



Environmental Liability in Transition

A Look at the Record in Hungary

by *Maria Csanádi and Ruth Greenspan Bell*

The records of privatization in a former communist country offer a rare glimpse at how environmental liability fits into the puzzle of moving toward a market economy.

When the Soviet Bloc crumbled almost ten years ago, countries in Central and Eastern Europe resolved to transfer into private hands property that had been under state control for forty-five years. Privatizing many thousands of industrial enterprises was complicated by a legacy of environmental neglect, sometimes predating communist times. The privatization process came to be entangled in questions about responsibility for environmental liability.

If such questions were new to privatization officials in what were once collective economies, they were routine to prospective buyers from the West. Years of experience with the Superfund regime in the United States caused them to worry about paying for past pollution; they were hardly reassured by the lack of clear liability principles in the former Soviet Bloc countries.

The transition to market-based economies has been going on for some time now. Nevertheless, little is known about how these countries have responded to investors anxious about how much liability might come with the facilities they purchased. Our ignorance about this issue is partly a consequence of government secrecy, but investors, too, have been reluctant to share specifics. As a result, whatever information is available has been largely anecdotal.

This article reports on one of the first opportunities to review the written records of a governmental entity responsible for privatization, in this case what is referred to here for simplicity's sake as Hungary's state property agency (SPA). The records reflect privatization activities between 1990 and 1998. Co-author Maria Csanádi traced how Hungary's SPA, with little law or experience to guide it, evolved in its management of contamination issues in privatization transactions. For Hungary, like many of its neighbors, did not have laws on compensation for the restoration of environmentally damaged industrial sites, should remediation be required; nor did it have soil cleanup standards. At the same time, however, Hungary's Civil Code, written long before site contamination became an issue, broadly provides that a purchaser acquires property with all rights and duties pertaining to it.

The Records Reviewed

The Hungarian government made available for examination twenty-six hundred contracts memorializing privatization transactions. The transactions selected for study were those officially registered as having environmental aspects. In seventy-nine cases, the contracts clearly indicated SPA commitments to shoulder in some

way the cost of cleaning up contamination at the sites purchased. Another sixty-eight contracts set out similar commitments by the purchasers. However, many of the records examined were incomplete or contained inconsistent information, suggesting some caution in analyzing results. Whether these shortcomings were a result of the speed with which a transaction was conducted, sloppiness, or more fundamental problems (such as falsification of data) could not be determined.

In addition, privatized properties were not routinely subjected to environmental audits. Thus, it is impossible to verify, for example, whether the 147 transactions were the only ones that involved environmentally contaminated properties; in fact, it seems unlikely that they were. As in Poland, another country with an active privatization program, the issue of contamination was probably ignored unless raised by a purchaser. It is a safe assumption that numerous contaminated properties were transferred to domestic buyers without any consideration of environmental liability. Potential liability was a concern principally of prospective Western European and North American buyers, although not among all of them. Among the purchasers that did not express concern, some may have hoped to benefit in the short term precisely because of the uncertain legal environment.

Sophistication in Three Stages

The records suggest that SPA treatment of environmental liability in the privatization process grew progressively more sophisticated as it developed in roughly three stages. As privatization began, Hungary developed its first laws to govern management of the process. But these laws did not address potential responsibility for onsite contamination. Officials acting on behalf of the state had little guidance on how to negotiate such issues.

A transaction involving the purchase of the Hungarian refrigerator manufacturer Lehel is an example of what occurred in this early period. Without specified cleanup standards, the SPA agreed to cover the cost of cleanup at the site, up to the total purchase price. When a post-purchase audit revealed significant site contamination, the record indicates that the purchaser responded by making only the first of two installments toward the purchase price. The buyer diverted the balance it owed to finance cleanup, and continues to bill the SPA for cleanup costs to this day.

In what might be considered the second stage of privatization, between 1992 and 1995, investors began to demand environmental guarantees. In some cases, purchasers sought blanket assurances of exemption from the costs of any future cleanup requirements. Or, they negotiated for discounted purchase prices to compensate for projected costs. In response, Hungary began to establish policies and laws, but the process of considering environmental contamination remained irregular at best. The SPA had not worked out consistent ways of obtaining site information from the Environment Ministry and the local environmental offices. Even when environmental obligations were placed in contracts, the SPA did not routinely communicate this information to the local agencies, which might have been able to track compliance.

In the third stage that began after 1995, Hungary developed laws with explicit provisions governing how environmental liability was to be handled in privatization. And by then the SPA had had time to develop institutional expertise (and was partly obliged by government order) to manage liability issues as part of the privatization process. As its understanding of the issue grew, the SPA also developed internal regulations to guide environmental negotiations. The percentage of a purchase price that the SPA would commit to cleanup fell from 100 percent to the 10- to 25-percent range, and a buyer had a limited time in which to claim it, usually three to five years.

Audits Avoided

At the outset, Hungarian officials resisted involving environmental experts in the privatization process because they feared their input would slow or divert transactions, an approach that also characterized the early period of privatization in Poland. Eventually, however, the government included such experts on its transaction teams. This integration of environmental considerations into the privatization process should not, however, suggest that the SPA embraced its environmental responsibilities enthusiastically. The environmental experts were never made full members of the privatization team and were excluded from upper-level decisionmaking.

Nor did the SPA make consistent efforts to learn about site contamination. The review of the records indicates that the SPA commissioned pre-negotiation environmental audits in only a fraction of the transac-

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tions examined. Early in the process of privatization, audits were simply an unfamiliar tool for privatization officials; officials feared highlighting problems with the properties they were trying to sell and thereby weakening Hungary's negotiating position.

Over time, officials learned the utility of understanding site conditions, so as to be able, for example, to dispute sometimes extravagant purchaser claims of contamination. However, the closest Hungary came to mandating environmental audits was in the 1995 environment and privatization laws, which required a company or local environmental agency to report onsite conditions in the context of a real estate analysis prepared for privatization.

The SPA viewed environmental audits as costly and in conflict with other pressing objectives. The SPA's goal was to maximize proceeds from privatization as quickly as possible, and to minimize its own costs in the process. The environment was a secondary concern at best. In what might be characterized as a "Wild West" atmosphere, SPA employees were working under enormous pressure to complete transactions. On-the-job training matched them against some purchasers with much greater understanding of the issues. Documentation was poor, process controls were few,

and staff frequently had to make ad hoc decisions based on their limited experience, as did their supervisors and managers. Some transactions may have been tainted by outright corruption.

Perhaps the most significant effort the SPA made to understand the extent of the problem was a 1996 survey that the agency director commissioned of hazardous environmental contamination at the enterprises in which SPA still owned 50 percent or more of the shares. The survey relied on information provided by the enterprises themselves.

However, the review of the records showed that, for whatever reason, SPA made many commitments without audits. Of the seventy-nine contracts reviewed in which the SPA made some commitment to pay for cleanup, only about one-third involved an SPA-requested audit of the sites. The records do not show whether purchasers conducted their own environmental audits, how many of these were done, and how they affected negotiations. However, officials interviewed indicated their belief that large multinational purchasers routinely ordered audits, which supported cleanup costs on the high end. This belief alone raises questions as to why the SPA did not prepare itself better for negotiations with more audits.

Guarantees Take Shape

Where environmental liability was addressed in the course of a transaction, the records indicate that the SPA took several approaches to facilitate transfers. In some instances, the state simply sold the clean parts of a physical plant or company and retained the polluted parts. In at least one case, the agency arranged for hazardous waste from the privatized site to be removed and trucked to a part of the property excluded from the purchase. The state retained responsibility for the part of the property with the relocated waste, which was placed in bankruptcy.

The state also offered financial guarantees, as it did in the case of the Lehel purchase cited earlier and in the energy sector. The guarantees usually earmarked portions of the proceeds from the sale of property. The designated funds could then be drawn down to cover the costs of cleaning up contamination onsite at the time the purchase contract was signed and for which the SPA had not contractually avoided responsibility. The SPA called such arrangements "undisclosed liabilities."

“First phase” privatization in the energy sector illustrates the government’s growing savvy. Having assessed the strength of its position in discussions with potential investors, the state was able to contract on favorable terms. The SPA agreed, for example, to cover a maximum of 10 percent of the purchase price for cleanup at gas company sites and 25 percent at electricity company sites. The agency also established tough criteria for drawing on guarantees. For example, the new owner of a firm had to prove a decrease in the value of share prices entirely related to environmental contamination. In addition, the new owner was allowed only three years to identify contamination and work out an environmental cleanup plan. The process of drawing on the state guarantees was made particularly difficult by a requirement at each step for approvals from the local environmental authority and/or the SPA’s environmental expert.

Other process and financial controls included requirements off and on from 1993 that the country’s Environmental Ministry be consulted before privatization officials made guarantees worth more than 100 million Hungarian forints (roughly \$480,000 in 1998 dollars). By the second phase of privatization in the energy sector (1996–98), local authorities, the SPA, and the Finance Ministry all had to approve cleanup investments.

The State Cleans Up

Guarantees generated concern in the Hungarian government that cleanup commitments would drain profits from privatization. The growing oversight and limitations placed on guarantees reflect the SPA’s response to that concern. In fact, however, it appears that guarantees were rarely given and that guarantees supporting cleanup were rarely exploited. In the period studied, environmental guarantees amounted to about 74 billion forints. For purposes of comparison, total Hungarian proceeds from privatization through 1996 was 1,070 billion forints. Thus, roughly 7 percent of the proceeds from privatization were vulnerable to claims for cleanup.

More than 80 percent of these guarantees have now expired and it is possible to draw some modest conclusions. Despite investor concerns expressed in the course of privatization transactions, they ended up claiming only about 4.1 percent (3.1 billion forints) of

the funds earmarked for site cleanup, roughly three-tenths of 1 percent of total privatization proceeds. The relatively low claims disprove the general fear of the government and privatization experts that state property agents overcommitted themselves when they agreed to establish guarantees. The records do not reveal why so few purchasers used the guarantees to fund site cleanup. There have also been exceptions to the government’s general reluctance to pay for cleanup, such as a recent decision to allocate a portion of revenues from the sale of the “clean” part of a company to pay for remediation of the polluted part that the government retains.

In retrospect, guarantees and the other devices that Hungary used apparently helped the SPA close deals. In most cases, the solutions designed to respond to environmental liability were not costly to the government, at least in terms of having to draw down proceeds from privatization. It is unknown whether information about site conditions or alternate negotiating strategies might have improved the price Hungary received in some transactions or whether stronger bargains might have been struck. In some instances, Hungary appeared to be taking chances with guarantees that committed the state to support cleanup in the absence of site-specific information at the time of contract negotiation.

What the records do not tell us is also revealing. They do not, for example, tell us the status of contaminated sites now in private hands, or whether contamination poses environmental or health problems at those locations no longer under government control. The contracts reflect power relations between seller and buyers, more than they do any considered, deliberate environmental strategy. To the extent that this approach has deferred cleanup into the future, environmental liability may come home to roost as unfinished business, if the European Union membership to which Hungary aspires demands the eventual cleanup of contaminated sites.

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