

1-1-1994

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Recommended Citation

Jose Luis de Salles Freire and Jose Emilio Nunes Pinto, *Privatization in Brazil*, 17 HASTINGS INT'L & COMPL. Rev. 689 (1994).
Available at: https://repository.uchastings.edu/hastings_international_comparative_law_review/vol17/iss4/3

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Privatization in Brazil

By JOSÉ LUIS DE SALLES FREIRE *and* JOSÉ EMILIO NUNES PINTO*

In 1990, the Brazilian government initiated an ambitious privatization program (the "Program"), which has since been carried out with a fair amount of success. The Program was instituted by Federal Law No. 8,031, of April 12, 1990. It has three purposes:

(1) To change the strategic position of the state in the economy by transferring to the private sector many of the activities that have so far been carried out by the public sector. The government expects that the public administration, by focusing on priority areas of government, will become more efficient. Furthermore, it is expected that once in private hands, the privatized companies will become more dynamic and productive.

(2) To reduce the state's internal debt by using the proceeds from the sale of the privatized companies to repay such debt and by cutting state investment in the activities now transferred to the private sector.

(3) To strengthen the Brazilian capital markets and to democratize the capital of the companies to be privatized.

Pursuant to the provisions of Decree No. 99,463/90 which regulated Law No. 8,031/90, the government may privatize the following: companies controlled directly or indirectly by the federal government which were created by law or derived from legislative authorization; companies owned by entities which are directly or indirectly controlled by the federal government; and companies that were originally private but have since been transferred to the direct or indirect control of the federal government. The government may also privatize certain services by granting a concession or permission for private companies to operate broadcasting services; services and facilities related to the supply of electricity and to the use of water to produce energy; air and space navigation, as well as services related to the infrastructure of the ports; rail and waterway transport between Brazil-

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ian ports and the national borders; interstate and international road transportation of passengers; and sea, river, and lake ports.¹

On the other hand, the law establishes that the companies that operate in areas of exclusive state competence are excluded from the Program. Such activities are listed in articles 21, 159, item I, (c), and 177 of the Federal Constitution, and mainly comprise the mail services; the telecommunications services; the nuclear industry and related services; the research, exploitation, refining, importation, and exportation of oil and gas; the transportation by sea or by pipeline of oil and its subproducts, as well as natural gas of any origin; Banco do Brasil S.A.; and Instituto de Resseguros do Brasil — IRB (which is the national reinsurance institute).

As far as the actual procedure for the sale of the state-owned companies to the private sector is concerned, the law establishes the following alternatives for the government when privatizing its companies:

(1) *Selling its holdings in the equity capital of state-owned companies.* Such sales shall preferably be directed to the general public, specifically the employees, suppliers, and consumers of the company being privatized. The law establishes that such sales must be made either through public auctions held on the floor of a Brazilian stock exchange, or through a public sale of shares at a fixed price. This provision permits a wide distribution to the general public, including minority shareholders, employees, suppliers, and consumers.

Taking into consideration that one of the objectives of the Program is to develop the Brazilian capital markets, the government in some instances has made public offerings of shares which were subsequently listed on the main Brazilian stock exchanges. This occurred in the cases of Usiminas S.A., Cia. Siderúrgica Nacional and Petroflex Indústria e Comércio S.A. .

Pursuant to the Brazilian Corporation Law, every company has to comply with the terms of any shareholders' agreements duly filed at its head-office.² This legal requirement, which ensures the validity

1. Some states and the federal government have initiated independent programs aimed at transferring the operation of major highways to private hands, among them the highway between São Paulo and Rio de Janeiro. Such programs will involve the investment of approximately one billion U.S. dollars in the next few years, and will require sophisticated structuring to solve legal matters related to the agreements between the government and the concessionaires, as well as between the concessionaires and the international banks which will provide the funds necessary for the projects.

2. The purpose of a shareholders' agreement is usually to create limitations on the transfer of shares and to establish how the parties will exercise their voting rights.

and enforceability of the agreements between shareholders, has been the cause of lengthy and complicated negotiations between government agencies and their private partners during the privatization process of certain joint-venture companies, especially in the petrochemical sector.

(2) *Opening a state company's capital.* The Brazilian Corporation Law defines "publicly-held companies" as companies whose securities are traded either on stock exchanges or in the over-the-counter market and are registered with Comissão de Valores Mobiliários (CVM), the Brazilian equivalent to the Securities and Exchange Commission.

A company may open its capital either by a capital increase through a public offering of shares, or through an auction of shares which must be performed by a financial institution and carried out pursuant to the CVM's rules on block trade.

(3) *A capital increase coupled with a partial or total waiver or assignment of the subscription rights of the Federal Government or the controlling shareholder of the company.* In this case, the other shareholders may increase their holdings in the company by exercising their subscription rights. The federal government or the controlling shareholder, when waiving their subscription rights, may still retain control of the company or at least a significant number of shares of the company.

(4) *The conversion, merger, amalgamation, or spin-off of the company.* According to the Brazilian Corporation Law, conversion is the operation whereby the company is converted from one corporate type into another without being liquidated. Merger is the operation whereby one or more companies are merged into another causing the disappearance of the companies that are merged into the surviving one. Amalgamation is the operation whereby two or more companies are united to form one new company which succeeds them in all rights and obligations. Spin-off is the operation whereby the company transfers all or part of its assets to one or more companies, whether incorporated for such purpose or not.

(5) *The dissolution of a state-owned company through the sale of all of its assets.*

In addition to the various forms by which the privatization may be affected, the regulations also authorize the use of the so-called privatization currencies as means of payment, other than cruzeiros and foreign currency, for the acquisition of the companies that are being privatized. The main privatization currencies are the following: (1) TDA — bonds issued by the government for the payment of ex-

propriated rural land; (2) OFND — bonds issued by the National Development Fund, a fund composed of shares of companies directly or indirectly held by the Union; (3) Certificates of Privatization — certificates issued by the federal government and compulsorily acquired by financial institutions; (4) *Siderbrás debentures*; (5) Securitized Debt — overdue and renegotiated debts made up of general credits against the Union or guaranteed by the National Treasury; (6) Overdue National Housing System debts; and (7) Brazilian foreign debt instruments and securities.

The three most commonly used privatization currencies are Securitized Debts, *Siderbrás Debentures*, and Certificates of Privatization. As of December 1993 they represented, respectively, 35.36%, 20.45%, and 19.35% of the total volume of currencies applied towards the acquisition of shares of companies being privatized.

All of the privatization currencies are traded at different prices in the secondary market, and therefore the financial engineering of the bids to be made by prospective purchasers depends upon their actual discounts. Except for foreign debt, which implies a twenty-five percent discount on its face value, all other currencies are accepted at their face value in the Program.

The process further provides for a so-called pre-qualifying phase. This phase is intended to ensure that bidders, if their offers are awarded, will have a sufficient amount of privatization currencies to pay for the shares. In the pre-qualifying phase, bidders must detail and produce evidence of the currencies they hold or, alternatively, tender a first-class bank letter of guarantee to ensure that the purchase price will be timely settled. This safeguard adopted by the authorities is intended to eliminate any possibility of a sale being frustrated by a lack of currency in the hands of the awarded bidders, which has been a problem in other countries.

To finalize a description of the legal structure of the Program, it is necessary to describe the process which the government follows to appraise each company being privatized. The process begins with the Banco Nacional de Desenvolvimento Econômico e Social (BNDES), the federally-controlled development bank, hiring two consulting companies to perform the appraising services. Each consulting company is responsible for conducting an initial economic appraisal. In addition to the first economic appraisal, a second economic evaluation is performed by a consortium of consulting companies whose duties include a due diligence work, the presentation of a suggestion from a legal and technical standpoint regarding any adjustments to be made

by BNDES prior to the privatization, and the preparation of a proposal as to the format of the privatization process. The results of the reports prepared by the consortium are fully disclosed to bidders. If there is a difference of more than twenty percent in value between the results reached by the two economic evaluations of the companies, the government must hire a third consulting company to ascertain the value of the company going private.

In spite of such thorough evaluation, BNDES does not guarantee any contingencies, which, if any, must be totally borne by the investors. In any case, our experience working in the Usiminas and Cosipa consortia (steel mill plants located in the states of Minas Gerais and São Paulo, respectively), and leading the consortium in charge of performing the Petroquímica União appraisal shows that the degree of information disclosed is such that a bidder receives sufficient data on contingencies and is in a position to ascertain risk.

Twenty-five companies have been privatized by the government under the program: eight steel companies (Usiminas S.A., Aços Finos Piratini S.A., Companhia Siderúrgica do Nordeste (COSINOR), Companhia Siderúrgica de Tubarão (CST), Cia. Aços Especiais Itabira (ACESITA), Companhia Siderúrgica Nacional (CSN), Aço Minas Gerais S.A. (Açominas), and Companhia Siderúrgica Paulista (Cosipa)); nine petrochemical companies (Petroflex Indústria e Comércio S.A., Companhia Petroquímica do Sul (COPEL), Nitriflex S.A., Indústria e Comércio, Polisul Petroquímica S.A., Companhia Brasileira de Estireno S.A. (CBE), PPH, Poliolefinas Oxiteno Indústria e Comércio S.A., and Petroquímica União (PQU)); five fertilizer companies (Fertilizantes Fosfatados S.A. (FOSFÉRTIL), Goiás Fertilizantes S.A. (GOLASFÉRTIL), Ultrafértil S.A., Ind. e Com. de Fertilizantes, and Indag S.A.); a shipping company (Serviço de Navegação da Bacia do Prata S.A.); a maintenance company specializing in aircraft engines (Companhia Eletromecânica Celma); a manufacturer of railroad equipment (Mafersa S.A.); and a soda manufacturer (Companhia Nacional de Alcalis). These sales have totalled an aggregate selling price of U.S.\$ 6.57 billion.

An examination of the transactions shows that less than four percent of total proceeds derive from cash payments (local and foreign currency), while the remaining ninety-six percent of the payments were made in the various privatization currencies described above. This allowed the government to cancel more than 6.5 billion U.S. dollars of its debt to the private sector.

The disparity between the amount of privatization currencies received and the amount of cash received has generated an intense debate in Brazil about possible changes in the relevant regulations. The government has decided that, depending on the interest a company generates in the market, a minimum cash amount may be required. That amount will be decided on a case-by-case basis by the President of Brazil, on the basis of a proposal submitted by the Program's Steering Committee.

It is worth noting that although privatized companies have attracted a good deal of interest within the Brazilian private sector, the participation of foreign investors in the Program has been insignificant. Probably the main cause for the absence of foreign investors is the fact that the pricing of the Brazilian foreign debt has not been competitive vis-a-vis the other privatization currencies. It must be pointed out, however, that there is no prohibition on foreigners acquiring, in the local market, privatization currencies other than foreign debt, thereby maximizing the structure of their bids.

Notwithstanding the above alternative, let us concentrate for a moment on the specific rules regarding the use of foreign debt. At the beginning of the Program, the proceeds resulting from the swap of foreign debt for investment in the companies being privatized had to remain in the country for twelve years. Shares acquired by a foreign investor could not be sold for at least two years, although purchasers were free to repatriate dividends declared by the privatized companies. In order to attract foreign investors, the federal government reduced the twelve-year period to six, and abolished the restriction regarding the transfer of shares which may now be traded immediately upon their acquisition.

All foreign debt used in the Program is subject to a standard discount of twenty-five percent of its face value. There have been discussions regarding the elimination of this pre-established discount. It is suggested that it instead be determined by auction. However, the rule has not yet been changed.

The discounted face value of the foreign debt is the limit for registration of the foreign investment with the Central Bank of Brazil. Such registration affects the taxation of any capital gains made in the sale of the investment. Dividends paid by the privatized companies are freely remittable.

One relevant issue related to the participation of foreign investors in the Program is the so-called "forty percent rule," established by Section 13 (iv) of Federal Law No. 8,031, of April 12, 1990, which

states that "the sale to foreign individuals or legal entities of the stock of the companies going private shall not exceed forty percent of the voting stock," unless Congress decides otherwise. This rule limits the participation of foreigners in the Program. For example, in the steel mill industry, the majority of the companies going private already had foreign shareholders. The maximum percentage offered for purchase by foreigners was thereby reduced by the percentage already held by the existing foreign shareholders.

In light of the small interest foreign investors have expressed in the Program, and with the intention of increasing the prices paid for the privatized companies, the government issued Provisional Measure No. 432, dated February 23, 1994, which allows any foreign individual or legal entity to purchase the whole of the voting stock of companies being privatized. However, according to this provisional measure, the government is entitled to reduce the percentage of stock that may be purchased by foreigners in certain companies in sectors considered to be strategically important. Provisional Measure No. 432 has not yet been voted on by Congress.³

It is also necessary to discuss briefly the role played by the local and international equity capital markets in privatization in Brazil. The Brazilian equity markets are fully equipped, both in terms of technology and regulations, to be widely used in the Program. The São Paulo and Rio de Janeiro stock exchanges are modern entities, where a substantial volume of transactions, amounting to more than US\$150 billion and US\$30 billion, respectively, is traded daily. The market is supervised by the CVM, which, together with the Central Bank of Brazil, has recently opened the markets to participation by foreigners, allowing non-Brazilian residents to invest in the Brazilian stock exchanges.⁴

In addition, the government has also issued regulations authorizing Brazilian companies to access the foreign financial and equity markets. In connection with the privatization, an important innova-

3. According to the Brazilian Constitution, Provisional Measures have to be confirmed by Congress within thirty days following their enactment to become definitive laws. Notwithstanding the foregoing, Provisional Measures produce effects upon enactment, and may be renewed should Congress fail to vote within thirty days. Although Congress has yet to confirm Provisional Measure No. 432, it has been consistently renewed by the government.

4. The main vehicle for foreigners to invest in the Brazilian securities market is the "so-called Annex IV" regulation, under which foreign institutional investors, as defined by the regulations, may establish a portfolio of securities traded on the Brazilian stock exchanges.

tion is the option for Brazilian companies to issue depositary receipts, such as American Depositary Receipts, abroad.

Regardless of the uncertainties initially faced by the Program, and the strong reaction by the labor unions and certain political parties, the Program has proven to be successful and a necessary part of the newly enacted Economic Stabilization Plan.

The final adjustment implies a drastic reduction of budgetary transfers by the government and a maximization of the social investments in health, education, housing, and plans designed to diminish poverty. The lack of funds leads the government to dispose of its holdings in the state-owned companies, eliminating the risk of such companies becoming obsolete by the introduction of new technologies and more efficient managerial techniques.

The Program creates an opportunity for the employees to participate in the capital of the companies going private. By listing the shares on the stock exchanges, employees can participate in the profits of the companies.

Last but not least, the majority of privatized companies have, in a short period of time, shown positive results. Shares listed have had a substantial increase in their quotations on the stock exchanges and shareholders have benefited from the distribution of dividends.