safeguard clauses shifts an incalculable risk onto the investor. An employment and investment guaranty may easily become a time bomb. The THA cannot be interested in letting it go off.

Therefore, the THA hesitates to take a sledgehammer to crack a nut. She prefers other measures instead of imposing a fine. An adequate measure is to raise the purchase price subsequently. In fact two types of safeguard clauses are common: the penalty and the conditional deferment of payment (see Annex 2 for typical contract clauses). From the legal point of view raising the purchase price is easier to handle than enforcing a penalty (Wächter, 1994).

V Conclusions

The THA intends to close her shop at the end of 1994. Within 3 ½ years she has privatized or liquidated more than 13 000 companies (a rate of approximately 10 per day) which is undoubtedly an impressive success story. Nevertheless, the THA has invested a lot of money for getting her social goals realized. Time must tell whether the results make all these efforts worthwhile.

The THA has undertaken her best to safeguard what she has reached in lengthy negotiations with the investors. The typical acquisition contract is fully crammed with warranties. By and large, the THA can be satisfied as the majority of investors has fulfilled or even exceeded their obligations. A minority, however, has failed or will probably fail to do so. Some investors have shown themselves even as criminals who purchased a company only to plunder it - the THA estimates her losses caused by shady businessmen in a range of some billion DM. But, in fact, the one hundred dealers and wheelers are negligible in quantity. Much more important are those some hundreds of well meaning investors who are in serious financial difficulties or even on the verge of bankruptcy. In these cases she has to exercise utmost caution in pushing through her claims.

Could the THA-contracting procedure be a model which CPEs should emulate? The answer is yes and no:

- The THA has been very successful in putting an investor on the chain. She does not only pay lip services to them. Her contracts normally include specific investor's guarantees. Although the clauses are legally simple, they have proved to be a useful means of exerting pressure.

- The THA, however, is not forced to maximize the revenues flowing into her coffers. She is able to sugar the pill for the investor. It goes without saying that in this respect the THA cannot be an example for governments in CPEs.

A possible way out of this dilemma may be a device of risk sharing between the seller and the purchaser. A practised form of this is the "take-over" of a company by an investor in form of a charge of administration (*Geschäftsbesorgung*). In that case the investor alone is responsible for running the company but the state remains the legal owner while the investor holds an option for buying the company later on. What is most important: he has not taken on liability for losses, e.g., to be due from overstaffing.

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Annex 1: Evaluation of An Investor's Business Concept

Figure 1

Business System				
Company number:	Plan		Assessment	
	Content	Conditions/assumptions	Measures introduced	Evaluation
Research & Development * New technology * Development potential	New composite materials: process and plant engineering to recycle organic and inorganic waste materials	Know-how available to develop double-twist cable technology to manufacture steel strands	Focus of R & D on industrial engineering	Expenditure 4.4% of turnover vis-a-vis comparable firms e.g. for 89/90, 4.2% of turnover from tech. prod. sections. Backlog
Purchasing * Suppliers * Purchasing power	Raw materials, electric motors, automatic control, where same types usable in different areas of the business, purchasing synergies used		Investigation of price advantage to be gained by consolidating purchase of materials	Moderate reductions in cost of materials likely (up to 5%)
Production * Technology * Structure * Vertical range	Capacities and equipment in production workshops to be concentrated and laid out logistically to guarantee optimum work flow. Vertical range of manufacture to be reduced as part of optimization process. Standard times for machine work to be adjusted to those of the old Lander (Lower Saxony).			Value added is insufficient. Time standards for assembly work.
Marketing * Target segments * Price positioning * Marketing channel * Advertising * Service	Ministry of Metallurgy is customer for products 1-4	Can secure SU sales on medium term through market position and personal relations		Time of high SU sales must be better used to expand market in former NSW countries
Administration/organization * Structure * Systems	Law, taxes, financing, insurance, balance sheet preparation, quality assurance, contracts	Functions consolidated	Organizational structure streamlined in industrial engineering, rolling mills, metallurgy divisions	Production and central sections: comb. business sectors & depts, creation of profit centres
Management appraisal:	Motivated and decisive management has enabled introduction of targeted and coherent business plan. The prominent role of one person in the marketing of all products, particularly in countries with central economic reforms, creates the risk of a "one-man show". Chief executive, who did not fulfil the requirements, replaced on 7.6.			
Management committee:				

Figure 2

Revenue situation									
Company number:		Business plan					Assessment		
		2nd hf 90		Planning			Conditions/assumptions	Measures introduced	Evaluation
		Target	Actual	91	92	93			
Turnover in DM million	Restr. plan total perf. sales revenue of which: Comecon FRG + former GDR former NSW	383	496.5	522.7	546.7		Orders for 1992 & 1993 already on books ensuring 80% & 70% cap. util. from today	Turnover for 1992 & 1993 very probable	
	THA advisory group	166.7	489.8	511	541.2				
		199	294.3	278.3	283.5				
		25.3	150.5	157.4	168.5				
Product groups (prop. of sales)	1. Rolling mills		37%	36%	35%	Hammer forge (part of metallurgy) allocated 1991. Steel foundry, on the other hand, to be taken over to optimize own capacity utilization.			
	2. Cable & stranding machines		23%	28%	27%				
	3. Crushing & build. material machines		7%	8%	8%				
	4. Cranes		7%	5%	5%				
	5. Oil machines Metallurgy		7%	5%	5%				
	Other		14%	12%	12%				
Orders on hand as per 1.7.91 in DM 450 million			9%	7%	8%				
Market assessment/competition	All products involved in highly competitive markets. Strong position in Comecon area, particularly Soviet Union, is being expanded and lucrative orders from this area used to adapt technology for prod. groups 1.2 & oil machines to requirements of free international markets. Expanded marketing activity targeted on priority markets (EC, Iran, India, Far East), in part with partners, in part alone.							Despite high level of orders on hand from east, activities targeted to breaking into western markets must be accelerated	
Core problem areas	Share of SU market & good prices are postponing pressure to win bigger shares of the market internationally								
Overall rating	Successes with SU orders as matter of trust, from unification treaty, as barter trade or from Mollmann commitments are largely due to one man								
Management committee:									

Figure 3

Company number:		Business plan						Assessment	
		2nd half 90		Planning		Conditions/assumptions	Measures introduced	Evaluation	
		Target	Actual	91	92				93
Expenditure on materials (DM million)	Rstr. plan		205.8	315.8	316	308	System to measure purchasing potential to be introduced	Extra buying of assemblies tailored to needs using purchasing power of consolidated demand	This will fully utilize potential for rationalization in the order of 5-10%
	Adv. Grp								
Exp. on personnel (DM million)	Rstr. plan		122.1	167.9	155.3	175.6	1752 jobs cut 11/90 through early retirement, normal retirement & transitional payment scheme. Hiring off to be pursued & part-time & non-permanent staff to be transferred from employment in cu. to personnel placement co.		Company to run for agreed period from 1. 91-21. 12 92. Extension of skill-upgrading will cost DM 20 million gross
	Adv. Grp		3.1	11.1	21.6	10.7			
Other expend. (DM million)	Rstr. plan		83	60.9	53.6	56.8			Other expend. for same turnover for 1991-93 quoted DM 54.4 million lower in comp. with May figures
	Adv. Grp								
Result (DM million)	Rstr. plan		-31	-59.2	-23.8	-4.4		Throughput times have been drastically cut, thereby reducing costs and increasing efficiency	Making use of potential for rationalisation from job cuts & purchasing potential scheme will bring positive result by 1993 at latest
	Adv. Grp								
Staffing plan (no. of emp)	av. eslab.		10,556	5,722	4,589	4,277			
	> Production		8,242	4,828	3,756	3,455			
* av. wages/salaries	> R & D		430	189	182	182			
	> Administration		1,636	598	533	522			
* social plan costs	> Marketing		243	107	118	118			
	> Part-time workers								
* av. wages/salaries pa			17,950	29,400	33,800	35,250			
Cost position in relation to competition	Materials		TDM per emp. per year achieved in mechanical engineering in 1991, 1992 & 1993: 170, 202 and 232 resp.; in metallurgy: 94, 109 and 125.				Sales targets will be met, jobs cut as planned & costs reduced		Per capita sales DTM 1992 = 113.9, 1993 127.8 is unsatisfactory & must be improved by reducing central areas & hiring off persn.
	Personnel								
Other									

Core problem areas	Time & motion study needed in central area to cut jobs. Products from different business sections must undergo a value analysis, capacity examined in the light of market opportunities & contribution margins determined. Transparency of costs is essential for establishment of profit centres/GmbHs.
Overall rating	
Management committee	

Figure 4

Company number:	Profit and loss / cash flow						Assessment
	Business plan (DM million)			THA advisers (DM million)			
	1991	1992	1993	1991	1992	1993	
Result after depr. before interest	-59.2	-23.8	-4.4	-60.1	-30.0	-9.9	Interest and depreciations slightly underestimated; targets for job cuts are ambitious
- interest	10.3	6.9	5.8	10.3	11.4	11.4	
Result after depr. after interest	-69.5	-30.7	-10.2	-70.4	-41.4	-21.4	Total net cash flow 1990-1993 = 7.112 million DM
+/- Δ provisions	-30.5	7.2	1.9	-1.7	0	0	
+ depreciation	27.9	23.4	24.5	28.8	29.6	30.0	
- investments	22.5	22.4	23.1	-22.5	-22.4	-23.1	
+/- Δ working capital	73.5	2.5	1.9	46.3	19.1	11.6	
+/- other (cap. invest. bonus) disposals dur. period	5.0	8.5	8.0	5.0	8.5	8.0	
netto cash flow	-16.5	-23.9	1.2	-14.5	-6.6	5.1	

Financial requirements (million DM)	Assets / financing						Assessment	
	Business plan (DM million)			Sources of finance (DM million)	Business plan (DM million)			
	1991	1992	1993		1991	1992		1993
One-off expenditure	1.7			Internal finance	28.8	29.6	30.0	
Fixed assets	22.5	22.4	23.1	injection of equity cap.				
Current assets (incl. neg. result)	24.1	22.3	9.8	Outside finance	14.5	6.6		
Repayments			5.1	Export promotion				
Other				Other	5.0	8.5	8.0	
Total	48.3	44.7	38.0	Total	48.3	44.7	38.0	

Overall appraisal	In view of the scope for reducing costs in the sectors of materials and personnel, it is likely that net cash flow will improve, making repayments possible before 1993.
Management committee	

Figure 5

Privatization			
Company number:	Business plan	Measures introduced	Assessment
Scope for restructuring * Hiving off parts * Concentration	Selling the GmbH as a whole is difficult. Profit centres for rolling mills, ind. eng. oil machinery, metallurgy and central functions have been established. These may later become legally independent and be restructured and/or privatized individually at a faster rate.		Plan is in line with objectives
Privatizations * Reprivatization claims * Business plan * Activities * Status	No reprivatization claims. Up to 1993 revenue from sale of surplus plant and equipment likely to be in region of DM 5 + 8.5 + 8.5 million; this has to be set against book values totalling DM 41.9 million. Parts of the 1.5 km ² site are to be made available for an industrial park.	Structural steel engineering, construction firms, bungalow on Lake Barbel have been sold for book value.	
Overall appraisal	Chances for privatization will be improved by the planned establishment of profit centres and/or GmbHs, since the enterprise in its present structure cannot be privatized.		
Management committee			

Source: Vogelsang (1992).

Annex 2: Typical Safeguard Clauses in Acquisition Contracts

Conditionally granted partial payment delay

The purchase price amounts to 10 mill. DM. A minimum purchase price of 2.9 mill. DM has to be paid within 10 days after notarial certification. The final payment of 7.1 mill. DM will be deferred interest-free until December 31, 1997. The THA will waive the final payment already now, if the buyer invests 16 mill. DM into the business activities of the acquired company by June 30, 1997. ... Should the buyer invest less than 16 mill. DM, the THA waives the final payment in the relation of the actual investments to 16 mill. DM.

Purchase Price Back-Payment/Increase

The parties agree that the purchase price was stipulated on the basis of the buyer's promise that by privatization on the average 600 full-time jobs p.a. could be created or preserved in the privatized company for the next three years. If this number is not reached or not completely, the buyer has to pay the seller, as an additional purchase price, 2 500 DM per full-time employee and month of employment, by which this number has fallen below the stipulated level in the average of the 36 months.

Contract Penalty

The buyer intends to invest 14 mill. DM into the company until June 30, 1994, by acquisition of investment goods listed in Annex ... or functionally comparable goods. ... Provided these investments are not carried through at all or not completely, the buyer has to pay the seller a contract penalty amounting to p.c.

Open formulation

The buyer commits himself to employing at least 145 people on the annual average in the acquired part of the company until December 31, 1996. If he violates this commitment, he is obliged to pay the seller 25 000 DM per employee and year.