

LEGAL FOUNDATIONS FOR A SUCCESSFUL PRIVATIZATION PROGRAM IN CUBA¹

Matias F. Travieso-Díaz and Alejandro Ferraté

This paper describes the legal bases for a privatization program in Cuba during its free-market transition.² An adequate legal framework will be necessary to remove Cuba's state-owned enterprises ("SOEs") from state control and allow the resulting private entities to function efficiently. Recent examples of successful privatization programs from which one can draw guidance for Cuba are found throughout the world, particularly in Eastern Europe and Latin America.

The management of SOEs in state-dominated economies, such as Cuba's,³ suffers from a number of shortcomings that prevent the effective operation of the enterprises.⁴ Basically, SOEs are used by the government to further its social and political goals. The

state's lack of concern for their efficient operation renders the SOEs uneconomical and, in most cases, incapable of functioning without financial aid.⁵

The main goals sought in privatizing state-owned enterprises are to improve their efficiency and increase their productivity.⁶ Other potential goals of privatization programs include reducing the size of the government, providing a "jump start" for the economy, increasing worker ownership in the nation's assets, and raising revenues for the state.⁷

Few, if any, sectors of the economy are so vital that they need to remain under the ownership and control of the state. The experience of those privatization programs that have been implemented in a compre-

1. This paper is a condensed version of the paper presented at ASCE's Seventh Annual Meeting in August 1997.

2. A commonly used definition, and the one used in this paper, applies the term "privatization" to the transfer or sale of any asset, function or activity from the public to the private sector. ERNST & YOUNG, *PRIVATIZATION: INVESTING IN STATE-OWNED ENTERPRISES AROUND THE WORLD* 29-34 (1994) [hereinafter *PRIVATIZATION AROUND THE WORLD*]. This definition encompasses "joint public-private ventures, concession leases, management contracts, as well as some specialized instruments, such as build-own-operate-transfer (BOOT) agreements." *Id.* Outsourcing of government functions and services (e.g., water supply) is also included in this definition. See Richard M. Phillips & Marian G. Dent, *Privatizing Eastern Europe: A Challenge for the Nineties*, in *JOINT VENTURES AND PRIVATIZATION IN EASTERN EUROPE* 448-49 (Practising Law Institute Commercial Law and Practice Course Handbook Series No. 575 (1991) for other, broader and narrower, definitions of the term "privatization."

3. Private ownership of income-producing property in Cuba is limited to small plots of land in the hands of farmers, and the assets of joint ventures between state enterprises and foreign venturers. CONSTITUCION DE LA REPUBLICA DE CUBA (1992), published in *Gaceta Oficial* (August 1, 1992), arts. 19-23 [hereinafter "1992 CONSTITUTION"].

4. See, e.g., Jozef M. van Brabant, *PRIVATIZING EASTERN EUROPE: THE ROLE OF MARKETS AND OWNERSHIP IN THE TRANSITION* 23-26 (1992).

5. Horst Brezinski, *The Autonomous Sector in a Society of Shortage*, in *PRIVATIZATION AND ENTREPRENEURSHIP IN POST-SOCIALIST COUNTRIES: ECONOMY, LAW AND SOCIETY* 33 (Bruno Dallago et al. eds., 1992).

6. Mary M. Shirley, *The What, Why, and How of Privatization: A World Bank Perspective*, 60 *FORDHAM L.REV.* 23, 25-27 (May 1992).

7. *PRIVATIZATION AROUND THE WORLD*, *supra* note 4, at 10-13. See also, van Brabant, *supra* note 9, at 188-189; Jan Winięcki, *Polish Mass Privatization Programme: The Unloved Child in a Suspect Family*, in *MASS PRIVATIZATION: AN INITIAL ASSESSMENT* 48 (1995).

hensive manner shows that even instrumentalities carrying out traditional governmental functions—including those which Cuba cites as the main accomplishments of the 1959 Revolution, such as education and health care—can be successfully transferred to the private sector.

A factor that may complicate the prospects for privatization in Cuba is the existence of a large number of claims by U.S. nationals, Cuban Americans, and Cubans living in the island for the expropriation of their assets after the Cuban Revolution.⁸ Cuba has failed to provide compensation to any of these groups, thus they all have outstanding claims against the state, and may seek restitution of the confiscated assets in lieu of compensation or other remedies.⁹

The outstanding expropriation claims will need to be addressed early in Cuba's transition to a free-market society. The Cuban government will need to resolve the claims to restore full relations with the United States, foster political stability, and encourage foreign investment. To the extent that any expropriation claims are resolved through restitution of the assets to their former owners, privatization of those properties will automatically occur.¹⁰ This paper assumes that the enterprises subject to privatization are those against which no outstanding property claims exist, or that claims against those properties have been denied or resolved through non-restitutional means.

Enterprise privatization, once decided, can be total (i.e., the complete transfer of ownership and control of the SOE to private parties) or partial, with the state retaining an ownership interest and/or a degree of control over the enterprise. Common methods used for the outright sale of an SOE include: auction, negotiated sale, tender, stock offering, stock distribution, voucher or coupon privatization, and management / employee giveaway or buyout. Partial privatization methods include joint ventures, build-own-operate-and-transfer (BOOT) agreements, leases, and management contracts.¹¹ These privatization options are summarized below.

ALTERNATIVE METHODS FOR THE PRIVATIZATION OF STATE-OWNED ENTERPRISES

This section describes the methods most commonly used to privatize SOEs. The privatization method chosen often depends as much on the political and economic climate prevailing in a country as on the characteristics and condition of the enterprises. It is not unusual for a privatization effort to start under one method and are completed under another, as political conditions change.

Gradual Versus Rapid Privatization

A privatization program may be designed to occur gradually, or to take place as rapidly as the circumstances permit. Gradual privatization is used in countries which seek to retain a centrally-planned economic system. China and Vietnam, for example, are implementing gradual privatization programs de-

8. See, e.g., Matías F. Travieso-Díaz, *Some Legal and Practical Issues in the Resolution of Cuban Nationals' Expropriation Claims Against Cuba*, 16 U. PA. J. INT'L BUS. L. 217 (1995); Matías F. Travieso-Díaz, "Alternative Remedies In A Negotiated Settlement Of The U.S. Nationals' Expropriation Claims Against Cuba," 17 U. Pa. J. Int'l. Bus. L.659 (1996); Matías F. Travieso-Díaz, *Legal and Practical Issues in Resolving Expropriation Claims*, NEW YORK L.J., February 20, 1996.

9. Cuba may need, for political reasons, to provide comparable remedies to claimants living in the island to those given to Americans and Cubans living abroad. See, e.g., Matías F. Travieso-Díaz and Steven R. Escobar, *Cuba's Transition to a Free-Market Democracy: A Survey of Required Changes to Laws and Legal Institutions*, 5 DUKE J. COMP. & INT'L L. 379, 412 (1995) [hereinafter LAWS AND LEGAL INSTITUTIONS]; Rolando H. Castañeda and George P. Montalván, *Economic Factors in Selecting an Approach to Expropriation Claims in Cuba*, presented at the Shaw, Pittman, Potts & Trowbridge Workshop on Resolution of Property Claims in Cuba's Transition, Washington, D.C. 16 (January 1995).

10. This paper does not address the issue whether restitution of SOEs to their former owners should be favored by the Cuban government as a way to bring about the rapid privatization of SOEs.

11. PRIVATIZATION AROUND THE WORLD, *supra* note 2, at 17-18.

signed to unfold over long periods of time.¹² Such programs have proved to be slow, awkward and bound by political constraints. Nonetheless, even these limited efforts have been beneficial in driving the management and workers of SOEs toward profit-seeking activities, resulting in increased productivity.

A rapid privatization program is one whose goal is to turn SOEs over to the private sector as quickly as practicable. Rapid privatization methods attract private investors and foster the re-emergence of a domestic enterprise sector. They are, therefore, the most appropriate methods for handling the transition from a state-controlled to a free-market economy. The discussion in the remainder of this paper assumes that Cuba will seek to implement one or more rapid privatization methods.

Full Privatization

Full privatization is used when the state no longer wants to retain any ownership or control over an SOE. Full privatization is particularly appropriate in the case of commercial enterprises that provide no essential services to the public and have no perceived security or strategic importance, hence there is no reason for continued state involvement in them.

Direct Sale of the SOE: Selling state-owned enterprises allows the state to draw income from the sale of the companies or their assets.¹³ On the other hand, the sale of SOEs tends to concentrate ownership in the hands of a few individuals or corporations, often foreign, which may cause public resentment if it is

the exclusive way of dealing with all state-owned enterprises. Therefore, SOE sales are often coupled with other methods as part of the overall privatization program.

Preparation of Enterprises for Eventual Sale: Before an SOE is offered for sale, a feasibility study should be conducted to determine whether the enterprise can be sold as an ongoing concern, or should be liquidated.¹⁴ Assuming the enterprise is salable, it should be prepared for the sale.¹⁵ This preparation requires: (1) conversion of the state-owned enterprise's accounts and financial records into a form that meets international accounting standards and allows the preparation of reliable financial statements; (2) writing a report identifying any potential problems with the sale; (3) engagement of advisors to help address legal issues relating to the sale and to prepare the necessary legal documents; and (4) appointment of an economic/financial advisor to value the company's assets and liabilities and perform other financial analyses.¹⁶

The enterprise may also have to be restructured to make it more attractive to potential purchasers. Structural changes include refinancing or writing off debt, eliminating unprofitable lines of business, reducing the number of employees, hiring new managers, and disposing of assets and liabilities that make the enterprise more difficult to sell.¹⁷

Negotiated Sale: In a negotiated sale, sometimes called a private sale, the SOE negotiates directly with

12. Fan Liufang, *China's Corporatization Experiment*, 5 DUKE J. COMP. & INT'L L. 149 (Spring 1995); Matthew D. Bersani, *Privatization and the Creation of Stock Companies in China*, 1993 COLUM. BUS. L. REV. 301 (1993); Andrew Xuefeng Qian, *Riding Two Horses: Corporatizing Enterprises and the Emerging Securities Regulatory Regime in China*, 12 UCLA PAC. BASIN L. J. 62 (Fall 1993); FREEHILL HOLLINGDALE & PAGE, VIETNAM: A BUSINESS GUIDE 103 (1991). China has coupled the limited opening of SOEs to private ownership with a grant of increased operational autonomy to its SOEs. BARBARA LEE & JOHN NELLIS, ENTERPRISE REFORM AND PRIVATIZATION IN SOCIALIST ECONOMIES 7-9 (1990). See Steven Mufson, *Profit Motive Praised for Chinese Firms*, WASHINGTON POST, Sept. 12, 1997, at A27.

13. Farid Dhanji & Branko Milanovic, *Privatization*, in 2 THE TRANSITION TO A MARKET ECONOMY: BROAD ISSUES 30 (Paul Marer and Salvatore Zecchini, eds., 1991) [hereinafter TRANSITION TO A MARKET ECONOMY].

14. United Nations, ACCOUNTING, VALUATION AND PRIVATIZATION 14 (1993) [hereinafter ACCOUNTING].

15. United Nations, LEGAL ASPECTS OF PRIVATIZATION IN INDUSTRY 35-36 (1992) [hereinafter LEGAL ASPECTS OF PRIVATIZATION] at 42-43.

16. *Id.* at 43.

17. ACCOUNTING, *supra* note 14, at 14-15.

a potential buyer towards the transfer of the enterprise's assets or stock.¹⁸ The advantages of a negotiated sale include speed and flexibility.¹⁹ A private sale may allow the seller to impose certain requirements, such as asking prospective buyers to submit a proposed management or restructuring plan to ensure successful performance of the enterprise after the sale.²⁰

On the other hand, it is difficult to obtain a fair price in negotiations with a single buyer, and the state may receive a lower price than the enterprise would command in a competitive environment. There is also a potential lack of transparency in the transaction, which may create the possibility (or the public perception) of fraud.²¹

Auctions: Public auctions are an effective way to sell quickly small, commercially viable companies. A drawback of this method is that auctions seldom realize the full value of the enterprises. Therefore, the auction sale of SOEs is not effective in maximizing receipts by the state.²² Auctions should be preceded by the pre-qualification of bidders to ensure they are capable of operating the enterprise.²³

Tenders: A tender is similar to an auction except that it is a formal process, conducted under pre-established rules and timetables. In a tender, the state solicits sealed bids from potential buyers. Bids are received up to a certain date, after which the bids are

opened; the highest responsive bid wins. The competition between investors produced by the secret bidding process may enable the state to obtain a higher price for the SOE than what would have been obtained at an auction.²⁴ On the other hand, there are significant costs and delays associated with the formal tender process, which tend to offset some of its benefits.

One important advantage of the tender method is that the transfer of ownership occurs through a transparent process, thereby protecting the government from charges of secret deals or favoritism.²⁵

Stock Offerings: Offering stock of an SOE for public sale allows the government to raise capital and spread ownership of the enterprise among many investors, including local ones. Stock offerings, however, are only effective in promoting domestic ownership when there is a functioning local capital market. In the case of countries like Cuba, with non-existent or poorly established capital markets, privatizing SOEs through this method will require selling the shares in international markets and vesting stock ownership in foreign investors.²⁶

Another problem with stock offerings is the dilution of ownership interests it produces, which complicates management oversight. This problem can be alleviated, however, by selling a large block of shares to a single purchaser, to ensure there is at least one share-

18. PRIVATIZATION AROUND THE WORLD, *supra* note 2, at 20. These negotiations are often brokered by an investment bank or other financial intermediary. *Id.*

19. VAN BRABANT, *supra* note 4, at 221.

20. This approach was frequently followed in the privatization of SOEs in East Germany. Wendy Carlin, *Privatization and Deindustrialization in East Germany*, in PRIVATIZATION IN CENTRAL AND EASTERN EUROPE 137(1994) [hereinafter PRIVATIZATION IN CENTRAL AND EASTERN EUROPE].

21. *Id.* at 221-222.

22. PRIVATIZATION AROUND THE WORLD, *supra* note 2, at 19-20.

23. For example, the auctions conducted in Chile during the second phase (1975-1983) of its privatization program did not require bidders to undergo pre-qualification procedures. As a result, some enterprises were sold to purchasers lacking adequate financial bases or technical and managerial expertise. The absence of rigorous pre-qualification criteria was one of the factors that contributed to the bankruptcy or renewed privatization of about 70% of the enterprises privatized in Chile during the second phase. Helen Nankani, 2 TECHNIQUES OF PRIVATIZATION OF STATE-OWNED ENTERPRISES 17, 21 (1988).

24. *Id.*, at 21.

25. Carlos E. Martínez, *Early Lessons of Latin American Privatizations*, 15 SUFFOLK TRANSNAT'L L.J. 468, 493 (1992).

26. Nankani, *supra* note 23, at 22-23.

holder with enough of a stake to ensure the enterprise is managed properly.²⁷

Management/Employee Buyouts or Giveaways:

The management/employee buyout or giveaway method allows the SOE managers and/or workers to acquire all or a portion of the shares in the enterprise. This method has the advantage of giving managers and workers a direct stake in the success of their enterprise, and thus may improve the employees' productivity.²⁸ On the other hand, leaving the old management in control risks a continuation of the pre-privatization methods of operating the enterprise. This tendency and the likelihood that the enterprise will suffer from early financial problems due to lack of operating capital make buyouts and giveaways risky.²⁹

Voucher or Coupon Privatization: Also known as mass privatization, voucher or coupon privatization involves the sale or giveaway to private citizens of "vouchers" representing the right of ownership in, or the right to buy, shares in an SOE.³⁰ This method can, in theory, produce a rapid privatization of an SOE, but yields little or no compensation to the state.³¹ Furthermore, the wide dispersal of the owner-

ship of the company allows the existing managers to maintain control over the enterprise until the shareholders organize themselves.³²

Partial Privatization Methods

Under partial privatization methods, the state maintains some degree of ownership and/or control of the SOEs. Maintaining government ownership of the enterprise assuages criticism over selling a country's "patrimony" to a privileged few or to outsiders. In addition, partial privatization methods are sometimes used to prepare SOEs for an eventual privatization by introducing improved management and technology that will make the enterprise more attractive for potential investors.

Joint Ventures: In a joint venture, the private investor and the state-owned enterprise contribute assets to a new entity under a joint venture agreement.³³ The private partner usually supplies technology (and capital) unavailable in the host country, and the government usually provides labor and physical resources.³⁴ Joint ventures can take different legal forms, ranging from simple trade agreements to jointly-owned companies.³⁵

27. This approach has been used in New Zealand, where the government extracted a control premium by selling sizable blocks of shares to strategic investors. Stephen Franks, *Rigorous Privatization: The New Zealand Experience*, 28 COLUMB. J. OF WORLD. BUS. 85, 92 (1993).

28. *Id.*

29. ACCOUNTING, *supra* note 14, at 11. One of the best known instances of management/employee "buyouts" occurred in Hungary. When that country enacted laws that permitted management and employees to initiate the privatization of their enterprises, many managers "spontaneously" privatized their companies, confiscating their assets and becoming owners, or selling the enterprise to foreign investors and becoming managers in the new firms. BARBARA LEE AND JOHN NELLIS, ENTERPRISE REFORM AND PRIVATIZATION IN SOCIALIST ECONOMIES 11 (1990).

30. PRIVATIZATION AROUND THE WORLD, *supra* note 2, at 23-24.

31. *Id.* Stanley Fischer, *Privatization in East European Transformation*, in THE EMERGENCE OF MARKET ECONOMIES IN EASTERN EUROPE 237 (Christopher Clague and Gordon C. Rausser eds. 1994) [hereinafter EMERGENCE].

32. PRIVATIZATION AROUND THE WORLD, *supra* note 2, at 23-24. See also Saul Estrin, *Economic transition and privatization: the issues*, in PRIVATIZATION IN CENTRAL AND EASTERN EUROPE, *supra* note 20, at 26-27.

33. PRIVATIZATION AROUND THE WORLD, *supra* note 2, at 24.

34. Martínez, *supra* note 25, at 498.

35. ACCOUNTING, *supra* note 14, at 11. Joint ventures between SOEs and foreign partners have been permitted in Cuba since 1982 after the Cuban government issued its first foreign investment code, known as Law 50. Matías F. Travieso-Díaz and Alejandro Ferraté, Recommended Feature of a Foreign Investment Code for Cuba's Free-Market Transitions 21 N.C.J. INT'L & COMM. REG. 511, 516 (1996) [hereinafter RECOMMENDED FEATURES]. Joint ventures with foreign investors may continue to play an important role in Cuba's free-market transition, provided the proper legal and regulatory conditions are set in place for their operation. In addition, joint ventures may provide the springboard for the privatization of many Cuban SOEs. See below.

Leases and Concessions: In these arrangements, the lessee or concessionaire pays a fee in exchange for the right to operate a facility or provide a service, keeping the proceeds from the operation. Leases are generally granted for the exploitation of natural resources and the use of manufacturing facilities, while concessions refer to a public services or other public activities.³⁶ The lease/concession method has certain advantages, including making it easier for the government to achieve enterprise efficiency without needing to transfer ownership of the asset to the private sector.³⁷ However, since the lessee or concessionaire generally has no incentive to invest in the assets beyond what is necessary to ensure a return for the period of the lease or concession, it may be difficult to ensure that the value of the assets will be maintained past the term of the lease or concession.³⁸ Another problem is the need to price out any improvements made during the term of the lease or concession once it has terminated and the improvements are conveyed to the state.³⁹

Management Contracts: In a management contract, the government hires a private firm to operate a public facility or provide a service.⁴⁰ Management contracts are often used in developed countries to pro-

vide local government services such as public transportation, garbage collection, street cleaning, etc.⁴¹ Management contracts are also starting to be used for industrial facilities in developing countries.⁴²

Management contracts require intensive monitoring, since they are subject to the problems associated with the separation of ownership and control.⁴³ Management contracts must be accompanied by the deployment of an effective oversight mechanism by the state.⁴⁴

SURVEY OF PRIVATIZATION METHODS THAT COULD BE USED IN CUBA

This section seeks to explore the applicability to Cuba of methods commonly utilized to implement the rapid privatization of SOEs. The discussion in this section is intended to be illustrative and does not cover in detail all, or even a significant portion of, Cuba's SOEs. Nor is it our objective to develop a blueprint or proposal for a privatization program in Cuba. Rather, our aim is only to examine how the various privatization techniques could be applied to the Cuban situation.

36. PRIVATIZATION AROUND THE WORLD, *supra* note 2, at 25-26.

37. Martínez, *supra* note 25, at 497.

38. LEGAL ASPECT OF PRIVATIZATION, *supra* note 15, at 53. Another problem that may arise is that of asset stripping by the lessee. VAN BRABANT, *supra* note 4, at 218.

39. *Id.* at 218-219.

40. PRIVATIZATION AROUND THE WORLD, *supra* note 2, at 26. Management contracts have some similarities with leases, such as control over the operation of the assets, but there are several marked differences between both methods. In a lease, the lessee assumes total control over the leased assets, and also exposed to financial risk if the enterprise is not profitable. In a management contract, the management contractor's authority is limited by the terms of the contract, yet it is paid its management fee regardless of whether or not the enterprise is profitable. CHARLES VUYLSTEKE, 1 TECHNIQUES OF PRIVATIZATION OF STATE-OWNED ENTERPRISES 36-37 (1988). In Poland, SOEs were given the option of entering into management contracts (with both insiders and outsiders) during an interim restructuring period before full privatization. The goal was to improve the enterprise's performance in expectation of its future privatization. ROMAN FRYDMAN, ANDREJ RAPACZYNSKI, JOHN S. EARL ET AL., THE PRIVATIZATION PROCESS IN CENTRAL EUROPE 199 (1994) [hereinafter PRIVATIZATION IN CE].

41. ACCOUNTING, *SUPRA* note 14, at 9.

42. Sri Lanka, for example, has successfully transferred many SOEs, particularly textile mills, to the private sectors through management contracts. NANKANI, *supra* note 23, at 132.

43. The delegation of a management responsibility to a private firm also requires that the owner (in this case the state) expend resources to monitor the managers' performance, lest the manager fail to discharge its duties appropriately or use the firm's resources for its own, rather than the owner's, profit. See Larry E. Ribstein, Business Associations 4-5 (1990). Constraints placed on the state, such as limited resources and bureaucratic entanglements, may impede proper monitoring of the manager's efforts.

44. VAN BRABANT, *supra* note 4 at 219-220.

General Considerations

Political Factors: In addition to the legal factors described in this section and throughout the paper, there are political considerations that may dictate in a given country whether, when and how particular enterprises will be privatized. Many strategies can be followed to carry out the privatization process; each has inherent political risks as well as potential benefits. Cuba's privatization process will accompany the restructuring of an entire political, economic and social system. Therefore, privatization of SOEs in Cuba is likely to elicit the political scrutiny, and often opposition, that is common in post-Socialist environments.⁴⁵ Like the recent privatization processes in Eastern European countries, Cuba's privatization will involve a variety of government actions including the breaking-up of state-owned enterprises, the search for new owners, the transfer of state assets to the private sector, and the closing of unproductive operations.⁴⁶ These actions will inevitably lead to political reactions that must be taken into account in choosing the privatization model.

There are also macroeconomic transformation processes that will need to take place during the transition period, which will influence the privatization program. While a discussion of those processes is beyond the scope of this paper, recent studies suggest that the economic changes must result in the rapid, and most likely painful, liberalization of the economy if the transition is to be successful.⁴⁷

Important Privatization Decisions: An early, "large-scale" privatization of state-owned enterprises would quickly eliminate state control of Cuba's SOEs in a short time and allow for immediate access to the country's productive assets by the private sector. However, such a massive change could have signifi-

cant short-term consequences, including unemployment, increased interest rates and high inflation. The concurrent privatization of a large number of SOEs may also prove infeasible due to the lack of the necessary external financing.⁴⁸

Alternatively, the government could take the less risky political route of privatizing at first only a few large, relatively successful enterprises, to showcase the positive effects of privatization. If the initial privatization of a few large enterprises is successful, the positive political impact of this success could be great. On the other hand, if the privatization of those enterprises runs into difficulties or yields disappointing results, these setbacks could discredit the privatization process and erode public support for the project.

A political strategy that might prove viable over the long run would be to seek foreign investors with the necessary capital resources, technology, and know-how for the privatization (early or late) of major SOEs, and to find ways of turning over other enterprises, particularly medium and small ones, to local entrepreneurs. For, if the privatization of Cuba's SOEs is to be successful, a balance may need to be eventually struck between foreign and local participation in the process.

Privatization Method: In addition to the decisions as to the timing, scope and sequence of the privatizations, Cuba's leaders will need to choose for each enterprise from among the many available methods of privatization, a decision that may have an impact on what results are achieved and affect public perceptions. The choice of privatization method will involve several balancing acts, including choices between economic efficiency and political expediency.⁴⁹ Thus, for example, political considerations may dic-

45. David Gordon, *Privatization in Eastern Europe: The Polish Experience*, 25 L. & Policy in Int'l Bus. 520 (1994).

46. *Symposium: Economic, Legal, and Political Dilemmas of Privatization in Russia: Privatization in East Europe: Another Case of Words That Succeed and Policies That Fail?* 5 Transn. L. & Contemporary Problems 8 (1995) [hereinafter SYMPOSIUM].

47. See Ernesto Hernández-Catá, "Liberalization and Behavior of Output During the Transition from Plan to Market," in this volume.

48. Simon Johnson and Gary W. Loveman, *Starting Over in Eastern Europe: Entrepreneurship and Economic Renewal*, IAC (SM) Newsletter Database Central European Business Ltd. Business Europa, Harvard Business School Press, June 1, 1996, available in LEXIS Nexis Library, 3.

49. SYMPOSIUM, *supra* note 46, at 11.

tate that Cuba's government award long term concessions for the operation of critical enterprises such as the electric power company to avoid selling the company to a foreign investor, even though a sale might be more beneficial than a concession from the financial standpoint.

Role of Enterprise Managers and Employees: Cuba's privatization program will also have to find a role for the managers and employees of the enterprises to be privatized so they have an incentive to strive for the economic success of the newly-privatized companies. In fact, the property interest (if any) which employees and managers will have in the privatized enterprise should be settled before Cuba proceeds to make the SOE available to potential private buyers.⁵⁰

One approach, sometimes described as "external privatization," turns over the SOE to outside agents, including foreign investors, institutions, and even the public at large, leaving the SOE managers and employees without a stake in the new enterprise. At the other extreme there is an "internal privatization" model which transfers ownership of the enterprise to its workers and/or managers. Internal privatization could provide a means of shifting away from state-run management while allowing for Cuban participation in the newly privatized enterprise. However, internal privatization will not yield the same level of revenues for the state as an external sale.⁵¹ In addition, since the transfer of ownership to the managers and employees excludes the general population from the opportunity to buy into the new company, it

may be perceived by the population as no less arbitrary than the external method of privatization.⁵²

The privatization program could also provide some form of employee-ownership programs.⁵³ Allowing employees to acquire an interest in the privatized enterprise may quiet political resistance to privatization, but may also result in gridlock as managers, employees and investors compete for control and influence over decisions.

Classification of Cuba's SOEs for Privatization

Purposes

For analytical purposes, it is possible to classify the state-owned economic resources in Cuba into three main categories:

- Assets subject to joint ventures between the state (or one of its agencies, instrumentalities, or wholly-owned companies) and a foreign investor
- Co-operatively held property or enterprises in which the co-operative members have perpetual or time-defined rights to exploit the resource in question (typically, agricultural land)
- Wholly state-owned and operated enterprises.

The most appropriate methods for dealing with each type of economic entity are likely to be different. Therefore, in the discussion that follows, each type will be addressed separately.

Privatization of Enterprises Subject to Joint Ventures

Cuba's efforts in the last few years have succeeded in attracting a certain amount of foreign investment.⁵⁴ Foreign investment in Cuba has bolstered discrete

50. For a discussion of the importance of selecting privatization models which meet political objectives and the interests of enterprise managers and employees, see Igor Filatochev, Robert E. Hoskisson, Trevor Buck, Mike Wright, *Corporate restructuring in Russian privatizations: implications for U.S. investors*, California Management Review (January, 1996) available in LEXIS Nexis Library, at 9.

51. Farid Dhanji and Branko Milanovic, *Privatization in Eastern and Central Europe: Objectives, Constraints and Models of Divestiture*, Working Papers, Country Economics Department, World Bank 1991, at 17.

52. *Id.*

53. *Id.* at 10.

54. It has been estimated that between 1990 and January 1997, \$707 million of foreign investments were committed or delivered to Cuba. EIU Country Reports (Cuba) April 11, 1997, available in LEXIS, Nexis library. This relatively low figure would imply that, despite some notable exceptions, the international investor community has been slow to enter into significant long term commitments in the island.

economic sectors, particularly tourism. Cuban officials have pointed to foreign investment as one of the mechanisms on which the government relies to overcome the country's economic crisis.⁵⁵ An example of the role of foreign investment is the exploration and production of oil. Having depended heavily on Soviet oil supplies and Soviet technical assistance in oil exploration, the national oil company, CUPET, found itself after 1989 limited by inadequate technology and lack of financing. CUPET sought to solve this deficiency through several joint ventures, such as the formation of an oil prospecting company jointly owned between France's *Total Compagnie Européenne* and CUPET. Likewise, *Mexpetrol*, a Mexican-based group of public and private companies, has entered into a joint venture with CUPET to renovate the Soviet-constructed Cienfuegos oil refinery.⁵⁶

As will be further discussed below, the Cuban government may be able to raise capital and "jump start" its privatization program by selling its interest in some of the SOEs subject to joint ventures to the foreign participant in the venture, or to other foreign investors. Since foreign investors are already part owners in these enterprises, turning the enterprises totally over to foreigners should have limited political impact. Using the oil industry as an example again, the privatization of the oil joint ventures (and similar ventures engaged in mining projects) could be ac-

complished by a renegotiation of the terms of the agreement to grant the foreign venturer a sole concession or lease to explore and exploit the property for a period of a specified number of years, subject to the payment to the state of increased concession fees, an undertaking by the concession holder to improve the physical facilities for the extraction and processing of the oil or minerals, and the pertinent technology transfers that will permit the state or another licensee to assume operation of the properties once the concession is over.

Summary Overview of Current Foreign Investment Regime in Cuba:

It was not until the collapse of socialism in the Soviet Union and Eastern Europe and the attendant steep decline in the Cuban economy that Cuba actively sought to attract foreign capital.⁵⁷ In order to draw investment to the island, the government liberalized certain restraints on its investment practices.⁵⁸ Amendments to the Cuban Constitution in 1992 eliminated important restrictions on foreign investment, permitting property ownership by mixed enterprises and the transfer of state property to joint ventures with foreign capital.⁵⁹

These constitutional amendments signaled the institution of a less restrictive foreign investment regime.⁶⁰ Indeed, the entire Cuban economy, with the exception of health care, education, and the military sector, was declared open to foreign investment in

55. See MATIAS F. TRAVIESO-DIAZ, *THE LAWS AND LEGAL SYSTEM OF A FREE-MARKET CUBA—A PROSPECT FOR BUSINESS* (Quorum Books, 1996) [hereinafter LAWS AND LEGAL SYSTEM], Chapter 5, for a detailed discussion of Cuba's foreign investment program. See also, Jorge Pérez-López, *A Critical Look at Cuba's Foreign Investment Program*, paper presented at the 1995 Meeting of the Latin American Studies Association, Washington, D.C. (Sep. 1995) 1-4 [hereinafter CRITICAL LOOK]; see also Carmelo Mesa-Lago, *Cuba's Economic Strategies for Confronting the Crisis*, in *CUBA AFTER THE COLD WAR 200-203* (Carmelo Mesa-Lago ed., 1993) [hereinafter CONFRONTING THE CRISIS].

56. GARETH JENKINS & LILA HAINES, *CUBA: PROSPECTS FOR REFORM, TRADE AND INVESTMENT 121*(1994) [hereinafter CUBA PROSPECTS].

57. GILLIAN GUNN, *CUBA IN TRANSITION—OPTIONS FOR U.S. POLICY 34* (Gillian Gunn, ed., 1993) [hereinafter CUBA IN TRANSITION].

58. *Id.* at 32. In order to make itself more attractive to possible trading partners, the Cuban government began in 1989 to form business-oriented *Sociedades Anónimas* (SAs). SAs are state-owned enterprises, organized like corporations and acting in many respects like private companies (e.g., they hold foreign exchange in offshore accounts, serve as trading partners to foreign investors, and can hire and fire at will).

59. See 1992 CONSTITUTION, *supra* note 3, art. 23.

60. CARMELO MESA-LAGO, *ARE ECONOMIC REFORMS PROPELLING CUBA TO THE MARKET? 17* (1994) [hereinafter MESA-LAGO ON ECONOMIC REFORMS].

1994. However, the main sectors where significant foreign investment has taken place are still limited to tourism, mining, oil exploration, construction, and agro-industry.⁶¹

The most commonly used format for foreign investment has been the formation of joint ventures between the foreign party and a Cuban enterprise, which is either an existing state instrumentality or a “private” company (S.A.) formed by the Cuban government. Over 270 such ventures have been established in the last seven years.⁶²

On September 5, 1995, Cuba’s National Assembly of People’s Power (the country’s highest legislative body) enacted a new foreign investment law, known as Law No. 77 of 1995 (Law 77).⁶³ Some of these changes in Law 77 represent potentially significant improvements over previous legislation and, if fully implemented, could help liberalize the investment climate.

Law 77 retains several forms of business organization already allowed by Cuban law (joint ventures, production agreements, and joint accounts), and creates a new form of investment vehicle, the “enterprise with wholly foreign capital,” which is a company formed by foreign investors without Cuban equity participation. Such companies can be established in two different ways: either by the foreign individual or entity registering in its own name with the Chamber of Commerce of Cuba, or by setting up a wholly-owned Cuban corporation as a subsidiary of the for-

eign entity.⁶⁴ The law contains an express guarantee against uncompensated expropriation of the property of foreign investors.⁶⁵ The state also promises to “protect” the investor against third-party expropriation claims, to the extent such claims are in accordance with Cuba’s laws and the rulings of Cuba’s courts.⁶⁶

The present state of Cuba’s foreign investment program is not unlike that which existed in Central and Eastern European countries, such as Hungary, the former Czechoslovakia, and Poland, prior to their transition to free-market economies.⁶⁷ Like the socialist governments in those countries, Cuba’s leadership still imposes significant constraints on foreign investment in order to control the investment process.⁶⁸ Thus, although the new foreign investment law creates a somewhat improved framework for investment in the island, Cuba’s transition to a free-market economy will require a far greater liberalization of the country’s foreign investment regime than this law provides.

Case Study of Privatization of SOEs Subject to Joint Ventures—Cuba’s Tourism Industry: Cuba’s tourism industry has become the engine driving the country’s economy. It is a rapidly growing industry in Cuba and is said to have already replaced sugar as the number one source of income for the country.⁶⁹ Foreign investors play an increasingly influential role in Cuba’s tourism industry. The success of the tourism joint ventures has often been based on the satisfactory exchange between the foreign investor’s man-

61. See generally, CUBA PROSPECTS, *supra* note 56.

62. Robert P. Walzer, *Cuba Trade Official Sees '97 Tourism Income Up 16%*, WALL ST. J., JUNE 5, 1997, at A1.

63. LEY NUMERO 77 DE LA INVERSION EXTRANJERA, *published in* Gaceta Oficial, Sep. 6, 1995.

64. *Id.*, art. 15(2). However, no instances of enterprises wholly-owned by foreign investors have been reported since the new law was enacted. This is not surprising, since upon enactment of Law 77 President Castro warned that very few businesses would ever be authorized to operate as 100% foreign-owned ventures. Douglas Farah, *Socialist Cuba Alters Course to Spur Foreign Investment*, WASHINGTON POST, Sep. 6, 1995, at A25.

65. Law 77, *supra* note 63, art. 3.

66. *Id.*, art. 5.

67. For example, until 1988 foreign investors could only operate in Hungary as minority partners in joint ventures with domestic enterprises. ZBIGNIEW DOBOSIEWICZ, FOREIGN INVESTMENT IN EASTERN EUROPE 45 (1992).

68. See, e.g., MESA-LAGO ON ECONOMIC REFORMS, *supra* note 60, at 17.

69. *Cuba Sees 18% Tourism Rise Despite Hotel Blasts*, ASSOCIATED PRESS, July 21, 1997.

agement know-how and capital resources and Cuba's supply of physical facilities and cheap labor.

Cuba's tourism industry currently includes many joint ventures with foreign investors. For example, the state-owned enterprise *Cubanacán* runs over a dozen hotels under joint ventures with foreign contractors, including a joint-venture with the Spanish group, *Sol Meliá*. Many of these agreements are based on management contracts, including those with foreign investors such as *LTI-International Hotels* of Germany, a subsidiary of the German air charter group *LTU*, and the Amsterdam-based group, *Golden Tulip*. Cuba's agreement with *LTI* requires that *LTU* manage the Tuxpan hotel in Varadero. The contract with *Golden Tulip* has the Dutch company managing the *Hotel Caracol* in Santa Lucía and providing marketing and sales services.⁷⁰

Potential Privatization Methods: The portion of the tourism industry subject to joint ventures with foreign investors lends itself well to a "private sale" privatization method in which the state sells all or most of its interest in the enterprise to the private investor, leaving perhaps a minority interest in the hands of the workers. Typically, the SOEs subject to joint ventures are already organized as *sociedades anónimas*, so the initial phase of the transformation has already been achieved. Thus, the only major step remaining for a full privatization is the transfer of the residual equity in the venture. Whether Cuba chooses a private sale to liquidate the state's interest in tourism joint ventures will depend, among other things, on the perceived political risks of allowing complete foreign domination of the industry. Since tourism-related facilities are not critical to the running of the Cuban economy (as opposed to, for example, public utilities), they perhaps could be sold to foreigners without raising the concerns that might be present for more sensitive industries. Thus, Cuba

may well decide to privatize much of the tourism industry by selling the state's interest in a private sale to the joint venture partner or, if that should fail, through a stock sale to other investors.

Enterprises Subject to Cooperative Arrangements

Cuba's reforms allowing the creation of cooperative farms may provide a starting point for the eventual privatization of agribusiness. In 1992, approximately 144,000 private farmers developed 22% of Cuba's cultivable land and 34% of its pasture land.⁷¹ In 1993, the Cuban government enacted Law-Decree No. 142 establishing a form of agricultural cooperative known as the Basic Units of Cooperative Production ("UBPCs").⁷² Art. 1 of the law states that the UBPCs will be based on the following principles:

- the linking of the man to the land;
- the self-sufficiency of the worker's collective and their families, with a cooperative effort, and the improvement of their living conditions;
- the worker's earnings will be rigorously related to the production achieved; and
- to develop the autonomy of management and to administer their resources with the objective of achieving self-sufficiency in the productive process.

Although the members of the cooperatives are assigned a share of machinery and equipment, they do not receive title to the land they farm.⁷³ When Cuba proceeds towards decentralization of these cooperatives, it will need to transform its property laws by conveying title to the lands of the cooperative farmers.

Case Study—Citrus: Approximately 90% of Cuba's citrus output is produced by thirteen SOEs (the rest is produced by private interests). These SOEs are un-

70. CUBA PROSPECTS, *supra* note 56, at 86-88.

71. *Id.* at 96.

72. Law-Decree No. 142, *published in* Gaceta Oficial, September 20, 1993.

73. José Alvarez and William A. Messina, Jr., *Cuba's New Agricultural Cooperatives and Markets: Antecedents, Organization, Early Performance and Prospects*, in CUBA IN TRANSITION: PAPERS AND PROCEEDINGS OF THE SIXTH ANNUAL MEETING OF THE ASSOCIATION FOR THE STUDY OF THE CUBAN ECONOMY 175, 178 (Aug. 1996) [hereinafter ASCE-6].

der the control of the Junta Central de Planificación (JUCEPLAN).⁷⁴ Joint venture agreements have aided in stemming the almost 40% decline in citrus production that took place between 1989 and 1993.⁷⁵ For example, the British company *Sims & Co.* has created a joint venture with Cuba by supplying Cuban fruit to two major British supermarket chains. Cuba's citrus company, the National Fruit Corporation, also maintains a joint venture with the Greek company, *Lomar Shipping*, under the name *Lola Fruit, S.A.*, by exporting its citrus to Europe.⁷⁶

Cuba's citrus industry has also employed the management contract models prevalent in its tourism industry. For example, the Israeli Company, *Grupo BM*, manages a lime plantation of 115,000 acres in the Matanzas province. The citrus fruit industry has also benefited from Chilean capital and foreign fertilizer for its product export.⁷⁷

Implementation of the 1993 Cuban legislation in the citrus industry has allowed the creation of cooperatively run farm units providing a measure of autonomy for farmers.⁷⁸ Since many citrus groves have already been turned over to cooperatives, a logical step in the privatization process would be to give title to the land to the cooperative farmers, probably subject to a long-term mortgage in favor of the state and certain restrictive covenants on the alienability and use of the land for a limited period of time. Also, the farmers' limited experience in making market-based decisions requires that agricultural privatization be managed, at least initially, by an experienced participant in the joint venture with access to international markets and technology. (This participant can be, if appropriate, the joint venture partner that holds an existing management contract.) Such a manager should be required to commit to acquiring a signifi-

cant stake in the output of the agricultural enterprise to ensure international market access for the harvest and bind the manager to the venture in order to avoid the "shirking" of responsibilities.

Enterprises Under Total State Ownership and Control

Enterprises under total ownership and control by the state comprise the majority of the non-agricultural business activities in Cuba. Also under total state control are a number of agencies and instrumentalities that carry out public or public/private functions (e.g., the ports). Clearly, no single formula would suffice to meet the needs of every type of SOE. The discussion that follows provides examples of approaches that could be applied to important categories of enterprises.

Large SOEs: Some of the large, state-owned SOEs could be attractive to foreign investors and could be sold off through a tender process, that is, through an offer to sell the stock of the company (after its transformation into a *sociedad anónima*) to pre-qualified bidders. The Cuban national carrier Cubana de Aviación might be sold in that manner, and so could the rum refineries, cigar manufacturing facilities, and other industrial and commercial enterprises. As an intermediate step to full privatization, these SOEs might have to be run under management contracts for a period of time in advance of the privatization in order to improve their efficiency and make them more attractive acquisition targets.

Medium and Small-Sized Enterprises: There are a large number of medium and small industrial and commercial enterprises throughout Cuba. Many of these are insolvent or uneconomical to operate due to obsolete equipment or technologies, need for expen-

74. Joseph M. Perry and Louis A. Woods, *Cuban Citrus Production in a Post-Transition Economy*, in CUBA IN TRANSITION: PAPERS AND PROCEEDINGS OF THE FIFTH ANNUAL MEETING OF THE ASSOCIATION FOR THE STUDY OF THE CUBAN ECONOMY 383, 384 (Aug. 1995) [hereinafter ASCE-5].

75. William A. Messina, Jr. *et al.*, *Cuba's Non-Sugar Agriculture: Current Situation and Prospects*, ASCE-6 at 17.

76. Perry and Woods, *supra* note 74, at 383-85.

77. *Id.*

78. The UBPCs in the citrus industry must still purchase inputs from the State and sell a portion of the harvest to SOEs or joint-venture. Messina *et al.*, *supra* note 75, at 18.

sive repairs, high production costs, and general inefficiency. Those enterprises proved to be uneconomical should be liquidated and their assets sold to the public or to foreign bidders.

The transition government, through a newly-created Privatization Agency (see below) should determine which medium-sized and small enterprises would likely be salable. Those could be offered for sale at public auctions. The auctions should be conducted following the Czech model, with an initial round open only to Cuban nationals, and a second round open to foreign investors as well as Cuban nationals if the first round fails to yield a satisfactory bid. The main problem to be encountered by Cuban nationals wishing to participate in these auctions will likely be the non-availability of credit to finance their acquisitions; a source of credit for such entrepreneurs should be established in advance of the auctions.

Enterprises Providing Public Services: There are a number of SOEs that provide essential public services: energy, bus and rail transportation, postal service, water supply, garbage collection and disposal, airports, ports, and the like. While each of these presents a different picture in terms of financial and physical condition, they bear in common the need to ensure that the services are provided reliably and at as low a cost as possible to the population. To ensure

this result, the transition government should concession out through competitive bidding the provision of these services to qualified foreign bidders.

Some of the enterprises—e.g., the power companies—may be amenable to a sale through a tender process. However, given the political sensitivity of turning ownership of public utilities to foreigners, the actual sale may need to be postponed by several years. In the meantime, the terms of the concession agreement should require the concession holder to make the necessary capital investment to upgrade, expand and modernize the facilities.⁷⁹

A Special Case—The Sugar Industry: Cuba's sugar industry has suffered a spectacular decline since the demise of the Soviet Union, a formerly reliable trading partner that supported Cuba's industry through favorable trading of oil for sugar.⁸⁰ The industry is significantly distressed, after a number of years of decreasing sugar cane production, deteriorating physical plant, and poor labor productivity. This has been true even after the conversion of state farms into UB-PCs.⁸¹ Cuba claims to seek foreign investment in its sugar industry, but has made no moves to privatize the basic components of the industry.⁸²

The establishment of cooperatives in the sugar plantations may allow the use of the same transitional

79. As part of the concession of public utilities and other enterprises providing public services, the transition government may enter into Build-Own-Operate-Transfer (BOOT) type arrangements with foreign investors. BOOT projects are typically government concessions for large projects (typically, infrastructure development projects) built and financed by the private sector. PRIVATIZATION AROUND THE WORLD, *supra* note 4 at 25. Under such a concession, the private investor operates the project long enough to recover its investment and obtain a return by charging user fees. At the end of the term, ownership and management of the enterprise are turned over to the government.. *Id.* Malaysia has implemented an aggressive BOOT program which has resulted in the construction of billions of dollars worth of projects, including highways and submarine pipelines. The government expects to build airports, free-trade zones, railway and road projects, and water supply and treatment facilities through BOOT concessions. Matthew L. Hensley & Edward P. White, *The Privatization Experience in Malaysia: Integrating Build-Own and Build-Operate-Transfer Techniques with the National Privatization Strategy*, 28 COL. J. OF WORLD. BUS. 71, 79 (1993).

80. Oscar Echevarría, *Cuba and the International Sugar Market*, ASCE-5 at 363, 364-65; CONFRONTING THE CRISIS, *supra* note 57, at 214-15.

81. *Havana Mum on Sugar Harvest Outcome*, CUBANEWS, June, 1997, at 2; *Descalabro en la Zafra*, CUBA NEGOCIOS, June 1997, at 2, 3; *Sugar Cooperatives in Deep Trouble*, CUBANEWS, May, 1997, at 8. Some recent estimates place the 1997 zafra at no more than 3.5 million tons. Roger Fontaine, *Cuba Begins to Slide Back Economically*, WASHINGTON TIMES, July 15, 1997 at A12.

82. Investment in sugar is still limited to the prefinancing of sugar crops and loans towards acquisition of fuel, fertilizers, herbicides, spare parts, and other inputs rather than the transfer of ownership or control of productive assets. See *Sugar Slump Blights Improving Cuban Economy*, REUTERS, Jul. 21, 1995; *Dutch ING Financing 20 Pct. of Cuban Sugar*, REUTERS, Apr. 4, 1995. However, some of this financing may be disappearing due to concerns over U.S. actions against foreign investors in Cuba. *ING Withdrawal May Involve Bank Acquisition*, CUBANEWS, September, 1996, at 3.

model for the sugar cane production as was discussed earlier with respect to the citrus industry. However, sugar—unlike citrus—is a highly processed product that requires significant industrial operations. The sugar mill portion of the industry will require massive capital investment to repair and upgrade existing facilities, provide modern harvesting and transportation equipment, and generally reduce production costs. These needs leave little choice but to sell the mills to foreign investors, either through private sales or auctions. The “capitalization” schemes used successfully in Bolivia, where part of the proceeds of the sale are earmarked for financing improvements in the SOE, may work well in the case of Cuban sugar mills. The state may decide to “package” several facilities to be sold jointly to improve marketability, and may need to sell some of the plantations together with the mills. Whatever the means, the sale of the sugar industry components to the private sector should occur quickly, since the state is unlikely to have the means to undertake the complete overhaul that the industry requires.

LEGAL FOUNDATIONS OF CUBA’S PRIVATIZATION PROGRAM

Whatever methods are chosen for carrying out Cuba’s privatization program, their success will require the existence and effective administration of four types of laws and attendant regulations: (1) laws, like the Constitution, providing the fundamental legal underpinnings for the program; (2) laws governing the conduct of the program itself; (3) laws on subject areas which either relate to privatization (e.g., foreign investment) or which would be important to private parties participating in the privatization of SOEs (e.g., bankruptcy); and (4) laws whose application could result in financial benefits or penalties for a

party acquiring an interest in a privatized SOE (e.g., environmental laws). We will discuss each of these categories of laws separately.

Laws Providing Fundamental Support for Privatization

Constitutional Law Provisions: Some countries have included in their constitutions a requirement that the state retain ownership of certain areas of the economy, such as mineral rights. A privatization program in those countries will necessarily be limited in scope and may be less likely to succeed than those in countries with no limitations on the sectors open to privatization.⁸³ Since the constitution generally determines the scope of private sector participation in the economy, Cuba’s Constitution should explicitly declare the economy to be open for private investment, and impose few (if any) restrictions on the types of state-owned enterprises eligible for privatization.⁸⁴ In addition, the Constitution will need to expressly authorize the privatization of SOEs and the conveyance of state-owned property to the private sector.⁸⁵

Property Rights Laws: Clearly defined property rights are the foundation of free-market economies and provide an incentive for foreign and domestic investment in privatized enterprises.⁸⁶ The existence of well-defined property rights is also a pre-condition to the establishment of a system of enforceable contractual relationships.⁸⁷ Well defined property rights are also critical for the privatization process itself, because in order for an SOE to be sold, leased, concessioned, or even given away, the bundle of property rights associated with the property must be defined and parsed out. Property rights should also be enforceable through an effective dispute resolution system.⁸⁸

83. Martínez, *supra* note 25, at 497.

84. LAWS AND LEGAL INSTITUTIONS, *supra* note 9, at 407-408.

85. As noted earlier, Cuba’s current Constitution prohibits the transfer of title of state-owned property to private parties. 1992 CONSTITUTION, *supra* note 3, art. 15.

86. See Michele Balfour & Cameron Crise, *A Privatization Test: The Czech Republic, Slovakia and Poland*, 17 *FORDHAM INT’L L.J.* 84, 87-88 (1993).

87. Paul H. Brietzke, *Designing the Legal Frameworks for Markets in Eastern Europe*, 7 *TRANSNAT’L LAW* 35 (1994).

88. LEGAL ASPECTS OF PRIVATIZATION, *supra* note 15, at 15.

In particular, establishing adequate property rights to real estate is critical to privatization:⁸⁹ without such rights, private ownership of agricultural land cannot be implemented, urban land cannot be transferred, and any type of transaction involving land cannot be consummated.⁹⁰

Enforceable intellectual property rights will also have to be established in order to disperse through the private sector the property rights now vested in the state. Cuba should, therefore, quickly accede to international conventions on intellectual property rights, or adopt interim laws based on internationally-recognized standards, before it initiates the privatization process.⁹¹

Another set of laws affecting property, contract laws, are essential to a successful privatization program.⁹² Some of the elements of contract laws that are crucial to privatization include: rules to determine when a contract has come into existence; and what type of contract it is; rules to determine when a breach of the contract has occurred; rules for the establishment and dispensation of remedies; rules to determine the measure of damages; and rules regarding the validity of certain types of clauses or contracts.⁹³

Laws Governing the Resolution of Expropriation Claims: One of the legal problems that needs to be addressed by Cuba as a condition to a successful

privatization program is the resolution of outstanding property expropriation claims. As noted above, Cuba has outstanding expropriation claims by many hundreds of thousands of its nationals, both in the island and abroad, as well as claims by almost six thousand U.S. nationals whose assets in Cuba were expropriated without compensation during the early years of the Revolution.⁹⁴ It is imperative to establish a framework for the resolution of these claims before the privatization process gets fully under way.⁹⁵

Procedures to resolve conflicts between owners of privatized enterprises and expropriation claimants will also have to be established. Germany provided a straightforward solution: successful claims against already privatized property did not result in restitution, but entitled the claimant to compensation from the government.⁹⁶ This method, however, may only be feasible to the extent funds can be made to finance such a compensation program, or if alternative compensation methods acceptable to the claimants are provided.

Whatever methods and procedures are used, they must set a firm deadline for raising expropriation claims; any claims raised after the deadline would be disallowed, and the property would remain in the hands of the new owner.⁹⁷ Although imposing deadlines may leave some expropriation claimants with-

89. A dependable property registry must be established from the outset, since it is a necessary component of a system where land is alienable. See CHERYL W. GRAY, WORLD BANK DISCUSSION PAPERS VOL. 209, EVOLVING LEGAL FRAMEWORKS FOR PRIVATE SECTOR DEVELOPMENT IN CENTRAL AND EASTERN EUROPE 5 (JULY 1993) [hereinafter EVOLVING LEGAL FRAMEWORKS].

90. VAN BRABANT, *supra* note 4, at 218.

91. The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs Agreement) of the Uruguay Round of the GATT may provide an adequate model for Cuban interim intellectual property laws. The TRIPs Agreement establishes minimum standards for the protection of patents, trademarks and copyrights, although several important aspects of intellectual property are not addressed. Tara Kalagher Giunta & Lily H. Shang, *Ownership of Information in a Global Economy*, 27 GW INT'L L. & ECON. 327, 336-338 (1993-1994).

92. Balfour & Crise, *supra* note 86, at 88-89; LEGAL ASPECTS OF PRIVATIZATION, *supra* note 15, at 23.

93. *Id.*

94. See note 8, *supra*, and associated text.

95. Stanley Fischer, *Privatization in East European Transformation*, in THE EMERGENCE OF MARKET ECONOMICS IN EASTERN EUROPE 230-231 (Christopher Clague & Gordon C. Rausser, eds., 1994). *Id.*

96. *Germany: Why Unification Has Made the Road to Economic Integration Difficult*, EUROMONEY SUPPLEMENT, July 7, 1991 (no page citation available).

97. See LEGAL ASPECTS OF PRIVATIZATION, *supra* note 15 at 18.

out remedy, it avoids holding the privatization program hostage to conflicting property claims.

Laws Governing the Privatization Process

Laws Permitting the Preparation of SOEs for Privatization: Before an SOE can be privatized, its legal status must be changed from public to private and its affairs must be set in order.⁹⁸ Typically, this process requires the transforming the enterprise into a state-owned corporation;⁹⁹ legislation must be enacted to permit such a change. The enterprise's pending litigation, administrative or judicial proceedings, and other liabilities should be settled or assumed by the state, so investors will not be deterred by potential liabilities.¹⁰⁰ Other legislation dealing with the specific problems of an enterprise or industry sector (e.g., telecommunications) may also need to be enacted.

Enterprise Transformation Laws: Transformation laws are the rules governing the privatization of SOEs. They define the types of enterprises eligible for privatization, identify which parties can initiate a privatization, establish the procedures by which privatization can take place, and nominate the agencies responsible for overseeing the privatization processes.¹⁰¹ The countries that have not formalized these matters in a law generally have not had successful privatization programs.¹⁰²

Power to Initiate Privatization: The transformation laws must define who has the power to initiate the privatization of an SOE. In Poland, the Privatization Law allowed the Minister of Privatization to "transform the enterprise upon the joint request of the managing director and the worker's council" (after consultation with a general assembly of all employees).¹⁰³ Under this system, the employees maintained an effective veto power which often blunted the privatization efforts.¹⁰⁴

The negative Polish experience provides an important lesson. Employees or managers of SOEs should not be given the right to initiate privatization, or have express or effective vetoes over the disposition of the enterprises.

Likewise, transformation laws that allow the "spontaneous" privatization of SOEs, such as those enacted in Hungary, should be avoided.¹⁰⁵ "Spontaneous" privatization transfers de facto ownership of the enterprise to the current managers, which often means simply changing the name of the state-owned enterprise, rather than carrying out a true change in organization.¹⁰⁶ Transformation laws that permit spontaneous privatizations often also create business environments ripe for fraud, or at least questionable transactions involving the newly privatized enterpris-

98. Martínez, *supra* note 25, at 488.

99. Paul Marer, *Transformation of a centrally-directed economy: ownership and privatization in Hungary during 1990*, in *PRIVATIZATION AND ENTREPRENEURSHIP IN POST-SOCIALIST COUNTRIES* 179 (Dallago et al., eds. 1992).

100. Martínez, *supra* note 25, at 488.

101. See *PRIVATIZATION AROUND THE WORLD*, *supra* note 2, at 49.

102. *Id.*

103. *PRIVATIZATION IN CENTRAL EUROPE*, *supra* note 40, at 204.

104. *Id.* The enterprise's employees and other interested parties often had to be, in effect, bribed by the Polish government to agree to privatization. The Polish government offered them, among other inducement, preferential sales of shares in the newly privatized companies, exemptions from certain taxes, and reductions on excess wage taxes. *Id.* Another privatization method, conceived as an exceptional measure, allowed the Prime Minister to initiate the transformation without consent from the managing director, employees or other interested parties, although the Privatization Minister had to solicit their opinion. *Id.*

105. Hungary is not the only country that experienced spontaneous privatizations. Spontaneous privatizations have also been recorded in Russia and Ukraine. Simon Johnson, Heidi Kroll & Santiago Eder, *Strategy, Structure, and Spontaneous Privatization in Russia and Ukraine*, in *CHANGING POLITICAL ECONOMIES: PRIVATIZATION IN POST-COMMUNIST AND REFORMING COMMUNIST STATES* (Vedat Milor, ed., 1994).

106. In Hungary's "spontaneous" privatizations, the existing managers gained control of the enterprise and continued the old ways of doing business. Michael Mandelbaum, *Introduction*, in *MAKING MARKETS: ECONOMIC TRANSFORMATION IN EASTERN EUROPE AND POST-SOVIET STATES* 180-182 (Shafiqul Islam & Michael Mandelbaum, eds. 1993).

es.¹⁰⁷ In addition, managers turned into owners are also more likely to strip the enterprise of its assets.¹⁰⁸

The most common, and probably most efficient, way to transform Cuba's state-owned enterprises is to keep the state as interim owner of the enterprise until the privatization has been accomplished through one of the methods described earlier. There are several good reasons for having the state remain in control. First, the state may be able to preserve the enterprise as a going concern, rather than allowing its assets to be "stripped" for short-term gain.¹⁰⁹ Second, the state may have to retain ownership of some enterprises to fulfill its governmental functions.¹¹⁰ Finally, and probably most importantly, the state, as interim owner, can more easily settle the enterprise's outstanding obligations and make it ready for privatization.¹¹¹

Responsible Agency: Transformation laws often nominate a body (ministry or independent government agency) to be responsible for the implementation of the privatization program.¹¹² The policy-making and implementation functions of such an agency should be separated to assure that the privatization program does not get bogged down in political debate, and to avoid corruption and the misuse of political influence.¹¹³

Following the examples in Poland, Eastern Germany and elsewhere, an independent governmental body ("Privatization Agency") should be established in Cuba to implement the privatization program and

supervise its day-to-day operation. The functions of the Privatization Agency include:

- Guiding the transformation of state-owned enterprises into private ones.
- Retaining consultants and determining the best privatization methods.
- Obtaining independent valuations of the enterprises to be privatized and marketing the eligible enterprises to suitable prospective buyers.
- Initiating and following through the tendering process in those instances in which the SOE is to be sold through competitive bidding.
- Selling some enterprises (usually small concerns) through auctions or other mechanisms.¹¹⁴

Privatization Rules: In addition to establishing the Privatization Agency and defining its functions, the transformation law must set out the rules that will govern the privatization process. One of the key concepts that must be implemented through these rules is that of "transparency". A high degree of transparency deflects any suspicions that could build up and impede progress in privatization.¹¹⁵

Other Provisions of Transformation Law: Other basic features of the transformation law include:

- Provisions that authorize the government to sell the SOEs or dispose of their assets, assume their

107. In Hungary, the managers of spontaneously privatized enterprises used them as captive customers or suppliers for companies they had set up on the side. Another practice was to sell the enterprise at below market prices in exchange for job security and job-related financial considerations. *Id.* at 181-182.

108. See Eva Voszka, *Spontaneous Privatization in Hungary*, in *PRIVATIZATION IN THE TRANSITION TO A MARKET ECONOMY* 97 (John S. Earle et al, eds., 1993).

109. Ronald Daniels & Robert Howse, *Reforming the Reform Process: A Critique of Proposals for Privatization in Central and Eastern Europe*, 25 N.Y.U. J. INT'L L. & POL. 27, 37 (1992).

110. *Id.*

111. *Id.*

112. LEGAL ASPECTS OF PRIVATIZATION, *supra* note 15, at 32.

113. Phillips & Dent, *supra* note 2, at 490-91.

114. LEGAL ASPECTS OF PRIVATIZATION, *supra* note 15, at 33.

115. V.V. Ramanadham, *The Monitoring and Regulatory Aspects of Privatization*, in *PRIVATIZATION AND AFTER* 11 (V.V. Ramanadham, ed., 1994) [hereinafter *PRIVATIZATION AND AFTER*].

liabilities, and apply the proceeds to state needs (e.g., external debt reduction)

- Provisions that grant the state the power to give warranties or indemnities to purchasers of SOEs.
- Provisions to ensure that accounting standards are adhered to and that there is a tendering or bidding process.¹¹⁶

Laws to Regulate Newly Privatized Enterprises:

Once state-owned enterprises are privatized, new laws and regulations will have to be drawn to regulate the areas of the economy controlled by the private sector. Post-privatization regulation of the private sector should not be excessive; overregulation could, if carried to extremes, virtually expropriate again the privatized enterprises.¹¹⁷ Care must be taken in drafting the regulations affecting newly privatized sectors of the economy to avoid placing unfair and stifling requirements which may affect the viability of the enterprises and the competitiveness of the economy as a whole.

Other Laws Indirectly Supporting A Privatization Program

Business Organization and Governance Laws: Cuba needs to enact a Companies Law (perhaps as a part of an updated Commercial Code) that authorizes the formation of the types of companies that are likely to result from privatization (i.e. corporations). Cuba could use as a model for this purpose the business organization forms used in Latin America, which are also similar to those used in the United States.¹¹⁸

Special provisions regarding business governance in the context of privatization will need be included in Cuba's Companies Law. The provisions include those granting voting rights or seats on the board of directors to employees participating in the privatization of the company, establishing "special" shares giving veto power to the government, regulating the exercise of such veto power, and defining the governance regime after the enterprise becomes part of the private sector.¹¹⁹ It will also be important to provide for the separation of ownership and control in publicly held corporations, and the prevention of oppressive conduct by some owners against others in closely-held corporations and other forms of business associations.¹²⁰ The Companies Law should also deal with subjects such as voting rights, voting agreements, allocation of power between shareholders and directors and other corporate governance rules.¹²¹

Securities Laws: The privatization program may eventually contribute to the development of a securities market in Cuba, once the market is established.¹²² At that time, the government could give a boost to the stock market by placing shares of privatized companies in the market.¹²³ The market could also provide an "exit route" for foreign investors who wish to sell the shares they acquired in the privatization program.¹²⁴ The creation of a securities market and entities to supervise it would be a necessity if the privatization program includes the distribution of SOE shares to the citizenry, as has occurred in Cen-

116. Zeljko Bogetic, *Is There a Case for Employee Ownership?* in *THE TRANSITION FROM SOCIALISM IN EASTERN EUROPE* 88 (Arye L. Hillman & Branko Milanovic, eds. 1992).

117. This is known as "creeping expropriation," a process in which there are regulatory measures that have the effect of impairing the economic viability of an enterprise. ALAN C. SWAN & JOHN F. MURPHY, *CASES AND MATERIALS ON THE REGULATION OF INTERNATIONAL BUSINESS AND ECONOMIC RELATIONS* 785-787 (1991).

118. *Id.*

119. *EVOLVING LEGAL FRAMEWORKS*, *supra* note 89, at 7.

120. *See* LARRY E. RIBSTEIN, *BUSINESS ASSOCIATIONS* 103 (1990).

121. *Id.* at 103-169.

122. *See* Balfour & Crise, *supra* note 86, at 90.

123. Martínez, *supra* note 25, at 490.

124. *See* *LEGAL ASPECTS OF PRIVATIZATION*, *supra* note 15, at 24.

tral and Eastern Europe.¹²⁵ Before such a market is developed in Cuba, however, securities laws must be issued regulating the operation of the market and protecting the rights of market participants.

Competition Laws: Competition laws will be necessary to remove the barriers to entry imposed by the existence of monopolistic or oligopolistic SOEs. To do so, however, it is important to establish competition laws early in the game to prevent anticompetitive behavior to arise.

The competition laws should address the problems of monopolies, trade restraints and restrictive business practices created by privatized enterprises, and should contain provisions that:

- Allow the government to implement measures to avoid the abuse of monopoly power.
- Regulate the merger of enterprises, to prevent the creation of enterprises with market dominance.
- Regulate agreements by enterprises that fix prices or divide markets either by product or geographically.
- Regulate anti-competitive provisions in agreements to prevent undue influence over weaker competitors by stronger ones.¹²⁶

Bankruptcy Laws: Bankruptcy and bankruptcy procedures in centrally-planned economies such as Cuba's do not exist, since the state prevents companies from becoming bankrupt.¹²⁷ Once the privatization process commences, however, bankruptcy laws will be necessary to deal with insolvent enterprises, and to provide an orderly process for paying creditors out of

the remaining assets of the enterprises.¹²⁸ In addition, the bankruptcy laws must provide mechanisms for closing inefficient state-owned enterprises and restructuring enterprises with potential for recovery.¹²⁹

Foreign Investment Laws: Cuba's privatization program should be wide open to foreign investors. For the reasons discussed above, suitable laws to promote and regulate foreign investment must be enacted in Cuba. One important aspect of foreign investment laws directly related to foreign investment in privatized SOEs is the existence of international commitments to protect and promote foreign investments. These international commitments include Bilateral Investment Treaties, accession to multilateral conventions such as MIGA and ICSID, and membership in regional conventions.

Dispute Resolution: An impartial and effective judiciary is essential to the success of the privatization program, especially with regard to foreign investment. Foreign investors are less likely to participate in the privatization program if they are not confident that the courts will enforce their rights, enforce contractual agreements, and give effect to foreign judgments.¹³⁰ The dispute resolution process is itself amenable to privatization. Private means (such as arbitration) for the resolution of commercial disputes may be an effective alternative to traditional dispute resolution mechanisms, such as the courts.¹³¹ This is particularly true if the courts lack experience with the complex issues that arise from the privatization of SOEs.

Labor Laws: In the context of privatization, the labor laws must include provisions to address the following:

125. See OECD, MASS PRIVATIZATION: AN INITIAL ASSESSMENT 24 (1995). The distribution of shares to the citizenry is usually associated with voucher privatization schemes, which were carried out in the former Czechoslovakia, Lithuania, Mongolia, and Russia, among others. *Id.* at 18.

126. LEGAL ASPECTS OF PRIVATIZATION, *supra* note 15, at 28.

127. LEGAL ASPECTS OF PRIVATIZATION, *supra* note 15, at 24.

128. *Id.*

129. EVOLVING LEGAL FRAMEWORKS, *supra* note 89, at 11.

130. Martínez, *supra* note 25, at 486.

131. EVOLVING LEGAL FRAMEWORKS, *supra* note 89, at 15.

- Occupational health and safety (minimum standards)
- Compensation for loss of employment (contractual damages or statutory provisions)
- The transfer of employees of the former state-owned enterprises to the newly privatized companies. Provisions must be included to determine which employees will be transferred to the newly privatized enterprise and who will pay compensation to those employees who lose their jobs. This is important because foreign investors are less likely to invest in enterprises that inherit a bloated work force
- The power and structure of labor unions
- The creation and maintenance of pension plans and tax regimes that make them attractive to employers and employees.¹³²

The right balance between employer's and employee's rights and obligations will be a critical component of the privatization program. If the labor laws tilt too far in favor of the employees, investors, particularly foreign investors, will be hesitant to invest in privatizing companies with expensive labor benefits, hurting the privatization program as a whole. The German "social market economy," for example, with laws that provide for short work weeks, strong labor unions, high severance payments, worker participation in important management decisions, generous worker benefits and high capital gains taxes, scared some U.S. investors away from privatized East German enterprises.¹³³

Tax Laws: The privatization of SOEs also requires the existence of a comprehensive Tax Code that addresses both any unique treatment of newly privatized enterprises and accommodates increased private participation in the economy. One aspect of taxation requiring serious attention is the avoidance of double taxation of foreign investors, which if occurring could adversely affect the privatization program.¹³⁴ Elimination of double taxation should be a legislative priority for a government considering the privatization of its SOEs.

Environmental Laws: One of the most serious obstacles encountered in the Eastern European privatization programs were the huge environmental liabilities accrued by the state-owned enterprises.¹³⁵ These liabilities complicated the privatization of state-owned enterprises in Europe, often blocking the sale of SOEs.¹³⁶ In particular, the environmental liabilities often hindered foreign investment in these enterprises.¹³⁷

Absent a massive infusion of foreign economic assistance for this purpose, Cuba will have to adopt a legal framework during the privatization process that shifts the cost of cleaning up contaminated SOEs to those who acquire them. The drawback of such a system is, obviously, the potential to discourage investment in the privatization of SOEs. The government, however, may consider a cap on the extent of liabilities. This middle-of-the-road approach recognizes the limited resources and limited options available in the resolution of this issue.

Whatever method is chosen, the applicable legislation should clearly define what the liabilities consist

132. LEGAL ASPECTS OF PRIVATIZATION, *supra* note 15, at 29.

133. Anthony Gardner, *Why So Timid in Eastern Germany?*, N.Y. TIMES, March 8, 1992, at 13.

134. LEGAL ASPECTS OF PRIVATIZATION, *supra* note 15, at 27-28.

135. Randall S. Thomas, *The Impact of Environmental Liabilities on Privatization in Central and Eastern Europe*, 28 U.C. DAVIS L. REV. 165, 167 (1994).

136. Francis S. Kiefer, *Air Clears Up in Eastern Germany*, THE CHRISTIAN SCIENCE MONITOR, March 19, 1992, at 12.

137. Sam Loewenberg, *Pollution Often Part of Package Deal with Eastern Block Firms*, L.A. TIMES, August 28, 1994, at D3. The absence of environmental regulation in the former communist states resulted in the production of extreme amounts of pollution by inefficient state-owned enterprises. Foreign investors in former state-owned enterprises usually do not discover the extent of the environmental hazards associated with the assets they have purchased until after they have purchased them. *Id.*

of and the what the standards of environmental quality are. These guidelines should define the environmental obligations of SOEs and the steps investors have to take to achieve compliance with environmental regulations.

CONCLUSIONS

There is no single or preferred recipe for privatizing Cuba's SOEs. It is not even necessary in every case that ownership pass at once from the state to a private party: interim devices such as management contracts, leases, and concessions can be used to bridge the gap between state and private ownership and allow the state time to better prepare itself for the eventual divestiture of the enterprise.

Several important policy decisions must be made, however, at the outset of Cuba's privatization program. These include, for example, whether managers and employees of SOEs will be allowed to acquire significant interests in the enterprises. If managers and employees become majority (or even significant minority) shareholders in an enterprise, sale of the enterprise to private parties may become difficult or impossible.

Another important decision is whether the state wishes to maximize hard currency receipts from the disposition of SOEs, which would point to the sale of

all or part of most enterprises to foreign nationals. On the other hand, to the extent that the state wants to maximize enterprise ownership by Cuban nationals, stock issuances to the public, "voucher" privatizations, or auctions from which foreigners are excluded would be appropriate.

Still another key decision will be whether the state will proceed as quickly as possible with the privatization process or whether it will seek to minimize the short-term effects on the work force by keeping in state hands as long as possible enterprises that should be liquidated as economically not viable, or whose transfer to the private sector would likely entail massive layoffs of personnel. Related to this decision is that of building sufficient to popular support for the privatization program to make it politically viable. This may require time.

Equally important will be the enactment of legislation that shapes the privatization process or bolsters it indirectly by creating the necessary legal infrastructure. Privatization touches on, and is affected by, many areas of the law. Accordingly, for Cuba's privatization program to succeed, it must be accompanied by comprehensive legal reforms that propel the country into a modern, free-market system of laws.