Management Contracts
Main Features and Design Issues

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Management Contracts
Main Features and Design Issues
This series is produced by the Industry Department of the World Bank to disseminate ongoing work and stimulate further discussion. The series will include studies of individual sectors in industry, aspects of world industry, industrial strategy and policy, and industrial finance and financial development. Already published are the following:

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Management effectiveness is widely recognized as a critical factor in determining the performance of enterprises. Many enterprise owners, whether individuals, private companies or public enterprises, lack the necessary management skills and technical resources to manage their businesses efficiently and effectively.

The management contract offers a vehicle by which an integrated package of management skills, technical and other resources can be acquired from one source by the enterprise owner. Ownership is retained but management control is effectively vested in an external manager or management company possessing the specialized skills required by the owner. Over an agreed period of time, well-defined business objectives can be achieved by this injection of external management skills and the enterprise enabled to develop a sound internal management base for the future.

The purpose of this paper is to familiarize operational staff in the World Bank with the main features of management contracts and the design issues common to such contracts whatever the sector. While sector-specific issues are important, the cross-sectoral issues addressed in this paper tend to be universal in character and are of fundamental importance to the successful development and implementation of management contracts. The paper draws upon a review of 40 contracts from diverse sources and sectors, discussions with individuals and enterprises familiar with the workings of management contracts, and the limited writings available on the subject.

Management contracts have become an increasingly common feature of international business in the past 25 years in both industrialized and developing countries. These contracts have their widest application in business operations which are relatively simple or can be easily duplicated. They are most common in the hotel industry and reasonably well known in health care, agriculture, transportation, certain service industries and industrial operations such as cement, breweries and textiles. They have also been used (but less frequently and with mixed results) in large and complex natural resource projects and manufacturing operations such as steel, integrated textile mills, fertilizers and chemicals.

Four factors are vital to the success of a management contract: (i) there must be a supportive external policy environment; (ii) the business must be, or have the potential to become, viable; (iii) the owner of the enterprise must be convinced that the management contract route is the best alternative and must fully support it; and (iv) the owner must give the manager sufficient control and authority to manage the enterprise to achieve the objectives of the contract. The absence of any one of these factors makes the chances of success under a management contract remote.

Management contracts are but one option available to enterprise owners to remedy management-related problems. However, their wider application in the public and private sectors of developing countries has significant potential if their strengths and limitations are properly understood and if the design and business issues inherent in the management contract concept are realistically addressed by the parties.
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CHAPTER 1

INTRODUCTION AND SUMMARY

This Chapter provides an introduction to and summary of the main features and design issues related to the effective use of management contracts. Chapter II discusses their nature, the parties involved and distinguishes them from other contract forms. Chapter III examines why and when they may be used and their benefits and drawbacks. Sector-specific highlights are provided in Chapter IV. Chapter V looks at the structuring of a management contract while Chapter VI outlines some of the more important features and issues to address in preparing and negotiating such contracts. Chapter VII contains a discussion of the various compensation packages found in management contracts.

The management contract concept is a simple one. A manager assumes responsibility under contract for the management and operational control of another company and is paid for its management skills.

The manager is normally a company drawn from the same line of business as the owner's company but can also be an individual or group of individuals possessing the specialized skills required by the owner. The factor which distinguishes a management contract from other arrangements for management services is that the manager is given contractual authority by the owner to manage the company, not simply to provide advice or consulting services.

The underlying reason for the owner of a business to entrust its management to an unrelated manager is also comparatively simple. The owner, whether an individual or private company, a government or public enterprise, lacks the necessary managerial skills and technical resources to manage the business efficiently and effectively.

In the classic situation, the owner retains full ownership and provides the funds necessary to run the business; the manager provides an integrated package of managerial skills necessary to develop, run or rehabilitate the business and is compensated under the terms of the management contract. However, there are a number of varying commercial situations where the manager may take an equity position in the owner's enterprise or the management contract may be combined with a licensing, joint venture or franchising agreement. In such cases, the manager will have financial interests over and above the compensation payable under the management contract and the relationship between owner and manager will be more complex.
Management effectiveness is widely recognized as a critical factor in determining the performance of enterprises, whether private or public. It is all the more important in the current environment of rapid changes, intensified competition and increased uncertainty. Management contracts are most effective when addressing short-term and predominantly management-related problems. They are but one option open to enterprise owners to remedy management weaknesses. If management is only one of a number of long-term entrenched problems, other options are likely to be more effective.

In both industrialized and developing countries, governments have used management contracts to divest management control of ailing public enterprises while retaining ownership. In several circumstances, this represents an effective and pragmatic alternative to full privatization or an intermediate step on the road to privatization of ownership. The use of management contracts in this context may become more common in developing countries where private capital is not readily available or is reluctant to acquire troubled or debt-ridden public enterprises.

Management contracts have become an increasingly common feature of international business in the last twenty-five years in many different countries. Their use in the private sector of industrialized countries has been particularly widespread and they have been an important vehicle for transferring managerial, corporate and technological skills to enterprises at all stages of growth and development. In developing countries their application and usefulness have sometimes been marred by adverse experiences or by their use in quite inappropriate circumstances. However, their wider application in the private and public sectors of developing countries has significant potential if their strengths and limitations are properly understood.

These contracts have their widest application in business operations which are relatively simple and/or can be easily duplicated. They are most common in the hotel industry and reasonably well known in health care, agriculture, transportation and certain industrial operations, like cement, breweries and textiles. They have also been used (but less frequently and with mixed results) in large and complex natural resource projects and manufacturing operations such as steel, integrated textile mills, fertilizers and chemicals.

They can be found, with varying degrees of frequency and acceptance, in many African countries, the Middle East, South East Asia and Latin America. They are both employed in and "exported" from Europe and the United States. Companies from newly industrializing countries such as India, Korea and Brazil have operated under management contracts in the Middle East and Africa. Companies from other industrializing countries can be expected to play a more prominent role in the future.

In some COMECON countries, management contracts under differing nomenclatures are operating unobtrusively in connection with franchised services, construction projects and hotels. In China, there is evidence
of companies which manage a wide range of activities on behalf of related companies under arrangements akin to those encompassed under management contracts.

The above listing of countries and sectors might carry with it the implication that management contracts have gained a wide acceptance or constitute a preferred method of operation. Apart from the hotel industry where management contracts have become relatively standard, this is not necessarily the case. Management contracts are tailored to specific situations; depending upon favourable or adverse individual experience of the parties to a contract, reactions and opinions have been moulded accordingly. As a result of this diversity of experience in different countries, sectors and enterprises, valid judgements as to their general effectiveness are made difficult. A more telling indicator is to discover what factors contributed to their success or failure in a given situation and to look across a broad range of sectors and contracts to discover uniform patterns and common features associated with effective contracts.

Quite apart from determining why and when management contracts should be used, four principal underlying factors have been identified as vital to the success of a management contract. The absence of any one of these factors, if not fatal, makes the chances of success under a management contract remote. These may be summarized as follows:

- The existence of a supportive external policy environment - management expertise cannot be effective if severe price/tariff distortions or adverse government policies and interference hamper the promotion of efficient enterprises.

- The owner's basic business must be viable - no amount of managerial skill can convert an ill-conceived project or unmarketable business into a successful one.

- The owner of the enterprise must be convinced that the management contract route is the optimum alternative and must be fully supportive of it.

- The owner must give the manager sufficient management control and the authority to manage the enterprise in order to achieve the objectives of the contract.

Assuming these factors are present, why use a management contract as opposed to other alternatives and for what distinct purposes? There is no simple answer to the first half of the question other than a careful analysis of the problems faced by the enterprise and the matching of the most effective option to those problems. For example, a public enterprise experiencing severe institutional, managerial and technological problems may choose between full divestiture, joint venture, leasing, franchising or a management contract; or it may choose to address the three problems individually by instituting public enterprise reform, employing new management from within its own ranks and entering into tech-
nology agreements. The choice of one of the solutions ("management tools") to solve the complex amalgam of problems will depend upon three factors:

- The perceived or analysed effectiveness of the management tool.
- The availability of the management tool (which will vary between countries, sectors and sub-sectors).
- The political acceptability of the management tool.

Acknowledging the variability of the solution imposed by the above factors, and understanding the dynamics of the different management tools, is a more realistic approach to the question of "why use a management contract" than attempting a neat formatting of options against set circumstances. The important point is to be aware of the range of management tools available and the need to adapt the most appropriate of those tools to the specific circumstances of the enterprise in question. Governments will come to different conclusions on the most appropriate management tool because of varying ideology, sense of urgency, degree of risk aversion and the relative weight given to financial and other benefits as against the political costs. A state-owned cement plant may be divested in one country, leased out in another or operated equally successfully under a management contract in a third country. Each alternative might represent the optimum management tool given the circumstances of each country, sector and enterprise.

The answer to the second half of the question, "for what distinct purposes," is more straightforward. Various circumstances lend themselves to the use of a management contract. They may be appropriate where:

- The owner of a new enterprise lacks the necessary managerial and technical skills to establish the initial business of that enterprise.
- The owner of an existing enterprise wishes to address managerial, technical or financial difficulties through an injection of advanced management and other skills.
- The owner wants to undertake a rehabilitation effort, the benefits of which can only be derived with improved managerial efficiency.
- The benefits of a new or advanced technology cannot be obtained unless management capacity, systems and expertise are first implanted in the enterprise.
- A government wants to divest a public enterprise but needs to return the enterprise to a reasonable level of performance in order to attract investors.
In each of these cases, the management contract offers a vehicle by which a whole package of managerial skills and related resources can be acquired from one source. Where a management company is employed (which is the majority of cases), the management team will transfer and adapt to local conditions not only their own individual skills but the corporate skills, managerial systems, procedures and "culture" of the management company. However, the owner may decide to "de-package" the required inputs, limit the scope of the management contract and use it in conjunction with separate licensing or technology agreements, as the case may be. Thus a management contract may be the principal vehicle or it may play a supporting role in a wider joint venture, licensing or other arrangement.

The growth of management contracts reflects perceived benefits and opportunities for owners and managers. For the owner, it allows retention of ownership and overall policy direction; it provides for an infusion of managerial and technical expertise and the transfer of technology and corporate skills; it may also allow access to foreign markets, international financing and improved growth opportunities. For the manager, it permits the sale of its managerial, technological and other specialized skills, usually with no equity risk; it is a means of establishing or maintaining a presence in a foreign market where foreign direct investment may not be welcome or is strictly controlled; and there may be procurement, raw materials or product tie-ins which run parallel with the management contract and produce their own financial benefits.

While there are benefits to be gained, this arrangement can carry with it certain drawbacks. For the owner, there is the loss of day-to-day operational control of the enterprise and the corresponding need to monitor the performance of the manager and ensure that overall policy direction is maintained. The owner continues to be responsible for injecting funds into the enterprise and, depending upon the compensation package agreed, may be faced with significant management costs. For the manager, there are risks such as dependence upon the owner's financial strength and policy decisions made by the owner which may affect the viability of the managed enterprise.

The design and structure of the overall management contract arrangement, the relationship to be created and its parameters, are matters which the owner should consider well in advance of negotiations with a potential manager. Enterprises in both the private and public sectors of developing countries might usefully consider retaining consultants to assist in this process during the pre-negotiation stage. An analysis of the problems facing the enterprise will determine the nature and extent of the managerial and other inputs which might be necessary. The setting of objectives which the management contract can realistically be expected to achieve will follow. While the potential manager will have its own commercial motivations (and, in many cases, parallel financial interests), the determination of clear objectives against which the manager's performance can be judged serves the interests of both parties.

Determining the method of choosing the manager (direct invitation or competitive bidding), evaluation and selection are all critical steps but should be influenced by design decisions already taken by the
owner. Thus, the identification of specific problems and the setting of objectives might lead the owner to approach directly a company which is an acknowledged leader in its field and whose size, technology and managerial systems are best suited to assist the owner's enterprise; or they may lead the owner to look for an individual or group of individuals with general managerial skills and arrange for the required technical or other inputs directly from another source.

Once the manager has been identified, the stated objectives will be discussed as will the owner's assessment of the likely cost of the management contract. It is preferable for both parties to work from agreed sets of figures so that anticipated revenues and other financial projections form a sound basis for structuring a reasonable compensation package designed to achieve the owner's objectives. The choice of the management team is critical and the owner will need to assess the overall suitability of the personnel assigned under the contract. To the extent possible, such personnel should be drawn from the manager's own corporate staff where a management company is employed.

In spite of the large differences existing among management contracts in different sectors, there are features and issues which are common to all management contracts: the owner-manager relationship and the role each party is to play; the scope of the manager's authority and control; the inputs and facilities to be provided by the owner; the process by which decision-making, communications, control and monitoring are to be accomplished; staffing and personnel issues; training and technology transfer; the form of compensation package and other related issues. The resolution of these issues will to a large extent define the parameters of the business relationship being created between the owner and manager and will influence the success of that relationship.

Various compensation packages have been used in different contracts - a basic management fee, a fixed fee plus costs, agreed percentage of profits or production, incentive payments, commissions and other non-quantifiable benefits. Apart from the hotel sector where there is competition among established hotel management groups, there are no standards or market-dictated methods of determining appropriate levels of remuneration. This makes it difficult for the owner to assess whether the cost will be commensurate with the benefits. However, a growing number of management contracts in many sectors have included as part of the overall compensation package, performance-based incentives. A blend of management fee, agreed cost reimbursement and incentives for performance probably constitute the optimum compensation package.

Management contracts can be difficult and time consuming arrangements to design and structure properly. The more complex the enterprise, the external environment and range of managerial inputs needed, the greater will be the effort required by the parties to structure the business relationship and to reflect their agreement on the various issues in the contract itself. However, if properly understood and used in appropriate circumstances, management contracts can be an effective means of improving management and management-related aspects of private and public enterprises.
CHAPTER 2

THE NATURE OF MANAGEMENT CONTRACTS

2.1 Distinguishing Features

A management contract provides the legal framework for a unique type of business relationship in which the owner of an enterprise entrusts the management and operational control of that enterprise to an unrelated manager for an agreed period in return for compensation.

The manager is usually a company drawn from the same sector or industry as the owner's enterprise but can also be an individual with the skills required by the owner. In this paper, the term "manager" covers both situations but the main focus is on management companies.

Implicit in the classic management contract concept is the separation of ownership and management. This is not to say that a management contractor never takes an equity position in the enterprise it is managing. This is sometimes a requirement of the owner or sometimes the desire of the manager to indicate commitment to the enterprise. In most cases, however, the owner retains full ownership and provides the working capital. The management company provides an integrated package of managerial, technical, financial, marketing and other skills required to develop, run or rehabilitate the enterprise while preparing local personnel to operate it at the end of the contract.

What distinguishes a management contract from other arrangements connected with management services is that the incoming management group is given full management control and the authority to manage. There has been a tendency to confuse management contracts with other arrangements which provide for management services or technical assistance. In examining the nature of a management contract it is helpful to distinguish it from those other arrangements.

Under consulting contracts, management assistance agreements or other arrangements where an outside company provides management services, that company normally acts in an advisory capacity but does not have management control or authority. These arrangements are therefore outside the scope of this paper.

There is sometimes a blurred distinction between a management contract and a contract under which an enterprise brings in an individual chief executive officer or group of specialists in time of crisis. If the individual or group are given full management control and authority to manage, the contract under which they operate is a management contract in the real sense. If not, the individual or group acts more in an advisory capacity and their ability to achieve the desired results will
depend upon the quality of the advice given and the extent to which it is accepted and implemented by those who do have management control. The African Management Services Company which is presently being established by the Bank's affiliate, IFC, is a good example of a situation where individuals possessing general managerial skills will be assigned to client enterprises under management contracts. Managing rather than advising the client enterprise is the distinguishing feature of all management contracts.

Management contracts are often confused with construction or project management contracts. In different sectors, project management is an arrangement where the owner of a complex construction project enters into a contract with a company which undertakes the task of managing and coordinating the design and construction phases of the project. The company engaged does not normally undertake the construction itself but subcontracts it out. The company is, therefore, managing and coordinating the development of a physical project for the owner. It is not undertaking responsibility for the management of the underlying business connected with that project (i.e., a fertilizer plant or mine) which is the case in the true management contract situation.

There are also cases in the construction industry where a plant or factory has been constructed under turnkey arrangements. At the end of the construction and commissioning phase, the owner may request the contractor to run the plant for a number of years, to provide management for the newly formed company or to build up marketing. Depending upon the terms of the agreement, i.e., if management control and authority to manage are vested in the contractor, this would be a management contract. If the contractor is only retained to assist management or to advise on the technical aspects of plant operation, a fundamentally different technical advice or consulting relationship is created.

In some developing countries there is a great deal of sensitivity to management contracts for political reasons. Contracts which are pure management contracts are given misleading titles such as "technical cooperation agreement" or "management assistance agreement." In all these cases, the distinguishing feature will be whether the management company is given management control of the operation and the authority to manage.

Equally, some foreign companies are sensitive to "management" contracts because they are worried about legal liability and prefer to use a different nomenclature. Unfortunately, in the process of "whitewashing" the true nature of the relationship, some of the substantive rights, authority and management control which should be vested in the management company are eroded or excluded. This undermines the manager's ability to manage effectively, thus defeating the whole purpose of the contract.

There are many examples of licensing agreements which may include management services such as finance, marketing, production and personnel. While they may have some of the characteristics of a manage-
ment contract, they do not constitute a management contract. Joint venture agreements sometimes include detailed provisions for the management of the venture by one of the parties but without assigning full management control of the venture to that party. While many of the management provisions may approximate those found in a management contract, the relationship created between the joint venturers is quite different to that created between an enterprise and management company under a management contract.

2.2 Parties to Management Contracts

Although the relationship created between the owner of the enterprise and the manager is based upon and governed by a contract, the relationship is essentially a business relationship. Three entities are normally involved in this business relationship:

- The owner of the enterprise in need of managerial services.
- The manager, which may be an individual but more often a public or private company from either an industrialized or developing country.
- The enterprise itself.

In developing countries, the owner will, in a large number of cases, be a government and the enterprise a state-owned enterprise. However, private companies can equally benefit from an injection of external management expertise and the more progressive private companies in developing countries may increasingly seek this form of assistance. The manager might be a local company if the enterprise is located in one of the newly industrializing countries or in a country with a reasonably developed private sector. In many cases the manager will be a foreign company which is either in the business of providing management services overseas or which has been specifically approached by the owner to manage the enterprise because it possesses unique managerial or technical expertise of relevance to the owner.

The management contract itself may be between the owner and the manager or between the enterprise and the manager. Normally, governments do not enter into management contracts although there are examples where a ministry is sometimes designated as the government party. Where the enterprise to be managed is a public enterprise, that enterprise would be the party to the contract.

A management company which contracts with a public enterprise will be dealing not only with the existing management of that enterprise but also with the government, government officials and government representatives on the Board of Directors. It is therefore the total business relationship which should be taken into account, not merely the relationship established between the two parties to the contract.

While there will only be two parties to the contract itself, the triangular owner/enterprise/manager relationship is important to remember. In the private sector and especially the public sector, each of
these entities has quite different perspectives, motives and objectives. Unless all three are understood and accommodated the management contract will run into trouble.

2.3 Pure Management Contracts

In the classic management contract situation, the owner normally provides the equity and other working capital inputs while the manager supplies the management and technical skills.

The manager is primarily interested in selling an agreed range of management and other services and receiving a fee or some other form of compensation for its efforts. The owner's principal objective is to obtain the benefits of those management skills (for the least cost) without bringing the manager into an equity position. This arrangement may be called a pure management contract situation i.e., the management contract arrangement stands alone and is the only basis for the business relationship between the owner and the manager.

This "pure" contract is mostly found in the agricultural sector, in public utilities and the transport sector and in many of the hotel management arrangements. The following are but a few examples: Transmark (the consulting and management arm of British Rail) manages and operates a national rail system (or a specific part of a system) in several countries a fee being the only form of remuneration. Commonwealth Development Corporation manages government-owned plantations and estates in a number of countries in return for a fee plus costs. The U.S.-based Health Care Associates undertakes the management and operation of privately and publicly-owned hospitals in a wide range of countries and derives its income solely through an agreed financial formula without any ownership stake. These are all pure management contracts where management services alone are being bought and sold.

Many situations in which management contracts are used are not quite so basic and simple. The management company might provide some equity and derive part of its income not only from the fee but also from dividends. It might have a buyer-customer relationship with the enterprise (i.e., it might buy or sell its raw materials or products) and derive additional income from commissions on purchases or sales. It might have a technical assistance agreement with the enterprise and receive a separate fee for these technical services. There may be a joint venture arrangement, a franchise agreement or licensing arrangement with the enterprise which needs the additional support or input of advanced management and technical expertise. In designing and structuring a management contract arrangement, the owner should be aware of such parallel financial interests and motivations and ensure that they do not interfere with the achievement of the objectives under the management contract.

Wherever the management contract ceases to be "pure" in the sense described above and other commercial/financial interests are involved, the fundamental relationship between the parties will be different.
and the motives and aspirations of the parties may diverge. The different contract forms commonly associated with management contracts are briefly examined in the next sub-section.

2.4 Management Contracts Combined with Other Contract Forms

Management contracts are often found in conjunction with technical assistance agreements. Even though the management contract will usually provide for the transfer of management, technical and other skills, there may be highly specialized or proprietary technical matters which can best be dealt with under a separate agreement. In this case, the management contract is supportive of the technical assistance agreement in the sense that the technical services cannot be properly provided and adopted by the enterprise unless the managerial capacity exists to absorb the technology.

The management company receives separate remuneration under the technical assistance agreement over and above whatever compensation package may have been negotiated under the management contract. The management contract in conjunction with a technical assistance agreement is found in most sectors, particularly in the agricultural sector and many areas of the manufacturing sector.

Management contracts are also combined with licensing, technology and franchising agreements in order to complement the licensed technology or the franchise with the expertise to use it. Licensing involves the exchange of technical information by transferring patented technology or know-how in return for a fee. Under franchising arrangements, the franchisor possesses a proven business concept which he places at the disposal of the franchisee. Licensing or franchising assumes that the licensee or franchisee has the managerial and other business skills plus the capital to use the licensed technology or to run the franchised business profitably. This is largely the case in industrialized countries but not necessarily so in many developing countries. In this latter situation, a separate management contract might accompany the licence or franchise either from the outset or when the licensee or franchisee begins to experience serious difficulties. Licence agreements and franchise agreements might contain provisions for technical or even managerial assistance for initial periods of operation but this does not, from a legal standpoint, convert them into management contracts as such. In practice, however, distinctions can become blurred and if the amount of managerial and technical help required by the licensee or franchisee becomes significant, a separate management contract might be entered into by the parties.

Joint ventures are frequently accompanied by management contracts. While this is more common in the private sector than in the public sector, the effect is the same. One of the joint venture parties is given full management responsibilities for the company or operation in question. The party entrusted with management may possess particular skills or, where their industry experience and managerial skills are roughly the same, the joint venturers may simply decide that one of the parties should manage the company or operation.
This latter case is frequently found in mining joint ventures in the private sector. In the public sector, where a state-owned enterprise is in joint venture with a private company, the private company might demand full management control in order to protect its equity position and to ensure that the operation is tightly controlled in all respects. This frequently happens where private companies have faced a "localisation" program and have had to reduce a majority position to a minority equity holding. The case of Lonrho and the Assante gold fields in Ghana is a case in point as is Falconbridge in the Dominican Republic. In both situations, the private company saw the need to protect its minority position through management control under a separate management arrangement.
CHAPTER 3

THE USE OF MANAGEMENT CONTRACTS

3.1 Pre-Conditions to Use

Before examining why and when a management contract should be used, there are certain fundamental factors which must be present, regardless of country or sector, if the arrangement is to work effectively.

A management contract encompasses a business relationship which is subject to all the factors that customarily influence business development. Like any other business arrangement, if the prevailing external or internal conditions affecting the management contract are unfavourable, its chances of success are reduced. Although the pre-conditions for their use may seem obvious when outlined, a surprising number of enterprises and managers have proceeded to their detriment without a thorough examination of those conditions.

In discussions with a number of management companies, consulting groups and individuals who have had experience of operating ventures under management contracts, four factors kept recurring as being essential pre-conditions to use. While the absence of any one of the pre-conditions would not necessarily prove fatal, the task of managing the enterprise is made considerably more difficult and the management skills injected rendered less effective.

First and foremost, the basic business of the enterprise must be viable. If the owner's business is declining or facing difficulties because it is essentially non-viable, neither a management contract nor any related management services arrangement will cure that situation. It may help to solve temporary management-related problems but not inherent business deficiencies. In this respect, an enterprise owner needs to conduct an analysis of the problems encountered by the enterprise to identify whether they are capable of resolution through the vehicle of a management contract. An enterprise whose markets are declining or whose product has low acceptability might trace these problems to weak or inefficient managerial systems, poor marketing or production skills. Equally, they might be traced to more fundamental market conditions which will persist however strong management might become.

Second, the external environment has a profound effect upon the efficiency and effectiveness of any enterprise. A manager will fare little better than the existing management of an enterprise if it is expected to operate in an adverse business environment. If the enterprise is subject, for example, to price controls, tariffs, import restrictions
or has poor foreign exchange access, the benefits of a management contract are unlikely to be recognized. In the public sector, the problems can be more acute if there is direct government interference in the enterprise and social and other politically-influenced objectives take priority over commercial considerations.

A recent report prepared by the Bank's affiliate, IFC, assessed the potential demand for management and related services among commercially operated public enterprises in Sub-Saharan Africa. It identified countries in which "the environment is already favorable for independent business management or which are in the process of introducing structural adjustment programs containing broad macro-economic reforms and rationalization of the public enterprise sector as part of the process to improve the business environment." The need to ensure that the overall business environment is conducive to a management contract arrangement is tantamount and recognized as a precursor to a successful management operation. Some management companies operating in the public sector have entered into direct accords and understandings with governments on basic business conditions (prices, foreign exchange access, lifting of import restrictions) prior to signing management contracts with a public enterprise. This practice is not as yet widespread but is likely to become more common in the future.

Third, the owner of the enterprise must be convinced that the management contract route is the optimum solution and be fully supportive of it. Cases were cited of management contracts being made a condition of financing or presented as the only solution without consideration of alternatives. As the relationship between owner and manager and their respective personnel lies at the base of the arrangement, a non-supportive owner or an alienated incumbent management will present major difficulties for the incoming manager. However well written the contract may be, the relationship which underlies it must be sound and both owner and manager willing to understand and accommodate the often conflicting interests, motives and objectives which they possess.

Fourth, but very much related to the third point, the owner must be willing to delegate to the manager sufficient management control and authority to permit the manager to run the day to day operations of the enterprise and realise the objectives set by the contract. In one sense this is not so much a pre-condition as an implementary requirement. On the other hand, the owner will need to determine during the planning and pre-negotiation stage the parameters of the manager's authority and the extent to which it intends to confine itself to the overall policy direction of the enterprise. The objectives set by the owner must be capable of achievement by the manager and its authority and control in some measure related to the tasks it is expected to perform. Several contracts were reviewed where ambitious objectives were specified but quite restricted management powers and authority granted. This is a contentious issue in both the private and public sectors but possibly more difficult to reconcile where a public enterprise is involved.
3.2 Why Use a Management Contract?

The competitive environment and complexities of running an enterprise efficiently present owners with a continuous series of business problems. An analysis of the full range of those problems is beyond the scope of this study. However, at the risk of over-simplification and without attempting to be exhaustive, some typical problems can be classified in three groups according to magnitude and complexity.

First, discrete problems related to strategy, organization, systems and procedures. These could include choosing between two large investment projects, diversifying a product line, strengthening the R & D effort, introducing a new accounting system, changing marketing strategy, finding working capital or reorganizing the computer department. Second, specific problems of a more fundamental nature: weak or deficient management; inefficient or non-competitive technology; outdated and ineffective systems and procedures. In the case of a public enterprise, there might be the added institutional problems inherent in the relationship with the government. Third, complex problems which might be an amalgam of problems of the type just mentioned.

An analysis of the problems facing an enterprise is the starting point in determining what an appropriate solution might be to remedy those problems. A management contract is but one option open to enterprise owners to remedy management weaknesses. Any enterprise which is considering the use of a management contract has to be reasonably confident that it is the best means of addressing and resolving the problems which it faces. The first question which arises, therefore, is "why use a management contract? What are the alternatives?"

The first set of discrete problems mentioned above are mostly of a short term nature and can typically be solved by internal personnel and/or by external management or technical consultants. The central problems are not management-related.

If the problems are of a more fundamental or complex nature (i.e. those mentioned in the second and third categories above), more comprehensive and penetrating solutions are required. A public enterprise may be experiencing severe institutional, managerial and technological problems. In theory, the government has an array of solutions ("management tools") available to it. It may choose to address the three problems individually by instituting public enterprise reform, employing new management and establishing technology agreements.

If the above problems are partly management-related, the degree of the management problem will help to decide whether a less comprehensive solution than a management contract will suffice. This can be more clearly demonstrated by a public enterprise example where a number of lesser measures might be considered before resorting to a management contract:

- There may be experienced and talented local managers and technical personnel available in other areas of government or in the private sector who are able to make sound contributions—provided that the management deficiencies are not too severe and that skilled technical and other personnel are not so reduced in
numbers as to be ineffective. In order to attract such local skills, the government would need to offer a competitive compensation package and other incentives. Unfortunately, many governments are reluctant to take such an enlightened step.

Another alternative within the government's power is to reduce the government "pressures" which make management of the enterprise difficult, if not impossible, whatever the calibre of existing management. Government interference, lack of management autonomy, public sector procedures and pay scales, lack of incentives, pressures to maintain depressed price levels or large numbers of staff at uneconomic levels all combine to produce a "management" problem of the government's own creation.

If the management problem is identified simply as a somewhat reduced level of local managerial and technical skills and provided that the problems are not too severe, it may be possible to engage consultants to advise and assist management and to provide technical and other assistance where necessary. The employment of consultants who have no executive or managerial standing, assumes that a reasonable management structure and level of competence is in place and that advice and assistance is sufficient to overcome the problems.

If, as is likely, the problems are intertwined and not capable of individual solution, more comprehensive solutions have to be considered. These include full divestiture, joint venture, leasing, franchising or undertaking a management contract. These different management tools (solutions) may address the main problem areas more or less effectively depending upon the circumstances. Table 1 on the next page shows in simple terms examples of the different problem areas which certain management tools might be expected to tackle. It will be seen that some can only address individual problems while others are stronger in two or more areas.

Given the number of variables in each case, it is impossible to state in precise terms which solution fits which problem. However, a more important point to note is that not every management tool may be available in a particular situation. The actual choice of management tool will depend upon three factors:

- The effectiveness of the management tool.
- The availability of the management tool, (a factor which will vary between sub-sectors and countries).
- The political acceptability of the management tool.

Each of these inhibiting factors is briefly examined below.

**Effectiveness.** The effectiveness of individual management tools will depend in part upon their comparative advantage vis-a-vis each other. For example, if an enterprise's problem is both management and technology, then inherently a management contract is better than just hiring new management. If the problem is technology and public enterprise institutional
<table>
<thead>
<tr>
<th>Management Problems</th>
<th>Examples of Discrete Problems Solved on Project Basis</th>
<th>Fundamental Problems Requiring More Permanent Solution</th>
<th>COMMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management Tools (Solutions)</td>
<td>Build New Plant</td>
<td>Strategic Direction</td>
<td>Discrete Operational Problems</td>
</tr>
<tr>
<td>1. Management Consultants</td>
<td>***</td>
<td></td>
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</tr>
<tr>
<td>2. Technical Consultants</td>
<td></td>
<td></td>
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<tr>
<td>3. Turnkey Project Management</td>
<td>***</td>
<td></td>
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<tr>
<td>4. Public Enterprise Reform</td>
<td></td>
<td></td>
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<tr>
<td>5. Technology/Licensing Agreements</td>
<td></td>
<td></td>
<td>***</td>
</tr>
<tr>
<td>6. New Management</td>
<td></td>
<td>***</td>
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</tr>
<tr>
<td>7. Management Contract</td>
<td>***</td>
<td>***</td>
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<tr>
<td>8. Franchising</td>
<td>*</td>
<td>***</td>
<td>*</td>
</tr>
<tr>
<td>9. Leasing</td>
<td>***</td>
<td>***</td>
<td>***</td>
</tr>
<tr>
<td>10. Joint Venture</td>
<td>***</td>
<td>***</td>
<td>***</td>
</tr>
<tr>
<td>11. Full Divestiture</td>
<td>***</td>
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<td>***</td>
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</tbody>
</table>

*** = This management tool is typically best suited to address this problem.
* = This management tool can also contribute to solving of this problem.
relationships, then a franchising option or joint venture are likely to be better than a management contract. If all three problems exist, full divestiture will, in most cases, be the best alternative. However, if there is a lack of high quality private investors, a better alternative may be the leasing of facilities/assets or a management contract. In addition, effectiveness will also depend upon the strength of the managerial and technological skills supporting the particular tool. While a joint venture arrangement might offer certain advantages over a management contract (i.e. the joint venture partner may be willing to provide capital), a proven management company which is a leader in its field might be more effective in solving the problems faced by the enterprise than an untested joint venture partner with more funds than experience.

**Availability.** One solution may be analysed as being the most effective in the circumstances but may not be available. Divestiture may not be viable if there is no developed private sector or if the enterprise is essentially unattractive to private investors. Similarly, joint venture and leasing may be discounted because of the poor financial position of the enterprise or the physical state of the enterprise's facilities.

**Acceptability.** When the owner is the state, political acceptability becomes an important consideration. For example, full divestiture might address all the major problems faced by a public enterprise but the leasing of facilities and the retention of ownership may be perceived as a more acceptable alternative by the government. In a situation where a public enterprise is facing severe institutional, technical and managerial problems the most efficient solutions, in order of priority, might be full divestiture, joint venture, leasing, franchising and management contracts. In terms of political acceptability, the order might be completely reversed. Acceptability will vary between countries and sectors and between enterprises in a sector or sub-sector. Factors influencing acceptability of a management tool include government ideology towards privatization, the visibility and size of the enterprise, potential unemployment problems and identity of prospective private sector purchasers. A government which favours state ownership of a particular enterprise might, for example, rank the management tools in the following order:

<table>
<thead>
<tr>
<th>Management Tool</th>
<th>Government Ownership and Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Management Contract</td>
<td>Ownership of enterprise</td>
</tr>
<tr>
<td></td>
<td>Control of policy</td>
</tr>
<tr>
<td>2. Franchising</td>
<td>Ownership of enterprise</td>
</tr>
<tr>
<td></td>
<td>Control of policy</td>
</tr>
<tr>
<td>3. Leasing</td>
<td>Ownership of assets</td>
</tr>
<tr>
<td>4. Joint Venture</td>
<td>Part-ownership of enterprise</td>
</tr>
<tr>
<td></td>
<td>Partial control of management and policy</td>
</tr>
<tr>
<td>5. Full Divestiture</td>
<td>No ownership interests</td>
</tr>
<tr>
<td></td>
<td>No controls</td>
</tr>
</tbody>
</table>
Governments trying to remedy the severe institutional, technological and managerial problems facing public enterprises must search for solutions that consider effectiveness, availability and acceptability and also weigh the financial and other benefits against the political costs of change. Governments will reach these decisions differently because of differences in ideology, perception of urgency and degree of risk aversion. A state-owned cement plant may be divested in one country, the assets leased out in another country and operated by a management contractor in a third country. There is no contradiction in this state of affairs and no proof that one solution is more successful than another. It is merely illustrative of the varying situations and problems in different countries, sectors and enterprises and the variety of solutions which can prove to be effective, available or acceptable in those situations.

3.3 When to Use a Management Contract

Experience has shown that management contracts are most effective when addressing predominantly management-related problems. Weak management permeates all areas of a business or operation and can give rise to problems from production right through to marketing. Appropriate managerial inputs in identified weak areas, combined with technical or other resources, can resolve a wide range of corporate, financial, technical, administrative and marketing difficulties which are traceable to managerial deficiencies.

A management contract provides a vehicle for transferring an integrated package of skills covering the managerial spectrum. The management company can normally provide not only the managerial and technological skills required to meet the specific difficulties facing the enterprise but also effect a transfer of its corporate "culture" and proven industrial experience. Included in this would be its own management systems and procedures, corporate planning techniques and overall management style and philosophy. What is being sold is its ability to run a business combined with specific and advanced knowledge of the particular industry or sub-sector in which the owner's enterprise is located. These "corporate" aspects are not present when an individual or a group of individuals is engaged as manager; but their general managerial abilities and experience in operating successful enterprises lies at the heart of the decision to engage them under a management contract.

If this aspect of a management contract is clearly understood, the circumstances in which such a contract can be effectively used are more easily discernible. Management contracts are often used as vehicles for training, for technology transfer and for other purposes but these should be subsidiary to the main focus on management. If training or technology are the prime interests of an owner, these can be accomplished under separate programs or agreements without need for a full management contract. Similarly, if management deficiencies are the reasons for engaging the manager, conditions must be such that its management skills can be fully utilized. Imposing internal enterprise constraints by limiting its managerial authority and control; or permitting external conditions to frustrate its managerial initiatives run counter to the whole rationale underlying the arrangement.
Experience has also shown that management contracts can be used most effectively in business operations which are relatively straightforward and/or easily duplicated. For example, management companies which have managed hotels, medium-sized manufacturing operations, transport operations, health care inputs, agri-businesses etc., have been able to effect significant turnarounds in similar operations in a wide variety of countries if the problems are principally management-related and the technical inputs within their specialized area of expertise. When the enterprise and the problems are more complex and the variety of factors affecting the enterprise more diverse, the management focus may become diverted and the manager's task made more difficult.

In general, management contracts are used less frequently than other management tools mentioned above. Management contracts materialize as good second or third best solutions under the following circumstances:

1. Where the government is owner and divestiture is not considered to be a politically acceptable alternative.
2. The enterprise is facing fundamental problems regarding both management and technology.
3. The inherent business is relatively simple and the manager's systems and skills can be transferred from another location and duplicated in the owner's enterprise.
4. The value added to the enterprise by the manager in terms of management, corporate culture (i.e. systems, procedures, concepts and skills) and/or technology are high enough to justify the costs.
5. When the number and variability of risk factors related to the economic policy environment and the owner-enterprise-manager relationship are not allowed to grow too complex.

At the risk of oversimplification, where the principal objective is to ensure ultimate managerial efficiency in its widest sense (i.e. to develop local management's ability to manage all aspects of an enterprise and to achieve a viable commercial operation), then a management contract is probably the most appropriate method of achieving that objective. It is a temporary and intermediate step on the path to the enterprise's overall viability.

The circumstances in which an enterprise might entertain the above objective will vary but several distinct situations can be envisaged:

1. Where the owner of a newly established enterprise or project feels that there is insufficient local expertise available to establish and run the new enterprise or project in the initial phase.
Where an enterprise faces severe managerial technical and financial difficulties and wishes to regain profitability in order to continue trading under upgraded and better trained local personnel.

Where an enterprise wishes to undertake the rehabilitation of a project or operation which is its principal source of business and decides that the benefits of such rehabilitation can only be derived if its local managerial capacity and efficiency are also increased.

Where a government wants to divest a state-owned enterprise but must first return it to a reasonable level of performance attractive to private investment.

Where the benefits of a new or advanced technology, process or other resource cannot be achieved without external management capacity, systems and technical expertise to introduce and adapt the resource to local conditions.

From the above it will be appreciated that the use of management contracts is not confined to any one situation but there are a number of factors which will determine their successful use. The analysis of problems faced by the particular enterprise and consideration of the various options available to solve those problems is an essential prerequisite to any decision to use a management contract.

### 3.4 Benefits and Drawbacks of Management Contracts

Any management contract will carry with it certain benefits and drawbacks for the parties involved. The perception of these by the owner and the manager will depend upon their respective objectives and commercial motivations. In addition, potentially unfavorable aspects can be reduced or eliminated during negotiations. Given the variables between different contract situations, countries and industries, it is not helpful to be too dogmatic about benefits and drawbacks. Table 2 on the next page highlights the more obvious pros and cons of management contracts.

The major benefit for the owner is that the management contract route permits it to retain ownership. This may be a dominant consideration in the minds of some governments and may explain why this option has been more politically attractive in many cases than direct local or foreign investment or entering into joint ventures. It also allows the government to solve its managerial and resource deficiencies by obtaining the most suitable managerial expertise and influencing both its scope and use by means of the management contract.

On the manager's side, the benefits are several. Its financial commitment relative to its return will be minimal, particularly where it is not required to make an equity investment. It will receive an agreed income flow through the management fee and can probably earn additional bonuses based upon such variables as performance, sales or other agreed
Table 2
MANAGEMENT CONTRACTS: BENEFITS AND DRAWBACKS

<table>
<thead>
<tr>
<th>Owner</th>
<th>Benefits</th>
<th>Drawbacks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Allows ownership retention.</td>
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</tr>
<tr>
<td></td>
<td>Loss of day to day operational control.</td>
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</tr>
<tr>
<td></td>
<td>Provides managerial and technical expertise.</td>
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</tr>
<tr>
<td></td>
<td>Management fee generally payable regardless of profitability</td>
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<tr>
<td></td>
<td>Overall policy direction maintained.</td>
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</tr>
<tr>
<td></td>
<td>Owner remains responsible for all operating expenses and debt servicing.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Technology transfer which includes training and transfer of management and corporate skills.</td>
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</tr>
<tr>
<td></td>
<td>More expensive than other options.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Access to new markets and international financing.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Time consuming and complex to structure properly.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Greater profit potential in the long run due to improved management and technical efficiency.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Possible drain on enterprise's foreign exchange supplies.</td>
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</tr>
<tr>
<td>Manager</td>
<td>Agreed income flow via management fee.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Financial risk if prevented from earning performance payments.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Compensation for service, usually with no equity risk.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Dependence on owner's financial strength.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Means of establishing new markets.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Lack of control in policy areas.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Maintain presence in foreign market, especially in countries inhospitable to direct investment.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Lack of control over &quot;external&quot; factors such as government interference, policies etc.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Possible procurement, raw material, and product tie-ins.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Risk of early contract termination.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Device to adapt commercial strategies to changes in international market place.</td>
<td></td>
</tr>
</tbody>
</table>
criteria. The manager may also gain access to the markets of another
country, access to primary resources, commission on procurement and other
pecuniary or strategic advantages, depending upon the terms of the
contract.

The drawbacks for the owner and manager may be summarized as
follows:

Owner

1. The owner gives up control of day-to-day management and opera-
tions, although ultimate policy and budgetary control are nor-
mally retained.

2. The management fee or some substantial element of it may be pay-
able regardless of the profitability of the enterprise or the
performance of the manager. The owner must therefore be convin-
ced that the enterprise will be able to generate additional
income to cover the management fee and any other compensation
payable.

3. The owner bears the full risk of any shortfalls in income rela-
tive to operating expenses and debt payments. Unlike a lease
situation, the owner is not receiving any fixed rental.

4. Management contracts are time-consuming and can be expensive to
implement, both absolutely and relative to other options. (If
successfully implemented, the long-term gain generally justifies
the resources and the investment furthers the long-term develop-
ment of the country's managerial and technological base).

Manager

1. The financial risk is low in comparison with that under leased
or joint venture operations. If the business is operating below
its break-even point, the owner, not the manager, must make up
the cash deficits. However, if the business is operating above
its break-even point, the management company may realize a lower
return than it would under alternative arrangements. In effect,
the management company gives up some potential profit for less
risk and investment.

2. The management company is reliant on the owner's ability to pro-
vide long-term infusions of financing when the cash flow is
inadequate to meet operating, debt servicing and management fee
expenses.

3. Unless the management company has equity in the enterprise, it
has minimal influence on decisions regarding the sale or dispo-
sition of the business and on major policy decisions affecting
the direction of the enterprise.
The advantage of attempting to analyse the owner's or management company's respective positions in terms of drawbacks is that it allows either party to attempt some diminution of the same during the negotiating process. For each one of the potential drawbacks mentioned above, a contractual provision can be agreed which will have the effect of minimizing (or even removing) what might have been an unacceptably high risk if not identified as such and openly discussed in those terms during negotiations.

For example, on the owner's side, loss of day to day control by the manager is a seemingly profound "disadvantage" and leaves it at the mercy of the manager. It will be seen later in Section 6 that the owner can impose workable checks and balances on that day to day control in the form of reserving certain major decisions for its prior review; requiring consultation on other matters (i.e., recruitment and promotion); establishing a sound communications and reporting system on agreed matters; and having the capacity to monitor the management company's performance.

The problem connected with payment of a management fee irrespective of performance can, in most situations, be minimized by reducing the pure fee element and linking the bulk of the compensation package to performance/profitability-related criteria.

On the manager's side, there can be a similar diminution of drawbacks in most areas but some areas do continue to present quite high levels of risk whatever the contractual provisions. The owner's policy decisions, its financial resources, access to foreign exchange, and possible influence by government in the case of a state-owned enterprise, are all matters which the management company has to take into account in assessing the overall risk and the minimum compensation which it must receive to run that risk.

This last point is more often than not misunderstood by government. There is a tendency to equate management contracts with consulting contracts and to cost them in the same manner. The fact is that a management contract is quite distinct from a consulting contract both in substance, the nature of the responsibilities undertaken, the risk element and the relationship created. It is therefore a more complex and expensive proposition than a consultancy.
CHAPTER 4

MANAGEMENT CONTRACTS IN SPECIFIC SECTORS

Management contracts have become an increasingly common feature of business management during the last twenty-five years. The economic sectors in which management contracts have been commonly used are summarized in the Table below. For a wider treatment of the different sectors in which management contracts are used, reference should be made to Dr. Brooke's book (described in the bibliography) upon which parts of this Chapter are based.

Table 3

GENERAL USE OF MANAGEMENT CONTRACTS IN DIFFERENT ECONOMIC SECTORS

<table>
<thead>
<tr>
<th>Agriculture</th>
<th>Industry</th>
<th>Transport</th>
<th>Public Utility</th>
<th>Services</th>
<th>Tourism</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining/ Mineral Processing</td>
<td>Airlines</td>
<td>Gas</td>
<td>Banking</td>
<td>Hotel</td>
<td></td>
</tr>
<tr>
<td>Manufacturing</td>
<td>Airports</td>
<td>Road</td>
<td>Water</td>
<td>Insurance</td>
<td>Travel services</td>
</tr>
<tr>
<td>Fertilizer</td>
<td>Rail</td>
<td>Electricity</td>
<td>Retailing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Textiles</td>
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4.1 **Tourism/Hotels**

Management contracts have found their widest application in the tourism/hotel industry, where they have become standardized in the sense that an accepted format and reasonably uniform provisions have evolved. They grew rapidly in the United States during the '50s and '60s and tourist growth overseas led to their use in many developing countries. They became the preferred arrangement in these countries because international hotel groups could expand rapidly with low financial risk in areas where the investment climate was perceived to be somewhat unstable. Unlike the extractive industries and complex manufacturing enterprises, ownership was not felt to be vital to control an individual operation or to transfer and maintain a business concept.

Most international hotel management contracts specify a wide range of management services: the integrated package includes operational management, financial control, accounting, a complete training program at all staff levels, and specialized services such as purchasing and worldwide marketing. The management company supplies experienced personnel for senior management and supervisory positions and has carefully defined powers with respect to personnel, their quality being vital.

The management fees payable under hotel management contracts in most cases conform to a certain pattern. The reason is that the intense competition between hotel management chains allows owners to shop around and compare standard packages, a luxury not available to the same extent in other sectors. The management fees may be calculated as a flat rate (more common in earlier domestic United States/European contracts), but more frequently as a percentage of turnover or profits, or based on a mixed formula.

Given the prevalence of hotel management contracts and the constant refining of their financial provisions in a highly competitive environment, they are a useful guide to possible approaches to structuring financial packages for management contracts in other sectors. Certain of the principles hammered out in hotel contracts (full management control, specific management powers and responsibilities, no interference by the owner except in defined circumstances, control of personnel, and a well-defined compensation structure), are applicable to other sectors in spite of the obvious sectoral differences.

One feature of hotel management contracts that is somewhat unique is their duration—10 to 20 years, with options to renew on the same or similar terms for further periods of 5 to 10 years. International hotel chains insist on long contracts not only for financial reasons, but also to ensure that their corporate operating philosophy and systems are fully absorbed and that their reputation is safeguarded.

There is considerable variation in hotel management contracts when it comes to equity holdings. In many cases the management company does not acquire an equity position, but in some developing countries the government may specify that it do so. Generally where an equity position is taken, some specific circumstances will have led to that step.
In recent years, management contracts have been negotiated in such countries as Egypt (by Brent Walkers), Sudan (Ramada), Tunisia (Trusthouse Forte) and Zambia (Caledonian Hotel Management). The Intercontinental International hotel chain alone has management contracts in a number of African countries including the Ivory Coast, Central African Republic, Zaire, Gabon, Zambia, Liberia and Kenya. In all these cases they have proved to be politically acceptable and commercially successful for both owner and management company. Several countries have had adverse experiences but many of the problems encountered can be traced back to inappropriate use or undue government interference in the hotel operation.

4.2 Agriculture/Agro-Industries

Agriculture is the second major sector in which management contracts are used although not nearly as extensively as in the hotel industry. Dr. Brooke has observed that the link between technological innovation and management skills is as close in agriculture as in any other industry sector. Planning, timing, stock control, storage, marketing and the correct use of chemical and mechanical aids—and the need to coordinate the activities of disparate groups of farmers—are all required to ensure that plantation, forestry, sugar, rubber or oil palm undertakings are efficient producers.

Some management contracts arose as a result of the nationalization of plantations but their growth has tended to be in support of establishing an individual plantation or rehabilitating an existing one. They have also grown up in conjunction with technical assistance agreements and licensing agreements, lending crucial management support to the technical activities. As was noted earlier, many examples of pure management contracts can be found in the agricultural sector but advanced technological inputs have equally led to the need for more advanced management skills. Management contracts have played a support role in these situations.

The nature of many agricultural projects is such that management companies do not find it an attractive proposition to take up equity; and in some developing countries, governments are reluctant to permit foreign ownership of basic agricultural activities. While no statistics have been collected in this area, a review of agricultural management contracts by Dr. Brooke in African countries shows that several countries seem to have encouraged a minority equity holding by management companies—i.e., Zambia (tobacco and sugar), the Ivory Coast (rubber) and, in one contract, Malawi (sugar). In other African countries such as Swaziland (sugar), Ghana (oil palm), Nigeria (sugar), Tanzania (tea), Kenya (furfural and sugar) and Malawi (tobacco, coffee and sugar) equity holdings by the management companies were usually below five percent.

Modern plantation development calls for a high level of managerial and technical skills which are not readily available in the developing countries of Latin America, Africa and South East Asia. In addition, a series of foreign inputs may be required in the form of fertilizers, seeds, machinery, finance, marketing and knowledge of commodity markets. This array of inputs, technical skills and overall management are supplied
by a number of international companies which have experience in vertically integrated operations from primary production to international sale.

While the owner of the plantation will usually own the land, plantation facilities and machinery, the terms of the contract may call for the management company to supply fertilizers, advanced machinery and even finance for the same. While processing facilities will normally be owned by the domestic enterprise, the later stages of the process—bulk storage, shipping, insurance, further processing, wholesaling and retailing may fall within the scope of the management company's responsibilities and to a large extent will be handled by the relevant departments of the management company's head office.

From the plantation owner's point of view, management contracts solve many problems. Among them are lack of experience in modern techniques of cultivation, seed development and harvesting as well as the inability to provide adequate training. Both Booker International Inc., a major agricultural management company operating in many parts of the world and the U.K.-based Commonwealth Development Corporation, indicated that key problems which their management responsibilities were designed to assist were the lack of (or failure to keep) accurate data on production and harvesting operations, inability to estimate output volumes and thus to balance capacity with inputs at different stages of production, processing and marketing. In addition, a number of external factors such as weather, natural disasters and fluctuations in commodity markets call for a level of planning, coordination and control which can be supplied by international management companies.

Management contracts reviewed for the purposes of this study in the agricultural sector covered arrangements between the Government of Jamaica and a U.K. company for the operation of sugar factories, proposals for the external management of agricultural estates in Sao Tome and Principe and arrangements for a complex sugar refining project in Sudan managed by a U.S. based company. All three contracts contained marked differences in approach and in the compensation structures designed to achieve specified objectives.

4.3 Public Utilities/Service Industries

In many developing and industrialized countries, public utilities such as gas, water, electricity, telecommunications and health care are in the public sector. A wide range of transport services—air, sea and land—are also part of the public sector.

Many of these state-owned public utilities have experienced severe managerial and financial problems in recent years. In some developing countries, the management corps in key public utilities has dwindled as good managers are attracted to the private sector at home or overseas. In others, inefficient, poorly trained and poorly motivated managers, deficient management, planning and control systems, low levels of technology and government pressures to maintain jobs and prices rather than to operate on a sound commercial basis, have led to a serious decline in public utility services and financial performance.
A special feature of management contracts with public utilities is that management services are often provided by the management/consultancy arm of counterpart utilities in other countries. Public companies in Britain, France, Canada, Australia, India and other countries compete to provide management services to public utilities in developing countries, often with the active support of governments wishing to promote their own trading interests.

The duration of management contracts in the public utilities sector is often short—two or three years. Fees are often calculated on a cost-plus basis, the main component being expatriate salaries. Contracts usually call for a high level of expatriate personnel for a concentrated period, technology transfer and systems adaptation. More than most other sectors, management contracts come hand in hand with high levels of equipment supplies, usually from the management company's own country, and the fees may be quite subsidiary to the higher and more strategic benefits which accompany equipment supply.

In the transport sector, management contracts can be found in road passenger, road freight, rail, air, shipping, cargo handling and port activities, whether publicly or privately owned. As with public utilities, the state-owned transport systems are not usually open for investment. Thus, management contracts tend to be of the pure variety, with short durations and a cost plus compensation scheme. Once again, national transport companies from foreign countries tend to predominate—especially in the rail and air transport sectors. For many years, the Indian railway administration managed the Nigerian railway system, Aer Lingus managed Zambia Airways, KLM managed Garuda and the Ghanaian shipping line was managed by an Israeli navigation company. British Rail (under its international subsidiary, Transmark) are operating in Africa, the Far East and Latin America as are a number of other state-owned British enterprises in the airline and airline-related sectors.

In France, many municipal authorities contract out the supply of services to private firms and there are a number of examples of management contracts for the operations of treatment plants, sewage disposal, water supply and waste collection. A well-known example in a developing country is that of Societe de Distribution D'eaux de la Cote d'Ivoire (SODECI) by which the water and sewerage services of the Ivory Coast are managed. Its fee structure is cost-plus and is indexed against inflation. The venture is the only water supply company in West Africa to possess its own training centre. The services are of high quality and paid for by the consumers who pay a variable tariff to keep down the cost to the poor.

A number of international telecommunications companies have been active in seeking opportunities to develop and manage telecommunication systems in developing countries, mainly as a means of selling their technology and equipment. However, companies such as British Telecom, Cable & Wireless and several Canadian companies see management contracts as a business in their own right. The proposed privatization of the Sri Lankan telecommunications system (on which the Bank has been advising) may depend no a large extent upon a management contract to be negotiated between the
proposed Sri Lanka Telecommunications Company and an international telecommunications company. The latter would supply the requisite management and technological skills during an initial period of about five years and would ensure that a management organization, systems and technical capabilities are built up.

The growth of contracts in the health care sector has been extremely rapid. A number of international companies (some linked to pharmaceutical companies but most concentrating on management aspects) have specialized in the design, equipping and management of hospitals, specialized health-care facilities and other medical enterprises. Many other companies (operating principally out of the United States and Europe) have negotiated management contracts in the Middle East, with military hospitals or with facilities for large industrial complexes connected with mineral extraction, refining and processing. Such contracts are very difficult to obtain probably because this has become a highly competitive area and contractual terms are sensitive. One U.S. based company, HCA Management Company, delivers health care to more than 400 hospitals in the United States owned or managed by HCA or its subsidiaries and operates under management contracts in seven foreign countries.

4.4 Industry

The use of management contracts in the industrial sector is not so widespread as in the hotel and agricultural sectors but there are still many examples in both industrialized and developing countries. There is a growing tendency to employ them in conjunction with technical assistance, licensing and other technology/know-how transfer arrangements. There appear to be increasing numbers in basic manufacturing industries such as textiles, food processing, fertilizers and chemicals. In each case they are closely tailored to highly individual circumstances and no pattern or uniform set of provisions can be discerned.

Examples of management contracts are found in the mining industry but many of these are the result of management control being maintained under contract after nationalization, the retention of management control after reducing an equity position, or management control in support of a joint venture. They are invariably complex arrangements and very much tied to the achievement of the foreign mining company's corporate and strategic objectives. The Bank's only experience of management contracts in the mining sector has been the Mano River Project in Liberia and the recently negotiated management contract between State Gold Mines Corporation (SGMC) of Ghana and a Canadian mining group for the rehabilitation of three of SGMC's gold mines.

A number of management contracts in the mining sector were reviewed for the purposes of this paper. There were most significant variations in their terms and approach to different issues, merely illustrating the fact that they were negotiated in entirely different circumstances and in varying socio-political and market conditions. A number of mining joint ventures combining management contract arrangements were in operation during the late '60s and early '70s in Zaire, Zambia, Ghana and Sierra Leone but copies could not be obtained.
In the petroleum sector, their use has been limited (and very infrequent) to the management of oil refinery operations or as part of the arrangements for the overall operations of a petroleum-related complex. One contract reviewed was for the INDENI petroleum refinery in Zambia which was managed by Agip Petroli of Italy. Another was connected with the construction and management of gas facilities in the United Arab Emirates.

Management contracts are frequently cited as being connected with oil and gas drilling and exploration ventures but these are in essence operating agreements under which one of the joint venture parties undertakes responsibility for the management of the exploration program or drilling activities.

Manufacturing operations connected with management contracts have not been confined to the larger industries. Many small manufacturers have engaged companies under management contracts with highly beneficial results. A number of case studies have been conducted on Swedish companies which have operated in African and Middle East countries and the success rate has been high in such diverse activities as boat building, explosives, pulp and paper and chemical plants.

Management contracts have been employed in heavy engineering and steel-making projects, aluminum plants and smelters and rubber and glass plants. The incidence in these areas is not limited to developing countries and a number of companies in industrialized countries have employed industry leaders with proven records and high technological capabilities either to assist in the commencement of a new industrial operation or to revamp an old one.

Manufacturing industries, especially those where new technology or advanced management systems are required in order to remain competitive, have used management contracts in recent years. Existing manufacturing enterprises which have declined both in terms of available managerial skills and financial performance have sought foreign management expertise to assist in rehabilitation programs. In Sri Lanka, the government undertook an extensive rehabilitation program for some of its textile mills and brought in Indian and British companies under management contract arrangements.
5.1 Factors Influencing Design

The design and structuring of the overall management contract arrangement needs to be considered by the owner well in advance of negotiations with a potential manager. The pre-negotiation phase encompasses a number of steps, each of which will have an impact on the ultimate viability of the management arrangements and the relationship to be created between the owner and manager.

Commencing with an analysis of the enterprise's problems, the owner will determine whether the management contract route is appropriate and, if so, the nature and extent of the managerial and other inputs which might be necessary. The business objectives of the contract have then to be considered i.e. what is the manager expected to achieve during the term of its management role and the medium/long term position of the enterprise thereafter. Once the broad objectives have been determined, the owner must estimate the possible cost of the contract to ensure that it is a financially viable solution. Decisions can then be taken on the characteristics and qualifications of the manager to be engaged (whether a company or an individual).

A number of companies and consulting groups which have had experience of the management contract process have identified the pre-negotiation phase as critical and probably one to which many owners pay inadequate attention, especially in the public sector. In many cases, consideration of design features and issues stemming therefrom do not take place until negotiations. At that stage, the manager may have presented a draft contract for consideration. Ideally, the draft contract should reflect the owner's basic thinking and judgements on different design features. This will not occur if the pre-negotiation phase has been omitted or inadequately utilized. The consideration of a number of key factors during the design stage will have an influence on the structure of both the relationship and the contract. These factors can include the following:

- The possible need for consultants to assist the owner in the design stage. This will depend upon the owner's capabilities and experience in this area. Public enterprises in developing countries with little or no experience of the management contract process would be well advised to consider engaging limited consulting services for this purpose.
- Detailed analysis of the problems facing the enterprise and priority ranking of those problems to determine appropriate managerial and other inputs.
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o Evaluation of the external environment and determination whether manager's inputs will be unduly prejudiced by that environment. Where the owner is the government, this is an area which can be influenced and tempered by the government.

o Realistic assessment of whether the owner and existing management team will be fully supportive of the proposed management arrangement.

o Determination of the medium and long-term business objectives to be achieved by the proposed contract and plans for sustaining the improvements and management efficiency gained thereby.

o Intended scope of the management role and degree of authority and control to be vested in prospective manager.

o Evaluation of possible cost of the contract and its impact upon financial position of the enterprise.

o Desirable characteristics of manager and determination of best approach to engagement (direct or tendering).

The remaining sections look at several of the more important steps and factors mentioned above in the design stage.

5.2 Defining the Objectives

Management contracts have to accommodate a wide range of differing and often conflicting, motives, objectives and interests. The success of the business relationship will depend heavily on the extent to which the parties identify the differences, actual or potential, prior to negotiations, compromise on them during negotiations, and accommodate them during implementation. Management contracts have often failed because the parties themselves have failed to recognize or understand each other's quite different motives and expectations.

The underlying motivations of the parties will probably not be discussed explicitly during negotiations but will manifest themselves in the setting of objectives, the strategies designed to achieve those objectives and in delineating areas of particular concern in the contract provisions. In setting objectives, the owner should attempt to understand the commercial motives of the management company. Where the owner is a government, the political/social motives of the owner should be taken into account by the management company. Any lack of understanding as to the true objectives of the contract, the expectations of the other party or the real dynamics of the owner-manager relationship either before or during the negotiations, will inevitably cause problems during the implementation of the contract.

The starting point with any management contract must be the definition of objectives—what does the owner want to accomplish? The answer to that question will not only determine whether the management contract is the appropriate tool, but will govern the choice of manager
and the general structure of the contract. The objectives will help deli-
neate the general nature of the contractual relationship to be created;
the roles to be assigned to each party; the authority and control the man-
ager will have to be given for it to achieve the owner's objectives; the
specific managerial or other skills to be acquired; the duration of the
contract; the nature of the assistance or facilities the owner needs to
provide; the staffing pattern; and the compensation package that will best
induce the manager to achieve the stated objectives.

The prospective manager will also have certain objectives. It
will want to sell as wide a range of management and other skills as possi-
ble on the best terms. In addition, it might want to gain access to mar-
kets, or take up a minority equity position in the enterprise to assure
continued access. Another objective might be to establish a buyer-cus-
tomer relationship with the enterprise and buy its raw materials or sell
the manager's own products to the enterprise.

Very few of the management contracts reviewed set out in clear
terms the objectives to be achieved by the contract. This probably stems
from a failure on the part of the owner to formulate fully the precise
objectives rather than the draftsman omitting them from the contract.
The setting of clear objectives at an early stage of the pre-negotiation
phase is an essential pre-requisite to the whole management contract
process.

It is interesting to note the comments and insights of several
consulting groups who have assisted a number of governments and state-
owned enterprises to identify and select suitable management companies for
projects in different parts of the world. Both groups made the comment
that governments, in approaching a management contract situation, have
tended to adopt an essentially short-term, profit-motivated approach.
They did not place the management contract in the context of a long range
business plan for the enterprise or determine how improvements in the
enterprise were to be sustained at the end of the contract. In other
words, they failed to set either medium or long term objectives which
could be achieved through the management contract process and to determine
the precise direction of the enterprise after the termination of the
contract.

In this context, the use of consultants may be considered to
carry out the necessary examination of the enterprise, the problems which
it faces, the short, medium and long term business objectives which could
be achieved by the management contract and the financial and economic
costs of the same. Such consultants could also be involved in the selec-
tion process for the manager and advise the government or enterprise dur-
ing negotiations.

5.3 **Evaluating the Costs**

With the identification of problems, required managerial and
other inputs and the setting of overall objectives for the contract, the
owner is faced with the question of the possible cost of the proposed
arrangements.
The owner needs to determine whether a management contract is affordable, given the likely cash flow of the enterprise and its other resources. The owner will continue to be responsible for the capital and operating expenses, debt servicing and other outgoings of the business. Depending upon the nature and extent of the problems, estimates can be made of the likely management personnel costs, the management fee and such other compensation elements as incentive payments, commissions, production or sales bonuses, etc. These costs have also to be borne by the enterprise and should be factored into financial projections to discover whether the enterprise can generate sufficient revenues to accommodate these additional costs. Equally, the estimated benefits to be derived from the contract in terms of increased production, sales or other criteria, should be made part of the overall financial analysis.

Apart from a straight financial analysis, the owner may look at external factors which may affect the manager's estimate of cost either positively or negatively. On the negative side, if external factors have led to the current unprofitable position of the enterprise, the manager may be reluctant to undertake the contract without a high management fee element. Similarly, if political risks are perceived to be high, the manager may want those risks to be reflected in its fee. On the positive side, the owner may investigate whether there are special conditions which may make the overall management assignment more attractive i.e. access to raw materials, domestic markets, sale of the manager's products/technology to the enterprise, procurement benefits, etc. Quite often these are equally beneficial and attractive to the manager as the contract compensation.

By undertaking the above analysis, the owner will be able to form initial ideas on the likely form of the compensation package and the type of manager which might be interested in undertaking the proposed arrangement. While these ideas have still to be tested during negotiations, the design and planning process combined with the evaluation of likely costs will place the owner in a sound position at the outset of negotiations. The owner will, in effect, be laying down the parameters and defining the main elements of the proposed relationship. These will be modified during the course of negotiation but cost proposals by the manager can be balanced against the owner's own estimates. In this respect, the preparation of financial statements which can be agreed with the prospective manager during negotiations is important. Both parties should be working from a set of figures and financial data in which they have confidence and which can serve as a proper basis for their respective financial projections.

5.4 Choosing the Management Company

The choice of manager can either lead to a beneficial contribution to the owner's business if the relationship and contract are allowed to function well; or to a worsening position if the business and contractual arrangements fail. Depending upon the scale of the problems and size of the enterprise, the owner will have to determine whether an individual or individuals can undertake the contract or whether a management company
should be approached. Management companies are usually drawn from the same industry as the enterprise. Some international companies regard management contracts as a business in their own right and openly market their services. Others are known to be leaders in their field and are approached by the owner directly.

It is not possible to draw up criteria capable of meeting all situations and the industry in question will significantly influence the type of management company sought and chosen. The owner's objectives (if clearly formulated) will provide some indication of the likely characteristics of the management company—large or small; world-wide interests or restricted to one country or region; an established record in a particular industry; the possession of specific expertise; or qualities which are directly relevant to the owner's business.

Depending upon country and owner characteristics, there may not be a wide choice of companies. Even when tenders are invited, there may be only one or two responsive bidders. An international competitive bidding process may attract those companies which are in the business of providing management services. A systematic prequalification process based upon the owner's objectives, medium and long term business aspirations and other factors is more likely to unearth a suitable short list of candidates. If consultants are involved in the process and the objectives and other owner/country characteristics are matched with a foreign company or companies after a comparative survey, there may well be merit in permitting a direct approach.

5.5 Choosing the Management Team

However exacting the provisions of the contract may be, the contract will not work if the personnel provided by the management company are not of the highest quality. The following characteristics have been identified in personnel assigned under successful contracts: a high level of competence in their particular discipline; the ability to translate expertise into practice in exacting circumstances; ability to communicate effectively with managers of a different cultural background; ability to adapt the management company's "corporate culture," business concepts, skills, systems and procedures to local conditions; and to create enduring systems, not systems which can only be understood and maintained by the management company's personnel.

The management team should normally be drawn from the contractor's own corporate staff and should be accustomed to working as a cohesive team. One of the principal purposes of a management contract is to transfer the company's corporate skills and knowledge and this can only be done through the company's own personnel who are imbued with the "ethos" of their corporation. This feature would not be present when an individual is engaged but, even in this case, the individual's managerial skills would be based upon knowledge of systems and procedures in other enterprises and transferred accordingly.
The process for recruiting personnel under a management contract is completely different to that of recruiting consultants. First and foremost, a corporation is being recruited with the specific objective of obtaining an internal team which is equipped, both professionally and personally, to undertake the management tasks encompassed in the contract. In a sense, the owner is buying a "slice" of the management company. Recruitment of personnel outside the corporation has the effect of diluting the team and increases the chances of failure in an already difficult situation. Only specialists who are not available internally are normally recruited externally.

The use of the contractor's own personnel has a further benefit for the owner. Such personnel will be guaranteed a job to return to within the organization. Retention (and probably enhancement) of promotion prospects, together with pension and other rights, will also be guaranteed. This element of job security means that the manager in the field is not looking for opportunities to extend the contract and thereby the employment of the management company's team.

One example which is worth quoting in this context is the recent management contract negotiated for a mining operation in Ghana. During the evaluation stage it was noted that several bidders had included large numbers of personnel drawn from outside their own organization. In one case, a large and well known company had simply gathered together all the personnel required from outside, the project manager being the exception. This perhaps indicates that some major companies are not familiar with the actual workings and requirements of management contracts and also that the owner should be alert to this problem at the evaluation stage.

5.6 Preparing the Contract

The contract form which serves as the basis for negotiations is usually provided by the management company in those sectors where management contracts are used extensively. Its provisions tend to favor the management company's position—the hotel industry being a prime example.

In the industrial sector, enterprises and projects are substantially more complex and the management company will not necessarily be in the business of providing management services on a regular basis. The owner, having formulated its objectives, undertaken the necessary studies and financial evaluation, will in all likelihood be in a better position to draw up the management contract as the basis for negotiations.

In the overall financing of a project, it would be most advantageous to make provision for legal assistance to draft a management contract which encompasses the owner's objectives and its position on the key issues. While the owner's initial (and optimum) position in the draft contract will be modified during the negotiating process, at least the main principles and elements which the owner feels are essential for achieving its objectives will be embodied in the draft.
CHAPTER 6

COMMON ISSUES IN MANAGEMENT CONTRACTS

6.1 General

The terms and conditions of management contracts are specific to the country, industry and enterprise to which they relate. In certain sectors - the hotel sector being the prime example - there are standard features and provisions which are used industry-wide. In most other sectors, terms and conditions vary widely as do the size, content and format of management contracts.

Notwithstanding this diversity, a number of issues are common to all management contracts: the owner-manager relationship and the role each party is to play; the scope of the manager's authority and control; the obligations of the owner; the process by which decision-making, communications, control and monitoring are to be accomplished; staffing and personnel issues; training and the transfer of skills and technology; the compensation package; the liability of the parties; settlement of disputes; duration of the contract; and several other related issues.

Each of these issues needs to be considered and resolved by the parties at an early stage in the planning and negotiating process. Although ultimately reflected in the contract, they are not issues which should only be considered when confronted with a draft contract. They are part and parcel of the business relationship which is being created. The manner in which they are resolved will define the parameters of that relationship. These issues should, therefore, be considered in the context of establishing a workable relationship, with the contract providing the specific framework and mechanisms necessary to achieve the objectives of the parties.

The issues mentioned above are by no means exhaustive and the discussion which follows is only intended to highlight some of the different ways in which these issues have been handled.

6.2 Scope of Management Role

The precise scope of the manager's role and the responsibilities undertaken must be clearly defined in the contract.

Many contracts merely state that the management company will conduct the business affairs of the enterprise in an efficient and profitable manner without specifying the parameters of the management role and this invariably leads to problems at the implementation stage. Owners or the incumbent management group sometimes wish to leave unclear the true limits of the management company's role and responsibilities in the belief that they will retain more control or management power. This attitude
causes conflict during implementation and is quite counter-productive. The management company has no accurate perception of what is required of it; and the owner has in effect failed to decide upon the objectives of the contract and the specific content of the management role required to achieve those objectives.

In general, the following activities and responsibilities might be included within the scope of the management company's role: general management (overall corporate planning, organization and personnel planning); financial administration (planning, budgeting, financial analysis, borrowings, liquid assets control and accounting); personnel administration; production management and provision of technical know-how; training of local staff in systems, procedures and specific management and operational functions; marketing and distribution (depending upon the type of enterprise); and such other matters as may be included in the scope of the management role specific to the industry and enterprise.

The scope of the management role must be commensurate with the objectives which the manager is expected to attain. If the manager is to be responsible for turning around an unprofitable mining operation or agri-business, the scope of its role cannot be confined to purely technical areas. Achieving higher production or outputs might be possible through a purely technical role. Turning around a business and being accountable for profitability demands a far wider role for the manager. Those inputs which the manager must realistically make in order to achieve the owner's desired objective must help to determine the scope of the manager's role and its attendant responsibilities.

An example can be taken from a contract which was recently negotiated in Ghana. The manager was required to manage the rehabilitation of three mines for a state-owned mining enterprise, the prime objective being the return of the enterprise to a profitable situation. Under the terms of the contract, the manager was responsible for the planning, management and supervision of mining operations, geological services, mining services, metallurgical services and specific rehabilitation projects. These areas might be characterized as technical in nature. However, on the non-technical side, a wide range of activities fell within the scope of the management role, namely, accounting, financial control, procurement, personnel, office administration, communications, design and implementation of training programs, formulation and implementation of sales policy and even financing assistance. The parties had accurately identified the areas in which the manager would have to make an input (in the absence of local management personnel) if both the operational and commercial objectives were to be achieved. In doing so, the scope of the management role for the particular situation faced by the Ghanaian mining enterprise was defined and reflected in the contract.

The nature of the problems faced by the enterprise will also have a bearing on the scope of the management role. In some situations there may be a need for concentrated technical services or technology transfer with an associated but limited managerial function to ensure proper adaptation and incorporation into the enterprise's business. In
such a case, the management contract might provide a specific and limited managerial role, with the technical services or technology transfer separated out under a parallel technical assistance or licensing agreement. Owners quite often attempt to "de-package" the management skills required and to provide for specific inputs under accompanying licensing, marketing or technical agreements. While the scope of the management role may vary widely from contract to contract the need to link scope with ultimate objectives remains true in all cases.

6.3 Management Authority and Control

If the manager is to be given the responsibilities outlined in the contract, it must equally be given the management authority and control required to fulfill those responsibilities. This is one of the most difficult areas to negotiate in a management contract and yet it is crucial that it be realistically and equitably negotiated. The problem of management authority and control is often stated in terms of a conflict of interests—the owner wishing to retain as much control as possible over the operation; and the manager requesting full authority to undertake all the activities and responsibilities which it feels are prudent and necessary to operate a commercial enterprise. While in one sense there is a conflict of interests, it is not necessarily useful to examine the problem in those terms.

What is happening is an agreed allocation of management authority and control—the delineation of the day to day management powers which the management company must have if it is to run the domestic enterprise. It is quite distinct from the overall policy direction and the right to review and approve major financial and operational matters in respect of which the owner quite justifiably seeks to retain a degree of control. If the manager is to be held accountable for the performance of its responsibilities, the "lack of authority" excuse often raised by managers when there has been a failure to perform should not be a defence made available by the owner itself.

In a growing number of contracts, a list of specific powers and areas of responsibility are provided for, these being powers which the manager sees as crucial to the fulfillment of its management functions. Equally, it is usually specified that the Board of Directors of the enterprise will have responsibility for the overall policy direction of the company and that certain major matters will be subject to final Board review and approval.

Among the key management powers will be found, for example, control of the owner's personnel, including hiring and firing, promotion and layoff; the planning and design elements of the particular project or production process; control of production schedules, procurement and maintenance programs, and preparation of annual work programs and accompanying budgets. Among the matters subject to the owner's approval are critical matters such as approval of work programs, capital and operating budgets, expenditures in excess of amounts provided in budgets; and proposed contracts in excess of an agreed amount.
The manager must be given sufficient management and day to day operational control to run the enterprise and owner "interference" must be limited to defined circumstances. Although the word "interference" will almost never be found in management contracts in the industrial sector, in hotel management contracts there is usually a standard undertaking that the owner will not interfere in the manager's day to day management of the hotel. In an area such as the hotel industry where management contracts have been extensively used and refined, the irony of bringing in an external party to manage and then not permitting it to manage was learned at an early stage. The management powers found in hotel management contracts are far wider than in any other sector and would probably represent an unacceptable level of control in most other sectors. For example, one hotel contract (with a major international hotel chain) provided that "the Manager shall have absolute control and discretion in the operation of the Hotel."

One contract reviewed was between the Jamaican Government and a U.K. management company for the operation of sugar factories and cane sugar estates. The objectives of the contract were clearly stated and the duties of the manager comprehensively documented. The grant of management powers and authority was directly linked to the performance of those duties and is a good example of management powers being made commensurate with the responsibilities undertaken by the manager and with the achievement of specified objectives.

6.4 Allocation of Responsibility

The threefold nature of the business relationship (owner, manager and enterprise) requires a number of organizational decisions and a clear allocation of responsibility for the various tasks set forth in the contract.

The Board's role will normally be restricted to overall control, broad policy direction and the review and approval of matters specifically reserved to it in the contract. The separate Board-management roles which have become familiar in many industrialized countries are not so established in developing countries and there are many instances, especially in public enterprises, where the Board exercises powers and exerts control over management functions. A management contract cannot afford to leave the respective roles of Board and management vague.

One international management company concerned with the provision of management and technical services to major agro-industrial concerns in many parts of the world, has drawn up a "preferred" contract form based upon its long experience of management contracts. Throughout the contract, the allocation of responsibility as between Board and manager is clearly spelt out. The manager's appointment is for the "management of the whole of (enterprise's) business and undertaking for a period of (seven) years." Subject to the overall direction of the Board, the manager's specific responsibilities are outlined. The precise relationship between the Board and manager is also specified: the Board will determine the overall policy of the enterprise and "the manager will be responsible
for the day to day implementation of operations within the agreed policy."
The Board designates one of its members to liaise with the manager in all matters of policy and the manager's representative is invited to attend all meetings of the Board.

The principle of overall Board direction of the enterprise is usually stated but without prejudice to the specific management powers given to the manager and its control and management of day to day business operations. If the manager's duties are clearly and comprehensively set forth, there is less chance of arguments over "grey" areas. By specifically excluding from the manager's duties and attendant powers those matters which only the Board can decide, the Board's residual management-related powers can be defined. For example, the manager may be given no authority to borrow money on behalf of the enterprise; to sell or otherwise dispose of the enterprise's unmoveable property; to invest the enterprise's monies (save for short term deposits); to commit to expenditures beyond those approved in budgets; to create mortgages or liens; and to enter into contracts unrelated to the specific operation or in excess of a stated amount.

Where the manager holds no equity in the enterprise (as in a pure management contract) there is no direct representation on the Board. However, in such cases there is usually a provision made in the contract for the manager to be present at Board meetings in order to be made aware of general policy matters and to present reports on the enterprise's operations. The precise reasons for the manager's presence will be outlined in the contract.

If the manager does hold equity in the enterprise, direct Board representation may be demanded (whatever the shareholding) but voting powers would be proportional to that shareholding. In these circumstances, the manager is likely to have a more influential voice on the Board, even if the shareholding is small, by reason of representing a shareholder and by reason of his control of day to day operations.

Where a Chief Executive of the enterprise remains in place (i.e., the manager's representative does not have a direct reporting relationship to the Board), particular care has to be taken in the contract and in the organizational structure to ensure that the allocation of responsibilities is clearly understood and that staff at all levels also understand the reporting lines.

Several cases have been cited of a strong Chief Executive undermining the manager, countermanding operational decisions well within the manager's authority and, in effect, ignoring the new management relationship and the fundamental basis of the management contract. While the contract cannot prevent this happening (unless the manager determines that the contract has become impossible to perform and has grounds for termination), the proper examination of the issue at negotiations and a clear understanding of the manager's role may help to prepare the way for easier implementation. Other contracts were reviewed where all management actions were "subject to the prior concurrence of the Board" or "subject
to the approval of the Board's designated representative." This formulation in effect usurps the management role and cannot be expected to work well in practice. It merely indicates that the owner has not accepted the principle of external management.

The allocation of responsibility between Board, Chief Executive (if there is one), the manager and the management company itself will be made somewhat more complex when dealing with a state-owned enterprise. This brings into play yet another level, namely, that of government. While not a party to the contract, the government and the ministry or agency responsible for the enterprise will have a vested interest in the progress of the contract and may wish to become involved. This is one of the more difficult aspects to deal with during negotiations but it should be tackled; and government representation, coordination and communications should be encompassed to the extent possible in the contract.

6.5 **Decision-Making and Communication**

The manner in which the decision-making process and lines of communication between the parties are established should follow and reflect the control, authority and allocation of responsibility lines discussed in earlier subsections.

Contracts are often silent on these matters. It may be that these are matters which are ultimately worked out in practice. However, the management contract should provide the overall framework within which the parties will operate. During the negotiation process the means whereby the parties will arrive at decisions, the communication of those decisions and any special bodies (i.e., technical committees, Board sub-committees, coordination committees or groups) which may facilitate the decision-making and coordination process should be discussed and formalized in the contract.

The contract can call for a series of different reports and information flows from the manager. These might include technical, operational, financial, progress or other reports which are either informational or specifically designed to elicit a decision from the Board on a specific matter. The more comprehensive the reporting system and agreed communication channels between the Board and manager, the more smoothly the contract can be expected to work. If procedures agreed are found to be unsatisfactory in practice or need to be modified during the course of the contract, the parties can agree to this.

If there is a specific area of concern i.e. procurement, marketing, technical matters, etc. where either the Board or manager feels that special decision-making processes should be established, these should be provided for in the contract. In many public enterprises, procurement or the consideration of technical recommendations by the manager may become bottlenecks. Board-appointed procurement, technical or other specialist committees with full delegated powers and manager representation have been successfully used to cut through unnecessary or time consuming internal procedures.
6.6 **Obligations of the Owner**

In the context of operations in developing countries, an owner is always required in the management contract to facilitate certain activities of the manager.

In one contract reviewed, the owner undertook to supply to the management company, without charge, agreed facilities, information, data and assistance in obtaining work permits, provision of housing, office space, transportation, and communication facilities. Some of the most important areas from a management company's viewpoint can be the obtaining of import licences, approval to open bank accounts, clearances through customs, export permits, and liaison with government departments.

The extent to which the owner honors these obligations will significantly affect the outcome of the contract, especially in countries where government procedures are the cause of extensive delays in equipment procurement and clearances for imports and exports. The management company is engaged to tackle the managerial and technical problems of an enterprise. It must receive assistance from the owner or enterprise in the areas mentioned above if it is to function efficiently and effectively. If there have been significant problems for the enterprise in the past, these should be discussed with the management company. The nature of the assistance to be provided by the enterprise (and by government where appropriate) should be clearly spelt out in the provisions relating to the owner's obligations. Several management companies have taken the added precaution of obtaining direct government assurances on basic conditions and provision of facilities when dealing with public enterprises. While this is by no means a standard practice, companies with experience in this area are reluctant to enter into contracts without direct assurances from government.

In a Jamaican contract, a detailed set of conditions precedent were set by the manager and had to be fulfilled by the government (owner) for the management phase to become operational. These included the owner bringing into effect a plan for the severance of personnel in excess of those required by the enterprise; the provision to the enterprise of funds sufficient to finance working capital, to pay for imported goods and services and to pay manager's fees, all as set out in the agreed initial budget for the first year of operation; and the approval of special exchange control facilities required for the operation of the enterprise and for payments to the manager and non-resident suppliers.

6.7 **Personnel**

In taking over the management and day-to-day control of the enterprise, the incoming manager will not only be providing its own qualified personnel to fill agreed managerial, administrative and operational positions, but will become responsible for the direction of the owner's personnel at all levels. The exact situation will differ from contract to contract but most contracts will attempt to provide for the manner in
which the management company's personnel will integrate into an existing structure and the control and authority which the management company's representative will exercise over the enterprise's personnel.

In the case of a state-owned enterprise, the problems connected with personnel, staffing policies and the right to hire and fire will be unduly difficult. However, without the right to exert control over local personnel, the management company will not be in a position to manage effectively. In situations where overstaffing is problematical, the management company might insist that the enterprise take action to reduce the work force before the contract commences (i.e. in the Jamaican example cited above).

The management company will attempt to secure the right to hire and fire, but workable arrangements can also be agreed to allow for consultation on recruitment, promotion and other areas where the Board of the enterprise had an obvious long term interest. The principle of day to day control over local personnel is especially important on the operational side where effective recruitment, dismissal and promotion controls are directly related to the overall efficiency of the enterprise. The management company's own personnel will normally be subject to prior approval by the owner. They may be removed for cause at the owner's request and replacements similarly approved by the owner.

A sensible formulation employed in many of the management contracts reviewed was to give the manager power to appoint and, if necessary, dismiss staff, agree terms and conditions of service and promotion and generally deal with all matters relating to the enterprise's employees in accordance with the laws of the particular country. Provided that all employee relations are conducted within the framework of the local labor laws, the manager should not be otherwise fettered. Hotel contracts almost invariably give the manager control over labor policies (including wage rates, the hiring and discharging of employees in accordance with local laws) as the quality and efficiency of staff has a direct and obvious bearing on the hotel's profits.

6.8 Training and Sustainability of Improvements

From the owner's viewpoint, the training of local personnel to fill key management and operational positions, thereby ensuring a viable, locally managed enterprise at the conclusion of the management contract, is normally an important objective. The management company is often required to undertake training programs, on-the-job training, overseas training in the management company's productive facilities (if applicable) and compensation may or may not cover the training element.

In a number of contracts reviewed, the management company was required to carry out an agreed training plan for the training of local personnel at all levels, including technical and management levels. The stated intention of such a plan was progressively to replace expatriates at all levels in accordance with an agreed localization timetable. The
manner in which the training provisions are structured vary considerably from sector to sector but are a relatively uniform feature of management contracts, whatever the sector.

A number of management companies have encountered considerable difficulties with the training component under their contracts. While their personnel are professionally equipped to carry out the management task, training skills are not necessarily highly developed. If training of local personnel is a key objective of the owner, careful consideration should be given to permitting a sub-contract for the training component under the overall supervision of the management company. In this fashion, specific training skills can be injected and blended with the management company's specific areas of expertise. Where a management company possesses an independent training capacity, this may not be necessary.

The formulation of suitable provisions to cover training is an area of especial difficulty for the draftsman. A number of contracts reviewed left the question open (i.e. "when, in the judgement of the manager, a local employee has reached the required level of training and efficiency, such local employee shall replace the member of the manager's staff"). This is thought to be unsatisfactory from the owner's point of view as no criteria are set for objectively determining when training has been "completed." Equally, training plans imposed by owners requiring certain numbers of local staff to replace the manager's staff each year seem to take little account of the quality or proficiency attained by such local staff. Several successful training programs provided for a continuing and joint assessment by owner and manager through a special training committee.

The emphasis on training in so many management contracts highlights a key objective for most enterprise owners - to ensure that the improvements made in management and enterprise performance during the tenure of the contract can be sustained on a long-term basis thereafter. While a "successful" management contract of 3 to 5 years duration may well return an enterprise and its management to efficient performance, it is questionable whether a contract can be said to have succeeded if management and enterprise gains are not sustained well beyond the term of the contract.

In this context, training in its widest sense becomes an all-important feature of a management contract if the owner is using the injection of management and other skills as the basis for long-term improved performance. The integrated package of skills, systems, procedures and corporate "culture" which is being brought to the enterprise by the management company has to be effectively transferred to the management and other personnel of that enterprise. This requires not only a determined training effort on the part of the management company (assisted, if necessary, by an external training group); but also a commitment on the part of the enterprise owner to make the investment in necessary counterpart staff at all levels who are capable of assimilating and maintaining the knowledge and systems transfer. In several cases examined, the momentum provided by the manager ran down after contract expiration - not
because the manager had failed (in one case it had been remarkably success-ful) but because the enterprise owner returned to the old, uncompe-titive salary structures and incentive systems, reverted to earlier prac-tices, lost the trained personnel and, ultimately, dissipated the gains achieved under the management contract.

Several commentators indicated that the end of the management contract was the true beginning of the enterprise owner's task — ensuring that the improvements are sustained. Training then becomes linked with long-term business objectives and is one of the important means of realiz-ing those objectives with the enterprise's own personnel. Training of management personnel (as opposed to technical training) requires greater effort and commitment on the part of owner and manager if longer term business performance is to be sustained. Very few of the contracts reviewed revealed imaginative or well-conceived training plans other than in the strictly technical area. This is an area which is receiving greater attention in more recent management contracts. It is noteworthy that in establishing the African Management Services Facility, the Bank's affiliate, IFC, commissioned a separate study on training aspects. It was recognized that enterprises had to treat training as a special area under management contracts and that the true gains available under management arrangements of this nature lay in the quality of the local management and technical personnel remaining after the contract had ended.

6.9 Transfer of Technology

The transfer of technology by a management company can be required through the use of provisions which approximate a licensing agreement. Where this is a central objective of the particular project or operation, it is questionable to what extent it should be included in the management contract and not, perhaps, in a separate technical assistance, technology transfer or know-how agreement.

Several of the contracts reviewed stated in specific terms the type of technology to be transferred and the methodology and timing for such transfer. In most other contracts which did not have separate technology or licensing agreements accompanying them, provisions on technology transfer tended to be vague or restricted to the manager "keeping the owner informed" of developments or research in areas of specific inter-est. It is doubtful whether such provisions can be beneficial to owners and perhaps indicates an inadequate focus by the owner on the technology transfer objectives of the contract.

Another, and sometimes equally important element of "technology" transfer, is the transfer of the corporate skills and managerial know-how from the manager to the enterprise. It is surprising that in many management contracts, this element, while expected or possibly referred to in passing, is not given the attention warranted. Most companies providing management services in a particular industry have developed their own sys-tems of management, financial control, accounting and planning, informa-tion systems, and inventory control which have been proven in their own
operations. The transfer of these management and corporate skills and their proper adaptation to local conditions by the manager is an area equally important as the training of local personnel.

6.10 Compensation

The range of compensation provisions in management contracts is as varied as the number of management contracts. The overall financial arrangements are dealt with in Chapter 7. However, the main compensation elements in a number of contracts reviewed contained three main features. First, charges for the provision of the management company's personnel in accordance with an agreed formula, such charges including a small profit element. Second, agreed reimbursable costs. Third, incentive payments calculated in accordance with an agreed formula.

The most highly developed formulas can be found in hotel management contracts where there are accepted and competitive compensation package structures. In addition, the formulation of compensation in the hotel industry is sometimes aided by reference to industry-accepted accounting codes such as the "Uniform System of Accounts for Hotels", as adopted by the American Hotel and Motel Association. In most other sectors there are no market-oriented guides for structuring the compensation package.

Incentive payments may be based upon a production bonus and/or a profitability bonus which become payable upon the achievement of levels of performance sufficient to establish the long-term viability of the enterprise as a commercial entity. Such payments should constructed in such a way as to ensure that production levels are not achieved by sacrificing costs and the longer term viability of the operation. Incentive payments can also be controlled by review and approval provisions for capital and operating budgets, work plans and annual production schedules.

6.11 Duration

Management contracts are valid for a specific duration and are often extendable for further periods upon the agreement of both parties. There is no term which is standard in management contracts but 3 to 5 years is normal depending upon the scale and complexity of the problems faced.

Sometimes the duration is fixed for a period anticipated by the owner as being sufficient for the manager to complete a training program for local staff. Sometimes the duration relates to the expected start-up period of a new commercial enterprise. In other cases, the duration of a contract is much longer either because the nature of the operation requires it (i.e. mining development or crop plantations); or because the manager will not commit its resources unless it has an assurance that its name and personnel will be a part of the operation for a long period of time. International companies in most sectors will be reluctant to risk their corporate reputation to undertake a project or operation in an unrealistic time frame. This is often cited as the reason for the long duration of hotel contracts (15-20 years) but is probably more related to the manager's interest in reaping long term gains.
6.12 Liability and Indemnification

The question of liability takes on an added significance in the case of large industrial projects, especially those where the contract requires the management of refineries, chemical/fertilizer complexes or mining operations.

If the management company is vested with full authority to manage and control the day to day operations of a plant or operation, it will in effect be in control of most of the factors which could lead to an accident or breakdown in safety procedures, (unless the owner or enterprise specifically reserves to itself or its own nominated personnel responsibility for such areas). Management companies are understandably reluctant to take on unlimited liability in operations which they manage but often seek to impose quite unrealistic limitations upon their liability.

In this area it is impossible to generalize and the facts of each situation need to be assessed to ensure that the interests of the owner or enterprise are adequately protected. The management company should bear a degree of responsibility and liability which is proportionate to its control of the operation or project. Reluctance on the part of the management company to accept a degree of liability sometimes stems from the fact that it is difficult to arrange adequate insurance coverage for projects in certain countries.

In a contract for mine rehabilitation in Ghana, the management company's limit of overall aggregate liability was negotiated to a level which was deemed by both the enterprise and the management company to be reasonable given the circumstances of the mine, operational conditions and other relevant factors. Particular attention was paid to the possibility of environmental damage, waste of ore and safety aspects. Detailed indemnification and insurance provisions were provided in order to identify the specific types of insurance which had to be taken out during the contract period and the limits of such insurance.

A management company will typically not accept liability for indirect or consequential loss or damage (including loss of profits) however such loss or damage may arise. Liability of the management company is also sometimes governed or influenced by customary industry practices (the oil industry for instance) and it is extremely difficult for an owner to negotiate a higher liability level than is normally accepted in that industry.

6.13 Other Provisions

As with any contract, a management contract contains provisions covering such areas as settlement of disputes, governing law, taxation, non-assignment, notices, compliance with local laws, force majeure, procurement, termination and the like.
The law of the country in which the contract is to be performed will be the law chosen to govern the contract in most cases. However, most managers, if not drawn from that country, will insist upon international arbitration with organizations such as the International Chamber of Commerce, ICSID or other recognized bodies. In view of the nature of the relationship and the number of potential areas for disagreement, particular attention should be paid to the arbitration provisions.

One matter which might be noted is the taxation of management fees and the repatriation and convertibility of moneys earned by the management company under the contract. These matters, which are of vital importance to the management company, are often not examined by the parties until negotiations. Where the owner is the government, government policy or regulations on the treatment of management fees, moneys earned and repatriation of such moneys should be examined. A determination should be made at the pre-negotiation phase whether the overall investment/taxation regime is conducive to management contract arrangements and whether the particular circumstances of the proposed contract (i.e., its importance to a key industry or foreign exchange earner) is such as to warrant a review or modification of such regime.
7.1 General

The structuring of the financial arrangements under management contracts varies widely from sector to sector and will inevitably be the product of a compromise by the parties. One of the major difficulties in fixing the level and method of payment is that there is rarely any assistance from, or reference to, market mechanisms. Management contracts involve the transfer of a package of skills which may be unique to one company. The pricing of that package will to a large extent be arbitrary and the result of a compromise i.e. what the purchaser is ultimately willing to pay and the contractor willing to accept in all the circumstances.

In the developing country context, the settling of the financial arrangements is even more difficult because many non-financial factors are at issue. If the parties are unknown to each other, there will naturally be considerable caution on both sides, each party trying to protect its interests. A state-owned enterprise will be under great pressure to keep down the costs of the contract not only for budgetary reasons but for political reasons as well. The enterprise may be thinking of costs and financial structuring in terms of a consulting contract and looking at costs on a man-month basis rather than on the purchase of a package of management skills. Conversely, it may try to "unpack" the skills in an attempt to reduce costs.

The management company will want to sell a total package of skills, ensure the maximum degree of control and secure a reasonable level of income. It will not undertake a contract unless it feels that there is a reasonable prospect of profit and a cash flow from day one. The management company is selling the management services as a part of its business and will not assume uncommercial risks however much the contract may be desired. Ultimately, the management company has a board and shareholders to satisfy and profit will be uppermost in its thoughts.

The enterprise will normally be in a weak bargaining position. It lacks the management and technical skills required to operate the business and probably does not have a wide choice of contractors who can do the job. In such circumstances, the enterprise has to analyse what it can afford, and whether there are any other benefits to the contractor which could be bargaining levers.

There may well be strategic benefits to the contractor in terms of new markets, new sources of raw materials, control over supplies, an opportunity to enter a country where direct foreign investment as such is prohibited. These "benefits" need to be quantified by the enterprise. The government may be in a position to make tax and exchange control regulations more favourable or to ensure that fees, interest payments, dividends, and other payments are easily remitted overseas. In other words, there could well be a number of "indirect" bargaining levers besides money available to the owner.
A list of various compensation packages, their features, advantages and disadvantages are summarized in Table 4. The following subsections describe various elements sometimes found in different combinations in compensation packages.

7.2 Annual Fixed Fee

While this is comparatively rare in the contracts reviewed and in general practice, it is a form of payment which many management companies prefer and attempt to negotiate at the outset. Several of the companies interviewed stated that the annual fixed fee provided a guaranteed source of income and minimized the risks to which they might be subjected. They emphasized that in order to set an annual fixed fee, they had to ensure that costs were meticulously calculated and that this was of benefit to the domestic enterprise.

This was not an entirely convincing argument because they still wished to be protected against inflation and for the annual fixed fee to be subject to escalation! In those contracts where an annual fixed fee was found, it was probable that the contractor might also be deriving a benefit from other areas of activity, i.e., sales to the enterprise, a source of raw materials or the opening of a new market. In other words, an annual fixed fee set at a reasonable level was negotiated not because it guaranteed the recovery of all costs plus a profit element but because it was a convenient cash flow mechanism which was complemented by other indirect but perhaps more important strategic benefits.

An annual fixed fee is rarely acceptable to a state-owned enterprise. First, it is difficult to determine a reasonable level and there are few (if any) benchmarks against which to measure what might constitute a "reasonable" level. Second, the contractor is bound to build in cost and inflation elements (if there is no escalation clause) and a profit element, all of which adds up to a figure which is regarded as astronomical by the enterprise. Third, in many developing countries, annual fixed fees are regarded with suspicion and are politically unacceptable. There may also be a perception by the government that the contractor is receiving indirect benefits in the form of market opportunities, sale of goods on favourable terms, dividends (where there is an equity participation) or other benefits and that the annual fixed fee should not be calculated without some attempt to quantify such indirect benefits and thereby reduce the fee.

The most valid objection the enterprise can make against the annual fixed fee payment is that there is absolutely no guarantee of performance. Whatever the level of performance, the fixed fee must be paid. Against this, management companies have stated that their corporate reputation and future business prospects in the country are sufficient guarantee of performance. While these are undoubtedly potent factors which will motivate companies which enjoy (and must protect) an international reputation, it is not a convincing argument at the political level. The company's interest in the enterprise will probably be less if payment is assured and there is no additional benefit to the management company if above average performance is achieved.
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<td><strong>VARIOUS COMPENSATION PACKAGES: FEATURES</strong></td>
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<th>Forms</th>
<th>Basic Management Fee (Annual Fixed Fee)</th>
<th>Fee as Percentage</th>
<th>Incentive Payments</th>
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<tr>
<td>o Fixed lump sum</td>
<td>o Management Fee + Costs</td>
<td>o Fee as percentage of profits</td>
<td>o Based on: increased production - profitability - fuel or input conservation - plant + equipment efficiency and availability - achievement of localization targets - others</td>
<td>o Used largely for: purchasing - marketing - ancillary operations</td>
<td>o Purchase agreements for raw materials</td>
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<td>o Payment based on agreed benchmark</td>
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<td>o As percentage of sales</td>
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<td>o As percentage of production</td>
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<td>o Opportunities for direct investment</td>
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<td>o Fixed lump sum o Management Fee + Costs</td>
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<td>o Payment based on agreed benchmark</td>
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<td>o Other Sources (such as interest, bonuses, etc.)</td>
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<td>o Fee normally clarified, owners can assess charges</td>
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<td>o Facility of overseas remittance</td>
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<td>o Possible to determine fee and whether owner can afford fee</td>
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<td>o Guaranteed performance</td>
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<td>o Offers incentive for increased profitability and production</td>
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<td>o Reward linked to results and performance</td>
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<td>o With use of ceilings, owners and managers know maximum cost and potential earnings of contract</td>
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<td>o Difficult to determine reasonable fee without market standards</td>
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<td>o Higher cost for enterprise because of possible hidden charges</td>
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<td>o Politically sensitive</td>
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<td>o Offers no guarantee of performance</td>
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<td>o Lack of formal performance guarantees</td>
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<td>o Reluctance to tie fee to non-performance related service</td>
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<td>o Difficulty with determining index to be used as base</td>
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<td></td>
<td>o Could be complicated by issues of transfer pricing</td>
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<td>o Few managers contract under this basis alone</td>
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<td>o Possibility that managers will attempt to achieve outcome by sacrificing costs</td>
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<td>o Purchase agreements for raw materials</td>
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<td>o Access to domestic market</td>
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<td>o Opportunities for direct investment</td>
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<td>o Favorable taxes and exchange control</td>
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<td>o Dividends</td>
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<td>o Interest payments</td>
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<td>o Facility of overseas remittance</td>
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Assuming that the enterprise could negotiate a reasonable and non-escalating fixed fee (i.e., a fee fixed at a level which it felt was commercially and politically acceptable), such a method might be advantageous for the following reasons: the absolute cost of the contract (and the foreign exchange burden) would be known in advance and could be properly budgeted; the management company's income would remain static in spite of rising costs and higher sales volume; where a bidding process was involved, the bid could be more easily compared and evaluated; and the cost of an annual fixed fee may be lower than incentive payments which are a relatively unknown factor in terms of ultimate levels (unless ceilings are imposed).

7.3 Fixed Fee Plus Costs

The fixed fee plus costs is a more normal arrangement but is still open to criticism because of the lack of any performance guarantee. In a fixed fee plus costs methodology the fee can be reduced by the exclusion of costs but the reimbursable costs require careful definition. The financial provisions of a management contract placed on a fixed fee plus costs basis would be structured in much the same way as a consulting contract.

In defining reimbursable costs under a management contract, there may be greater emphasis on the proportion of head office costs to be included depending upon the role to be played by head office. A number of management companies structure their operations in such a way that full use can be made of head office personnel, systems and facilities and this factor has to be accounted for accordingly.

It would appear that the fixed fee plus costs methodology has brought more attention to bear upon the fixed fee component because it represents not only the profit element but perhaps other elements such as perceived country risks, potential competition risks from the enterprise and constraints placed upon the contractor's other projects. Governments and state-owned enterprises are hesitant to pay large management fees when all the contractor's personnel costs, reimbursable costs and such other defined costs as may be applicable have been fully covered.

7.4 Percentage Fees

In place of a fixed fee, the parties to a management contract sometimes prefer to stipulate a fee based upon a percentage of profits, sales or production (as the case may be).

A profits-based fee can be calculated in a number of different ways--principally on the basis of pre-tax or post-tax profits. There are, however, a number of difficulties encountered during negotiations on the means of calculating profit. While a number of the contracts reviewed contained profits-based fees, there was a general awareness that this methodology had some inherent risks. The unscrupulous contractor might try to attain short-term profits by sacrificing longer-term advantages.
Where the contractor is engaged in sales to or purchases from the enterprise and has the ability to make adjustments on charges for such sales or purchases, the question of transfer pricing and the manner in which it can prejudice profit-related fees will arise.

Few contracts reviewed provided for fees based purely on profits and this may be because the owner felt that relating fees to profits did not necessarily create an incentive for the manager to achieve optimum production in the long term; that profits do not necessarily stem from managerial competence but from factors outside the control of the management; or because the contractor might be reluctant to accept a profits-related fee when it may be prevented from making profits for reasons beyond its control. However, a number of contracts did provide for a combination of fees based on a percentage of profits and sales or profits and production.

Fees based on a percentage of sales were either based on a proportion of total sales or of the number of units sold. Sales are obviously preferred by management companies as a basis for fees because sales are more predictable than profits and will probably occur sooner than profits. The risk to the enterprise is that the manager will attempt to boost the volume of sales without attempting to control or reduce costs. This is equally the risk where production is used as a basis. In practice, any form of percentage fee which allows one party to prosper while the other suffers a drop in income or profitability is inherently unsatisfactory.

7.5 Commissions

A range of commissions have been found in a number of management contracts including purchasing commissions, marketing commissions and commissions for operating related functions. Whether or not part of the compensation package is based upon a commission seems to depend largely upon the practice of a particular industry.

7.6 Incentive Payments

In the more recent management contracts, part of the compensation package is represented by a scheme of incentive payments. Given the cost of management contracts, owners and enterprises are concerned to ensure that the objectives which have been set are in fact achieved and that the management company is rewarded by results and performance.

Depending upon the owner's objectives, incentive payments can be devised to reward increased production, profitability, fuel conservation, plant and equipment efficiency and availability, sales, achievement of localization targets and a range of other benefits which the owner wishes to realize through the means of the management contract.

In structuring the incentive scheme, experience has shown that there should be a reasonable balance between the fee component, the reimbursable costs and the incentive payments. Few, if any, management companies contract on the basis of performance-related payments alone, even if they have favourable cost reimbursement provisions in the contract.
This is not because they doubt their own capabilities but because whatever the extent of their management control over the particular operation, there are still many factors entirely beyond their control which may prevent them from performing to the levels anticipated. Government interference, non-approval of important matters by the Board of the enterprise, lack of foreign exchange for essential capital expenditures, changes in government policy, events of force majeure and the like have all been cited by management companies as matters which have frustrated performance and their ability to earn the incentive payments.

While incentive payments are undoubtedly attractive to management companies, they should be structured to ensure that the companies are not presented with a bonanza if circumstances turn out to be unexpectedly favorable or anticipated levels of sales or production have been underestimated. Normally, some scaling down of incentive levels in specified circumstances is provided for in the contract to cover such eventualities.

Where increased production is one of the objectives of the owner, care should be taken to ensure that the management company does not achieve higher production levels by sacrificing costs. Production has therefore to be linked (if applicable) to profitability or achieved strictly within the limits of approved budgets. The importance of the Board of the enterprise being in a position to assess independently work plans, budgets and technical matters is vividly illustrated in this area. If the Board is not capable, or if it does not have recourse to independent advisers, the manager can underestimate production levels, inflate the budget and ostensibly achieve above average output.

7.7 **Performance-Oriented Trends**

As management contracts and their workings have become better known in international business, a growing emphasis has been placed upon ensuring performance—both to achieve the overall objectives of the contract and the managerial/financial benefits promised by the contract.

It is important to pay careful attention to the structuring of the contract, particularly a clear exposition of the objectives, the means by which those objectives are to be achieved and the achievement of a performance-oriented compensation package.

Management contracts are primarily designed to improve the management environment and the many corporate areas and activities which depend upon effective and efficient management. The introduction of targets, incentive payments and other rewards related to performance are more likely to ensure committed and progressive management by the management company than the traditional fixed fee concept. Performance-oriented contracts impose positive burdens upon the enterprise itself in that the local management (and government where a state-owned enterprise is involved) must ensure that it works towards the creation of both an internal and external environment which will make achievement of agreed targets and levels of performance feasible.
Agreed levels of performance, for both the enterprise and the management company, also provide a reason for monitoring performance and taking timely action to improve performance where it is tailing off or being impeded by external factors. The use and design of management contracts are not technical issues but rather tools to achieving economic and/or financial viability, transferring of business concepts and systems and/or training of management and workers. These broader objectives must guide the development and implementation of management contracts. Levels of performance and the setting of targets should, therefore, be realistic and take account of the factors which could affect desired performance or results.
BIBLIOGRAPHY

In preparing the study, written materials from a wide variety of sources, published and unpublished, were reviewed. The following only outlines several of the more important reference materials used and does not list materials from World Bank reports, corporate reports, government sources, and newspapers.

Brooke, M.Z. (1985) Selling Management Services Contracts in International Business, originally published by Holt Rinehart and Winston but currently handled by Cassells in England and the New York University Press in the United States. This is by far the most comprehensive available publication on the whole subject of management contracts, and itself contains a most valuable bibliography.


