LEGAL ASPECTS OF FINANCING PRIVATISATION

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New Zealand has had an enormous upheaval in the last four years. Tens of thousands of people have been affected, thousands have lost their jobs, or had their jobs changed dramatically. I believe many are working a good deal harder than a few years ago - and a number of lawyers are working extremely hard in the midst of the upheaval. The cause of the turmoil has been corporatisation, which has become, for New Zealand, the first stage of a privatisation.

What are the elements of this process which should concern bankers and their lawyers? Are there any general guiding rules or is the experience different for every activity to be privatised?

I believe that there are a few helpful general rules which can be drawn from my firm's experience with a range of state owned enterprises over the past 10 to 15 years. They are drawn from various roles, as solicitors for the enterprises, solicitors for the Crown in dealing with and selling the enterprises, solicitors drafting law constituting and governing such enterprises, solicitors for purchasers of such enterprises or of businesses or assets from them, and solicitors for bankers or other prospective investors in them.

In essence corporatisation has been intended to achieve a management structure for state owned enterprises as near as may be to that of private sector businesses, save for retention of complete or partial state ownership of the entities' "shares". This paper does not examine such fascinating questions as the reasons for corporatisation or privatisation, whether corporatisation is only a necessary stage of privatisation, whether the ostensible objectives can be achieved without full privatisation, or the political causes and effects and costs and benefits of the process. The paper limits itself to exploring some common pitfalls for the corporatised organisations seeking loan funds, the peculiar risks lenders may face in evaluating such corporations as borrowers, and special considerations for lawyers dealing with the people manning the corporations.

WHAT IS THE DIFFERENCE?

The essential difference between dealing with new state businesses and dealing with private sector business is that the former have not had to pursue profit as a transcendent objective. This truism is very important but easy to forget. I was intrigued when reviewing the experiences of members of my firm with state owned enterprises, to find that most of the problems experienced could be explained by reference to it. It underscores the insight of some of the early company law judges who insisted on what sometimes appears to us to be overly rigid adherence to corporate purpose rules. In extreme cases, of course, such rules, when linked with narrow formulations of corporate powers, have resulted in unfairness to third parties.

Nevertheless, Parke v. Daily News Ltd [1962] 2 All ER 929 and similar cases counter the temptations people holding company assets may have to wander from their constraining purpose, namely to increase shareholder wealth with those assets. Notwithstanding some flirtation with notions such as the "social responsibility" of the corporation, the rule has survived. The wisdom of the rule seems to me to be well demonstrated by the experience of New Zealand state owned enterprises.

The private sector banker or lawyer may usefully compare him or herself to a muslim or other monotheist dealing with a pantheist. Our commercial law and experience accustom us to assume that business organisations should have but one god. They may not always follow that god or its rules. Nevertheless the unity of purpose represented by pursuit of profit for shareholders enables other diverting goals to be ranked and decision conflicts resolved. In contrast government businesses have been saddled with multifarious "gods". An Islamic suspicion or pantheism is prudent at all times when dealing with a corporatised state owned enterprise.

The symptoms of multiple purposes or objectives in state run businesses are that:

(1) They have in the past had no clear touchstone for evaluating investment or other proposals.

(2) They have had no clear measuring standard against which to judge the performance of employees and systems.

(3) They have had no primary objective the imperatives of which could act as a defence against other competing objectives, whether imposed by passing political fancies or the personal interests of the people engaged in the state businesses.

(4) They have had no particular reason to adopt and maintain consistent financial accounting standards or measures of resources and the efficiency of utilisation of them.

(5) While they have generally been obliged to maintain good records of cash expenditure they have had no reason to apply or understand accrual accounting concepts or maintain proper asset registers or other means of reporting on assets and their employment.

(6) They have had no particular reason to encourage proper delegations of authority or to encourage initiative in trading operations. In practice, avoidance of mistakes has been of more importance than efficient utilisation of resources.

The uncertainties generated by a multiplicity of objectives were curiously perpetuated in the first stage of New Zealand's corporatisation. The legislation which set up the first wave of corporations in the current phase said that they were to be profitable businesses but (presumably out of perceived political necessity) went on to say vaguely that they had social responsibilities including to be "good employers", and to carry on some loss-making activities when requested, with a rather ill-defined arrangement for subsidies for such business. The consequent confusion of goals has already been a problem in New Zealand not only in a management sense but as a legal issue. In Clutha Leathers Ltd (in rec) v. Telecom Corporation of NZ Ltd (1988) 4 NZ CLC the High Court held that Telecom could be injuncted against cutting off the telephone connection of someone who had unpaid telephone accounts. Among the reasons were that there is an arguable case that Telecom has a social responsibility which transcends ordinary business behaviour. It is perhaps significant that this year's Port Companies Act corporatising the commercial activities of harbour boards, omitted the extra objects, stating simply that the new company's principal objective is "to operate as a successful business". To encourage more than a mere change of hats by local authority members, the Act also provides that "the directors of each company shall be persons who, in the opinion of those appointing them, will assist the port company to achieve its principal objective".

DON'T TRUST THE BALANCE SHEET: EXTRAORDINARY UNCERTAINTY

Not surprisingly for organisations which have a problem with identifying their primary task or goal, the issues emerge in a range of ways. Prospective lenders to these corporations should be very careful about any of the financial information that is historical. That information will have been prepared in times when the primary goal of the organisation might have been expressly or implicitly "to give the best possible service to the public" or "to maximise employment opportunities" or "to ensure that the Minister never looks wrong". In such circumstances there is not very much relevance to balance sheets, to the asset valuations.

Lenders evaluating proposals involving newly corporatised state owned enterprises should distrust any asset register or balance

sheet unless it comes with reliable certification. The predecessor state entity is most unlikely to have had a complete or accurate record of assets held and will almost certainly have had no clear idea of the realisable values of assets.

Current Values Unknown

When there was no focus on getting a return on assets employed there was no particular reason why the organisation should devote resources to recording the assets held, and even less reason to know their value.

Uncertain Ownership

Assets may be assumed by a department to "belong" to it because they have been under the department's control for time immemorial when in fact they may be claimed by other interests, or held on trusts or conditions which mean they cannot pass automatically to a new commercial corporation.

Crown Privileges Essential

Crown privileges may have exempted Crown assets from onerous requirements which affect their value significantly when they pass to ordinary ownership. For example, normal planning requirements or perhaps effluent control standards may render uneconomic operations in "private" hands, which appeared strong while they were in Crown hands. When those assets cease to benefit from such privileges the compliance costs applicable in the normal private commercial environment can be prohibitive.

Unexpected Encumbrances

Apparently unencumbered assets may be subject to use rights or conditions which may virtually amount to prescriptive rights. They may flow from long and very strong political traditions or from recorded or unrecorded agreements which caused no problem for so long as nobody regarded the relevant asset as likely to be sold or used for ordinary commercial purposes. As an after-thought the draftsman of the State Owned Enterprises Act 1986 was instructed to provide that nothing in the Act affected the Treaty of Waitangi, which is a treaty 140 years old - between a number of Maori chiefs and the British Crown. As a result of that, after several court decisions which have said that the provision must be given full effect, according to newspaper reports more than half of the land in New Zealand is now subject to claim by the Maoris. Virtually all land held by the corporations will be held on a defeasible title, resumable by the Crown for possible retransfer to Maori claimants if their claims are upheld. The corporations can only pass such a title. What that does to the value of those assets has yet to be shown. Less controversial incidents of history may have similar effects. For example, a department may have informally allowed use of land by a local authority to run public utilities without knowing exactly whose

and where they are. Less dramatically, in New Zealand the Public Works Act requires that certain land acquired for public purposes must be offered back to the people it was acquired from, if it is disposed of when surplus to requirements.

Valuation Errors

The new corporations' opening asset values may be extremely uncertain. Much will depend on the start up method employed. In New Zealand many have been brought to life by an establishment board which has negotiated the acquisition prices of the relevant assets with Treasury representatives. Others have simply incorporated, at book value, assets of former state departments. If the latter method has been used, or if the negotiation is conducted "unfairly" or on the basis of inadequate information, the asset values may be seriously misleading for security purposes, as a depreciation base, and as an assurance of rationalisation cash flow. Has the relevant taxation authority accepted the valuation base for tax purposes? Some of the "assets" in the accounts may have resulted from treating employment creation expenditure as capital expenditure because it was politically inexpedient to acknowledge that an operating deficit was much larger than the reported figures. If the start up procedures can accommodate it, corporations may find it very helpful to obtain express statutory clarification of matters such as the acceptability for tax purposes of the start up financial records.

Deliberate Restructuring

If the entity is liable for income taxation for the first time on a particular date there will have been a temptation to enter into tax structuring immediately before the commencing date. Taxable income may have been anticipated and deductible expenses postponed.

Under-Recording of Liabilities

Liabilities may be understated, or not recorded. Contingent liabilities may be imposed unexpectedly or in circumstances where it is difficult to quantify them, during the politically awkward transition period. For example, promises of redundancy compensation or maintenance of unprofitable services may be made which constrain the freedom of action of the corporation management.

Deregulation Implications

Lenders will not need to be reminded of the asset value uncertainties associated with reviews of licensing regimes, and possible removal of statutory monopolies in connection with a privatisation.

The balance sheet uncertainties should be addressed specifically in any documentation with the corporation if they cannot be removed by enquiry during the early stages of negotiation.

EXISTING EXTERNAL FUNDING

If the corporatised entity has had an independent existence and specific funding facilities for some time, there are likely to be important issues to resolve before the corporation is privatised or made to stand fully on its own financial feet. These issues come readily to mind, but can be very difficult to resolve. For example:

Soft Vendor Loans

Corporations that embody assets or organisations that have been trading for some time may have specific securities over assets supplied with soft vendor financing. These and other funding facilities are likely to have been structured expressly or implicitly on assumed maintenance of full Crown control. Such facilities will require renegotiation and the lenders may seize the opportunity to extract costly concessions.

Change of Control Clauses - Implied Crown Guarantee?

Some facilities may benefit from an express and specified Crown guarantee, others may be covered by general statutory guarantees while others again may be in an indeterminate state, with the lenders claiming Crown liability by reference to some implied claim to Crown assets or revenues. Lenders whose documentation does not benefit from any specific or statutory guarantee may nevertheless claim an implied guarantee by virtue of reliance on a change of control clause. In our opinion these claims have no legal validity but they have nevertheless caused problems. The lender's argument is that the absence of other normal default events or security protections, coupled with reliance on change of control clause, creates an obligation on the Crown to fund the take-out if the financier exercises its rights to accelerate debt upon a change or threatened change of control.

Irrespective of the rights of such existing lenders, the renegotiation of banking facilities can be protracted. Retail bond issues can be particularly troublesome. We have had involvement with substantial amendments to two Euromarket facilities. The facility agreements did not have normal financial covenants because the original securities had been sold as Crown risk. Bondholders' meetings were necessary. It is an expensive process and the trustee and others acting on behalf of bondholders may want costly concessions in turn for releasing the Crown from its real or alleged obligations.

The prudent lawyer will take none of the pre-transition long-term funding for granted without enquiry as to current relationships with the lenders.

JOINT VENTURES AND MINORITY INTERESTS

Disposal of a Crown interest in a corporation may trigger pre-emptive rights in joint venture or minority interest documentation. Obviously, if the continued availability of benefits from such a venture is material, that documentation requires close scrutiny by all parties with a stake or potential stake in a state owned corporation heading for privatisation.

DOCUMENTING THE NEW FACILITIES

It seems to us that in several cases financial institutions and their advisors have endeavoured to take unfair advantage of the relative innocence or naivety of the finance people in new corporations. To me that is extremely short sighted. Some of these organisations may be around for a long time. In others the finance people are learning very fast and will not necessarily be replaced by private sector people. At least in New Zealand where the market is relatively small they will, quite properly, have long memories. Institutions taking advantage of inexperience with private sector borrowing arrangements can handicap the new organisations considerably.

The corporations should devote enough attention to their fair requirements, notwithstanding the uncertainty which often bedevils negotiations in the early stages of privatisation, and start out as they mean to go on. At an early stage they should settle on their minimum requirements for facility boiler plate as well as the more substantive issues. For example, the lawyers acting for the corporation should be in a position to offer to all lenders:

(1) standardised financial ratio covenants;

(2) standardised renegotiation or take-out provisions upon significant changes in shareholding (and, if requested, upon deregulation likely to eliminate monopoly profits);

(3) standardised events of default definitions, with particular care in relation to cross default triggers. Trigger rights should not later allow the extraction of commercial concessions because of a cross default triggered on a change of corporate ownership or structure which has no material adverse effect on the credit worthiness of the corporation;

(4) standardised force majeure events.

It may be difficult to settle on appropriate financial ratio covenants in view of the financial statement uncertainties mentioned earlier in this paper and the inevitability of having to rely on what may be brave projections of revenues and cash flow in a vastly different environment for the organisation, from that from which it is emerging.

We think some institutions have forgotten, when advising new corporations, that their initial years may be extremely important in "positioning" the organisation in the financial market. When a new company is floated on the share market the underwriters and brokers are extremely conscious of the importance of the market's first impressions. For this reason we think it is a mistake for new corporations to accept lightly interim documentation which "down classes" them or impliedly forgoes a claim to a status they should expect to enjoy. For example, if a financial institution is being corporatised and it should have bank or semi-bank status, it should not issue paper which is characteristic of industrial borrowers.

LAWYERS' ROLES

It appears to me that many Australians are interested in this topic because of the opportunities it presents for what they euphemistically call "business development". I understand that the phrase usually means "cut throat competition". However, corporatisation presents important opportunities for genuine new business development with a role which can contribute in a very constructive way. The process of transition is very threatening to many people. Uncertainties flow from the conflicting political pressures on the government, concerns of people for their jobs, and conflicts among the state servants involved. It makes the situation extremely fluid throughout the transition. Throughout that process lawyers are seeking clear and certain instructions, bankers are looking for certainty while some of the other interest groups will be trying their hardest to exploit any uncertainties about where things are or should be going.

Obviously the whole privatisation procedure takes its definition from a legal process. The interests of many of the people involved is to make sure that it stays a legal process and does not touch them at all, that nothing actually changes. Thus tensions arise. Instructions to effect changes legally mean that the legal work often has to be at white heat, it has to be done very carefully, it will be closely scrutinised by a number of hostile parties, and the Crown's own advisors (in a program of the kind which New Zealand has had where a whole lot of these processes were underway at once) may be quite overwhelmed with work. It may simply not be possible for them to try and do the work themselves. In New Zealand the in-house legal advisors of the Crown agencies have in many cases had to act as employers and managers of other peoples' legal services in order to get the work done.

RANGE OF ROLES

This paper has looked at the legal issues primarily from the perspective of a potential lender to the new corporate entity. However, the process requires legal advice from many perspectives. For most lenders, other than those financing the transition or involved in the initial stages of the life of the

new corporation, many of the issues mentioned above will have been sorted out before the finance market is approached. The various lawyers' roles include:

Advice to the Crown

As the owner and promoter of the corporation, the Crown must have full confidence in its legal advisors at this stage. If it does not it may postpone consulting them, for fear that the lawyers' involvement will be negative influence, slowing progress. At this stage, decisions can be made which overlook legal hurdles which later have to be surmounted with more difficulty than if the lawyers had been involved at an earlier stage. The Crown may need legislation, it may need to know what needs to be covered by legislation, it may need advice on very arcane tax issues. Many of these are likely to be issues in which the lawyer's commercial market experience is as important as knowledge of the law.

Advice to the Crown as Vendor

When a corporation is to be sold, whether or not it is ready, a fresh look at its legal structure and the issues mentioned earlier in this paper may turn up a number of problems or opportunities which may not have been evident earlier. This is particularly the case if the early phase of corporatisation was carried out without a particular expectation of subsequent sale. The significance of the Crown's position as vendor emerges most clearly if the privatisation is by way of public float, when the Crown's intentions and past dealings come under the microscope in the course of prospectus preparation and registration.

Advice to the Crown as Shareholder

In relation to corporations which are not privatised, the Crown's position as shareholder and often substantial financier of the corporation can put it in direct conflict with the board and management of the corporation and third parties dealing with the corporation. Minority private sector interests in a corporation may make it necessary for the Crown to deal with it at arm's length.

Advice to the Corporation

The integral role of legal advisors to the new corporation and their capacity for assisting or impeding its progress is very obvious. The rest of this paper focuses principally on that role and the role of lawyers acting for private sector third parties dealing with the corporation.

Advice to Lenders to the Corporation

The task of these people is to elucidate and endeavour to eliminate, so far as documentation can conveniently do it, the risks normally attendant on lending, and those which are particularly mentioned earlier in this paper.

Advice to Underwriters and Brokers

During the actual privatisation the underwriters of a float will need legal advice and the brokers may want separate advice.

Advice to Financial Advisors

In the New Zealand corporatisation and privatisation process there has been a heavy reliance on a wide range of overseas advisors. New Zealanders have taken a deliberate look at overseas precedents to try to avoid some of the problems already discovered. The overseas advisors in turn need domestic legal advice to apprise themselves of the implications of local conditions and law.

Advice to the Crown and Former State Sector Personnel of New Corporations

It will not surprise anybody to say that the lawyer's job is politically sensitive in this process. The politicians may have a range of objectives, there may be serious disagreements among them as to the primary objectives, the objectives are inter-related and as time passes the objectives may change. For example, whereas an early push to corporate and privatise may be prompted by a desire to eliminate operating losses and attack or side step intractable employee relations or productivity problems, when the new entity is on the way to dealing with those issues the earlier objectives may change, to more general goals such as increasing economic efficiency or maximising the sale price. These latter two goals may have very little to do with the particular interests of the corporation itself and indeed may be counter to its interests. For example, deregulation may directly reduce the potential sale price of a state owned enterprise which has historically enjoyed a monopoly.

Politicians and state sector people may be entirely unfamiliar with the corporate form and may require detailed and recurring advice on matters which the lawyer regards as part of the normal mental furniture of people in commerce. It may be necessary to explain exactly what directors do, in comparison to senior executives, and to distinguish among their duties to shareholders, staff, consumers or customers of the corporation, and the company itself. It may be necessary to interpret uncertain duties and give priorities to competing roles assigned by legislation or political necessity.

It may take some time to educate personnel on the use of legal opinions. Traditionally in the New Zealand state services a Crown Law Office opinion has been regarded as determinative of the law. The result has been that where state employees have feared an unfavourable opinion they have avoided raising matters with the lawyers. On the other hand, where they expect to get a favourable opinion they have assumed that obtaining such an opinion will dispose of the issues for all concerned. Naturally,

a group of private sector lawyers representing different interests jostling over possibly ambiguous points of law can appear to the state sector people as unnecessary and unhelpful. They may even be suspected of complicating matters solely because they are paid on a time basis.

HONEST BROKER

The lawyer acting for the corporation must become an interpreter and an honest broker whose advice on many issues can overcome barriers. The corporation people involved may not have much familiarity with what they are going into, some may have little knowledge of the specifics of operation of companies.

You may be asked for advice on such commercial things as, what is a normal fee for a banker or financial advisor, what kind of up-front facility fee, or margin, or line fee should be expected, whether a mandate should be given. You might have a superficial but wide knowledge of those things which no-one else will have, someone who the former state employees feel able to trust. Many of the other parties they are dealing with may be drawing fees contingent on a proposal going ahead. You should be drawing fees based principally on the time engaged. When your clients get to know you they will realise, if you are any good, that you are always too busy, that the last thing you would want to do is deliberately protract matters and that your interests and their interests are generally entirely congruent. Therefore they will become inclined to trust your view on matters as a sounding board where they might not trust some other sources of advice.

Whether you are advising bankers or the corporations, the honest broker role of the lawyer, in my opinion, places a high burden of good faith on the lawyer. Some of the people you will be dealing with will be overly aware of their lack of direct private market experience. They may have read the literature and attended conferences but they could be more humble about their position and easily influenced by confident bluster or false statements about "normal market practice" than they need to be. They are accordingly vulnerable to the enthusiasms, greed, and inexperience of the financial advisors who happen to establish a relationship with them.

Others may be experienced or confident, sometimes over confident, some may be newly appointed in positions without adequate definition, willing and eager to throw around the potential weight of their corporations. In all these cases the lawyer should of course follow instructions without deviation, but when advice is expected which may influence the instructions, or an honest comment is called for, I believe it is the lawyer's responsibility whichever party he or she is acting for, to moderate excess. It is in the best long-term interests of banks and other financial institutions dealing with new corporations, not to exploit inexperience.

Lawyers involved should be armed with sufficient market experience to explain and respect the natural market constraints and market etiquette. You should show why they may prompt consistent behaviour irrespective of strict contractual rights. It may be necessary to advise some newly liberated state sector people that the private market is not necessarily a jungle in which participants ruthlessly exploit every opportunity for gain offered to them by their contractual rights, because over time people will have to deal with the same participants many times, and a fair consideration for fellow participants may achieve as much as a dogged insistence on strict interpretations of contracts.

In short, you should be willing and able to point out the limitations of the law and the official role of lawyers, while performing in a professional way the traditional role as a wise counsellor.