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Mergers and Acquisitions in Chile: Approaching the Controlling Shareholder

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Investors analysing the possibility to acquire a Chilean corporation should carefully consider the specific structure of corporate control governing most of the legal entities in Chile, since it strongly determines the way mergers and acquisitions are carried out in this country.

The Chilean structure of corporate control

When we review what corporate control means under Chilean law, it becomes apparent that the controlling shareholder of the target corporation is the key player for any merger or acquisition: he or she is able to decide whether or not such a transaction will take place and to determine the way it will be structured.

An obvious consequence of this premise is that any person pursuing the acquisition of a corporation in Chile should assume that, to be successful, it will be necessary to start any negotiation by approaching the controlling shareholder.

Unlike in the US or the UK, where the ownership of corporations is widely dispersed among a number of shareholders, the ownership of Chilean corporations is highly concentrated in the hands of the controlling shareholder or group of shareholders, except for some rather uncommon cases.

To be clear, there is nothing like the separation of ownership and control here in Chile, and the powers of the board of directors and any other stakeholders are ultimately subordinated to those of the controlling shareholder.

According to Law 18,045 (the Securities Market Act), a person or entity is in control of a corporation when, directly or through another person or entity, it has an interest in its ownership and additionally, either is able to assure the majority of votes at shareholders' meetings and to elect the majority of the directors, or has decisive influence in the management of the corporation.

In Chile, the controlling shareholder typically enjoys full powers to elect and revoke the majority of the board members, appoint the external auditors, approve most of the by-law amendments and, more generally, determine the strategic policies of the company from a commercial and financial standpoint, including the approval of capital increases or decreases, credit agreements, bonds issuances or guarantees to be granted over substantial assets of the company, among others.

An iconic exception to the general rule is represented by La Polar, a well-known retail corporation which is not subject to any controlling shareholder; on the contrary, its ownership is widely dispersed among many shareholders (mainly institutional), none of which individually exceeds 10 per cent of the company.

This public corporation had achieved an impressive growth in the last decade under the guidance of a stellar team of directors and executives and, until a short time ago, was considered a shining example in corporate governance matters. However, in 2011 the company was affected by one of the worst financial scandals in Chilean history, which included the systematic falsification of financial statements, stock-option plans which stimulated short-term earnings, risky financial policies and conflicts of interests, among others.

This scandal seems to have generally reinforced the traditional confidence of local investors in corporations which have a strong controlling shareholder, or group of shareholders, seriously committed to the long-term results of the company.

In other words, controlling shareholders remain the kings of the Chilean corporate governance field.

Influence of the Chilean structure of corporate control in mergers and acquisitions

In the mergers and acquisitions field, although Law 18,046 (the Corporations Act) and the Securities Market Act contemplate certain special requirements in order to limit to some extent the powers of the controlling shareholder and protect minorities, the controlling shareholder still has an unmatched ability to decide the viability and structure of the transaction, especially when he controls two-thirds of the issued voting shares (which is quite usual in Chile).

We can see this control power reflected in every kind of corporate transaction available under Chilean law.

In the case of mergers, either through the absorption of one corporation by another or through the creation of a new entity, the approval of the shareholders meeting by the affirmative vote of two-thirds of the issued voting shares is required. Meanwhile, the main function of the board of directors is just to make available to the shareholders certain information necessary for the transaction (the merger agreement, the balance sheet and the expert’s valuation report). That is to say, the board could hardly prevent a merger from closing.

Something similar is applicable to the transfer of 50 per cent or more of the corporation’s assets; the transfer of 50 per cent or more of a subsidiary’s assets (when it represents 20 per cent or more of the holding’s assets); and the transfer of the corporate control of a subsidiary. All these transactions require the approval of the shareholders’ meeting by the affirmative vote of two-thirds of the issued voting shares. By contrast, the participation of the directors in these kinds of asset transfers is even less significant than in the case of mergers.

On the other hand, the main right available for dissenting minority shareholders in any of the above mergers or asset transfers is to leave the corporation by exercising their withdrawal right. But, at the end of the day, such minority shareholders have no substantial powers to interfere by themselves in a merger or acquisition.

As to takeovers, they are mainly a private and direct transaction between the purchaser and the controlling shareholder in the case of close corporations. No approval from the shareholders meeting or the board of directors of the target corporation is required and, therefore, neither directors nor minority shareholders could oppose it under Chilean corporate general rules (of course, this is still subject to shareholders agreements that could limit the shares' transfer).

Taking over public corporations

A different approach is contemplated by Paragraph XXV of the Securities Market Act regarding the takeover of public corporations: in fact, a highly regulated tender offer procedure (OPA) is the only means legally available to acquire control of these kinds of companies, unless an exception is expressly provided by law.

Pursuant to the Securities Market Act, an OPA is a tender offer for shares especially regulated therein, whereby a shareholder or third party offers to purchase a certain number of shares issued by the corporation, at a given price and during a specific term. In order to takeover or reinforce control of the corporation, the success of the OPA is generally conditioned by the offeror to having shareholders representing a minimum number of shares subscribing the offer.

Before the OPA procedure was enacted in 2000, the takeover of public corporations was a transaction mainly private in its nature. However, a famous judicial dispute among the shareholders of a large electric corporation in the late 90s (the Chispas case) led the Chilean legislator to introduce the mandatory OPA of Paragraph XXV of the Securities Market Act.

To put the case in a very schematic fashion, the shareholders who controlled a preferred series of shares representing a minority of the corporation had the right to elect an important number of directors, and in practice exercised control over the company. When a third party intended to takeover the corporation, the shareholders of the preferred series of shares, who at the same time acted as directors, negotiated a price for their shares which was substantially higher than the price offered to the other shareholders.

A long battle on the directors' fiduciary duty of loyalty started as soon as the ordinary shareholders obtained knowledge of the private negotiation taking place among the offeror and the shareholders of the preferred series of shares. The battle finished a few years ago with the application of high fines to the directors elected by the preferred series of shares who were involved in the challenged negotiation.

Considering the corporate governance standards which are typical in the Chilean market, the main anomaly of this case was that the corporate control was exercised in practice by a group of shareholders and directors who held a very small stake of the corporation, while the great majority of ordinary shareholders were in fact subordinated to them.

In reaction to this case, the OPA procedure was enacted with a view to assure equality among shareholders in the context of takeovers of public corporations.

This is why the Securities Market Act provides that any OPA must be addressed to all the shareholders of the corporation or to all the shareholders of a given series of the corporation, and when subscriptions exceed the shares offered to be acquired, the offeror must purchase the shares pro rata to the subscriptions of each accepting shareholder. Further to the above, the same conditions shall be offered to the shareholders of a given series, and in case the series subject to the OPA grants control over the company, a tender offer must be jointly carried out with respect to the shares of all the other series, and in the same percentage.

In general terms, the most important restriction to controlling shareholders under the OPA regulation is the exclusion of the possibility to individually negotiate a premium for the corporate control, which is now distributed among all the shareholders of the corporation or the respective series of shares, as applicable.

Despite the OPA regulation, no one in Chile could dispute that the controlling shareholder of the target company remains the key player in takeovers of public corporations, while the decision power of minority shareholders is reduced to joining or refusing to join the decision made by the controlling shareholder.

Consistently, the role of the board members of the target corporation consists mainly of facilitating the decision making of the shareholders by complying with their obligation to give them an opinion as to the convenience of the tender offer.

Likewise, the board is expressly forbidden from making certain decisions that could interfere with the OPA procedure while it is in force, such as creating subsidiaries, transferring assets representing more than 5 per cent of the total assets of the corporation or increasing its debts by more than 10 per cent with respect to the debts that it maintained before the commencement of the tender offer.

In other words, poison pills are not allowed under Chilean legislation, something that reflects the fact that in Chile the directors' role is strongly subordinated to that of the shareholders in matters concerning corporate control.

Empowerment of institutional investors

Notwithstanding the prominence of the power of controlling shareholders in Chile, some relevant cases in the last two years seem to show a new situation that other jurisdictions are already aware of: minority shareholders, and more specifically institutional investors, have acquired a better knowledge of the rights they are vested by corporate laws and regulations, especially in public corporations. At least, they have achieved a more deep awareness of their power to negotiate with controlling shareholders under certain circumstances.

In one such case, the controlling shareholder of a large public corporation in the electrics field let the board know its intention to promote a capital increase amounting to US$8 billion approximately, which was intended to be subscribed through the contribution of shares or equity rights in other companies in the case of the controlling shareholder, and through the contribution of cash in the case of minority shareholders.

As soon as they became aware of this situation, different pension funds, acting as minority shareholders, opposed the transaction by arguing that it should be considered not as a simple capital increase but as a related party transaction subject to Paragraph XVI of the Corporations Act.

The main difference between the two potential approaches was that capital increases subscribed through the contribution of assets require the valuation of experts and the approval of the shareholders meeting by the affirmative vote of two-thirds of the issued shares with voting rights, while related party transactions require, in addition to that, the approval of the board members. Conflicted directors cannot participate in the decision but in any case may have to give their individual opinion as to the convenience of the transaction.

The Securities and Insurance Authority accepted the position of the pension funds and requested that the board members review the transaction and give their opinion. However, the most important effect of the strong communications campaign carried out by the pension funds was that in practice, beyond the implementation of one or the other procedure, they obtained the possibility to negotiate with the controlling shareholder some terms of the capital increase.

Although we do not foresee a real decrease of the power of the controlling shareholder in Chile, it is not possible to deny that now any serious analysis of a potential transaction of a public corporation should try to anticipate the way institutional investors will react and how their reaction could impact the transaction’s structure.

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