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Preemptive Rights and Privatization

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Many governments have concluded joint ventures with private investors that contain preemptive rights contractually restricting the rights to transfer ownership of a company's securities. The privatization of these joint ventures often places governments in an awkward situation. Now wishing to sell some or all of their shares, they find themselves caught between the desire to divest at a good price, or at least a politically defensible one, and the need to comply with the contracts they have signed. What can they do? Depending on the amount of preemptive rights in the privatization portfolio, governments can adopt either a case-by-case approach or a more comprehensive solution. This Note sets out the options.

Preemptive rights are a common feature of private companies in many countries. They are often used by founding partners to diversify high-risk investments while retaining some control over who their cofounders are (box 1). Preemptive rights

have also been used by governments in privatization. One application is to ensure that certain categories of investors are favored or at least not excluded from privatization transactions. For example, many governments—including those of Argentina, France, the Islamic Republic of Iran, Mexico, and Russia—have granted preemptive rights to employees of privatized state-owned enterprises on all or part of the shares for sale, sometimes with large discounts on price (Guislain 1997). In France, Morocco, and the United Kingdom large privatizations by share issue have been structured with preemptive rights to favor retail over institutional investors. The initial public offers have been structured in tranches, with a claw-back on the institutional tranche if the retail tranche is oversubscribed. Many governments in Central and Eastern Europe granted preemptive rights to people who had been expropriated during the communist era.

“Golden shares,” special shares retained by the selling government that give it some say in major decisions of the privatized firm, contain some features of preemptive rights. For example, the French golden share mechanism requires government approval before a shareholder can

BOX 1 WHAT ARE PREEMPTIVE RIGHTS?

Preemptive rights are contractual restrictions on the rights of transmission of a company's securities. These rights give insiders a right of first refusal—they can *preempt* a sale by exercising their *rights*. Preemptive rights may be general, included in a country's civil code (as in Senegal), or specific, inserted in a company's bylaws or other founding documents or agreements (as in Argentina, Brazil, or Morocco). In all cases they set limits on how and to whom a company's securities may be sold. By requiring prior approval by a company's board of directors, they can affect a variety of possible transfers, including:

- The sale or donation of new or old shares to a third party, domestic or foreign.
- The transfer of a deceased shareholder's stake to his or her heirs or beneficiaries.
- The transfer of shares by public adjudication, for example, to enforce a pledge of shares.

In some cases even the sale of shares between existing shareholders (“insiders”) is subject to board approval.





BOX 2 HOW PREEMPTIVE RIGHTS WORK

When preemptive rights exist, a shareholder must notify the board of directors of its intention to sell all or part of its stake in the company to a third party, whether an insider or an outsider. The board then informs the existing shareholders of the opportunity to buy those shares.

The board typically has thirty to sixty days to consult with insiders and announce its decision to the seller. If at the end of this period the board has not notified the seller of its disagreement, the transaction usually can take place. But if one or more insiders wish to use their preemptive rights for all or part of the shares on offer, the board notifies the seller. If some shares remain unsold after preemptive rights have been exercised, they can be sold either to the proposed outsider (again subject to the board's approval) or to an alternative purchaser identified by the board. Sometimes the board is given complete discretion to find an alternative buyer even if insiders have declined to exercise their rights. If several insiders wish to buy all or part of the shares on offer, they are treated equally, though their relative stake in the company is taken into account.

Arbitration procedures are often provided for to settle disputes about value between the seller and insiders that wish to exercise their preemptive rights. To avoid a need for arbitration, sale prices may be stipulated. In some cases the sale price, a value per share, is fixed by the shareholders at each annual general meeting, based on a proposal by the board of directors. Different methods can be used to determine the value. Most common is to use the book value, or the stock market value if the company is listed on a domestic (or foreign) stock exchange. A more elaborate pricing formula also can be used, such as earnings multiples averaged over three years, discounted cash flow valuations, or dividend yields.

Some companies' bylaws stipulate that if the board of directors refuses to consent to a proposed sale of shares, it must offer the shares to the other founding partners at the price proposed by the selling shareholder. And some bylaws allow an independent expert or arbiter to be appointed when buyer and seller disagree on value.

increase its ownership in the company beyond 10 percent. Golden shares have been used by many governments, including those of Belgium, Brazil, France, Malaysia, New Zealand, Spain, Turkey, and the United Kingdom.

When used to favor a category of investors such as employees or retail investors, preemptive rights are a means to fulfill political objectives. Channeling shares to targeted groups or individuals usually reduces the privatization revenue, as the government could probably sell its shares at a higher price to other investors. But the discounted price often generates public goodwill. The general assumption—not par-

ticularly well tested—is that underpricing facilitates the transfer of state-owned assets to the private sector. In the special case of mixed ownership companies, however, these rights pose problems for privatizing governments. Preemptive rights may deter outside investors and prevent the government from selling for a fair market value. Where this is the case, the privatization law must address the preemptive rights problem.

Privatizing shares with preemptive rights

Underpricing to generate political support will not be possible if the preemptive rights are part of the enterprise's bylaws. Indeed, in these cases the rights will complicate the transaction and will almost always slow—and in acute cases, prevent—divestiture. Why is this so? Preemptive rights require board approval to conclude a transaction, giving existing shareholders the last say in any sale (box 2). The selling government's options are limited because of the insiders' extremely advantageous position relative to outside bidders. The common outcome: external investors become discouraged and walk away from the deal. Such difficulties in selling state-owned shares with preemptive rights attached have been reported in Argentina, Brazil, Kenya, Morocco, and the Philippines (Vuylsteke 1988).

Why does the government not simply sell the shares to the party holding the preemptive rights, at the stipulated price or a negotiated one? That is often the outcome, but the process is not easy or straightforward. Suppose a company's bylaws stipulate the price at which shares can be sold. When the stipulated price appears lower than the market value, insiders have a strong incentive to exercise their rights. But the government may not agree to the sale, because it perceives a fiduciary responsibility to sell the shares at their "fair" market value. When the stipulated price is higher than the market price, however, few bidders are likely to make an offer.

Even where the bylaws do not fix the transaction price, an auction is difficult to organize.

Outside investors will resist participating until they are on a level playing field with insiders.

Incentives of outsiders and insiders

When preemptive rights exist, insiders wait until all bids are in and then decide whether or not to preempt. Thus preemptive rights make every share auction a two-tier auction working in favor of insiders. To win, outsiders must bid high enough to deter insiders from exercising their preemptive rights. In these circumstances acquiring sufficient information to put forward a competitive bid is expensive and time-consuming. Most investors will make the effort only when they think there is a real chance of winning the auction.

An important factor, however, is whether the seller offers a minority or a majority stake. When a majority stake is up for sale, the most likely buyer is a strategic investor with potential synergies between its operations and those of the target company. Because of perceived synergies, some outsiders will set a higher value on the company than insiders. In this case preemptive rights may not hinder privatization, because the price offered by these outsiders is unlikely to be matched by existing shareholders, particularly if the outside bidders are prepared to forgo some of the incremental value generated by expected synergies.

If the seller offers a minority stake, the universe of potential buyers, and the dynamics, change. The most likely buyers for such a stake are passive investors that intend to hold the shares in a securities portfolio and have no immediate synergies between their operations and the target company's. Only rarely will such investors exercise active corporate governance, since they will be unable to change management if it fails to fulfill its objectives. Passive investors determine the value of a minority stake through an appraisal of the company, normally using information made available by the seller. That gives insiders another tactical advantage.

If an outsider bids at or below the shares' fair market value (as perceived by insiders), the

chances are it will be preempted. Once again, preemptive rights increase the risks and uncertainty for outsiders. They also tend to push prices upward and compound the risk of overbidding. For if an outsider is *not* preempted by insiders (which presumably know the company intimately), the chances are that the outsider has overpriced the shares and will be confronted with a "winner's curse" situation. That is why outsiders tend to shun such auctions.

Incentives to preempt are strong when the minority stake for sale is sufficient to give a majority of the voting rights to an insider that already owns a substantial minority stake. In this case the two-tier structure of the auction may allow it to buy a controlling stake for the price of a minority stake. Indeed, in a one-round auction the insider would have to include a control premium in its bid to ensure that it wins the auction. But with preemptive rights, the insider only has to match the highest bid of the outsiders, which are bidding for only a minority stake.

Insiders will not always exercise their preemptive rights. They may welcome the arrival of a competent and well-funded strategic investor, or they may wish to create a market for the value of their shares, expecting to harvest their investment later.

Getting around preemptive rights under mixed ownership

Some governments have ruled that if a privatization candidate has preemptive rights attached to its shares, the privatization agency does not have to sell the shares through competitive bidding but can engage in direct negotiations with the existing shareholders instead. This is the approach followed by the Brazilian government (Vuylsteke 1988).

If all shares must be sold through competitive bidding, however, the solution is to get rapidly to and through the period accorded to a company's board of directors to consult with insiders. Typically boards have between thirty and sixty days to respond. Insiders can be



considered to have waived their preemptive rights if they have been offered the opportunity to buy the shares at the seller's price and have declined or taken no action. They should then be precluded from reentering the auction later. Clarity on this point is essential before the shares can be offered on the market. This approach was followed by the Argentine government in privatizing Atanor Compañía Nacional para la Industria Química S.A., in 1987. The presidential decree authorizing the privatization allowed the existing shareholders to exercise their purchase option, as provided by the articles of association, for thirty days after being notified of the purchase price; shares not taken by insiders were then put up for general bidding (Vuylsteke 1988).

Another solution is to allow insiders to preempt the sale of part of the state-owned shares while selling the rest to outsiders. The Moroccan government privatized SMI, a mining company, in two lots: 36 percent to the preemptor and 20 percent through an initial public offering on the Casablanca stock market. As a condition of the sale, the preemptor worked with the Moroccan privatization officials to take the company public. This transaction structure fulfilled the political objective of broadening share ownership.

Yet another approach is to allow the existing shareholders to preempt the sale of shares to outsiders—provided that they have participated in the bidding and their bid is at least 90 percent of the bid to be equaled. This approach was used for the privatization of Carboquímica Argentina S.A. (Vuylsteke 1988).

When the board of a privatization candidate is appointed and controlled by the state, the government could instruct the board to propose to shareholders that they amend the company bylaws and waive the preemptive rights. This approach was used by the Moroccan government to privatize Sonasid, a steel rod manufacturer, which was sold to the highest bidder.

Another, more comprehensive solution is to include in the privatization law procedures for

extinguishing preemptive rights within a fixed time frame. This approach was also used by the Moroccan government after it realized that preemptive rights were slowing the privatization program. A law was prepared to amend those rights so that if there are preemptive rights in the bylaws of a privatization candidate, privatization officials must notify the insiders by registered mail of the government's decision to sell the state-owned shares, the offer price, and the deadline for exercising their preemptive rights. Failure to express interest before the deadline results in an irrevocable waiver of those rights. This solution is attractive because it sets out the framework for resolving conflicts of interest between the state and insiders while respecting the rights of existing shareholders. But such an amendment would probably require ratification by the legislature, usually a lengthy process in any country. Besides, it amounts to a unilateral amendment by the government of a commercial agreement and must therefore be used with the greatest care. In addition, care must be taken to ensure that such provisions are in harmony with the country's corporate law and securities act.

These examples show that many countries have devised legal and financial mechanisms that strike a balance between the contractual obligations embedded in preemptive rights and the need to transfer assets to private owners.

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