Report
Dynamo 33

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About Swindles and Swindlers

"The most incomprehensible thing about the universe is that it is so comprehensible", said Einstein in one of his most charming and mystic quotes. Capital markets, human institutions by nature, are a lot more unstable and fallible than the Cosmos. But there is an analogous paradox: what is impressive about the vortex of the Brazilian capital markets is that it allows a restructuring project that is so crystalline. Which one? It is simple (at least to describe): it is the straight line that passes through the institutional quality of the market regulatory agents and by the gradual elimination of the transgressions of the letter or the spirit of our Corporate Law. In this route, adequate jurisprudence could be built and meaningful penalties would be imposed to felons, both of which constitute the right incentive for the adoption of so-called good market practices. Already in our Report 19, under the title "The Theory of the Broken Window", we discussed this subject in greater detail. Since then, our Reports have been occasionally dedicated to illustrate some of the deviations which need to be corrected so that the geometry of the Brazilian capital markets can be closer to more perfect forms. This Report will focus in one more of these detours: the undesirable loan contracts extended by publicly-traded companies to their controlling shareholders.

Before we start, though, as an introduction, we cannot resist offering a few comments about the boisterous imbroglio involving Enron. As most analysts have been pointing out, the key issues of the case are the bad faith of the executives of the company and the inherent conflicts of interests in the interior of the organs that were supposed to verify the quality of the information divulged to the public by those executives (which is what we are more interested to understand). The logical conclusion of this episode is that neither the external auditors nor the audit committee have the independence required to perform an unbiased judgment of the management and accounting practices of companies. There is also an additional element: the conflict of interest of the fund management companies. At the same time that they should be exercising their corporate governance rights and policing the companies they invest (like Enron), their business is inextricably dependent on those same companies inasmuch as they represent potential clients from whom to raise funds to manage. Because this kind of conflict is increasingly relevant, we plan to dedicate one of our next Reports to the subject.

Auditors who are supposed to inspect accounts with skepticism are, at the same time, trying to cross-sell (to use a modern marketing buzzword) consulting services to the exact same companies their primary duty requires them to be suspicious of. And we are not even mentioning the constant flow of executives from auditing firms to their clients, which may create a certain positive bias towards potential future employees. With respect to the audit committees, the problem lies in the way their members are "elected" as most of them are actually appointed by the senior executives of the company.

The situation is quite serious. When the ones responsible to prevent shareholders from being defrauded become the ones who legitimize the fraud, the very nature of the market is at risk. The immediate and bold reaction of the public opinion and the regulatory agencies deserve loud compliments. A number of measures intended to clean and improve the auditing process and the accounting rules are currently being considered and one can easily conclude that the Enron "accident" will contribute to a better protection of shareholders interests in the future (as Mr. Greenspan has pointed out). Even a conservative magazine such as The Economist[1] , realizing the dangerous consequences of the Enron sting, does not balk in pondering that auditing services of listed companies should only be performed by state-owned accounting firms.

In reality – and that is the important lesson from this story – sometimes, in the complex and not always civilized process of building up relationships among market agents, there will be broken windows. If through them, a swindler or two pass by, that is life or, not to be unfair to the rest of Creation, it is human nature. What cannot be tolerated is that it takes so long for window fixers to spring into action that, through the broken glasses, a hoard of swindlers gallop by. The result is anarchy and insecurity, and the system evolves (when it does) too slowly. Unfortunately, this is what happens every too often in Brazil. The case about to be described illustrates very well the theme and the thesis of this Report.

From a legal standpoint, a corporation ("sociedade anônima" in Brazil) convene several individuals who cooperate for a common objective: to obtain an appropriate return on their investments. There are two distinct risks in this associative adventure: the first one has to do with the production of value as the project that originated the collective action might not succeed. The second risk, which has less to do with economics than, perhaps, sociology, is the fair and just distribution of the value eventually created by the company (from the latin *cum panis,* that is, those who eat from the same bread).

Since Rudolf von Ihering, a German legal philosopher of the late nineteenth century, concluded that "under the eyes of the modern legislator, corporations have been transformed into agencies for scams and robberies; their secret story has more outrage, infamy and villainy than a penitentiary"[2] , a lot has improved both in the legislation and the regulation of the corporate environment. However, still in the twenty first century, expropriation of minority shareholders, to say it in a less Germanic euphemism, has not yet disappeared. It continues to be intensely debated – and practiced –, and with even more excitement in less developed markets such as Brazil, as our readers know only too well.

One of the most corrosive forms of unilateral appropriation of undue benefits by controlling shareholders are loan contracts between the company and its owners (in Portuguese, such loans are called "contratos de mútuo" or, literally, mutual contracts). More specifically, we are referring to those contracts that allow the cash flow of companies to end up in the bank accounts of its controlling shareholders, be it the individuals themselves or vehicles used by them to facilitate their private business affairs.

(1) *The Economist, February 9-15th, pg. 9*
(2) *As quoted by Alfredo Lamy Filho and José Luiz Bulhões Pedreira in A Lei das S.A., Ed. Renovar, third edition, pg. 20*

The word "mutual" is of Latin origin and denotes reciprocity, fairness in a exchange or a trade. In its legal denotation, it means a contract by which one of the parties (the creditor) lends something fungible to another (the debtor). In its more popular and well-known version, it is simply a loan in which the conditions are set in a contract.

There are two conspicuous forms by which a company may return the funds to its shareholders: the payment of dividends or the payment of so-called Interest on its Own Capital ("Juros sobre o Capital Próprio", a kind of charge on a company's capital that is payable to shareholders which offers a clear fiscal advantage over dividends). In both instances, unless there are different clauses in the by-laws (such as a minimum, a priority or a fixed dividend), distributions will be made in proportion to the percentage of the capital owned by each shareholder. The utilization of the liquid resources of a company as a funding source for its controlling shareholder is utterly asymmetrical. We have never heard of mutual contracts to minority shareholders. Much less about any preemptive rights being extended when executives decide, for whatever exotic reason, to invest the company's cash lending money to its shareholders. In all cases we know, this is a private and exclusive right of the controlling shareholder.

And what could possibly explain the fact that executives take the initiative to divide the breads unequally, offering to a shareholder what they are not offering to others, even though all are members of the same society to which, by law, the executives are subordinated? This is not an easy question to answer. At the end of the day, for executives in a normal state of independence and competence there are certainly many more interesting alternatives. Investing excess cash in the more orthodox financial system seems safer, simpler and, certainly, more liquid. It is the usual and adequate procedure for the treasury department to follow. Appraising the credit risk of universal borrowers in the financial markets is definitely a lot easier than the credit risk of the controlling shareholder. Moreover, in the first hypothesis, redeeming the investments is much less complicated and conflicting. Therefore, maybe with rare exceptions, wherever there are mutual contracts of the type we are referring to, there is evidence of abuse from the controlling shareholder. If not how could he make the conflicted suspicious suggestion that the company should consider lending money to himself? Mutual contracts, for what they mean as a precedent of undue intervention by the controlling shareholder in a corporation, are as dangerous as an infected *aedes aegypti*.(a mosquito that carries a virus that is spreading very rapidly in some cities in Brazil this summer).

What is the size of the epidemic? We are not going to present a complete study about this kind of practice in the Brazilian market. Suffice to offer two examples, both painfully real. First case: the discounted cash flow of the company, or a reasonable comparable multiples valuation indicate a value per share of around R$ 6.00 to R$ 8.00 (that is without any controlling premium). The controlling shareholder owes the company around R$ 33.70 per share. Through mutual contracts, the company has become the holder of credits against its controlling shareholder equivalent to 118% of its net worth. In practice, this means that the stated objective of the company, as per its by-laws, has been violated given that the industrial activity has been substituted by a bizarre financial activity. In the market, the stock, which should be worth some R$ 42.00, trades around R$ 8.00.

Second case: the company has bank debt amounting to R$ 600 million. Revenues have been around R$ 850 million, but it has lost money in the last three years. It is likely that it needs a capital infusion from its main shareholders. The controllers claim they do not have any resources to meet their pro-rata share of a capital increase. They owe about R$ 200 million to the company. The stock price has declined more than 85% in the last two years.

These are very impressive stories indeed. But let's allow ourselves, *ad argumentandum tantum*, a moment of indulgence: could the controller be taking such attitude because he feels it is in the best interest of the company? In other words, could there be a situation where the best legitimate alternative for investing excess cash is to lend to the controlling shareholder? The difficulty with this hypothesis (which we strive to treat respectfully) is that the Corporate Law (heretofore, simply, the Law) does not permit the controller to borrow from his company under terms that are more favorable to him than he could obtain in the market (article 156, first paragraph)[3] . In the legal field, we could imagine then that at least these loans are made in terms that are equal or better than the ones the controller could obtain in the market. But if that is the case, why wouldn't he go to the market and not to the company? The truth is that these loans are attractive to the majority shareholder because he could not obtain them in any other place.

Our practical experience shows that these loan contracts are generally treated with a great dose of informality. In most cases, this loan is processed as a normal treasury operation and, usually, does not require any special approval from the board or from a shareholder's meeting. In one moment the cash is there, in another it has been transformed in an infamous credit against the controller.

The story gets worse when we think that the company may have financed itself - either with loans or share offerings - in the private markets or even with public money (through the development bank or official lines of credit) only to extend loans to the controlling shareholder, allowing the individual to prosper in the shadow of his company. To the minority shareholders, only perplexity.

In many cases, these loans are defended on the basis that they have been contracted at "market interest rates". But there is no mention whatsoever about the lack of proper guarantees, the unusual and unacceptable volume from a credit risk perspective or the terms that are too frequently longer than the longest terms in ordinary bank loans. And let's not forget that, when due date arrives, if it is necessary to roll over the loan, the negotiation between the parts ought to be quite smooth (that is, between the debtor / employer and the creditor / employee). All of these characteristics collide frontally with the notion of equitable practices foreseen in paragraph one of article 156 of the Law. Nevertheless they constitute one of these transgressions that, once committed, produce de facto irreversible effects.

Incidentally, in the chapter about illegalities surrounding this kind of loan, there are other very interesting points in the Law. Let's look at some of them.

The only paragraph of article 116 states that "The controlling shareholder must use his controlling power with the intent of assuring that the company fulfills its object (as defined in the by-laws) and its social function". It is simply impossible to imagine an interpretation that could lead to the conclusion that the extension of loans to the controlling shareholder fits into the either the letter or the spirit of this article. Unless the controller believes he is kind of a Madame Bovary businessman (*que los hay, hay*) and think loud (sic): "I am the social function of this company".

Article 117 states that the controlling shareholder is liable for damages caused by acts conducted with abuse of his power. The first paragraph of the article lists what are the types of abusive exercise of power. Among them, it is worth mentioning "lead the company to activities that are not within its social object – as defined in the by-laws – (...) or cause the company to favor another firm, Brazilian or foreign, to the detriment of minority shareholder's participation in the profits or assets of the company"; "provide for the adoption of policies or decisions that are not in the best interest of the company and aim

(3) *In fact, article 156 refers to the conflict involving the executives when they are, themselves, a counter-party in a transaction with the company. Obviously, in companies where the executives are hired and fired by the controlling shareholder, any interest of the latter is indirectly transmitted as an interest of the executives. Therefore, for all practical purposes, in companies with defined control, contracting with the controlling shareholder has the same conceptual meaning as contracting with oneself.*

to cause losses to minority shareholders"; "induce, or attempt to induce, any officer or fiscal council (equivalent to the audit committee) member to take any unlawful action" (the second paragraph of this article also states that, in this case, "the officer or the fiscal council member who commits such unlawful action shall be liable jointly with the controlling shareholder").

Article 153 determines that "in the exercise of his duties, the officers of the company must employ the care and diligence that any active and honest man customarily employs in the administration of his own affairs." Except for naive company officers, of the kind that believe in Madame Bovary controllers, it is very unlikely that we will find any mentally sane executives who would rather invest his own money in a loan to the controlling shareholder of his company than in the regular financial markets.

The first paragraph of Article 154 reminds officers that they must not fall into temptation: "An officer elected by a group or class of shareholders shall have the same duties and obligations towards the company as all other officers and shall not fail to fulfill such duties even at the expense of the interests of those who elected him". This is also the direction of Article 155, part II: "An officer shall serve the company with loyalty and treat its affairs with confidence and shall not (...) exempt himself from protecting the rights of the company or, with the intent of obtaining benefits, for himself or for a third party, fail to take advantage of a commercial opportunity that is in the interest of the company".

For the benefit of the busy reader but in consideration of the curious reader, we suggest some additional material: article 158, fifth paragraph (officers' liabilities); article 163, parts I, II and III (authority of the fiscal council); article 165 (duties and responsibilities of fiscal council); and last, but not least, the very interesting article 245. All of these articles deal primarily or secondarily, with the circumstances under which a company commits a loan to its controlling shareholder. A careful consultation of these various articles reveal how valuable the Brazilian Corporate Law can be. Our real problem is compliance.

Legally challenging these loans in the Brazilian judicial system is not simple. For various reasons, it is not an attractive cause to most lawyers. It is also complicated and lengthy to do it through the regulatory agency (the CVM). For these reasons, as we said before, once these loan contracts are signed, it is very hard to revert its consequences, regardless of the instance of appeal. So, what can be done?

In the Iliad (Book XXI), the full-flown Scamander river, tired of carrying the victims of Achilles, decides to battle the Achaean warrior himself. And his strategy is very appropriate for a river: he will try to drown his enemy. If this passage can serve as an example, better than waiting for the CVM or the lawyers, investors should tackle this problem themselves. Institutional investors should make an official announcement stating that they will no longer buy shares in companies that do not have, in their by-laws, a clear and unequivocal prohibition of loans (or any other form of credit) to the controlling shareholder. At the very least, by-laws should determine that such loans require approval from a shareholder's meeting where every share has a right to vote (including preferred shares but, of course, excluding the controller's shares). For reasons that are even more obvious, government-owned credit agencies should never lend any money to companies that do not include this prohibition in their by-laws.

In addition to fixing this broken window, attitudes such as the one we are suggesting could be the start of the paradigm that an efficient and legal market drowns its own enemies.

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
1998	-	-19,14	438,13	-	-31,49	31,54	-	-38,4	93,27
1stQuar/99	6,81	6,81	474,80	11,91	11,91	47,20	12,47	12,47	117,36
2ndQuar/99	24,28	32,75	614,36	24,60	39,44	83,41	2,02	14,74	121,76
3rdQuar/99	3,17	36,96	637,01	-4,71	32,87	74,77	-7,41	6,24	105,34
4thQuar/99	49,42	104,64	1001,24	62,92	116,46	184,73	59,53	69,49	227,58
1stQuar/00	6,15	6,15	1068,96	11,53	11,53	217,56	7,08	7,08	250,77
2ndQuar/00	-2,43	3,57	1040,57	-6,26	4,55	197,67	-9,03	-2,59	219,10
3rdQuar/00	4,68	8,42	1093,99	0,88	5,47	200,31	-6,10	-8,53	199,63
4thQuar/00	-4,98	3,02	1034,53	-7,69	-2,63	177,23	-10,45	-18,08	168,33
1stQuar/01	-0,98	-0,98	1023,40	-10,06	-10,06	149,33	-16,00	-16,00	125,39
2ndQuar/01	-6,15	-7,07	954,28	-1,76	-11,64	144,95	-3,73	-19,14	116,97
3rdQuar/01	-27,25	-32,40	666,97	-33,81	-41,52	62,12	-36,93	-49,00	36,84
4thQuar/01	38,52	-6,36	962,4	55,88	-8,84	152,71	49,07	-23,98	103,99

(*) 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.

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