Tag Along, ma non troppo

The capital market is built on a basic ingredient: confidence. As the popular saying goes, “a deal is a deal.” Therefore, disseminating that a specific country “complies with contracts” is not enough if the ways that the legislation is interpreted can be bent according to prevailing interests. Devious interpretations of the regulations frustrate investors’ expectations. At best, they judicialize the economic activity, translating that into a component of the “Brazil cost.” At worst, they undermine the country’s credibility, leading investors to seek more welcoming jurisdictions.

Examples of these issues are very frequent in the country’s daily newspapers. But here we want to focus on the effectiveness of a specific legal provision: the co-sale right, also known as tag-along right.

The tag-along right was considered a true *pièce de resistance* of the reforming movement of the capital market in the end of the 90’s. And not without reason. The possibility of selling a significant lot of shares for a price different from the prevailing market price violates a basic concept, according to which the share represents an ideal portion of a specific business, that is, the future cash flow of that specific company. Regardless of specialists’ claims, a transaction with different prices is always a subtraction in the pockets of those not involved in it – that is to say, the minority stakeholders.

The crucial issue to understand here is the reason why some people buy a “control premium.” Except for crazy or altruistic investors, the buyer foresees the possibility of making an amount of money from that share interest different from the amount foreseen by mere mortals.

Jurists say that such amount can be attributed to the “authority power”, to “synergies” or to “control burdens”. Well, the “authority power” by itself would justify the premium in two situations only: in the case of a theomaniac buyer or when this “authority power” can make the obtaining of disproportional earnings to the share interest possible. As to the former situation, the only possibility is to make the buyer undergo a psychiatric treatment. The second one is an abuse against minority shareholders. And that is stated not by investors, but by the authors of *Lei das SAs* (“Law of Business Corporations”): “*the difference in the unit value between controlling shares and minority shares is, in general, significantly small, except when the control is abusively exercised in favor of the controlling shareholder, it does not assure equity advantages that justify a higher price for the controlling stock.”*

Here, it’s even possible to see readers smiling. After scandalous control premiums witnessed in the Brazilian market – primarily during the 90’s, but unfortunately including transactions that happened as recently as 2012 – it’s clear that the authors of the law were either wrong or there is in fact a huge gap for the abuse of control. This second possibility makes more sense.

Let’s analyze this: a company’s “fair” price is 100, and the controlling shareholder sells half of its control for 60, what means that the other half is worth 40 – that is, a control premium of 50%. The minority shares would then price the company at 80, despite the fact that its economic value would be 100. Does a capital market like this make sense?

The “synergies” statement is as misleading as the “authority power.” If there are synergies, and they are subject to the company’s assets, their value must be shared among all shareholders, and not only among those that “sequester” its control. A building manager cannot benefit from the gains attained with the cellular telephony antenna installed on the top floor despite he/she is the one who signs the agreement: all dwellers must benefit from that.

Even more fragile is the statement related to the “difficulties” of being a controlling shareholder in Brazil – such as to grant a guarantee on the company’s behalf or be subject to equity’s risks. Any student of microeconomy understands that external factors must be priced. Have you granted a guarantee? Price it. Have you taken risks? Charge for it. And so forth.

In a nutshell: a partner is a partner. Shares are all the same and that’s the only way to price them correctly, making it possible that buyers and sellers meet and also making it possible that the market itself exists. The control premium puts an end to this logic. And analyzing the past, one can see that, once allowed, the control premium is able to reach Olympic levels in Brazil, reason why the tag-alone right is a *sine qua non* condition for the stock market’s operations.

Despite the outstanding importance of that, the victory of investors in the restructuring of the Law in 2001 and in creating the New Market have collided with our legal tradition and tricky and pragmatic statements – unfortunately adopted by the regulating agency.

CVM’s current jurisprudence is not able to ensure that many situations of divestiture of shareholding control are translated into an offer for minority shareholders. Based on the cases judged over the last years and on the valuable opinions generously given by the companies, CVM has voluntarily adopted a minimalist interpretation about what must happen to configure a divestiture of shareholding control. In particular, it has developed the “control reinforcement” thesis, according to which a minor shareholder becomes an isolated controller of a company with no tender bid. Clearly chained transactions – that result in the transfer of control – have been analyzed on a step-by-step basis – what leads to the inexistence of public offers. You go to bed and the controller is X, when you wake up, it’s Y, with no market offer.

In many cases, the regulating agency understands that there was a change in the control, but hesitates when it comes to establish a public offer as a result of previous cases (despite that IN CVM 361 clearly says that CVM can establish an offer “whenever it notices that a transfer for valuable consideration has taken place”).

The ongoing interpretation about the transfer of control is minimalist and not a result of the legislation. Actually, different from the old Article 254, as of 1976, the current wording does not subject the offer to the size of the lot of shares sold. Now, the legislation only describes the “shares part of the control lot.”

Accordingly, the way this provision is interpreted must be urgently revised. The existence of a premium in the transfer of a controlling share lot is an outstanding indication of the transfer of the authority power – yet of part of it. This value must be shared among all shareholders, even that it means the carrying out of a partial public offer (that is, for a specific number of shares), in line with the recommendations of IBGC's Code. The controlling shareholder, in this case, would not transfer all of its shares, but the integrity of each share would be preserved as a representative of part of the business.

Brazil cannot be considered the "mind you" country. We have a good legislation, a respected regulating agency, but in critical situations when shareholders' rights are crucial, *mind you*, they fail. The tag-along right is a fundamental tool to assure that a share is the ideal portion of a company. Therefore, we urgently need to review the understanding about the topic, making it become an effective protection for the minorities against the abuse of controlling shareholders (and buyers) of a company's controlling interest.