

The Prisoner's Dilemma and the Brazilian Corporate Law

Two conspirators are caught and put in separate cells without being able to communicate. A deal is offered to them: if only one confesses, he will go free but the other will serve ten years. If neither one confesses, both will serve five years, and if both confess, they will stay in prison for eight years. The dilemma is that the best decision for each individual (to confess) has negative consequences for the group whereas the best collective decision (silence) may produce the worst consequence for the individual.

This is the classical analogy used to describe the problem of collective action. The best decision from an individual standpoint brings negative results for the group. Even worse, when the situation involves a greater number of people, if everyone, except myself, works hard to achieve the collective good, I get a benefit without cost. However, if everyone thinks like me, the collective good is never produced. The parallel with the situation of the Brazilian capital markets is inevitable. For example, our extremely high cost of capital has been stimulating controlling shareholders to turn their companies private by making a tender for the outstanding shares. This is a classical problem of the collective action, especially when the tender is made on a two-tier price structure (whoever tenders first gets a better price). Undoubtedly, the best decision for each investor is to sell quickly regardless of price, as not only he may get a better price, but the stock will lose liquidity as the float shrinks substantially. However, the best collective decision is not to sell until the bidder offers a fair price. For this reason, it is not only justifiable but also desirable to have the competent authorities regulate tender offers from controlling shareholders.

Such tender offers are only one of the consequences of the acute problem of the capital markets in Brazil. In fact, this situation

has never been as bad as it was at the beginning of last year but, on the other hand, it may never have been as close to a significant improvement as it is today. A few groups within the government and the opposition parties have realized that a longer period of sustainable growth in this country is impossible to achieve without tackling the problem of long term financing. The only source of long term capital in Brazil is BNDES (the official development bank) which budget is increasingly limited when compared to the size of our economy. The stock market is currently not a viable option as multiples are too low and the markets thin. Obviously, the volatile economic environment does not help to build a healthier market but there is no denying that our regulatory environment and corporate law may be improved.

In this respect, a project from Congressman Emerson Kapaz has just recently been submitted to the Commission of Economy and Finance. If approved, this new law will contribute significantly to improve our current corporate law (Law 6404/76). A summary of the main proposed changes has been attached to this Report).

Generally speaking, we think that Law 6404/76 is very good. Suffice to say that it has survived more than 20 years without any significant changes except for Lei Kandir in 1997, a rare fact in Brazil. Having said that, we understand that the Law may be improved because it was conceived for a stock market that would grow and as such, market forces alone would create the correct incentives for fair corporate practices. As we have said before in this Report, the current situation is quite different as the market is actually shrinking. A number of important public companies have gone private in the last few years without a corresponding number of IPO's.

When the objective of the controlling shareholder is to turn his company private, a terrible conflict of interest arises. The natural market punishment for companies with bad corporate practices is a low share price (and high cost of capital) which is, incidentally, just what the controlling shareholder desires. This situation generates circumstances that are al-

most surreal; on more than a few occasions we have found ourselves arguing with company executives that their companies were performing much better than they were saying it was. In a specific company that has lent more than its net worth to its controlling shareholder (a practice which, by the way, is likely to be explicitly prohibited in Congressman's Kapaz' project), we had to argue that the creditworthiness of the debtor was much higher than he was trying to convince us of.

In any discussion about changes for our corporate law where the objective is to grant more protection for minority shareholders, the most heated debate is always on the issue of the preferred shares. There are a number of people that defend the simple extinction of preferred shares as they do not believe it is possible to create a fair corporation structure with non-voting shares. On the other hand, some people argue that investors are not really interested in voting and, as such, non-voting preferred shares are a legitimate instrument. As a proof of their argument, they point to the enormous amount of foreign money invested in Brazilian shares.

We see merit in both arguments. As most of you know, preferred shares in Brazil are really just a non-voting common, since most of them do not carry a coupon or a preferred dividend. The only real privilege most Brazilian preferred shares have is priority in the reimbursement of capital. Well, the only case in which this constitutes a real privilege is when companies go into liquidation, certainly not a desirable investment outcome, especially in Brazil. Having said that, no one can deny that preferred shares had an important role in the growth and success of various family-owned Brazilian companies in the last 25 years. If it was not possible for these families to fund their companies without losing control, maybe their companies would not have grown as much as they did.

However, the possibility of controlling a company with only 16.7% of its capital (or even less in a pyramidal structure) would allow many unscrupulous controlling partners to violate minority shareholders right even more fre-

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quently than they do today, particularly in a country where the legal system is not specialized in corporate matters and very slow to make final decisions. As the number of episodes where the rights of minority shareholders are harmed has been growing alarmingly, long term investors have been steering away from the Brazilian market, a fact that inhibits good quality companies from going public and stimulate controlling shareholders to buy their firms back from the market.

Somewhat against the trend, some respectable analysts have been arguing that Brazil should permit companies to issue super voting common shares, i.e., shares with multiple voting rights. Just like with preferred shares, super voting common shares allow companies to leverage more proceeds from the capital markets without diluting control. In the U.S., for example, it is possible to control a company with less than 1% of the capital. In fact, Brazilian preferred shares already a super-share structure, inasmuch as they permit a 6 to 1 voting power (one can control a company owning 16,67% of total capital). Having said that, the main advantage of the American system is that all minority shareholders own the same type of stock thus improving liquidity. The adoption of a super-voting stock can only make any sense if it came with minimum rights for the non-super-voting stock. For example, the owners of super voting would have to give tag along rights for all shareholders if they sell control; minority shareholders should have the right to elect a meaningful number of board members; maybe the super-voting status could be temporarily suspended if the performance of the company does not meet certain pre-specified criteria.

Although we recognize certain advantages in this system, we do not think it would be a good idea in Brazil. Given the current situation of our judicial system, the most likely outcome of the adoption of super voting stocks, a system where the economic interest is so dissociated from the political interest, would be a significant increase in minority shareholders' abuse, worsening the current problem.

In summary, the ideal corporate structure, in our view, does not include the extinction of preferred shares. We would rather improve the conditions of these shares by granting them economic privileges that mean a true preference. In addition, preferred shares should also be given some political (governance) rights that could be exercised, or even augmented, if and when the economic privileges are not being satisfied.

The Project in Discussion

We have attached to this report a table with the main changes in our corporate law that are being proposed in the project of Congressman Kapaz. We have also included our

suggestions for each point where we had a different point of view (note: the table that accompanies this report contains more up to date changes than the report in Portuguese). The main points of the current version are listed below:

1. Preferred shareholders, provided they hold at least 15% of total capital, will be able to elect one member of the board.
2. Tag along rights for common minority shareholders if control is sold (the situation reverts to what it was before Lei Kandir). Previous versions of the project included a discount to the sale price of the controlling shareholder in the range of 10 to 20%.
3. Controlling shareholders will be required to tender for all outstanding shares of companies with less than 20% of free float (effectively turning their companies private).
4. The minimum price for this tender will be book value (or economic value, if such mechanism is foreseen in the by-laws).
5. Preferred shareholders will be given the right to vote in Shareholder's Meetings called to decide on issues of conflict of interest.
6. Mergers and incorporations will allow non-accepting shareholders to redeem their shares at book value (another return to the situation pre-Lei Kandir).
7. Issuance of new preferred shares will be limited to 60%/40% (as opposed to the current 66.7%/33.3%) in the first year after the new law, 45%/55% in the second year and 50%/50% thereafter.

OUR SUGGESTIONS

Our main comments to the current version are as follows:

1. The issuance of new preferred shares should only be allowed if the new shares are entitled to a priority dividend of 6% per annum over the book value. As mentioned before, the only preference most of Brazilian preferred shares currently have - which in theory they received in exchange for forgoing their voting rights - is the priority in the reimbursement of capital. It is interesting to note that, in Brazil, it is a crime to liquidate a prosperous business.

This priority dividend should be non-cumulative and should not alter the current requirement that companies distribute 25% of their net profits. This means that preferred shares only get their dividends before common shares, and up to the point where they will have received a total of 6% per annum over the book value of the end of the previous year. If enough dividends are distributed that common shares also receive the 6% return, any additional amounts would be shared by each class on a capital pro-rata basis.

If controlling shareholders wish to increase their chances of receiving dividends on their common shares, they may (i) issue less preferred shares; (ii) distribute more than 25% of net profits; or (iii) only invest in projects with high return on equity (low-return strategic investments will require controlling shareholders to eventually receive less dividends in exchange for the supposed strategic value, effectively creating a cost for excess leverage in preferred shares).

We think that these characteristics result in an unequivocal alignment of interests. Actually, if it were not for reasons of pre-acquired rights or changing the rules in the middle of the game, we would defend that, after a certain period for adjustment, all preferred shares should be granted this priority dividend.

It is also worth noting that it would be important to have the book value (and not the value of paid-in capital) as the basis over which priority dividends would be calculated. Various Brazilian companies have preferred shares with minimum dividends which work like priority dividends, but all of them use the value of paid-in capital as the basis for calculation. Besides the fact that paid-in capital is a figure with no practical meaning - it is just an accounting concept - its value is also fixed in time whereas book value increases in exact proportion to the results of the companies.

2. We also think that it would be fair to change the way the Audit Committee ("Conselho Fiscal") is elected. We think that the composition should reflect the total capital of the firm. In practice this would mean that in a committee with three members, one would be elected by the preferred shareholders, another by the controlling shareholders and the last member would be elected by all shareholders present at the meeting. If a common minority shareholder also wanted to elect his representatives, the committee would have two extra members as the controlling shareholders would have the right to elect two counselors. A viable, but less desirable, alternative would be to adopt this mechanism only if the company did not distribute dividends for three consecutive years (or, maybe, did not distribute a pre-set minimum amount of dividends).
3. In this respect, if a company does not distribute any dividends for three consecutive years, the current law only grant voting rights to preferred shares with a minimum or a fixed dividend right. We think that any preferred share should have voting rights in this case.

4. In cases where the minority shareholder may exercise his redemption rights or for the tender offers mentioned in item 4 of the previous section, the price should be the economic value of the company. Book value is increasingly less representative as a measure of fair value of a company. Needless to say, the appraisal method for reaching the economic value is of utmost importance to make this method work.

The big question not addressed in the project nor in our comments is tag along rights for preferred shares. The issue of to whom the controlling premium belongs (some would argue that it does not even exist) is so complex and rich that it would deserve one whole Dynamo Report. We believe that it is totally unjustified to have very high controlling premiums received only by a small portion of the capital (as has been the case in most sales of control in Brazil, especially after Lei Kandir - please refer to our Report number 12 for comments on the matter). However, the compulsory granting of tag along rights to existing preferred shares would be a rupture to the existing law and not an evolution.

In our view, it makes more sense to improve the conditions of existing preferred shares both in terms of more protection

against violation of rights and in terms of more alignment of interests with controlling shareholders. It is much better if this can be achieved through market-based incentives instead of through coercive instruments.

For the truly outstanding companies that have been achieving high return on equity and reallocating cash flow in a rational way, not much will change except for a likely substantial reduction in their cost of capital.

However, nothing could be fairer and more democratic than when results become mediocre and remain like that for long periods, that preferred shareholders gain some political (governance) rights that, in normal conditions, they would not even care about. This is especially true when a company is highly leveraged with preferred shares, that is, when control is exercised with only 16.7% of total capital.

Some companies are analyzing the possibility of anticipating these changes and modernizing their corporate structures voluntarily. During the course of February, both Saraiva Livreiros and Ultrapar were the first Brazilian companies to announce the inclusion of voluntary tag along rights for minority shareholders in their by-laws. Not surprisingly, our fund has meaningful positions in these two

companies and Dynamo was very involved in structuring both deals. Having studied the issue of tag along rights for quite some time, we know only too well that the implementation of such measure is far from trivial under the current status of our corporate law (which, as we have mentioned, may be changed soon). The main difficulty derives from the fact that it creates an obligation to an unknown third party (the buyer of the company) in a contract between two specific parties (the controlling and the minority shareholders). We intend to write about this topic in detail in our next report.

Finally, just a quick note on Ultrapar, an important, albeit recent, addition to our portfolio. The company went through its IPO in early October. We are very optimistic about this company as it combines three of our most sought after characteristics in an investment, which are (i) a sound business; (ii) run by people who are highly competent, honest and energetic; and (iii) with a corporate structure that aligns the interests of executives, controlling and minority shareholders, as can be attested by the tag along rights described in the previous paragraph. As it is a relevant position in our fund, we will be writing more about it in the near future.

Dynamo Cougar x Ibovespa x FGV-100

(in US\$ dollars - commercial selling rate)

Period	DYNAMO COUGAR*			FGV-100**			IBOVESPA***		
	Quarter	Year to Date	Since 09/19/94	Quarter	Year to Date	Since 09/19/94	Quarter	Year to Date	Since 09/19/94
1993	-	38,78	38,78	-	9,07	9,07	-	11,12	11,12
1994	-	245,55	379,54	-	165,25	189,30	-	58,59	76,22
1995	-	-3,62	362,20	-	-35,06	87,87	-	-13,48	52,47
1996	-	53,56	609,75	-	6,62	100,30	-	53,19	133,57
1997	-	-6,20	565,50	-	-4,10	92,00	-	34,40	213,80
1 st Quar/98	16,55	16,55	675,66	18,15	18,15	126,83	15,07	15,07	261,14
2 nd Quar/98	-8,70	6,40	608,30	-19,40	-4,80	82,80	-19,60	-7,50	190,30
3 rd Quar/98	-33,50	-29,20	371,20	-27,20	-30,70	33,10	-33,40	-38,40	93,50
4 th Quar/98	14,20	-19,10	438,10	-1,20	-31,50	31,50	-0,10	-38,40	93,30
1 st Quar/99	6,81	6,81	474,80	11,91	11,91	47,20	12,47	12,47	117,36
2 nd Quar/99	24,28	32,75	614,36	24,60	39,44	83,41	2,02	14,74	121,76
3 rd Quar/99	3,17	36,96	637,01	-4,71	32,87	74,77	-7,41	6,24	105,34
4 th Quar/99	49,42	104,64	1001,24	62,92	116,46	184,73	59,53	69,49	227,58

(*) The Dynamo Cougar Fund figures are audited by KPMG and returns net of all costs and fees, except for Adjustment of Performance Fee, if due.

(**) Index that includes 100 companies, but excludes banks and state-owned companies. (***) Ibovespa average.

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www.dynamo.com.br

DYNAMO

**DYNAMO ADMINISTRAÇÃO
DE RECURSOS LTDA.**

Av. Ataulfo de Paiva, 1351 / 7º andar – Leblon – 22440-031
Rio – RJ – Brazil – Phone: (55 21) 2512-9394 – Fax: (55 21) 2512-5720

Main Changes Being Proposed For Brazilian Corporate Law (6404/76)

SUBJECT	AS IT IS	PROPOSED CHANGES	IDEAL CHANGES
Conflicts of interests Art. 115	Definition of what constitutes conflict is vague; preferred shares do not vote; only minority common shares vote but no provision for when controlling shareholders owns 100% of common shares	Preferred shares may be allowed to vote on matters of conflict of interest	Preferred shares must vote; CVM has helped by issuing an instruction defining what constitutes conflict.
Redemption rights for dissident shareholders Art. 137	No redemption rights in cases of mergers or incorporations if shares are part of Ibovespa	Only excludes this right in cases of privatization of companies whose shares are part of Ibovespa	O. K.
Companies going private Art. 4, Par. 2°	Tender Offers for taking companies private can be made at any price	Establishes Minimum price at book value or economic value, if such value is foreseen in the by-laws	It should be economic value from set by an independent appraisal in all cases.
Companies going private Art. 4, Par. 3°	Voluntary offers do not require companies to be taken private even if tender is made for all outstanding shares	Controlling shareholders of companies with less than 20% of free float will be required to tender for all shares and take the company private	Companies with less than 20% free float today should be given a few years to adjust
Board Seat for preferred shareholders Art. 18, par. 2°	No board seats for preferred shareholders	Preferred shareholders with at least 15% capital have the right to elect one member for the board of directors	Should be at least 15% of preferred shares, provided it represents at least 10% of total capital; controlling shareholders with preferred shares cannot vote
Tag Along for common shares - Art. 254	Tag along for common shares existed until Lei Kandir in 1997; preferred shares never had tag along rights	Establishes obligation for new controlling shareholder to tender for all common shares at 80% of price paid to previous owner.	Discount of 20% should be lower.
Election of members for Fiscal Board (Audit Committee)	Law is not clear whether controlling shareholders may vote with their preferred shares	Controlling shareholders cannot vote with their preferred shares	The majority of the Fiscal Board should be given to shareholders with the highest participation in total shares and not only in common shares *
Temporary voting rights for preferred shares – Art. 111	Not clear how many consecutive years without dividends implies voting rights for preferred shares; only preferred shares with minimum of fixed dividends are granted these voting rights	Establishes a maximum period of three consecutive years	Any preferred shares should be granted voting rights if no dividends are paid for three consecutive years.
Issuance of new preferred shares	Subject to the overall limit of 66% of total capital	Maybe subject to a limit of up to 50% in new issuances	The limit of 66% could be maintained but new preferred shares could only be issued if they were granted priority dividends of 6% per annum of book value **
Redemption of shares by companies Art. 44, par. 3°	Any shares maybe redeemed by companies at any time	Mandatory redemptions may only be executed if approved by a Special Meeting of affected shareholders	O. K.

* If Audit Committee is composed of three members: preferred shares elect one, controlling shares elect another, and third member is elected by the majority of all shares represented in the Meeting; If it is composed by five members: one extra member for the minority common shares and one more for the controlling shareholders

** Until these new preferred shares receive 6% per annum over the book value in dividends, common shares do not receive any dividends. After that, common shares receive up to the same 6%, and any remaining dividends are shared pro-rata of capital thereafter. The legal requirement that at least 25% of annual profits are distributed is not changed.

Other subjects covered by the project: Shareholders' Agreements, Audit Committees for subsidiary companies, issuance of shares without pre-emption rights, Constitution of Profit Reserves, Debentures, possibility of settling disputes through arbitration, Rules for publishing of financials.