Report
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Tag along: a real case

The discussions surrounding the reform of the Brazilian Lei das Sociedades Anônimas and other measures intended to improve our capital markets have been marked by extreme positions. Nevertheless, one point is notably consensual: the lack of a court specialized in corporate matters is a major obstacle to any significant advance in the institutional environment. The virtual absence of jurisprudence on corporate issues is a direct consequence of such fact as it leads to few suits being brought to the courts and even fewer being taken through all the instances for a final decision. As the complexity of corporate cases increases, this problem becomes even more relevant and represents one more hurdle for our capital markets.

It was for no other reason that our attention was caught by a report that came out last December in a local business journal stating that a minority shareholder of Banco Real (then, the fifth largest commercial bank in the country) had won a suit that granted him the right to sell his shares at the same price the controlling shareholder, Mr. Aloysio Faria, had sold his to ABN-AMRO. Or, as the headline appeared, the minority shareholder won a tag along right for his shares. The reason for our curiosity is quite obvious and we were actually struck by the little, if any, interest the report attracted from both investors and the rest of the financial press. The tag along right existed under Brazilian law only until the last reform of the law in 1997, and even then it was only valid for common shares. Like our judicial system, a number of our financial journalists are also not well versed in these complicated corporate legal issues, so the report that came out did not allow for any conclusion on what the decision really meant. Consequently, we decided to analyze the sentence itself. As expected, while its content was not quite what the headline stated, it is nevertheless of utmost relevancy for publicly traded companies, especially if the decision is confirmed by the higher courts.

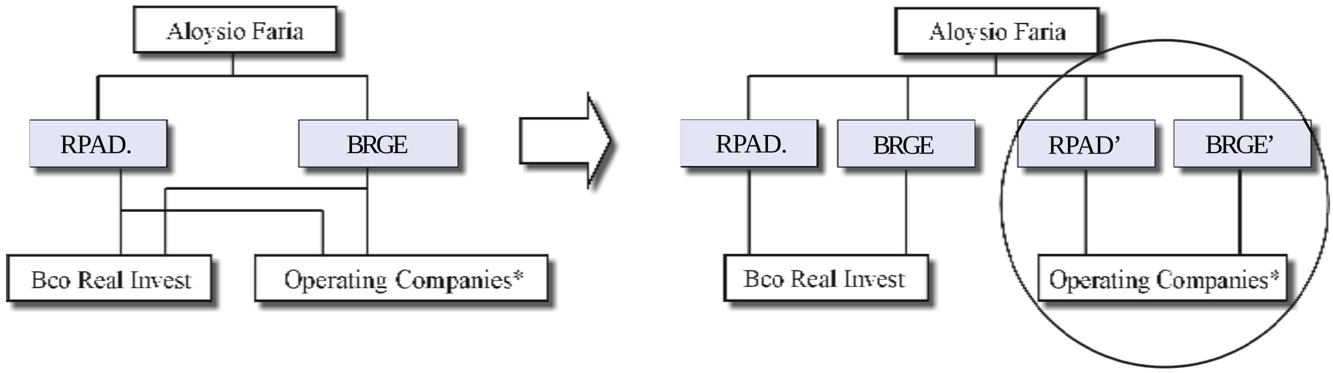
The decision was made by Judge Ione Perez of the 37th Vara Cível in Rio de Janeiro. In a judicial system where judges have to decide on a very wide range of different matters – such as commercial leases or residential condominium disputes - the level of understanding of this highly complicated case by Judge Perez was remarkable. She actually acknowledged this difficulty, albeit ironically, in the text of her ruling by mentioning that "... at the end of all transactions executed by the fourth defendant, which, by the way, were not few at all, ..." (free translation).

Notwithstanding the vast array of complicated transactions, the main point of the suit is relatively simple. Mr. Faria was the indirect controlling shareholder of two publicly traded holding companies, Real S/A Participações e Administração (Rpad) and Consórcio Real Brasileiro de Adm. S/A (Brge). These two companies shared jointly the control of Banco Real and other financial companies of the group, a number of which were also public. This pyramidal structure allowed Mr. Faria to effectively control the whole chain of companies with a minimum economic ownership. However, when the controlling shareholder decides to sell the companies that are below in the pyramid (in the case, Banco Real and the other operating companies) the question that arises is the following: to whom does the controlling premium belongs, to Mr. Faria as the ultimate controlling shareholder or to the publicly-traded holding companies that were the direct majority owners of the entities being negotiated ? That was precisely the object of the law suit as Mr. Faria, through the use of clever and sophisticated financial engineering, ended up being the sole beneficiary of the high controlling premium paid by ABN AMRO. The minority shareholder claimed that such premium should have been paid to Rpad and Brge, the two holding companies where he is an investor. Making a long story short, Judge Perez decided in favor of the minority shareholder and determined that the controlling premium belonged to the holding companies.

The two holding companies, which together held 63% of the voting capital of Banco Real, were split. The controlling shares of Banco Real and the other operating companies (with the exception of Banco Real de Investimentos – see figure 1) were then transferred to the two new companies. Subsequently, the control of these two new companies, which continued to belong indirectly to Mr. Faria, was sold to ABN AMRO. Nothing changed for the minority shareholders of Banco Real. However, the minority shareholders of Rpad and Brge, who supposedly were co-owners of the control of the companies that were sold, were left with minority shares in four holding companies: the two original ones (Rpad and Brge) still controlled by Mr. Faria, and the two newly created ones, now controlled by ABN AMRO.

To further complicate matters, since Mr. Faria intended to remain operating in the banking sector – now through Banco Alfa – it was necessary that one of the companies in the group, Banco Real de Investimentos, remained with him, that is, was not transferred to the spun-off companies. But since Banco Real de Investimentos controlled the Savings and Loan operation which

Figure 1 - Control Structure of Banco Real S/A



* Banco Real S/A, Cia Real de Crédito Imobiliário, Cia Real Brasileira de Seguros, Real Capitalização e Cia Real de Valores DTVM.

was sold to ABN AMRO, the same succession of spin-offs and sales had to be undertaken. Also in this case, Judge Perez ruled that the controlling premium on the sale of the Savings and Loan belonged to Banco Real de Investimentos.

It is important to note that if Mr. Faria had simply sold the shares he owned in the two publicly trade holding companies, Rpad and Brge, he would have received the entire premium in a way that, in our opinion, no minority shareholder would have any grounds to complain. From what we understood of the transaction, nothing prevented him from doing so except, maybe, his desire to maintain his efficient pyramidal structure of listed companies to control his new bank (it is also possible that there was some relevant fiscal issue which we are unaware of).

However, the way the transaction was structured, the minority shareholders of the two holding companies were clearly affected. For that reason, the objective of the suit was that these two companies, and not their shareholders, were compensated for their losses. In practice, this means that, in the unlikely scenario that there are no appeals, both Rpad and Brge will receive an amount equivalent to what they would have been paid if they had sold the control of Banco Real and the other operating entities directly. Hence, it must be noted that the ruling will not affect the minority shareholders directly except that they will now be investors in a company with a substantial amount of cash and they may get a dividend as the sale will most likely have a positive impact in the accounted earnings of both holding companies (also, in suits of this kind, the author is usually entitled to receive a payment equal to 5% of the value awarded).

The legal arguments from the author of the suit were centered on issues of abuse of power of the controlling shareholder, conflicts of interest and fiduciary duties (articles 116, 155 and 156 of Lei das S/A). Judge Perez ruled in favor of the minority shareholder because she understood that the defendant (i) abused on his controlling power when he voted to approve the spin-offs; (ii) did not perform his fiduciary duties as he used the opportunity of dealing with ABN AMRO to his sole and only benefit when nothing prevented him from dealing on behalf of the two listed companies; and (iii) voted in the Shareholder's Meetings that deliberated the spin-offs in clear and flagrant conflict of interest.

The arguments from the defense side are certainly worth examining. In addition to the usual procedural issues, the lawyers argued, first, that all of the transactions were perfectly legitimate, which is true but only if each one is analyzed separately. They also contended that none of the two holding companies had the control of Banco Real since each possessed only 31.2% of the voting shares and they were not linked by a shareholder's agreement that required them to vote together. This line of reasoning is almost an offense to the Judge's intelligence but it is still more plausible than the argument also used by the defense that although the investment bank owned the majority of the shares of the savings and loan, it did not control it because it could not act according to its own will, but rather according to the will of its own controlling shareholder. They also maintain that the author of the suit is claiming a participation in the sale that he is not legally entitled to. Here, the defense is right, which is exactly why the author asked the Judge that only the two holding companies be compensated, and not himself.

In any case, it is key to understand that the ruling only applies to controlling shareholders of listed companies that, by themselves, also control other listed companies and wish to sell only one of such firms. To us, it seems that the controlling shareholders have an unquestionable right to sell their shares directly without the previous spin-off stage, which is only possible if they wish to sell all of the companies that are at the base of the pyramid. Even in this case, eventual corporate restructuring transactions carried by the new controlling shareholder may result in situations of conflict of interest that may be questioned.

The Ruling and the Market

If confirmed by the upper courts, Ms. Perez ruling should have an interesting effect on some public companies in Brazil that are controlled through a pyramidal structure. For example, a few years ago the Hering family decided to sell the control of Ceval Alimentos, their food company. It happened that the family's control was indirect. The family controlled a holding company, Cia Hering, which, in addition to its textile activities, also controlled Ceval. The sale was structured just like the Banco Real transaction. Cia. Hering was first spun-off and the control of Ceval was transferred to a newly created firm. The next step was the sale of the control of this new company whose only asset were the controlling shares of Ceval. Several shareholders of Cia Hering complained but, to our knowledge, no law suit was brought against the family.

More recently, and in a case that affected many more investors, some analysts questioned the fact that CSN participated in the controlling block of Vale do Rio Doce (CVRD) from the perspective of who owned the potential premium of such position. In this instance, since the investment was made by all of the shareholders of CSN who paid a controlling premium then, there was very little doubt in our minds that if the controlling shareholders of CSN wanted to sell CVRD, they would not resort to the alternative of spinning-off of CSN, creating a new company which only asset would be the participation in CVRD. In fact, in the recently announced so-called "unbundling" transaction, the implicit controlling premium in the sale of CVRD shares by CSN did benefit all of CSN's shareholders and not only its controlling shareholders (the shares of CVRD were sold at R$ 81 when the market price was at R$ 47).

As a matter of fact, we have an enormous difficulty to understand the rationale of public companies that do not grant tag along rights to its shareholders, which acquire the control of other companies paying, naturally, a huge controlling premium. If all shareholders are implicitly paying this premium, nothing could be fairer than to distribute the premium on an eventual sale of their own company to all shareholders proportionately. Notwithstanding the overwhelming logic of this argument, some publicly traded Brazilian companies have been actively acquiring companies at huge premia – when their own shares are trading at multiples that are a fraction of the control value – without any questioning from minority shareholders. Even more puzzling are the cases when these companies fund such acquisitions with capital raised only from minority shareholders. It should be noted that we are not arguing against the rationale of growth through acquisitions, quite the contrary. Our point is that it is really difficult to decipher the economic sense of these acquisitions from the perspective of the minority shareholder when they are not granted a fair participation in the value that they helped to build.

With respect to the portfolio of our fund, the ruling may generate a few interesting situations. Itaúsa, the holding company of Banco Itaú which we have mentioned in earlier reports, is a good example. It trades at a significant discount to the sum of its parts. In all our calculations, we account for the shares they own of Banco Itaú at the market value but based on the decision by Judge Perez, we could use a proxy to the value of control which would increase the implicit discount substantially.

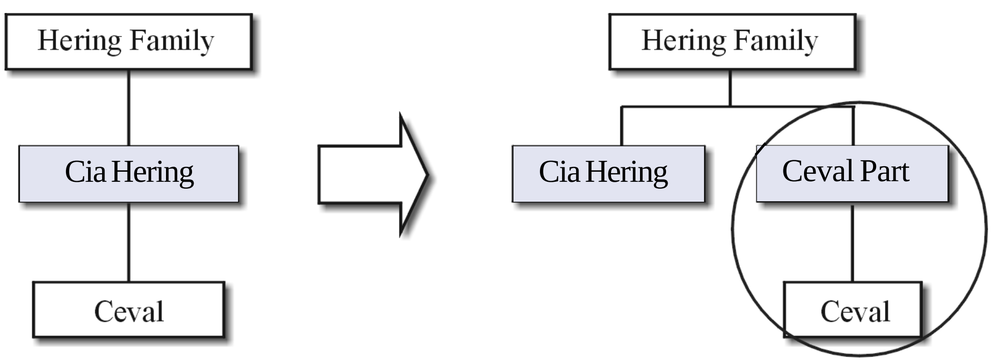
The situation of Distribuidora de Produtos de Petróleo Ipiranga (DPPI) is a case where the ruling may have an immediate effect. The reason lies on the fact that, in addition to its own operations of fuel distribution in the state of Rio Grande do Sul and the western part of Santa Catarina, DPPI also controls Companhia Brasileira de Petróleo Ipiranga (CBPI), which operates in the rest of the country and is approximately 4 times larger. Judging from what has been published in the financial press, the controlling shareholders of DPPI are analyzing alternative strategies for their companies which might include a sale of control. If that happens, it will be important to follow closely the structure of the sale, especially under the lights cast by the decision from Judge Perez.

Another case is Alpargatas which has a participation in the controlling block of Alpargatas-Santista. As this is not part of their core business, such block may be sold in the future. Again, in our analysis of Alpargatas, we account for the Alpargatas-Santista shares at market value which may be a third of the value of control in an eventual sale.

This ruling is also relevant for the analysis of the recent attempt to sell the control of Copene, a transaction that has an indirect impact in our funds because of Ultrapar, which is a potential buyer. The structure of the sale reflects the reality that the process was neither a privatization auction nor a private sale. Moreover, the existence of several sellers, each with its own particularities, resulted in an auction with unusual rules and that attracted only one buyer. The key rule was a "Committed Price" (Preço Vinculante), which was not revealed before the auction, and above which, all sellers pre-agreed to sell.

Two issues caught our attention in this case. First, according to press reports, in order to reach this Committed Price, the sellers started from the economic value of the company and added a premium that re-

Figure 2 - Control Structure of CEVAL



flected the possibility of the new owner to average down his price by acquiring shares from the minority shareholders at a much lower level. To the best of our knowledge, such concept was never applied in privatization auctions and that is precisely the reason why some buyers paid a huge overprice. The most notable case is, undoubtedly, the price paid by Banco Santander in their recent purchase of Banespa, which was almost immediately followed by a tender for the minority shares.

If, on the one hand, it is legitimate that sellers try to maximize their value without taking into consideration the situation of minority shareholders, on the other hand, it seems too risky to set the minimum price based on the theoretical hypothesis that the buyer will have the financial means and be willing to tender for the minority shares at a much lower price.

The second point that ought to be highlighted is the comfortable position of the minority shareholders of Ultrapar. Given that they have tag along rights, these investors know that any strategic value eventually created by the acquisition of Copene will be shared by all of them.

From what we have described in this Report, as well as in earlier ones, it is impossible to over-emphasize the importance of tag along rights, especially as a way of aligning the interests of all shareholders. The episode of Banco Real shows that a new jurisprudence may have created a new way for applying such feature.

Dynamo Cougar x Ibovespa x FGV-100

(in US$ dollars - commercial selling rate)

Period	DYNAMO COUGAR* Quarter	DYNAMO COUGAR* Year to Date	DYNAMO COUGAR* Since 09/19/94	FGV-100** Quarter	FGV-100** Year to Date	FGV-100** Since 09/19/94	IBOVESPA*** Quarter	IBOVESPA*** Year to Date	IBOVESPA*** 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

(*) 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.

For any further information, visit our web site:

www.dynamo.com.br

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