Report
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From Arbitrariness to Arbitration

Long before the concepts of justice, laws or courts were developed, arbitration mechanisms were already used to solve disputes. Pastor Paris, called by goddesses Juno, Pallas, Athenas and Venus to choose the most beautiful of them, is a privileged mythological precursor of current arbiters. The narratives about Marco Polo trips and the Council of Ancients of the homeric passages are arbitration's epic ancestors. The practices of commercial arbitration from Greeks and Phoenicians and the itinerant judges of Athens tyrant Peisistratus, are historic predecessors. The five judges of Sparta who ruled that the isle of Salamis belonged to Athens and not to Megara, and Themístocles, when he did the same for Leucas in relation to Corintho and Corcyra, are examples of international arbitration that took place way before globalization. Natural, commonsensical, simple and efficient, arbitration lies in the registers of History as a social clause to resolve conflicts[1].

Hence it is inadequate to criticize arbitration on the basis that it constitutes a dangerous innovation arising out of an improper privatization of the State monopoly in the production and distribution of justice. From the Early Ages to today, arbitration is the process by which States, institutions or people construe a voluntary agreement to submit their divergences to judges of their own choice, each party committing to accept the verdict as the very final one. It is a way of achieving a collective good (in some cases even a public good) through a contract between the parties involved without the interference of the State. Obviously, it is without interference but not against its will or consent as it is a State law that governs and regulates the use of arbitration in most countries, including Brazil. The key point is that the process of arbitration possesses, as stated by Carreira Alvim "the flexibility that it requires to fulfill its objective but works on a dogmatic basis so as to provide, in the conventional justice, the same security provided by the State Justice. The arbitration jurisdiction may be considered, without a doubt, as a particularization of the State jurisdiction in its most ample meaning: it represents a particular portion of the public jurisdiction, handed by the State to indi-

(1) *The history of arbitration presented here is based on Frances Keller's book "American Arbitration", BeardBooks, 2000*

(2) *Carreira Alvim, "Tratado Geral da Arbitragem", Editora Melhoramentos, 2000, page 72*

Our Performance

This Report covers the first half of 2002. Exceptionally, we will not publish a Report covering the first quarter of this year but we do intend to maintain the quarterly frequency. The third quarter 2002 Report will be published soon. Also, starting with this Report, the comments made in this section will refer to the performance of our domestic fund, Dynamo Cougar. As a consequence, this will become an integral translation of our original Report published in Portuguese.

During the first six months of this year, shares in Dynamo Cougar gained 12% in value. This compares with a loss of (18.5%) of the Ibovespa, (1.2%) of the FGV-100 and (1.8%) of the IBX (in Us dollar terms, the losses were % for our fund and %, % and %, respectively for the market indices). Once again, the concentration of the Ibovespa in telecom and utility stocks caused it to have a worse performance than the IBX and FGV-100, where the relative weight of Petrobrás and CVRD is greater.

It is difficult to make any comments about the performance of Dynamo Cougar this year without mentioning the political scenario. Even for investors like Dynamo, who really look at companies on a long-term basis, it has been hard not to incorporate in our analysis macro economic factors that, in normal times, would not be relevant. In this respect, since the last quarter of 2001, we have become progressively more convinced that, no matter who is elected in October, increasing exports significantly is the only possible solution for the successive balance of payments crisis which the country has been going through since 1995 (just to help our memory: first was the Mexican crisis in the beginning of 1995, then Asia in 1997, Russia / LTCM in 1998, Real devaluation in 1999, Argentina / energy rationing / September 11 in 2001 and, finally, the current election-driven crisis).

All theses events had negative impacts in various countries but the ones dependent on foreign capital to finance current account deficits, like Brazil, were most severely affected. Moreover, any new President is likely to shift the focus of the economic agenda from stability to growth. And regardless of the merits (or lack thereof) of the new policy, exporting will be crucial, albeit maybe not sufficient.

For this reason, during the course of this year, we have, in the Fund, increased the weight of companies that benefit from what we perceive will be the new economic policy. We believe that the comparative advantage arising out of having costs denominated in Reais and revenues denominated in US dollars is not only substantial but also enduring, despite the inescapable surge in inflation which shall eat into part of this advantage overtime.

In summary, our portfolio has fluctuated around 50-60% in exporting companies (or companies whose products substitute imports), 20% in companies whose value is, in principle, not affected by the devaluation, and 20% in companies which loose value with a weaker Real. Such combination has led to excellent results relative to the market indices in the first half of 2002. Even the absolute result has been satisfactory for a Real based investor looking at local inflation or alternative fixed income investments. Results could have been even better if shares of a few important exporting companies who gain fundamental value in dollars when the Real devalues, went up in Reais at least enough to maintain their dollar price of the end of 2001 (that is, these shares lost value in dollars this year).

Let us end by stating that our emphasis on exporting companies does not imply that we had any premonition about the current exchange rate. On the contrary, we are actually surprised by how far it has gone. We only thought that if the comparative advantage for exporting companies did not come through the devaluation of the Real, it would have come through fiscal reform and government stimulus, or even through all of these factors. And, under such scenario, companies geared towards the external markets would benefit enormously.

viduals (the arbiters), who should exercise it for the benefit of others (the interested parties)"[2]. The excessive mention of legal technicalities in what should be an investment report is justified, as it will become clear later, as an attempt to qualify arbitration as a normal operation and as modern law, and not as an opportunistic or casuistic approach that might suggest anarchy or discretion in the provision of justice. In any case, the association of the private and public sectors in the production of justice seems to be a contemporaneous and fertile trend that transcends the theme of this Report[3].

The natural right of auto-regulation for the enforcement of contractual obligations should be especially valued in democratic societies where the individual is free to contract whatever the law permits[4]. This is precisely the meaning of the first article of Law 9307, dated September 23, 1996 (The Brazilian Arbitration Law), which states that: "Any person capable to enter into contracts may use arbitration to solve conflicts related to legitimate available rights." The thesis of auto-regulation is reinforced in article 13 of the Law, which says: "Any capable person who has the trust of both parties may be an arbiter". The definitive character of the arbitration is given by article 31: "An arbitration decision produces for the parties and their successors, the same effects as a decision coming from the regular Judicial system and, if condemnatory, constitutes a valid legal claim".

Corporate legal issues in Brazil already show a relatively high degree of complexity. We do not have courts specialized in the matter. The combination of several constitutive instruments with the regulation of companies produces a set of normative rules that require a multidisciplinary approach not easily found in our judicial system. When one decides to appeal to the courts to solve conflicts of this nature, thick and endless legal documents attempting to explain intricate financial transactions and sophisticated corporate designs start to proliferate. The digestion of these arguments and counter-arguments is quite complicated. Not to mention the transit through the most varied instances until a final sentence is provided. All of which means that any decision will take long and will not necessarily be well founded. Recurring to arbitration is more economical than suing in regular courts, that is, excluding the case where one of the parties expect to achieve its objective not by reaching the final decision, but rather by its procrastination. As put by Carreira Alvim: "Even if the only advantage of arbitration was the possibility of a sentence within a pre-agreed timeframe, this would be more enough to justify it, especially in a country where the State justice is not fulfilling the expectations of citizens. In Brazil, there is one judge for every 20,000 people, whereas in other countries such proportion reaches a maximum of one judge for every 3,000 people"[5].

Over the last (almost) ten years, Dynamo has acquired a reasonable experience in investing in Brazilian listed companies. As active investors, we got used to discuss, suggest and follow the practical effects of the corporate improvements that have been taking place in some of these companies. The growing importance of what has been called good corporate governance practices is a good sign of the maturity of our capital markets. Today, we are entirely convinced that the solution of conflicts through arbitration would accelerate this process considerably. And more: without arbitration, there is a chance that recent rights gained by investors may not be claimed efficiently just when they will be most needed. We will explain the roots of such assertion.

Table I - Performance up to June/2002 (in R$)

Period	DynamoCougar	FGV-100	Ibovespa
60months	194.95%	112.90%	-11.09%
36months	118.50%	78.44%	-1.69%
12months	13.66%	2.57%	-22.86%
6months	12.04%	-1.24%	-18.50%

NAV/Share on 06/29/2002 = R$28,777020775

A corporation (in Portuguese, a Sociedade Anônima) is regulated basically by the following provisions: the Corporate Law, the company's charters (or by-laws), shareholder's agreements, rules issued by the National Monetary Council, the Central Bank and the CVM (Comissão de Valores Mobiliários, the Brazilian SEC), as well as by general capital market rules (we will refer to this set of general documents simply as GD). Only the company's charters and shareholder's agreements (the specific documents – SD) vary from company to company. Under ideal conditions, investors should count on the guaranteed protection of GD's and focus only on SD's before making an investment decision. SD's showing an equitable relation among shareholders of a given company should increase the propensity to invest, increase the share price, lower the cost of capital and, therefore, comprise a definitive comparative advantage. This natural selection process should lead to the evolution of SD's in the direction of investors' demands. Unfortunately, it just so happens that the quality of such documents is not enough to ensure that these virtuous processes takes place; one must also be certain that the contracts will be complied with. Which, in the case of Brazil, is not trivial. Without the agility and security of arbitration, in many cases it is preferable to invest in companies whose charters are superficial but the attitude of controlling shareholders is fair than in companies whose by-laws are almost perfect but the controlling shareholder may be, too often, inclined not to comply with it. Especially because it is impossible to predict all future contingencies. There is always the chance of different forms of interpretation or simply the absence of provisions in the by-laws dealing with issues that become relevant over time.

If an investor decides to buy shares of a company, it is because he has a certain expectation about the future results of that specific company and because he relies on a given legal environment to protect his rights as a shareholder. Suppose that this company does produce the projected results but does not distribute them as was expected. And it does so because the controlling shareholder - for the sake of this example, acting in good faith - has an interpretation about the dividend clause in the by-laws different from the one the minority shareholders had when they invested. Here begins a *via crucis* for the minority shareholders which the academic literature calls the problem of the collective action. Only the controlling shareholder has the power to take the decisions on behalf of the company, and he simply does so. His interpretation is the only one that counts even if that means that he will appropriate gains to himself that the other shareholders believe are not due. *Alea jacta est.* What can the minority shareholders do? The only thing is to try to recover what they feel is legitimately theirs. The first alternative is an attempt to convince the controlling shareholder that he is wrong. Failing that, maybe the executives could be more agreeable. If that does not work either, the only way out is to take the conflict to the courts. In all these initiatives, we have, on one side, an individual who has the ability to make decisions on behalf of the company. On the other side, a collective group who must act as such to try to recover what, in their judgement, was unduly subtracted from them. However, acting collectively involves a complex and, sometimes, insurmountable, problem of organization.

Until the mid-60's, the good social theory assumed that rational individuals[6] with a common objective would cooperate to achieve it. There's strength in numbers, so the

(3) *On this subject, we suggest the reading of the first chapter of the masters thesis "Atuação do Estado e Produção do Direito: o Papel das Agências Reguladoras Independentes" ("State Operation and Production of Law: the Role of Independent Regulatory Agencies") from Mariane Sardenberg Sussekind, 2002. Also on the subject, from André-Jean Arnaud, "O Direito entre Modernidade e Globalização" ("The Law between Modernity and Globalization"), Editora Renovar, 1999, page 20*

(4) *See F. Keller's book, op. cit., page 4*

(5) *José Eduardo Carreira Alvim, "Tratado Geral da Arbitragem", quoted by M.S. Sussekind, op. cit., page 24*

(6) *If irrational, they would not be formally part of the market.*

stronger the group the better for each individual. Showing that the logic of collective action was quite another one was only a question of empirical observation: to obtain a collective good, the rational individual prefers the strength of the group to his own isolated work. But he has an even stronger preference for the efforts of everyone else without his participation as he will obtain the benefits (the result is collective) without costs to himself. To make matters worse, the more numerous and stronger the group, the more irrelevant the participation of each individual to the aggregate efforts to produce the collective good, even though the cost for each individual is high[7]. In other words, with respect to collective actions, the rational individual is, above all, a free rider, someone who tries to get a lift on the goods produced by others. The problem is that, if everyone thinks like that, the collective action simply does not come about.

Organizing minority shareholders to defend their interests is a process that inevitably bumps into the perverse logic of the collective inaction. Their situation is exactly the opposite to one of the controlling shareholder who has the agility of the individual action and the power to make the decisions, leaving the duty of proof to those who feel harmed. Given the high costs involved in a legal suit, in many cases it only becomes economical if several minority shareholders join together to share the financial burden (whereas the company itself almost always finances the controlling shareholder side). Our own experience shows that this task is often hard to accomplish and the collective action does not happen. Still, when, by a strike of luck, minority shareholders do form an organized and sufficiently numerous group, what lies ahead of them? A legal battle which, in Brazil, because of the excessive number of cases and the lack of specific expertise on the part of judges, may result in years of legal fees, an inordinate amount of time and energy from the people involved and, after all is said and done, an uncertain sentence. Anyone who has experience in litigation knows that a settlement, even when the value is lower than realistically expected, is better than the adventure of a judicial battle. As a side comment, settlements are indeed a great solution for the involved parties but, from a general point of view, they are not so good as no jurisprudence on corporate legal matters is produced in Brazil.

The combination of the difficulties for the collective action of minority shareholders with the sluggishness our judicial system produces an irresistible temptation for the controlling shareholder to behave arbitrarily. As a consequence, all corporate legal documents have their credibility threatened and it is up to the minority shareholder, when making their investments decisions, not only to study the fundamentals of the business and analyze all documents filed by the company, but also to appraise the ethics and fairness of the controlling shareholder. Well, since character does not publish a balance sheet, such appraisal is, in practice, imprecise and dangerously subjective.

This is an immense obstacle for the good functioning of our capital markets but it has a solution and its name is arbitration. As a result of the creation of the Level 2 and the Novo Mercado, Bovespa created the *Câmara de Arbitragem do Mercado* ("CAM"), which is already up and running[8]. Initially, the CAM has the main objective of working to solve conflicts that may arise in these special segments of the market. In a not so distant future, we hope that the scope of CAM is enlarged to include all segments of the Bovespa, and if that happens, one of the most profound and promising changes in the Brazilian markets may take place. We are enthusiastically in favor of a rapid migration of corporate conflicts in Brazilian companies from the ordinary courts to the arbitration courts.

The possibility to obtain quick and qualified decisions for corporate disputes radically changes the shareholder's environment

Bovespa installed the CAM in July of 2001 within the scope of Law 9307/06. This Law establishes that the signing of a commitment clause, through which the parties in a legal contract (in this case, the corporation's by-laws), previously commit to take to arbitration any conflicts arising out of such contract. This is what will happen to all companies listing in Level 2 or the Novo Mercado of Bovespa, as they will necessarily have to join the CAM. Once the option for arbitration has been signed on, the parties cannot appeal to the ordinary courts to solve eventual disputes, not least to modify or revert a sentence given by CAM. The same Law determines that arbitration sentences must be given in a maximum of 180 days.

The CAM offers more than 30 possible arbiters each of whom has a mandate of two years, and may be re-appointed. To become an arbiter at CAM, one must have a clean reputation, a profound knowledge about capital markets and be at least 30 years old. Among them, there is a concentration of experienced corporate lawyers. It is impossible to over-estimate the importance to the Brazilian capital markets of having corporate conflicts decided expeditiously by knowledgeable arbiters.

Joining CAM, which is done by signing a Term of Agreement, results in the automatic participation of the Bovespa, the company, its controlling shareholders, and its administrators (that is, members of the board, the fiscal board and directors). The signing up of other shareholders is voluntary but, obviously, only those who join may resort to the CAM. When joining the CAM, participants commit to solve through it any conflicts related to the Corporate Law (Lei das S.A.), the by-laws of the company, the rules of the National Monetary Council, the Central Bank and the CVM as well as any rules applicable to the Brazilian capital markets. Currently, conflicts related to the application of the rules in the Listing Regulation of the Novo Mercado or Level 2, as well as any contracts entered into by companies listed in these segments of the market must also be submitted to the CAM (which, obviously, include shareholders agreements).

There are three distinct arbitration procedures. The ordinary arbitration is intended to be used in the more complex cases and includes the participation of three arbiters, one appointed by each party and the third one chosen by consensus or, that lacking, by the President of CAM. Decisions by the arbitration court are taken by absolute majority. Summary arbitration is a quicker and simpler procedure intended for less complex questions and the conflict is solved by a single arbiter, chosen randomly. Finally, in the ad hoc arbitration procedure, the parties are allowed to propose an alternative informal mechanism to solve the dispute.

Any arbitration is preceded by a reconciliation attempt with the objective to settle the differences. If such settlement is reached, once it is made official by the president of the chamber of arbitration, it will have the same effect of an arbitration sentence, creating an obligation for the parties to abide by it. Therefore, and this is very important, as opposed to what happens in the ordinary courts of justice, settlements reached within an arbitration process have the status of a judicial decision and not of an out-of-court agreement. Anyone experienced in the litigation of corporate questions in Brazil knows how important such protocol can be. The arbitration sentence will not be made public, that is, only the parties involved will know its contents. The CAM will periodically publish the arbitration sentences given without disclosing the parties or any other elements that might lead to their identification including the names of the lawyers. Such practice aims to a help arbiters in future cases and to create a certain degree of jurisprudence, provided that, in any case, the independence of the arbiters be maintained intact. The intervention of the ordinary courts is only foreseen

(7) *For the really interested on the theme, we suggest the book from Mancur Olson, "The logic of Collective Action", Cambridge University press, 1971*
(8) *We suggest the reading of the document "Câmara de Arbitragem do Mercado", published by Bovespa*

for the case of parties not abiding by an arbitration sentence.

The creation of CAM by Bovespa is a noble and admirable episode in the progress of corporate governance for Brazilian companies. Not for any other reason, we have dedicated a considerable amount of time to carefully study its rules, as well as the arbitration rules in other countries. During meetings with the Bovespa team we were able to clarify several points and became convinced of the efficiency of CAM. It is impossible to sum up all technical details of its operation in a single Report and we are certain that this brief description will result in many other doubts about the procedures that organize the arbitration solution. Which is why we strongly recommend the thorough reading of the Regulamento da Câmara de Arbitragem do Mercado published by Bovespa.

The possibility to obtain quick and qualified decisions for corporate disputes radically changes the shareholder's environment. The endorsement, by Brazil, of the Convention of New York through Decreto Legislativo no. 52 of April 25th, 2002, which deals with the "Recognition and Execution of Foreign Arbitration Sentences", concedes an even more cosmopolitan character to this process. It is worth noting that even though Brazil is well known by the sophistication of its financial markets and contracts, it was one of the last countries to accept this Convention, which grants the enforcement and validity of Brazilian arbitration decisions offshore just like it does for foreign arbitration sentences in Brazil[9].

The use of arbitration must be one of the top priorities of large investors – institutional or not - in Brazil. There is no plausible reason for a company not to join CAM soon after the Bovespa makes it available for all companies listed in this stock exchange. The ones refusing to do so will be giving a dubious signal about their approach to good corporate governance practices. From an evolutionary point of view, the establishment of arbitration courts in Brazil, as it already happens in many other countries, is very important[10]. Investors will be able to choose companies taking into consideration their by-laws knowing that whatever clauses are included there will either be respected or eventual doubts will be clarified quickly and efficiently. Hence, instead of the struggle to improve corporate governance with ever more regulation (many of which becomes necessary to regulate creative interpretation of already existing rules), such result may be achieved naturally and directly by the market: it will be up to the charters of companies – provided they have a sound business - to grant the shareholders' demands to invest safely, as compliance will be assured by the arbitration courts.

We hope that CAM begins to operate as soon as possible and that its success serves as an incentive for Bovespa to extend its reach to all other listed companies. Likewise, it would be interesting if other arbitration courts are created, consolidating this modern advance in the field of solving corporate disputes in our capital markets.

Rio de Janeiro, September 10th, 2002

(9) *About the importance of this fact, we suggest the article " A Convenção de Nova York", written by Arnold Wald, published in Jornal Valor, page 24 of the May 24th, 2002 edition*
(10) *For a more conceptual and sophisticated analysis about the importance of arbitration for the solution of conflicts, we suggest the excellent paper 'Choosing Umpires: An Analytic History of Arbitration Mechanisms", Konrad Siewierski, Department of Political Sciences, Stanford University, 1998*

Dynamo Cougar x Ibovespa x FGV-100

(in US$ dollars - commercial selling rate)

Period	DYNAMO COUGAR*			FGV-100**			Ibovespa***		
	Quarter	Year to Date	Since 01/09/93	Quarter	Year to Date	Since 01/09/93	Quarter	Year to Date	Since 01/09/93
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%	-	-38,40%	93,27%
1st Quar/99	6,81%	6,81%	474,80%	11,91%	11,91%	47,20%	12,47%	12,47%	117,36%
2nd Quar/99	24,28%	32,75%	614,36%	24,60%	39,44%	83,41%	2,02%	14,74%	121,76%
3rd Quar/99	3,17%	36,96%	637,01%	-4,71%	32,87%	74,77%	-7,41%	6,24%	105,34%
4th Quar/99	49,42%	104,64%	1001,24%	62,92%	116,46%	184,73%	59,53%	69,49%	227,58%
1st Quar/00	6,15%	6,15%	1068,96%	11,53%	11,53%	217,56%	7,08%	7,08%	250,77%
2nd Quar/00	-2,43%	3,57%	1040,57%	-6,26%	4,55%	197,67%	-9,03%	-2,59%	219,10%
3rd Quar/00	4,68%	8,42%	1093,99%	0,88%	5,47%	200,31%	-6,10%	-8,53%	199,63%
4th Quar/00	-4,98%	3,02%	1034,53%	-7,69%	-2,63%	177,23%	-10,45%	-18,08%	168,33%
1st Quar/01	-0,98%	-0,98%	1023,40%	-10,06%	-10,06%	149,33%	-16,00%	-16,00%	125,39%
2nd Quar/01	-6,15%	-7,07%	954,28%	-1,76%	-11,64%	144,95%	-3,73%	-19,14%	116,97%
3rd Quar/01	-27,25%	-32,40%	666,97%	-33,81%	-41,52%	62,12%	-36,93%	-49,00%	36,84%
4th Quar/01	38,52%	-6,36%	962,40%	55,88%	-8,84%	152,71%	49,07%	-23,98%	103,99%
1st Quar/02	13,05%	13,05%	1101,05%	3,89%	3,89%	162,55%	-2,76%	-2,76%	98,35%
2nd Quar/02	-22,40%	-8,60%	871,04%	-22,45%	-19,43%	103,60%	-31,62%	-33,51%	35,63%

(*) 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.