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**Corporate Governance in Chile:
New Developments**

by

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I. Introduction.

Last year at the Corporate Governance Conference in Sao Paulo we had the opportunity to comment on what then was the bill being discussed in the Chilean Congress to introduce rules regarding tender offers (OPAs, as they are known in Spanish) and improvements to corporate governance. During year 2000 the bill was vigorously debated and negotiated by the Chilean Government and congressmen of both the opposition parties and the governing coalition parties.

Several important changes were introduced to the bill as part of the negotiations. In some areas it may be said that the changes reflect a technical improvement of the rules initially planned by the Government. Other changes rather reflect the accommodations negotiated to obtain the votes necessary to approve the law during year 2000. In this regard strong lobby was made by different groups of the private sector to protect their different interests.

The bill became law in December 2000.

II. Tender Offers and Corporate Governance New Law.

The Chilean Corporate Governance scenario is being subject of several and deep changes due to the new Tender Offers and Corporate Governance Law ("Law 19,705"), enacted in December 2000. Law 19,705 is an ambitious and innovative piece of regulation, directed to strengthen some basic principles in order to improve fairness, transparency and order in the Chilean Capital Market as a whole. Subsequently to the enactment of Law 19,705, several complementary regulations have been issued by the Superintendence of Securities and Insurance ("SVS"), stating precisely how the new legislation should be understood and how it shall be encouraged, controlled and enforced by the SVS itself.

We shall analyse now, succinctly, some of these principles and how they have become reality through the new regulation.

1. Transparency.

a) Tender Offers Regulations.

Previous to Law 19,705, no rules regarding tender offers were in force. The transfer of a controlling stake in an open stock corporation (publicly traded), or of its convertible securities, could be freely executed as a private transaction. Likewise, no tender offer was required for the purchase of any share capital percentage in such companies.

We may summarise the main new rules as follows:

i) Tender Offers Concept.

The Law 19,705 expressly defines the concept of “tender offer” as an offer launched to acquire from the existing shareholders a certain percentage of the shares of an open stock corporation within a certain period of time.

ii) Application of Tender Offer Procedure.

Law 19,705 is applicable to both voluntary and mandatory tender offers. The latter will be explained hereafter. Nevertheless, a tender offer for up to 5% of the company shares could be exempted from some of the requirements set forth in the Law 19,705 if:

1. The acquisition is carried out in a stock exchange;
2. The shares are acquired on a pro rata basis; and
3. The percentage of shares to be acquired by the offeror will not allow him to control the company.

iii) Mandatory Tender Offers.

Law 19,705 states that the following acquisitions of shares (or its convertible securities), whether direct or indirect, of one or more series, issued by a open stock corporation, must be carried out through mandatory tender offers:

1. Acquisitions which allow one person to control a company;
2. If as a consequence of any acquisition, one person reaches or exceeds two thirds of the issued voting shares of an open stock corporation. In such case, a tender offer shall have to be carried out for the remaining shares; and
3. If a person wants to acquire the control of a company, which in turn controls an open stock corporation, which shares represent 75% or more of the value of the company’s consolidated assets, a tender offer must be made first for the shares of the underlying corporation. The tender offer must consider a number of shares enough to acquire control over the corporation.

iv) Exceptions to Mandatory Tender Offers.

1. Acquisitions originated from a capital increase, through the issuance of new shares, which allow the acquirer to obtain the control of the issuer company;
2. Acquisition of shares sold by the controller of the company, provided that such shares have a significant trading volume and the purchase price is paid in cash and such price is not substantially higher¹ than the market price²;
3. Acquisitions produced as a consequence of a merger;
4. Acquisitions produced as a consequence of a death; and
5. Acquisitions produced as a consequence of mandatory transfers ordered by a court.

v) Shareholders Agreements Currently in Force.

Shareholders agreements regarding rights of first refusal for the purchase or sale of shares or for a new subscription of shares of an open stock corporation, shall not be subject to the tender offer provisions established by Law 19,705, only if such agreements:

1. Have been communicated to the company and made available to the shareholders knowledge, and
2. Have been registered in the Shareholders Register of the company. Both above-mentioned requirements must have been fulfilled before the enactment of Law 19,705.

vi) Exception in Favour of Current Controllers.

Current controllers of open stock corporations are allowed to freely transfer their controlling stake without being subject to the tender offer rules provided, however, that such transfer is made within three years as of January 1, 2000, and with the approval of a special shareholder meeting. In any event, the buyer of such shares shall be subject to the tender offer provisions of Law 19,705 if he/she wants to sale those in the future.

¹ For purposes of Law 19,705, "price substantially higher than the market price" is defined as the price exceeding the "market price", in a percentage which the SVS shall determine once a year, which may not be less than 10% and not higher than 15%. Currently, the SVS has fixed this percentage at 10%.

² For purposes of the Law 19,705, "market price" is defined as the price which results from calculating the average of the stock trading transactions made between the 90th business trading day and the 30th business trading day prior to the date on which the acquisition must be made.

This exception was intended to give some protection to the current controllers, who have already paid a higher price or “control price” for their controlling stake.

vii) **Complementary Rules.**

As a way to avoid any kind of fraud against the above mentioned rules, Law 19,705 states the following complementary rules:

1. A shareholder who has taken the control of a company may not, within twelve months following the date of the operation, acquire shares of such company for an amount equal or higher than 3%, unless pursuant to the rules of a tender offer. The price per share under such tender offer may not be less than the price paid in the operation whereby control was acquired. However, if the acquisition is made in a stock exchange, and on a pro rata basis, then the controlling shareholder may acquire a higher percentage of shares, according to the regulations to be established by the SVS in this respect.
2. The offeror must pay the same tender offer purchase price to all the shareholders selling their shares in the period starting 90 days prior to the tender offer and ending 120 days after the expiration date of the tender offer. Such a rule is meant to prevent potential abuses of privileged information and discrimination among shareholders.
3. During the period of the tender offer, the offeror may not acquire shares subject of such tender offer through private transactions or in stock exchanges, whether local or foreign, without being subject to the tender offer procedures.

b) Disclosure in Tender Offers Procedures.

Any person who, directly or indirectly, intends to take over an open stock corporation, must previously disclose such intention to the general public, the SVS, the target company, and the stock exchanges in which the target company securities are traded. In this regard, it is not relevant the form of the acquisition of the shares, and it includes direct subscriptions or private transactions. All information disclosed to the public must be specific, clear, precise and fair. It should not be conducive to errors or misinterpretations by the market, so it can correctly assess the prospective tender offer, the prospective buyers' purposes and their intentions to make future purchases. Similarly, agreements or prospective agreements to transfer control must be informed to the market accurately and on a timely basis.

c) Insider Trading.

Law 19,705 made several amendments to the Chilean Securities Market Law, incorporating stricter rules regarding the use of confidential information belonging to a company, and creating new situations of insider trading.

2.- Supervision.

SVS plays a strong and active role to assure the strict observance of the new rules, by means of look over the market to assure every agent participant in it, the protection to their interests as well as the public faith, emphasising self-regulation within the companies, etc. To fulfil such a labour, the SVS is empowered to take different and varied courses of action. Among them, we could remark the following:

- a) Issuing complementary regulations as demanded by Law 19,705;
- b) Imposing fines to the trespassers:
- c) Suspending tender offers procedures, even before they have started, when the information is not complete or there has been a legal obligation default; and
- d) Demanding complete information about the transaction.

3.- Protection of Minority Shareholders.

The last few years have been a scenario for mayor take over cases in Chile (e.g. Endesa, Enersis, CTC, Banco Santiago), and minority shareholders rights have been repeatedly challenged due to the lack of protective regulation. Law 19,705 included several provisions to protect these rights, among which we could emphasise the importance of:

a) Reinforcement of Institutional Investors

- i) Institutional investors (particularly Pension Funds and Mutual Funds) have been key players to defend the interest of minority shareholders in most of the recent cases where corporate governance issues have been the centre of the discussion.

Pension Funds are probably the most significant minority shareholders of Chilean publicly traded corporations. They have had an important legal limitation to participate in tender offers occurred in the last years, which is that they are only allowed to sell shares in the stock exchanges. Since most tender offers are arranged through multiple individual private sales, Pension Funds were in principle excluded from the tender offer processes. Thus, although it has not been a formal requirement, in practice it has been necessary for parties seeking to acquire control of publicly traded corporations to arrange for some total or partial “way out” for Pension Funds. These have become the most

powerful *de facto* players for the negotiation in the success or failure of a potential take over. At the same time, they were in a difficult position to openly negotiate.

Mutual Funds proved to be very effective to defend the interest of minority shareholders in the case involving the initial acquisition of Enersis by ENDESA (Spain). However, they had also an important limitation as shareholders, they could not vote at shareholders meetings but in a few cases. Thus, in most circumstances where a take over was involved, they could not vote.

- ii) Law 19,075 allows now Pension Funds to participate in tender offers regulated by the law. Thus, Pension Funds may now benefit directly and simply from the premium price normally involved in a tender offer procedure. They do not require difficult separate arrangements for the party offering the acquisition and they can openly sit in front as any other shareholder.
- iii) Mutual Funds may now vote as any other shareholder at all shareholders meetings. Law 19,075 eliminated the restrictions imposed on them.

b) Expanding the Possibility of Exercising Withdrawal Rights.

i) Withdrawal Rights.

As a general rule, under the Chilean Corporations Law (“Corporation Law”), withdrawal rights of dissenting shareholders are triggered as a result of resolutions adopted at shareholders meetings with respect to certain specific matters. Law 19,075 established new events enabling shareholders to exercise withdrawal rights.

ii) New Triggering Events.

The new events that according with Law 19,075 will confer withdrawal rights to dissenting shareholders are the following:

1. The approval by the shareholders meeting of resolutions regarding any of the following matters:
 - a) Sale or disposal of 50% or more of the corporation’s assets;
 - b) The granting of guarantees to secure third parties obligations that exceed 50% of the corporation’s assets;
 - c) The decision to cancel the registration in the Securities Registry of

- i) An open stock corporation that has ceased to meet the requirements contemplated in the Chilean Law to be considered as such, or
 - ii) A close corporation voluntarily registered in such Securities Registry; and
 - d) Other matters contemplated in the law or in the corporation's by-laws.
 2. If a shareholder, having acquired control of two thirds of the issued and outstanding shares does not make, within 30 days following the date it has acquired such control, a tender offer to the rest of the shareholders for the remainder of the corporation's shares.
- iii) Dissenting Shareholders Empowered to Exercise the Withdrawal Right.

As a general rule, dissenting shareholders entitled to exercise withdrawal rights are only those that:

1. Having attended the corresponding shareholders meeting, opposed to the approval of a resolution on a matter that gives rise to withdrawal rights, or
2. Not having attended such shareholders meeting, notify their opposition to any such approved resolution within the 30 days following the date of the relevant shareholders meeting.

Additionally, shareholders having withdrawal rights shall be entitled to exercise their right only with respect to the shares that are registered in their name in the shareholders registry of the corporation:

1. 5 business days prior to the date of the relevant shareholders meeting, if the withdrawal right is triggered by a resolution of the shareholders meeting;
 2. On the date of the publication of the lowering of the rating of the shares, in the case of open stock corporations in which the State or its agencies has a controlling interest, or
 3. On the date in which a controlling shareholder reaches or exceeds two thirds of the issued and outstanding shares of an open stock corporation.
- vi) Payment.

The corporation will pay the purchase price of the shares to dissenting shareholders, who have exercised withdrawal rights, within 60 days following:

1. The date of the shareholders meeting that originated the withdrawal rights;
2. The date of failure by the controlling shareholder to make a tender offer to the rest of the shareholders for the remainder of the corporation's shares; or
3. The expiration of the 30 day period following the publication of the lowering of the rating of the shares in the case of open stock corporations in which the State or its agencies has a controlling interest.

If the purchase price is not paid within the corresponding time frame, the price shall be adjusted in accordance local inflation and it will accrue ordinary interest as of the date of expiration of the 60 days term.

b) Derivative Action.

Any right is useless unless it provides the necessary mechanisms to assure its enforcement. In that respect, accountability actions constitute the indispensable legal back up for shareholders' rights.

There are two kinds of accountability actions in doctrine: derivative actions and direct actions. The distinction between them is based on who has been directly injured: if the injury affects the corporation, the suit to repair it is a derivative action; if the injury is to some or all shareholders, the suit is a direct one.³

Derivative actions intend to protect a corporation's interest in those cases where the board of directors is reluctant to pursue claims against anyone who has affected the corporation (generally against insiders).

Law 19,705 creates a derivative action ("Derivative Action"), which allows a shareholder or group of shareholders of a company, holding at least 5% of the company's shares, or any director of the company, to claim, in the name and on behalf of the corporation, for a compensation of the losses caused to it by third anyone which has violated the Corporations Law, its regulations or the company's by-laws. If the action succeeds, the costs caused will be paid to the plaintiffs (shareholder or group of shareholders, or director, as the case may be) and will not benefit the corporation; if it does not, the costs caused must be assumed exclusively by the plaintiffs.

Under Chilean law the derivative action is not well developed, in opposition to the American law where different conditions are required in order to allow the use of this kind of actions. For example, in Chile no reference is made to the board's failure to

³ Emanuel, Steven. "Corporations", Second Edition. Emanuel Law Outlines, Inc. 1992.

take action in order to protect the corporation's interests, which is considered an essential requirement for this kind of suits. There is no reference to the need of a prior presentation of the case to the board or to a special committee of directors. Nevertheless, it should be assumed that the intention was that this action be used when the board is inactive.

In respect to a prior presentation to the board, decisions on how the corporation's affairs should be run are reserved to the board of directors, therefore such board is the first responsible party in watching out for the corporation's interests. In other countries if a shareholder or a director considers that a damage has been caused to the corporation, he/she must inform that situation to the board, which will analyse the different alternatives available in order to decide which alternative is more convenient to the corporation. If the petitioner believes the board decision will not be impartial, he/she should apply to a committee comprised of directors who are not involved in the alleged wrongdoing

This is not the case in Chilean Law, where no prior requirements are demanded in order to exercise a derivative action. As the rule is now, it could be possible for a shareholder or a director to interfere with the board's representative role and cause even larger damages than those which compensation the plaintiff is trying to obtain.

Furthermore, procedural requirements, certain conditions that must be fulfilled by the plaintiffs, or the way to proceed in case of settlement, for example, are issues that are not yet covered by the Chilean legislation.

In any event, to have established a derivative action is an improvement to the corporation's legal framework. Until last December minority shareholders had very limited legal recourse to defend the company's interest against damages caused by malicious behaviour of controlling shareholders, directors or other persons. Whether this broadly defined derivative action may become an obstructive instrument to be used by abusive minority shareholders, will depend on the courts.

c) Restrictions on Sale of Assets

It is well known that one of the most common ways to damage minority shareholders is by means of selling the company's assets to a third party, even though when the selling price is fair or even higher than the market price. There are some assets that justify the shareholders investment, and without them such investment becomes meaningless.

Regarding these matters, Law 19, 705 has strengthened the old regulations as follows:

- i) The previous regulations stated that the conveyance of the company's assets and liabilities or of all its assets required an affirmative vote of, at least, two thirds of the voting issued shares. Law 19,705 is far more strict and says that such a vote will be necessary to transfer 50% or more of the company's assets, whether it includes or not its liabilities. The same rule is applied to the

formulation or amendment of any business plan which contemplates the transfer of assets for an amount exceeding the referred percentage. For this purpose, it is understood that one or more separate acts regarding any corporate asset within any period of 12 consecutive months constitute one single transfer operation.

- ii) Law 19,705 added to the matters that required an affirmative vote of, at least, two thirds of the voting issued shares, the following ones:
 - 1. The granting of guarantees for guaranteeing third party obligations which exceed 50% of the company's assets, except with respect to subsidiaries, in which case the approval of the board of directors of the company will suffice; and
 - 2. The acquisition by the company of shares of its own issuance in certain cases.

d) Tender Offers Regulations and Procedure.

The new tender offers regulations and procedure have not only improved transparency in our capital markets (as referred above), but also minority shareholders protection. Indeed Law 19,705 has as a main goal and inspiring principle the equal treatment of all shareholders, and the guarantee that their investments will be protected in case of a take over.

Among these new legal protections, and just as an example, we could mention the following:

- i) The tender offers must be addressed to all shareholders of a company, or of the respective series, as the case may be, and a prospectus must be available for the interested parties.
- ii) Offers are irrevocable, although the offeror may contemplate objective conditions of termination of the tender offer, which must be informed. However, the offeror may improve the price offered and increase the maximum number of shares included in the tender offer. Furthermore, the acceptance of the tender offer by the shareholder is retractable until the expiration of the tender offer period.
- iii) Competing offers may be submitted during the term of a tender regarding the same shares.
- iv) If the number of shares included in the acceptances of the tender offer exceeds the number of shares for which the tender offer was made, the offeror must acquire them on a pro-rata basis.

4.- Related Parties and Conflicts of Interest.

a) Related Transactions.

Chilean law establishes certain rules regarding transactions with affiliates, including officers, directors and related persons (“Related Transactions”), which demand such transactions to be executed in arm’s length conditions and to satisfy certain disclosure requirements. Related Transactions include transactions involving board members and their spouses or close relatives, as well as transactions involving third companies in which such board members perform as members of the board, or directly or indirectly control 10% or more of such companies.

i) Requirements.

The basic rule is simple, namely, companies may enter into Related Transactions when such transactions have:

1. Been approved by the board of directors (which approval shall be disclosed in the up-coming shareholders meeting), and
2. Are consistent with standards of fairness similar to those that normally prevail in the market.

ii) Subsidiaries

Transactions carried out by a corporation and its affiliated, or its subsidiaries, or by such affiliates and subsidiaries, must also be executed on arms’ length conditions. The same requirement is applicable to operations of a subsidiary in which one of the parent company’s board members may have a stake. In this case the situation must be reported to the respective shareholders meetings of both companies.

iii) Maximum Stock Percentage.

There are no restrictions regarding the percentage of stock that any individual or entity may hold in a corporation (including, directors, officers and employees), with certain minor exceptions such as banking institutions.

The transfer of stock to directors and officers shall be deemed as a Related Transaction and, therefore, such transfer may not be made below market price.

iv) Disclosure

Under Chilean law, any direct or indirect acquisition or sale of shares made by directors or officers of a corporation shall be disclosed to the SVS and to the Chilean Stock Exchanges within the following 2 business days.

v) Sanctions.

Transactions which do not meet the above mentioned conditions and requirements are valid and enforceable. Nevertheless, the board members who approved such Related Transaction are jointly and severally liable for damages suffered by the company, and the board member who directly or indirectly benefits from the same shall reimburse all such benefits to the company. The same rules apply to managers. In the case of open stock corporations, such board members and officers are also subject to fines and administrative sanctions

vi) Law 19,705.

Law 19,705 introduced relevant amendments to these matters to avoid damages as result of Related Transactions. Among them:

1. Operations with related parties must be previously approved by the board of directors.
2. It is understood that a director has also personal interest in a company act or contract when the parties involved in such act or contract are companies owned or directed by the director's spouse and relatives.
3. Whenever the respective act or contract executed with related parties involves relevant amounts⁴, the board of directors of the company must previously determine whether it complies with arm-length's conditions similar to those prevailing in the market.

In case the board of directors considers that it is not possible to determine such conditions, the board, without the interested director, may approve or reject the operation or, it may appoint two independent experts to provide an opinion. The experts' reports must indicate the conditions of the operation and the manner of payment of the price in case of assets not consisting in cash. Such reports must be made available to the shareholders of the company and to the board of directors for a term of 20 business days.

The board of directors of the company may only resolve about the approval or rejection of the act or contract once the aforementioned term has elapsed. If shareholders representing, at least, a 5%, of the issued voting shares of the company, determine that the conditions are not favourable to the company's interests, or the reports are substantially different, such shareholders may request the board of directors within the above mentioned term, to summon to an extraordinary shareholders

⁴ It is understood that the amount of such act or contract is relevant when it exceeds 1% of the net worth of the company, provided that such act or contract exceeds the equivalent to 2,000 *Unidades de Fomento* (Chilean indexation unit which current value is equivalent to approximately US \$ 27). In any event, the operation is relevant whenever it exceeds 20,000 *Unidades de Fomento*.

meeting to resolve the issue. In this case approval requires affirmative vote of two thirds of the issued voting shares.

4. The controller or the related party who intends to carry out a Related Transaction, must make available to the board of directors, all records, reports, documents, and communications related to the operation, submitted to foreign supervising or regulatory entities or foreign stock exchanges. These documents must be available at the date on which the board of directors must resolve about the transfer of the business, assets and liabilities, or assets, as the case may be. Likewise, such records, reports, documents, and communications must be made available by the board of directors to the shareholders within the next day as of their receipt.
5. If actions against a director are initiated to seek compensation for damages caused by Related Transactions, the defendant has the burden of proof to demonstrate that the act or contract complied with arm-length's conditions or that the negotiation conditions were beneficial for the company. The exception being the case when the operation has been approved by the extraordinary shareholders meeting referred above.

b) Obligation to Create Committees of Directors.

One of the mayor innovations of Law 19, 705 is the creation of a directors committee in open stock corporations, as established in most codes of best practice and guidelines of corporate governance in many countries during the last years.

Sound corporate governance requires a body of support and control, specialised in some sensitive areas, such as accounting, auditing financial information, insider trading and management remuneration. Therefore, Law 19,705 stipulates that open stock corporations with a stock market value equal or higher than 1.500.000 *Unidades de Fomento*, (approximately US\$40,000,000), must designate a directors independent committee with the following powers and obligations:

- i) To examine the reports from independent accountants and external auditors, the company's balance sheet and other financial statements prepared by the management or the company's trustees, prior to their submission for shareholders approval.
- ii) To propose to the board of directors the names of external auditors and rating agencies to be appointed at the annual ordinary shareholders meeting.
- iii) To examine the existing information about the company's Related Transactions and to prepare a report to the board giving its opinion regarding whether or not the corresponding transaction is arm's-length.

- iv) To examine the remuneration systems and compensation plans for the company's management and top executives.
- v) Other matters entrusted to the committee by the company's by-laws, shareholders meeting or board of directors.

The committee must be composed of 3 directors the majority of which must be independent from the company's controller. A director will be considered independent if in the last board election he or she would have been elected regardless of the votes of the company's controller.

The directors connected to the controller can constitute the majority of the committee, only if the number of independent directors elected is less than two.

The committee's functioning, deliberations, agreements and organisation is governed by the rules applicable to the board of directors. Law 19,705 provides that the committee will have a special budget for its functioning and advisors, which must be approved by the annual shareholders meeting.

The directors who are members of the committee, apart from their responsibility as directors, will be jointly liable for any damage caused to the shareholders and to the company as a consequence of the decisions made by the committee.

III. Final Comments.

This year 2001 will see the first effects of the new rules introduced by Law 19,075. The SVS has already issued a flood of new regulations related to the application of the Law. Some tender offers were even last year made in accordance to the would be rules, reflecting clearly that potential controlling shareholders were aware of the new scenario and that they did not want to be perceived as out of the "accepted standards".

The establishment of a tender offer mandatory procedure; the audit committee (although never mentioned as such in the Law); a derivative action to defend the interest of the company; stricter rules on Related Transactions, and the reinforcement of institutional investors, are all elements to bring the Chilean corporate legal framework close to acceptable international standards.

Some of these new rules are easy to apply and they will render fruits in the immediate future. Other rules require improvement and, likely, it will come after they are tested in real cases and after shareholders, directors, supervisory agencies and, ultimately, courts have to deal with them.

In any case the year 2001 will mark a new mile stone in the road of corporate governance and development of the securities market in Chile.

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