CULTURE AND CORPORATE LAW REFORM: A CASE STUDY OF BRAZIL

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ABSTRACT

The Brazilian capital markets are insufficient to provide companies with adequate financing. A 2001 reform in the Brazilian Corporate Law sought to strengthen Brazil's capital markets by providing stronger investor protection. Many of these latest reforms, however, turn out to be merely palliative, because controlling shareholders were able to capture the legislation in its crucial aspects. In this Article, I argue that public choice theory does not offer a comprehensive explanation of the legal reform outcome in the face of the particulars of the Brazilian institutional environment. The objective of the research is to develop an alternative approach to the public choice model by building upon Douglass North's work. In this approach, culture is incorporated into the economic model to account for divergent outcomes of similar pro-

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posed legal reforms. I demonstrate how culture can either reinforce or attenuate rent-seeking interests. In the Brazilian case, I analyze how rent-seeking interests combine with cultural values to hinder institutional change. The aim of the Article is to examine the economic impact of incentives on the Brazilian Corporate Law Reform, and to explore how culture can constrain corporate governance and economic performance.

TABLE OF CONTENTS

> The performance of economies is a consequence of the incentive structures put into place; that is, the institutional framework of the polity and economy. These are in turn a function of the shared mental models and ideologies of the actors.[1]
>
> *Arthur T. Denzau & Douglass C. North*

> The gradual development of informal norms of behavior that have become deeply imbedded in the society provides the stable underpinning to the adaptive efficiency characterizing the western economies with a long history of growth. We do not know how to create such conditions in transition or third world economies.[2]
>
> *Douglass C. North*

1. INTRODUCTION

In recent years researchers have been investigating which institutional conditions enhance the performance of national capital markets. The role of a country's law in this process has been the subject of intense discussion in the law and economics literature. Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny ("LLSV") have argued that minority shareholder protections, and in particular formal shareholder protection laws (including appropriate levels of enforcement), are the key factor in the development of capital markets.[3] Subsequent theories have contested this thesis. However, the following questions have not been properly addressed. How can countries succeed in creating

1 Arthur T. Denzau & Douglass C. North, *Shared Mental Models: Ideologies and Institutions* 15 (Econ. Working Paper Archive at WUSTL, 1993), *available at* http://econpapers.repec.org/paper/wpawuwpeh/9309003.htm.

2 Douglass C. North, *Some Fundamental Puzzles in Economic History/Development* 10 (Econ. Working Paper Archive at WUSTL, 1995), *available at* http://econpapers.repec.org/paper/wpawuwpeh/9509001.htm.

3 *See generally* Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000) (claiming that corporate governance is better understood through its legal determinants).

these "capital markets augmenting" laws? Most importantly, how can these countries assure the adequate enforcement of these laws?

Scholars have recently argued that law enforcement is a better predictor of equity and credit markets development than the law on the books itself.[4] Nevertheless, in spite of the principal role played by enforcement, it is worthwhile to remark that, especially for civil law countries, the question of how to create good law on the books is pivotal. In most cases, it is impossible for a civil law country to enforce something that is not a legal rule on the books. Consequently, in civil law countries, the proper enforcement of laws requires the passing of proper legislation.

Creating efficient laws, however, is not an easy task. According to public choice scholars, interest groups who rationally pursue their own utility maximization will engage in lobbying efforts encouraging the enactment of rent-seeking laws in their favor.[5] Hence, institutional change that promotes efficiency may be hampered.

Achieving efficient economic institutions through institutional change is a puzzle that has concerned economists for a long time. This concern is even more important in the case of economic policy implementation in developing countries because in these countries there are several market failures that hinder efficient outcomes.[6]

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[4] *See* Katharina Pistor, Martin Raiser & Stanislaw Gelfer, *Law and Finance in Transition Economies* 3 (Eur. Bank for Reconstr. and Dev., Working Paper No. 49, 2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=214648 (stressing the importance of legal enforcement for markets in transition).

[5] *See, e.g.*, Gordon Tullock, *The Transitional Gains Trap*, 6 BELL J. ECON. 671, 673-75 (1975) (describing how the mercantile community sought the enactment of blue laws for their own self-interest); *see generally* TOWARD A THEORY OF THE RENT-SEEKING SOCIETY (James M. Buchanan, Robert D. Tollison & Gordon Tullock, eds., 1980) (offering a discussion of rent-seeking and lobbying).

[6] Past evidence broadly suggests the failure of neoclassical mainstream recommendations. *See, e.g.*, WILLIAM EASTERLY, THE ELUSIVE QUEST FOR GROWTH: ECONOMISTS' ADVENTURES AND MISADVENTURES IN THE TROPICS (2001) (arguing that the failure to apply economic principles to practical policy work in developing countries has hindered economic development and improvements in the standard of living); Bernard Black, Reinier Kraakman & Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731 (2000) (explaining that strong governments are needed to build infrastructures that can support large-scale privatization); Bernard S. Black & Anna S. Tarassova, *Institutional Reform in Transition: A Case Study of Russia* (Stanford Law School, John M. Olin Program in Law and Econ., Research Paper 238, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=311276 (providing a case study of Russia to describe the expansive reforms necessary for a country to transition into a global market); Mary S. Shirley, Pressing Issues for Institutional

What do we know about institutional change? According to Nobel laureate Douglass North, institutional change occurs through a movement in relative prices and/or a change in tastes.[7] Neoclassical Economics deals well with the first source of change but not with the second. This is because economists have long assumed that preferences are exogenously determined. However, the assumption fails to recognize that culture and ideology can constrain the evolution of values and tastes.[8] Although the exact mix of change in price and tastes that can lead to institutional change is not yet clear,[9] there is a relatively new and large body of research[10] that considers informal constraints[11] or social norms[12] as

Economists: Views from the Front Lines (unpublished manuscript, Presentation at the 1st Conference of the International Society for New Institutional Economics, Saint Louis, 1997) (arguing that neglecting a country's particular institutional features is the main cause of failure for many World Bank projects regarding third world country development); Joseph E. Stiglitz, Senior Vice President and Chief Economist, World Bank, Remarks at the World Bank: Public Policy for a Knowledge Economy (Jan. 27, 1999), *available at* http://www.worldbank.org/html/extdr/extme/knowledge-economy.pdf (arguing in a speech that the World Bank's strategy for developing countries, which focused on building infrastructure and factories, was seriously incomplete and focused on the "easy part" of development, whereas the recent shift has emphasized intangibles of knowledge, institutions and culture in order to develop a more comprehensive framework of work).

7 DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 84 (1990) ("Institutions change, and fundamental changes in relative prices are the most important source of that change. . . . [T]he only other source of such change is a change in tastes.").

8 *See* Samuel Bowles, *Endogenous Preferences: The Cultural Consequences of Markets and Other Economic Institutions*, 36 J. ECON. LITERATURE 75, 83 (1998) (establishing that market and other economic institutions alter preferences, values and psychological functioning of people, affecting the evolution of norms and the process of its cultural transmission).

9 NORTH, *supra* note 7, at 85.

10 I refer to the New Institutional Economics movement and the new literature on Law, Economics, and Social Norms in particular. *See infra* note 12.

11 *See* NORTH, *supra* note 7, at 37 (stating that informal constraints "come from socially transmitted information and are part of the heritage we call culture").

12 There is a comprehensive account of literature on social norms. *See, e.g.*, ROBERT C. ELLICKSON, ORDER WITHOUT LAW (1991) (providing examples and analysis of communities that use informal social norms outside of the law to govern themselves); ERIC POSNER, LAW AND SOCIAL NORMS (2002) (using collective action to explain how cooperative behavior is achieved in the absence of law); Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585 (1998) (describing how the law can change social preferences and norms); Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. LEGAL STUD. 537 (1998) (surveying the main trends in social norms analysis); Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L.REV. 349 (1997) (clarifying the ways in which social influ-

central elements that shape economic development. Social norms are fashioned according to the particular culture or ideology of a given society. Institutional change therefore can depend on cultural or ideological change. North conceptualizes ideology as a device that provides a "world view" to individuals so that their decision-making process is simplified.[13] For example, ideology may simplify a decision-making process by reducing the number of options the actor takes into account or by determining his preferences. Ideology can also restrict decision-making abilities. It is possible that ideology is so embedded in society that a single change in a relative set of prices by itself will not be sufficient to alter the established perspectives or processes of individual decision-making. Consequently, persistent cultural traits will hinder modifications to formal and informal institutions, and create a stable equilibrium.[14]

This Article contributes to the current discussion of how existing values in society might prevent the adoption of corporate norms designed to increase overall efficiency. It provides a better understanding of the institutions (informal and formal) that shape the corporate governance structures and discusses why inefficient rules might persist, in spite of efforts to improve their efficiency. This Article expands North's thesis that ideology can account for institutional change, by investigating how ideology can constrain economic outcomes.[15] Also, the Article uses a case study of the 2001 Brazilian corporate law reform as its basis of inquiry.

The Brazilian economy has many characteristics that make it a valuable case study. Brazilian capital markets are largely ineffi-

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ence and meaning can influence individual choices); Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338 (1997) (advancing the esteem model to illustrate aspects of norm regulation and enforcement).

[13] *See* DOUGLASS C. NORTH, STRUCTURE AND CHANGE IN ECONOMIC HISTORY 49 (1981) ("Ideology is an economizing device by which individuals come to terms with their environment and are provided with a 'world view' so that the decision-making process is simplified."); *see also* CLIFFORD GEERTZ, THE INTERPRETATION OF CULTURES 216 (1973) ("Culture patterns—religious, philosophical, aesthetic, scientific, ideological—are 'programs'; they provide a template or blueprint for the organization of social and psychological processes, much as genetic systems provide such a template for the organization of organic processes . . . .").

[14] *See* NORTH, *supra* note 13, at 49-50 (stating that persistent changes that run counter to an individual's rationalizations will induce him to alter his ideology).

[15] *See also* MASAHIKO AOKI, TOWARDS A COMPARATIVE INSTITUTIONAL ANALYSIS 4 (2001) ("[U]nderstanding the process of institutional change may be tantamount to understanding the ways in which the agents revise their beliefs in a coordinated manner.").

cient because they are not able to provide companies with desirable financing.[16] Ownership in the Brazilian corporate structure is highly concentrated, a characteristic that can constrain the performance of the market. Stockholders have incentives to hold a large number of voting stocks because of the substantial private benefits of control.[17] Controlling shareholders tend to extract perquisites from the companies, and make inefficient decisions because of their "amenity potential."[18] Additionally, in the years preceding the reform, there was a strong trend in which many Brazilian listed corporations were going private.[19]

However, to address these problems, reforms in the Brazilian Corporate Law were enacted in 2001. These aimed at providing conditions that would promote market development. The initial proposals for the law reform envisioned a strengthening of minority shareholder protections in accordance with current models of good corporate governance. Crucial aspects of these proposals, however, were dismissed during the legislative process because of the pressure by controllers' interest groups.

Controllers' interest groups were able to "capture" the legislation both directly and indirectly. Directly, and most effectively, the interest groups exerted pressure on legislators and the President[20] to drop amendments aimed at increasing minority shareholders' rights. For example, the proposal requiring that potential buyers

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16 *See* Stijn Claessens, Daniela Klingebiel & Mike Lubrano, *Corporate Governance Reform Issues in the Brazilian Equity Markets* (World Bank Paper, 2000), *available at* http://rru.worldbank.org/documents/brazil_equity_market_and_corporate_governance.doc (providing a survey of Brazilian corporate governance).

17 *See* Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 539 (2004) (identifying some of the factors associated with the private benefits of control).

18 *See* Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155, 1161-62 (1985) (explaining some of the forces that affect corporate ownership).

19 *See* Chart 2 *infra* at Appendix. In 1999 there was a de-listing trend, as many companies decided to become closely-held corporations.

20 The President of the Republic vetoed the provision that mandated equal participation by the minority shareholders in the audit committee, arguing that it was contrary to the spirit of the law to establish such a norm because only stockholders with voting rights can elect the administrative body of the company. The President argued that this proposal would create a dictatorship by the minority shareholders and provide illegitimate pressure. *See* Presidência da República, Casa Civil, Subchefia para Assuntos Jurídicos, Mensagem No. 1.213 de 31 de outubro de 2001, *available at* http://www.planalto.gov.br/CCIVIL/LEIS/Mesagem_Veto/2001/Mv121301.htm.

make a mandatory public offer to purchase minority voting shares at the same price paid to the controllers was abandoned. After lobbying efforts, the price required by the law for a public offering was reduced to 80% of the price paid for controlling stocks.

The interest groups were also able to indirectly influence the proposed reforms by adding several amendments to the text of the law. These amendments reduced the effectiveness of minority rights. An example of this was the reduction in the issuance limit of nonvoting preferred shares from 2/3 to 1/2. Existing publicly held companies were exempted from the new limit.

At first glance, the path dependent outcome of the Brazilian Corporate Law reform might be explained by traditional public choice. Public choice theory, known as the economics of politics, suggests that influential interest groups seek rents through the legislative process by managing to capture legislation to their benefit through lobbying. Interest groups will dissipate wealth transfers through the political process, thus obstructing efficient economic reforms.[21] Moreover, public choice also assumes that it is usually costly to establish interest groups. Therefore, existing groups will have advantages in the political market over new interest groups who face the costs of establishing their infrastructure.[22] Public choice theory may provide an appealing explanation because controllers were largely able to capture the legislation to their benefit in Brazil. However, I will argue that the public choice model does not provide a comprehensive explanation. The model fails to detect other important variables that may be driving this outcome: the ideology and culture embedded in the particular society.

Culture and ideology are important variables in explaining institutional change. Bringing these variables into the analysis offers different predictions from the ones provided by the traditional economic model. However, public choice theory does not explain

21 *Contra* Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371, 384 (1983) (arguing that policies that increase efficiency will win the competition for influence in the legislative process).

22 *See* DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION 13–16 (1991) (reviewing literature regarding the pressure that interest groups are able to exert); *see generally* William C. Mitchell & Michael C. Munger, ECONOMIC MODELS OF INTEREST GROUPS: AN INTRODUCTORY SURVEY *in* 1 PUBLIC CHOICE THEORY 408 (Charles K. Rowley ed., 1993) ("[P]rofitable rent seeking is most likely in industries with a high degree of concentration and almost impossible among consumer groups."); THE POLITICAL ECONOMY OF RENT-SEEKING (Charles K. Rowley, Robert T. Tollison & Gordon Tullock eds., 1988).

why many countries have enacted and enforce laws that protect minority shareholder interests.[23] North argues that an economic model that does not include an ideological component cannot adequately explain why some changes happened in history and others did not.[24]

On the one hand, culture or ideology can dissipate rent-seeking pressures in a specific context, and can account for the emergence of other strong interest groups (such as minority interest groups). For instance, when society finds some forms of management compensations outrageous, managers will not engage in such practices. Managers have reputation concerns and once society strongly condemns certain practices, the opportunity cost to engage in those disfavored practices will be too high.[25] On the other hand, culture or ideology can work the other way, by augmenting the power of established interest groups. For instance, if society tacitly accepts certain practices by not exerting enough pressure to modify them, managers will not be constrained to adopt more adequate compensation patterns.

If there are strong rent-seeking interests, in addition to a culture that supports these interests, then we can expect path dependence to occur. This argument explains why the Brazilian reform has essentially failed despite the fact that there was significant international pressure towards the adoption of better standards of corporate governance, contradicting the expected outcome pre-

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23 I will expand upon my argument, discussing the American example in particular. The changes that occurred in Asia provide another example. Stiglitz, *supra* note 6, at 3, attributes part of the miraculous growth of East Asia to a change in ways of thinking, caused by "the knowledge culture."

24 See NORTH, *supra* note 13, at 55-58 ("The simple fact is that a dynamic theory of institutional change limited to the strictly neoclassical constraint of individualistic, rational purposive activity would never allow us to explain most secular change . . . ."). *See also* FARBER & FRICKEY, *supra* note 22, at 24:

> The various economic theories of legislation have in common their rejection of ideology as a significant factor in political process. They assume that ideology, defined simply as individual beliefs about the public interest, influences neither voters nor legislators. The heart of the economic approach is the assumption that self-interest is the exclusive causal agent in politics. (This may seem a cynical perspective, but in some ways it may actually be unduly optimistic, because it ignores the dark side of ideology as exemplified by the Nazis and other hate groups. There are worse forces in the human psyche than greed.)"

25 *See* Mark J. Roe, *Can Culture Constrain the Economic Model of Corporate Law?*, 69 U. CHI. L. REV. 1251, 1258 (2002) (presenting examples of how culture can affect the contractarian corporate model).

dicted by defendants of the "convergence thesis."[26] Culture can make rent-seeking interests more or less effective.

My argument for the centrality of culture and ideology to institutional change will show that the "patrimonial" and "personal" culture, deep-seated in Brazil for centuries, is a crucial factor that restrains the development of the capital markets. Brazil is not unique in this matter. Several "Brazilian features" are shared by other Latin American countries. The main points explored in this paper can therefore contribute to a theoretical understanding of how culture can constrain corporate governance. Although this paper does not address the institutional development of other Latin American countries, there is good reason to believe that their problems are similar in some respects because they share similar paths of historical development and cultural norms and preferences.

The Article proceeds in two Sections. In Section 2, I discuss the 2001 Brazilian Corporate Law Reform. In Section 2.1, I outline the characteristics that distinguish Brazilian corporate governance structures. This provides a picture of the ample range of problems that can constrain the development of capital markets. In Section 2.2, I describe the major changes that took place in the formal institutional environment. In Section 2.3, I analyze the legal reform, evaluating its possible impact on the market, as well as focusing on the failures of the new legislation to provide proper incentives.

In Section 3, I then explain why Brazil failed to pass reforms that would have improved the efficiency of its capital markets. I examine how Brazilian cultural and ideological norms influenced these reforms. In Section 3.1, I provide a selective and critical review of the Law and Economics literature, presenting the general framework used by scholars to evaluate incentives necessary for developing strong capital markets. In Section 3.2, I introduce cultural variables to the traditional economic model and explain why public choice theory is incomplete in its attempt to explain the Brazilian corporate law regime. In Section 3.3, I discuss the Brazilian institutional environment, taking into consideration its historical, political and social background, which made possible the maintenance of some particular cultural features. I then offer a link between patrimonialism, personal relations, lack of enforcement, and

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[26] *See generally* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001) (discussing the trend towards convergence in corporate law).

the positivist culture of the legal practitioners. In Section 3.4, I discuss how these cultural norms can constrain the development of capital markets. In Section 3.5, I briefly discuss the origin of belief systems and social norms, connecting their persistence to the collective action problem.

In conclusion, the paper articulates how culture shapes corporate policy. This conclusion affects the law and economics literature by showing that culture and ideology can play as important a role in outcomes as self-interest does in the public choice model.

2. A CASE STUDY OF CORPORATE LAW REFORM IN BRAZIL[27]

On Friday July 27th, 2001, the helicopter Agusta A 109 Power fell into the sea next to Maresias beach, off the north coast of São Paulo. The aircraft carried four people: João P. Diniz, the manager of Pão de Açúcar and the son of Pão de Açúcar's CEO; Abílio Diniz;[28] Fernanda Vogel, the girlfriend of João P. Diniz; and two pilots. Ultimately, one of the pilots and Vogel, a famous Brazilian model, died in the accident. The helicopter had left the airport at around 5 p.m. and had been heading toward the Diniz family beach house.[29]

The helicopter crash investigation immediately generated tremendous media attention. It was the cover story in several magazines, including the most prestigious Brazilian weekly news magazine, *Veja*. All major newspapers provided ample coverage. It took a few days for the Coast Guard to find the bodies, which increased the press's interest.[30]

Aside from its tragic nature, this case has some peculiarities. Articles pointed out that the helicopter belonged to Pão de Açúcar.[31] The pilots were said to be employees of Pão de Açúcar as well.[32] Pão de Açúcar is the commercial name of Companhia Brasileira de Distribuição, a publicly held company which has a sig-

[27] Note that this Article aims to discuss the cultural environment and available data in the period preceding the legal reforms Therefore, the discussion does not necessarily reflect the most recent developments in Brazilian capital markets.

[28] By way of context, Abílio Diniz is a very famous entrepreneur in Brazil.

[29] *See, e.g.*, Eduardo Oinegue, *"CHAMEI FERNANDA, E ELA NÃO RESPONDEU"* [*"I Called Fernanda and She Did Not Answer"*], VEJA, Aug. 8, 2001, at 116.

[30] *Id.*

[31] *Id.* at 118.

[32] *Id.* at 120.

nificant percentage of its total value held by minority investors. Companhia Brasileira de Distribuição is one of Brazil's top retail empires, and operates a large chain of supermarkets. It is listed on the BOVESPA (the São Paulo Stock Exchange) and the New York Stock Exchange.

The media attention focused on many of the accident's technical issues, such as whether the helicopter was authorized to fly, whether the heliport and the pilots were licensed, and whether human error or a mechanical failure caused the accident. However, the news coverage did not identify who actually owned the helicopter. Within any given article we can find references to "helicopter of the Diniz family falls," "helicopter of João P. Diniz," "helicopter of Abílio Diniz," "helicopter of Pão de Açúcar," and "helicopter of Pão de Açúcar Group," as if these were indistinguishable.[33]

Curiously, nobody ever questioned why the helicopter of a publicly held company was being used for a personal leisure trip. No article raised any questions regarding the probable extraction of perquisites at the expense of the company. Articles even stated that João P. Diniz frequently traveled by helicopter to his house by the sea.[34] Although it is known that Brazilian entrepreneurs extract many perquisites from the companies they run, nobody discusses the practice. Rarely does the extraction of prerequisites become public. Even when a clear case of perquisites extraction becomes public, nobody seems to realize it as the information is filtered by Brazilian culture. People seem to think it is natural that João P. Diniz, the son of magnate Abílio Diniz, uses the helicopter of "his father's company" to do whatever he fancies. It is tacitly permitted.

In Brazil, the property of the firm is easily confused with the property of the CEO, who is usually one of the company's major shareholders. This is common within Brazilian norms and it is not given importance. Brazilian socio-economical actors—even the press, who should be critical of such actions—are not concerned when managers use the company's valuable asset for private pur-

[33] *See, e.g.*, Francisco Brandão & Celso Júnior, *Helicóptero de Diniz é retirado do fundo do mar* [*Diniz's Helicopter Is Recovered from the Sea*], JORNAL DA TARDE, Aug. 5, 2001, http://www.jt.estadao.com.br/editorias/2001/08/05/ger031.html; Oinegue, *supra* note 28, at 119.

[34] *See, e.g.*, Vera Avedisian & Nivia Alencar, *Modelo Fernanda Vogel continua desaparecida* [*Model Fernanda Vogel Is Still Missing*], AGÊNCIA ESTADO, Jul. 27, 2001; Oinegue, *supra* note 29, at 119.

poses.[35] The informal cultural norm that underlies the subjective opinion of socio-economical actors is that "He is allowed to do that because he is powerful." In this context, company insiders are not criticized. Informal constraints like reputational concerns therefore do not play a significant role. Continuing with the Pão de Açúcar example, an article reported that the family of one of the pilots was suing Pão de Açúcar for economic and non-economic damages. The suit alleged that the company was liable for the accident. According to the family's lawyer, the company had already agreed to pay a settlement to the Vogel's family.[36] This highlights the impact of subjective mental models.

Conversely, in the United States, the extraction of perquisites from publicly-held companies must be disclosed in several ways. For example, regarding personal use of a company aircraft, an employee is generally required to treat the monetary value of the personal use as additional compensation. Also, the Securities and Exchange Commission requires that companies disclose the compensation of their top executives, including cash payments, bonuses and "other annual compensation."[37] Perquisites and other personal benefits received by executives are considered "other compensation," pursuant to Item 402(b)(2)(C)(1) of regulation S-K.[38] For tax purposes, the Standard Industry Fare Level ("SIFL") rules require that "[w]here a company aircraft is used for personal transportation of an employee, the employee is generally taxed on the value of the use of the aircraft. Under the general rule, the em-

[35] *See* Alexander Dyck & Luigi Zingales, *The Corporate Governance Role of The Media* (Nat'l Bureau of Econ. Research, Working Paper No. 9309, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=347081 (arguing that the media can affect corporate governance and companies' policies in many ways, but that the direction in which the press exercises its influence depends on a country's culture and values). The media can drive politicians to introduce corporate law reforms or enforce corporate laws. It can affect the judgments shareholders make about a company and its managers, and consequently cause managers' concerns about reputation to increase. The media can also affect the reputation of managers and directors in the eyes of society at large.

[36] Mauro Mug, *Pilotos do Grupo Pão de Açúcar estavam cansados, diz relatório [Pilots of Pão de Açúcar Group Were Tired, Report Says]*, AGÊNCIA ESTADO, Nov. 5, 2002, *available at* http://www.qualidadeaeronautica.com.br/Fiquepordentro.nov02.htm.

[37] Securities and Exchange Commission, 17 C.F.R. § 229.402 (2005).

[38] Securities and Exchange Commission, 17 C.F.R. § 229.402(b)(2)(C) (1) (2005) ("Perquisites and other personal benefits, securities or property, unless the aggregate amount of such compensation is the lesser of either $50,000 or 10% of the total of annual salary and bonuses reported for the named executive officer . . . .").

ployee is taxed on the charter value of the transportation."[39] Additionally, the media in the United States frequently discusses executive compensation,[40] which is quite the reverse from what happens in Brazil where discussing executive compensation is taboo. This contrast between the way perquisites extraction is treated in Brazil and in the United States shows the importance of subjective perceptions in the expectations and scrutiny that is placed upon corporate actors. These important subjective perceptions are largely the result of a culture's norms and traditions.

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[39] Law Offices of Phil Crowther—The SILF Rules, http://home.southwind.net/~crowther/Attorney/SIFLRules.htm. *See generally* 14 C.F.R. § 399.31 (2006) (establishing the Standard Industry Fare Level). The website of attorney Phil Crowther, *supra*, provides a good example of a SILF computation:

> Below is an example of a SIFL computation for a 750 mile flight by a control employee in a light business jet:
>
> | SIFL Rate | | Value |
> |---|---|---|
> | First 500 Statute Miles x 18.91¢ | = | $94.55 |
> | Next 250 Statute Miles x 14.42¢ | = | $36.05 |
> | Subtotal | = | $130.60 |
> | Aircraft Multiple x 300% | = | $391.80 |
> | Terminal Charge + $34.57 | = | $426.37 |
>
> Helpful rules may apply where over 50% of the seating capacity is filled with business travelers, where the trip is partly for business purposes or where a spouse is accompanying the employee on company business. Also, the mileage is computed by taking the shortest distance between the two points, not the distance actually traveled.

Id.; see also Law Offices of Phil Crowther—Personal Use of a Company Aircraft, http://home.southwind.net/~crowther/Attorney/PersUse.htm:

> Occasional personal use should not have a tax impact on the company, as long as the use is properly reported. (Although the IRS has disallowed deductions associated with the cost of flying customers to a hunting lodge.) Frequent personal use of a company aircraft can lead to problems with claiming deductions, particularly if business usage to drop [sic] to less than 50%. In the worst case, the IRS could argue that the principal stockholder has received a "constructive dividend", which would result in income to the stockholder and no deduction for the company.

[40] A somewhat similar situation arose in the United States when the media widely reported the scandal involving Jack Welch's use of perquisites. *See generally* Mark Lewis, *Welch Walks Away from Perks*, FORBES.COM, Sept. 16, 2002, *available at* http://www.forbes.com/2002/09/16/0917welch.html.

2.1. *Corporate Governance Environment in Brazil*

Brazilian firms face a difficult task when they seek financing. The Brazilian interest rate is one of the highest in the world, and it is difficult for the Brazilian capital markets to provide desirable financing for companies. Most firms are forced to rely on internal financing. This weak financing situation presents a significant barrier to industrial growth.

Brazil has undergone an enormous privatization process in which many of the largest national enterprises, formerly owned by the State, were sold to private entrepreneurs.[41] One of the objectives of the privatization program was to develop the capital markets.[42] The markets experienced a temporary boom in 1997 and 1998 (see Appendix Tables 1 and 2) when the government received the largest proceeds from the sale of the enterprises (see Appendix Chart 1). However, this increase in trading was largely due to the intensification of speculative trades just before the privatization. This short-lived increase in trading did not constitute a stable upward trend in liquidity activity. Scholars have pointed out that the privatization process has not resulted in a democratization of capital ownership.[43] The government chose to auction off controlling blocks of shares in order to capture the control price. It sought to raise funds in order to reduce its public debt instead of proceeding with a public offering strategy,[44] which might have helped strengthen the equity market in the long run.[45]

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[41] For a survey of Brazilian privatization data, see BRAZILIAN DEVELOPMENT BANK, PRIVATIZATION IN BRAZIL (2002), *available at* http://www.bndes.gov.br/english/studies/priv_brazil.pdf.

[42] *See* Lei No. 9.491, de 9 de setembro de 1997, D.O., (174; 1): 19941, set. 1997 ("The fundamental objectives of the Brazilian Privatization Program are: . . . VI - to contribute to the strengthening of the capital markets by increasing the supply of securities and by spreading out as widely as possible the ownership of the capital of the companies that make up the Program.").

[43] *See, e.g.*, Roberto Macedo, *Privatization and the Distribution of Assets and Income in Brazil* 19 (Carnegie Endowment for Int'l Peace, Working Paper No. 14, July 2000), *available at* http://www.ciaonet.org/wps/mar06/mar06.pdf (arguing that democratization of capital ownership did not greatly impact income distribution).

[44] *See id.* at 12 (reporting that only 5% of the total sales of the national program of desestatization in the period of 1991 to 1998 took the form of public offerings, while 91% of the sales were made by auction and 4% were offered to employees of privatized firms).

[45] *See* Klaus M. Schmidt & Monika Schnitzer, *Methods of Privatization: Auctions, Bargaining and Give-Aways*, *in* PRIVATIZATION AT THE END OF THE CENTURY 97, 126 (Herbert Giersch ed., 1997) (arguing that when pursuing an efficient allocation of ownership rights, the government should give away some fraction of all shares

Before the privatization process, the Brazilian government pressured legislators to pass Law No. 9457/97, which revoked article 254 of Corporate Law No. 6404/76. Article 254 gave minority voting shareholders the right to sell their shares at the same price paid to the control block in a control transfer of a publicly-held corporation. This is also known as a "tag along right." However, the passage of Law 9457/97, weakened the rights of minority shareholders, and the government received the entire control premium of the privatization sales. The privatization program in Brazil has not significantly fostered the development of capital markets. The Brazilian case, instead, has been an example of North's account of path dependence.[46] The outcome of privatization in Brazil appears to contradict empirical evidence that suggests that privatizations in the world have dramatically increased the number of shareholders and market liquidity.[47]

Brazilian corporate ownership is highly concentrated. Valadares and Leal find that in a sample of 325 firms, 203 firms (62.5%) have a single shareholder that owns an average of 74% of the voting shares. Of the remaining 37.5% of firms in the sample, the largest shareholder owns an average of 32% of the voting shares. Considering the entire sample, the main shareholder retains on average 58% of the voting capital, while the three largest shareholders own 78%, and the five largest shareholders own 82%. Even the firms that do not have a single majority shareholder will be controlled by the three major shareholders.[48]

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to the population, which will yield higher revenues in the future than a policy of selling all the firms to the highest bidder). *But see* Lucian Arye Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 7203, 1999), *available at* http://papers.nber.org/papers/W7203 (highlighting the weakness of the previous argument by arguing that dispersed ownership will not be stable when private benefits of control are high).

[46] *See* Douglass C. North, *Privatization, Incentives and Economic Performance* 11 (Wash. Univ., St. Louis, Econ. Working Paper Archive, Working Paper No. 9411002, 1994), *available at* http://129.3.20.41/eps/eu/papers/9411/9411002.pdf ("Path dependence implies that the organizations that evolved as a response to the instiutional framework that is being replaced will have tenacious survival ability and will attempt to 'sabotage' the institutional transformation taking place.").

[47] *See generally* Maria K. Boutchkova & William L. Megginson, *Privatization and the Rise of Global Capital Markets*, 29 FIN. MGMT 31 (2000) (finding that privatizations have greatly increased market liquidity and shareholders over the past two decades).

[48] Sílvia Mourthé Valadares & Ricardo Pereira Câmara Leal, Ownership and

TABLE 1: DIRECT SHAREHOLDING COMPOSITION OF COMPANIES (YEAR-END 1996)[49]

	Companies with a majority shareholder (203)		Companies without a majority shareholder (122)		Total sample (325)	
	Voting capital	Total capital	Voting capital	Total capital	Voting capital	Total capital
Avg. ownership of largest shareholder (median)	74% (73%)	51% (50%)	32% (29%)	25% (18%)	58% (58%)	41% (36%)
Avg. ownership of 3 largest shareholders (median)	89% (93%)	63% (63%)	67% (65%)	49% (42%)	78% (82%)	58% (53%)
Avg. ownership of 5 largest shareholders (median)	90% (94%)	64% (64%)	76% (73%)	56% (48%)	82% (87%)	61% (56%)

It is worth stressing that the difference between voting capital and total capital of the enterprise was due to the existence of preferred shares, which contribute to total capital but do not grant voting rights. The law permitted firms to issue shares without voting rights in an amount up to two-thirds of the total stock capital.[50] Consequently, control of a company could be guaranteed with only one-sixth of its total capital.

Control Structure of Brazilian Companies 22, (unpublished manuscript, on file with Social Science Research Network Electronic Paper Collection) (2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=213409. This data is also presented in Table 1, *infra*.

[49] *Id.* at 22. This table illustrates the direct shareholding composition of 325 Brazilian companies. A company with a majority shareholder is one where a single shareholder owns more than 50% of the voting capital. Annual Reports to the CVM (1997) (on file with author).

[50] The 2001 Amendment changed this number to one half. *See* Section 2.2 *infra*. In general, preferred shares are similar to nonvoting common shares, except that, according to the law, preferred shareholders must be granted some pecuniary advantages over common shareholders to compensate for the absence of voting power.

The capital of the average firm is made up of 54% voting shares and 46% nonvoting shares, so diffusion of firm ownership occurs to a certain degree through nonvoting shares.[51] Valadares and Leal argue:

> although nearly 90% of firms issue nonvoting shares, in most of these companies the controlling shareholder has more than 50% of the voting capital. In only 11 of the 203 companies with a single controlling shareholder does the major shareholder have just 50% of the voting capital, and of these 11, in only six is the fraction of total capital owned by the controlling shareholder near one-sixth, which is the maximum legal separation between ownership and control. So, usually control is guaranteed with more than the minimum necessary ownership.[52]

Although pyramidal ownership structures are not usually used in Brazil to maintain control with a lower portion of the overall capital, they are common in continental European countries, such as France, Germany, and Italy.[53] This shows that Brazil's corporate structure is characterized by concentrated ownership of *voting shares*. There is some dispersed ownership, but mainly in the form of *nonvoting preferred shares*.[54]

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[51] Valadares & Leal, *supra* note 48, at 2.

[52] *Id.* at 10.

[53] *See id.* at 5 ("[W]e will find Brazil to be closer to countries such as France and Germany, where other companies are the main direct shareholders, along with families and individuals."); *see also* Lucian Arye Bebchuk, Reinier Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: the Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights, in* CONCENTRATED CORPORATE OWNERSHIP 295, 297–98 (Randall K. Morck ed., 2000) (examining how pyramidal structures can enable control of a company by shareholders possessing less than a majority share of cash flow rights).

[54] This pattern is, in fact, not so different from corporate ownership all over the world. *See* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World,* 54 J. FIN. 471, 491 (1999) (showing that separation of ownership and control as suggested by Berle and Means is not widespread, as it is only found in 36% of the firms in their sample and it is concentrated in a few specific countries, but finding that family control is quite common, being found in 30% of their sample while state control is found in 18%). According to the authors:

> If we look at the largest firms in the world and use a very tough definition of control, dispersed ownership is about as common as family control. But if we move from there to medium-sized firms, to a more lenient definition of control, and to countries with poor investor protection, widely held firms become an exception. Berle and Means have created an

The privatization process has caused a change in the pattern of corporate ownership. As a result, there has been an increase in *shared control* within the ownership structure of the 100 largest companies. Shared control occurs when a single stockholder (an individual, a family, or a company) owns between 20-50% of the voting stock.[55] Moreover, there has been an increase in foreign as

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> accurate image of ownership of large American corporations, but it is far from a universal image.

Id. at 498.

[55] *See* Nelson Siffert Filho, *Corporate Governance: International Standards and Empirical Evidence in Brazil during the 1990s*, BNDES STUDIES (Brazilian Nat'l Bank for Econ. and Soc. Dev., Rio de Janeiro, Brazil), June 1998, at 12-13, *available at* http://www.bndes.gov.br/english/studies/044.pdf:

> In 1990, the foreign ownership and family ownership categories both included 27 of the 100 largest companies, corresponding to 26% and 23% of aggregate revenues respectively. Over the period 1990-97, this situation underwent a profound change, with foreign capital owning 33 of the 100 largest companies in 1997, and accounting for 37% of total revenues, while domestic families owned only 23 companies, which accounted for 16% of total revenues. It may therefore be observed that there was a significant advance in the presence of foreign companies from a wide range of countries among the largest companies in the Brazilian economy. . . . [However,] it should be remembered that family-owned companies are still a dominant feature of the Brazilian economy.

Family ownership is still dominant outside of the 100 largest companies, where changes in ownership mostly occurred because of the large size of the firms formerly owned by the State that were recently privatized. *See also* Nelson Siffert Filho & Carla Souza e Silva, *Large Companies in the 1990s: Strategic Responses to a Scenario of Change*, BNDES STUDIES (Brazilian Nat'l Bank for Econ. and Soc. Dev., Rio de Janeiro, Brazil), October 1999, at 3, *available at* http://www.bndes.gov.br/english/studies/largeco.pdf (pointing out the "expansion of the pattern of corporate control on the basis of shared control between Brazilians and foreigners, and the formation of strategic alliances between domestic groups"). The shared form of control has made shareholders' agreements extremely important in this context. Section 2.3.3, *infra*, analyzes the legal changes regarding shareholder agreements. There is evidence in Brazil that companies with more diffuse ownership structures tend to enjoy better economic performance than the companies with highly concentrated ownership. This evidence contradicts the results found in the United States. *See* Demsetz & Lehn, *supra* note 18, at 1162-65 (showing that diffuse ownership structures in U.S. corporations adversely affect corporate performance); *see also* Tagore Villarim de Siqueira, *Concentration of Ownership in Brazilian Quoted Companies*, BNDES STUDIES (Brazilian Nat'l Bank for Econ. and Soc. Dev., Rio de Janeiro, Brazil), December 1998, at 12-16, *available at* http://www.bndes.gov.br/english/studies/rev103.pdf (suggesting that there has already been an alteration in relative prices that makes the structure of firms with more dispersed ownership more efficient). However, there has not been a transformation in the pattern of corporate ownership in Brazil towards disperse ownership. A possible explanation is that preferences matter and entrepreneurs' preferences have not significantly changed in Brazil. This argument is developed in Section 3 *infra*.

well as institutional investor participation in the ownership of companies because these actors have participated in several consortia for the acquisition of privatized firms. The management of the company in these cases depends on agreements between the controlling shareholders. Family ownership, however, is still a dominant characteristic of the Brazilian corporate environment.[56]

Because of the concentrated voting power of large stockholders in Brazil, there is a different hypothesis than that typically found in the agency literature. There are more significant agency problems between controlling shareholders and minority shareholders (not between the management and the shareholders as in the United States). This agency problem occurs because controlling shareholders have incentives to reduce the return to minority shareholders, as there are no strong legal protections for minority shareholders and the enforcement of law is poor.

Stockholders have incentives to hold a large number of voting shares because there are substantial private benefits of control. According to Bebchuk's rent-protection theory of corporate ownership structure, when private benefits of control are substantial, controllers will tend to lock up control, keeping the ownership of the company concentrated in their hands when taking it public. Leaving control up for grabs would attract rivals seeking to capture these private benefits by attempting to wrest control by purchasing shares in the market or by takeover bid. Hence, diffuse ownership would not constitute a stable equilibrium because one would have incentives to buy blocks of shares in order to control the company and extract these benefits. In addition, the controller will obviously maintain a lock on control in order to capture the premium in a future control transfer.[57]

Private benefits of control are the value that controlling shareholders are able to extract from a company at the expense of other shareholders. This value increases as the protection of minority rights is weakened.[58] Private benefits can be pecuniary, including the opportunity to engage in self-dealing with the company as well as insider trading. However, private benefits of control can also be non-pecuniary, when the controller maximizes his or her utility by controlling the business. For instance, control may create non-

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[56] *See* Siffert Filho, *supra* note 55, at 13.

[57] *See* Bebchuk, *supra* note 45, at 2.

[58] *See id.* at 3.

pecuniary returns to the controller who founded the firm, if control has always been with the controller's family, or when the controller of the firm has prestige.[59] This last hypothesis is particularly relevant to the Brazilian case.

Dyck and Zingales, based on a sample of 412 control transactions which took place in thirty-nine countries between 1990 and 2000, found that the private benefits of control comprise 65% of the firm equity value in Brazil, the highest percentage in their sample.[60] This result contrasts with Nenova's finding that the average control value in Brazil is 16% to 23% of a company market value. Nenova used a sample of 661 dual-class firms in eighteen countries in 1997.[61] Although these two studies apply different methodologies,[62] both analyses show that private benefits of control in Brazil are large enough to be a significant deterrent to a well-functioning stock market.

Nenova concludes that the legal framework has enormous impact on private benefits of control. Her results show that about 75% of the systematic differences in private benefits are explained by the legal rights of noncontrolling shareholders, especially the quality of general investor protection, minority rights in the case of control transfer, and standards of law enforcement.[63] Dyck and Zingales find that legal protection strongly limits private benefits. They present a different focus by analyzing whether extra-legal institutions such as external product market competition, internal pressures from organized labor, internal policing of moral norms, potential impact of the press, and government as tax collector are also associated with lower measured private benefits. Dyck and Zingales find this hypothesis to be significant particularly when there is wide press coverage, a high rate of tax compliance, and a

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[59] *Id.* at 25.

[60] Dyck & Zingales, *supra* note 17, at 551 (finding that corporate control is worth 14% of the equity value of a firm in their sample average.) In Brazil, corporate control is worth 65% of the equity value of a firm, while in Germany it is worth 9.5% and in the United States, 1.8%. *Id.*

[61] Tatiana Nenova, *The Value of Corporate Votes and Control Benefits: A Cross-Country Analysis* (2000), *available at* http://ssrn.com/abstract=237809 (finding that in the U.S. control value is worth 1% to 2% of a firm market value).

[62] I believe that the methodology used by Dyck and Zingales, *supra* note 17, is more plausible. Nenova, *supra* note 60, failed to observe that preferred shares have a liquidity premium in Brazil, which may push their value up, giving the impression that there is less private benefits of control than is the case.

[63] Nenova, *supra* note 61.

high degree of enforcement of competition laws (strong competitive product markets). They conclude that extralegal mechanisms seem to be at least as important as legal ones.[64]

The classical view of the profit-seeking enterprise states that the self-interest of the property owner will guarantee wealth-maximization and economic efficiency. Berle and Means argue that majority control does not significantly interfere in maximizing total shareholder value.[65] However, when we observe real institutional environments this is not always the case. If institutional variables such as progressive personal income tax rates and corporate income taxes are considered, then "a majority stockholder may have the incentive and the opportunity to consume non-pecuniary sources of utility within the firm at the expense of his wealth, of the wealth of minority shareholders, and of the fisc."[66] Additionally, controllers might make some decisions based on personal tastes rather than on profit-maximizing goals, a situation called "the amenity potential of the owners."[67] In other words, "agency costs will be generated by the divergence between [the owner-manager's] interest and those of outside shareholders, since he will then bear only a fraction of the costs of any non-pecuniary benefits he takes out in maximizing his own utility."[68] Therefore, a large company owned by few individuals will not necessarily act as a wealth maximizer,[69] or rather, the assumption of the classic theory of the firm adopted by the Berle-Means thesis neglects important constraints imposed by the institutional environment on the outcome of corporate organization.

A distinguishing cultural feature of Brazilian entrepreneurs is that they tend to extract not only pecuniary benefits, but also, and above all, non-pecuniary benefits of their ownership. Brazilian entrepreneurs often have non-pecuniary motivations, such as maintaining their status and maximizing utility by feeling they are the

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[64] Dyck & Zingales, *supra* note 17.

[65] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 68 (1967) ("Presumably many if not most of the interests of a minority owner run parallel to those of the controlling majority and are in the main protected by the self-interest of the latter.").

[66] Louis De Alessi, *Private Property and Dispersion of Ownership in Large Corporations*, 28 J. FIN. 839, 843 (1973).

[67] Demsetz & Lehn, *supra* note 18, at 1161.

[68] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 312 (1976).

[69] *See* De Alessi, *supra* note 66.

"owners" of the firm. Controlling shareholders who extract non-pecuniary benefits from the firm, valuing them more than monetary returns, have few incentives to favor efficient corporate legal structures. As a result, in countries where firms are dominated by controllers with non-pecuniary motivations there will be less pressure for the adoption of a standard model of corporate law that favors all shareholders and enhances total shareholder value.[70]

One could imagine *ex ante* a manager that would pay for his or her extraction of non-pecuniary benefits by receiving a smaller wage that would compensate for his or her consuming more on the job. However, this seems unlikely because the majority shareholder-manager has discretion to determine his or her own wage. The board of directors tends to consist of family members of the CEO (owner-manager), or persons with whom he or she has personal ties. The wage revision process, which was postulated as a form of correcting the manager's deviations from contract *ex post*,[71] does not take place in Brazil because there are no strong managerial labor markets.

The number of preferred shares issued makes the owner-manager's fraction of the total capital decrease. Discussing the agency conflict between the owner-manager and the outside shareholders, Jensen and Meckling argue:

> [a]s the owner-manager's fraction of the equity falls, his fractional claim on the outcomes falls and this will tend to encourage him to appropriate larger amounts of the corporate resources in the form of perquisites. This also makes it desirable for the minority shareholders to expend more resources in monitoring his behavior. Thus, the wealth costs to the owner of obtaining additional cash in the equity markets rise as his fractional ownership falls.[72]

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70 Hansmann & Kraakman, *supra* note 26, at 462.

71 Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 306 (1980) (using the term "*ex post* settling up" to describe the point where managerial incentive problems are resolved).

72 *See* Jensen & Meckling, *supra* note 68, at 313. As explained by Black and Kraakman, there is a an adverse-selection problem, sometimes referred to as a "market for lemons." Bernard S. Black & Reiner Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L .REV. 1911, 1946 (1996) ("From a theoretical perspective, control (like other assets) tends to move to those who value it most. Multiple-class voting structures create incentives for control to move from good hands to bad because those who are willing to abuse control will often value it more than those who will not.").

Prospective minority shareholders recognize the divergence between their interests and the interests of the majority shareholder. They know that the controllers may well divert a share of the company's returns to themselves through inefficient management decisions. Accordingly, minority shareholders will discount the price of securities, rendering them unattractive and insufficient to provide financing.[73]

Many Brazilian-listed corporations have gone private (see Chart 2) and Brazilian dual-listings have increased.[74] A 0.38% tax on financial transactions, from which afterwards stock transactions were exempt, helped drive market activity from BOVESPA to the New York Stock Exchange.

Brazil's domestic market is characterized by weak competition among players. Weak competition permits the extraction of monopolistic or oligopolistic rents by players. Weak competition fits in well with concentration of ownership and supports its legal apparatus because weaker competition produces higher rents which, if large enough, will result in higher managerial agency costs for shareholders.[75] In other words, the extraction of large monopolistic or oligopolistic rents would augment the conflict among the players inside the firm (managers, shareholders and employees) regarding their division. However, when the majority shareholder acts as the manager of the firm, as is the case in a large number of Brazilian companies, disagreements on how to divide the rents are minimized, as the controller will "grab" the rents for himself or herself at the expense of the other minority shareholders. When the controller is able to extract the rents, he or she is lowering the agency costs that would emerge in a diffused ownership context.

[73] Jensen & Meckling, *supra* note 68, at 314.

[74] For data on Brazilian firms cross-listing see John Coffee, *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1774 (2002).

[75] *See* Mark J. Roe, *Rents and their Corporate Consequences*, 53 STAN. L. REV. 1463, 1464-65 (2001) [hereinafter Roe, *Rents*] (providing a distinction between monopolistic rents and corporate control rents. The former are rents obtained because of the lack of competition in the market, while the latter are rents that the controllers are able to secure from the firm at the expense of minority shareholders. The greater these two rents are, the greater the incentives will be to concentrate corporate ownership). *See also* Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2080 (2001) ("[W]here industry is weakly competitive, shareholder wealth maximization norms and institutions are relatively less effective in raising social wealth than they are in more competitive economies.").

The monopolistic or oligopolistic rents can become a slice of the rents diverted by corporate control rents to the majority shareholder.[76]

This paper does not examine in more detail the necessary changes that should be made in order to foster capital markets in Brazil. Black has already scrutinized the problems of Brazilian institutions by applying the theoretical framework he developed in the article *The Legal and Institutional Preconditions for Strong Securities Markets*[77] to an assessment of Brazil's institutions.[78] Black points to the following problems that constrain the development of the capital markets, with which I essentially agree: (1) the Brazilian Securities Commission ("CVM") has a very limited staff and budget and is not yet sophisticated enough to catch subtle forms of "misdisclosure" or self-dealing; (2) there are no specialized prosecutors with the skill to bring complex securities cases, and prosecutors have a reputation for not always being honest; (3) the courts lack sophistication; (4) there are no class action mechanisms; (5) Brazil does not yet have a strong culture of compliance with disclosure rules; (6) there are no strong rules for disclosure of self-dealing transactions; (7) there is a disincentive for private companies to prepare audited financial statements because it is more difficult for a company with audited statements to hide income from the tax collector; (8) lenders do not require audited financial statements as is the case of the United States; (9) there is no meaningful risk of liability for bad audits by accountants (there are no cases of accountants being found liable for violations); (10) BOVESPA does not have strong listing rules and relies mostly on CVM to establish rules for listed companies;[79] (11) publicly-held companies make little use of independent directors, and nominally independent directors may not be so independent in practice; (12) company insiders

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76 Roe, *Rents*, *supra* note 75, at 1472.

77 *See* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781 (2001) (describing elements required for strong securities markets and the laws and institutions necessary to create such markets).

78 Bernard S. Black, *Strengthening Brazil's Securities Markets* (Revista de Direito Mercantil, Econômico e Financeiro [Journal of Commercial, Economic, and Financial Law], Working Paper No. 205, 2001), *available at* http://ssrn.com/abstract=247673 (providing an analysis of the Brazilian market and its failures).

79 BOVESPA has created the *Novo Mercado* (New Market), a market segment that requires listing companies to comply with higher levels of disclosure. However, the majority of companies has not migrated to the *Novo Mercado*. I discuss this in Section 3.4.

face limited risks of civil sanctions, either from lawsuits brought by investors or by the regulatory authority (CVM); (13) company insiders face little risk of criminal liability for self-dealing or disclosure violations; (14) bankers do not face liability for frauds in practice; (15) there is no risk of civil liability for independent directors who approve gross self-dealing; (16) there are no significant number of cases seeking sanctions for market manipulation; (17) there are no sufficient procedural controls on self-dealing transactions, and there are no rules requiring accountants to review self-dealing transactions; (18) there is a problem with enforcing civil sanctions against inside traders; (19) Brazil does not currently have a good accounting standard body.

I discuss the problems identified by Black because I believe that most of them (problems two through eighteen above) are directly or indirectly related to the Brazilian culture and to the lack of social norms that would support reform of the corporate laws and its proper enforcement, along with other effective changes in Brazilian institutions.[80] I will propose this thesis in Section 3.

2.2. *Main Changes of the Legal Reform*

As discussed in the previous Section, Brazilian capital markets have been working poorly. To cope with this problem, a new reform in Brazilian Corporate Law sought to provide conditions to

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[80] Bernard Black has already emphasized the importance of culture for corporate governance practices, observing that their relation with one another is still blurred. *See* Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 573 (1990):

> My personal, unprovable [sic] belief is that culture—the developed sense of proper and improper behavior—plays an important role in managers' self-restraint. Less clear is the role of corporate law, as opposed to other forces, in affecting culture. Legal rules, such as the duty of loyalty owed by managers to shareholders, can affect corporate norms. But, norms for proper behavior also depend on what people do, and see other around them doing, even if that behavior isn't mandated by statute.

This paper also shares the ideas of the law and society movement that the law is essentially man-made and varies in time and space depending on the conditions of the culture in which it is embedded. *See also* Lawrence M. Friedman, *The Law and Society Movement*, 38 STAN. L. REV. 763, 768 (1986) (arguing that there is an unsolved problem of the relationship of law to culture and that it is a weakness in the conventional law and economics literature to exclude culture and particular contexts in its analysis); Lawrence M. Friedman, *Law, Lawyers, and Popular Culture*, 98 YALE L. J. 1579, 1579 (1989) (defining legal culture as "the ideas, attitudes, values and opinions about law held by people in a society") (quoting LAURENCE M. FRIEDMAN, TOTAL JUSTICE 30, 31 (1985)).

strengthen the markets.

The legislative process helps explain the content of the new law.[81] Deputy Hauly made an initial proposal to change the Law No. 6404/76 in May 1997, as part of the Project of Law No. 3115/97.[82] He proposed the creation of a new class of shares—the golden shares—that would grant the State power to veto particular changes in enterprises after the privatization process. Project of Law No. 3519/97 was then joined to the previous proposal in order to provide advantages to minority shareholders. Project of Law No. 3519/97 would have prohibited the issuance of preferred shares without voting rights thereby establishing a one share-one vote structure. This proposed law would also have created a permanent audit committee in open companies and the right of minority shareholders with at least 5% of the common voting shares to have a majority of the seats in the audit committee. Another proposal, Project of Law 1000/99, granted the right to preferred shareholders with more than 15% of the total capital of the company to elect one seat in the board of directors.

Deputy Kapaz, of the Commission of Economy, Industry and Trade, was in charge of analyzing the proposals. Before making his judgment, he argued for the deep restructuring of business organizations and for strengthening minority rights in order to foster efficiency and growth in the capital markets. He criticized the abuses committed by controlling shareholders against minority shareholders and argued that controllers should not benefit themselves at the expense of the company's interests. His proposals included the re-establishment of the 100% tag-along right for minority voting shares if the control block of shares was sold, and a new requirement for minimal dividend distribution.[83]

In his vote, Kapaz stated that the limit of 2/3 on the issuance of preferred shares permitted by the legislation was too permissive. However, instead of supporting the proposal that prohibited the issuance of preferred shares, Kapaz argued that the issuance of 50% of preferred shares would permit the capitalization of busi-

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[81] This paper only provides a brief overview of the legislative process, focusing on the provisions important to this study. For a detailed discussion of the legislative process see MODESTO CARVALHOSA & NELSON EIZIRIK, A NOVA LEI DAS S/A [THE NEW CORPORATIONS LAW] 7-29 (2002).

[82] A "Project of Law" means a law that was proposed, but not necessarily passed.

[83] This point regarding the distribution of dividends will be discussed in Section 2.3.1.2, infra.

ness enterprises while reducing the existent disparity between cash flow and voting rights. As this paper demonstrates, this argument is weak and does not take into account the existing level of preferred shares. Moreover, Kapaz argued that if the new 50% limit for preferred shares issuance were applied, controllers would be obligated to invest more capital in a public offering in order to keep control and prevent dispersed ownership. He concluded that this outcome would inhibit new investments and decided that the new 50% limit should only apply to companies incorporated after the enactment of the new law. After making a speech arguing for minority shareholder rights, Kapaz ultimately voted to maintain the status quo, permitting the issuance of 2/3 of preferred shares to existing companies.[84]

Similar to the proposals to reform the issuance limit for preferred shares, many of the other initial proposals were substantially changed during the more legislative process, which lasted more than four years. This paper will now analyze how the proposed measures for protecting minority shareholders largely failed to change the status quo. Controllers' associations exerted pressure in order to modify several articles and to introduce others designed to protect the interests of controlling shareholders. In comparison to what was originally proposed, minority shareholders lost on many important issues in the final draft.[85] The ultimate legislation, Law No. 10303 was enacted on October 31, 2001.[86] This law amends Corporation Law No. 6404/76 in many important areas.[87]

In this Section, I discuss some of the most important changes in the new legislation. I do not intend to discuss all the changes, but

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84 In the introduction of the book REFORMA DA LEI DAS SOCIEDADES ANÔNIMAS [CORPORATIONS LAW REFORM], Kapaz admitted that the approved changes are far from the envisaged ones: "[A]s inovações introduzidas foram aquelas possíveis de se realizar, dentro da atual cultura que rege o assunto das sociedades anônimas no país." ["[T]he innovations introduced were those possible to achieve considering the actual culture which governs the corporations in the country."]. Emerson Kapaz, *Lei das S.A.: Uma Contibução Decisiva [The Corporations Law: A Decisive Contribution]*, *in* REFORMA DA LEI DAS SOCIEDADES ANÔNIMAS [CORPORATIONS LAW REFORM] 2 (Jorge Lobo ed., 2002).

85 To recap, the following proposals did not pass: one share-one vote, changes in the board of the audit committee, full tag-along rights, and procedural changes regarding self-dealing. Changes concerning dividend rights largely maintain the status quo.

86 Lei No. 10.303, de 31 outubro de 2001, D.O.U. de 1.11.2001. (Brazil).

87 Lei No. 6.404, de 15 dezembro de 1976, D.O.U. de 1.12.1976. (Brazil).

rather focus on changes that were supposed to improve the capital markets.[88] These changes are presented in Table 2. I have drawn the table according to the legal dispositions, changing the wording whenever necessary for the purpose of simplification. It is worth noting that the majority of these rules consist of mandatory minimums rather than default provisions that can be changed by corporate charter and shareholder vote. The rules provide standards that the company has to follow. The company is free, however, to provide more rights than are required by the legislation. One example is the provision that provides minority shareholders with the right to sell their shares during a control sale for 80% of the price paid for the shares of the control block. While this value is the lowest value that a minority shareholder could receive, a company can establish, for example, a price of 90% in its bylaws.

The Brazilian reform is not likely to be a good investment.[89] It encompasses some appropriate changes such as the ability for disputes, between the shareholders and the corporation, or between the majority shareholders and the minority shareholders, to be resolved by arbitration. Other appropriate changes include: (1) the obligation requiring insiders[90] to disclose any changes in their ownership positions to the CVM and to the stock exchange where

[88] This paper focuses on the changes to Law No. 6404/76, so the changes to Law No. 6385/76, also enacted as part of the corporate law reform, are not discussed. Law No. 6385/76 attempts to strengthen the power of the Brazilian Securities Commission ("CVM") and to regulate criminal sanctions for crimes committed against the capital markets.

[89] Adopting a new legal structure involves huge costs. Parisi, Fon & Ghei argue that adopting a new law is similar to investing in a productive asset. Because legislation submitted to the legislative process cannot be changed every day, the lawmaking process can be seen as a sunk cost. Once the law has passed, it is very costly to change it again. Lawmaking costs cannot be recovered if the newly enacted rules prove to be ineffective or undesirable in the future. That is why legislators ought to look for the optimal time to institute legal intervention. If the legal system makes a misleading investment decision in achieving a desirable goal, it will not be easily recuperated. There is considerable cost associated with creating and learning a new rule. The greater the amount of these costs, the greater the possibility is that a path will be established. In order to achieve an efficient lawmaking process, the benefits of changing the law should exceed the sunk cost of making the change. Francesco Parisi, Vincy Fon & Nita Ghei, *The Value of Waiting in Lawmaking,* 18 EUR. J. L. & ECON. 131 (2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=267719.

[90] This category includes the controlling shareholder of a publicly held corporation, the shareholder or group of shareholders that elect a member of the board of directors or of the audit committee, and the members of the audit committee.

the securities issued by the corporation are traded,[91] and (2) the increase in the individual power of the members of the audit committee. In general, however, the law is not well written, and diverse interpretations can be advocated for based on its language. In turn, this will increase the transaction costs of enforcing its content.

[91] Instruction No. 299/1999 of the CVM, nevertheless, assigned similar obligations, and the new law just consolidated the administrative requirement in the statute. Instrução CVM N° 299, de 9 de fevereiro de 1999 [Securities and Exchange Commission Instruction 299, of February 9, 1999] *available at* http://www.cvm.gov.br/ (follow "Legislação e Regulamentação" hyperlink, then follow "Atos da CVM" hyperlink and search for "Instrução 299").

TABLE 2: CHANGES IN THE BRAZILIAN CORPORATE STATUTE IN 2001 – SUMMARY DATA[92]

	Before the Corporate Reform (Law 6404/76 modified by Law 9457/97)[93]	After the Corporate Reform (Law No. 10303)
Nonvoting Preferred Stocks – Issue	Article 15 § 2 The number of nonvoting preferred shares may not exceed two-thirds (2/3) of the total shares issued.	Article 15 § 2 The number of preferred shares without voting rights may not exceed fifty percent (50%) of all issued shares. *(BUT...)* Article 8 § 1 The proportion set forth in Law No. 6.404 of 1976, Article 15 § 2, shall be applied according to the following criteria: (I) *new corporations ("corps.")*: immediately; (II) *existing closely-held corps*: at the moment they decide to register as publicly-held corporations; and (III) *existing publicly-held corps*: ***may maintain the proportion of up to two-thirds of preferred shares to the total issued shares, including in relation to new issuance of shares.*** (emphasis added).

92 This table offers the author's elaboration on Lei No. 6.404, de 15 dezembro de 1976, D.O.U. de 17.12.1976. (Brazil), Lei No. 9.457, de 5 maio de 1997, D.O.U. de 6.5.1997. (Brazil), and Lei No. 10.303, de 31 outubro de 2001, D.O.U. de 01.11.2001. (Brazil).

93 Lei No. 9.457, de 5 maio 1997, D.O.U. de 6.5.1997. (Brazil).

Nonvoting Preferred Stocks—Dividend Rights	Article 17-I Law provides that a preferred share shall have the right to a dividend at least ten per cent higher than the one attributed to the common shares except in the case of preferred shares with fixed or minimum dividends. Notice that minimum or fixed dividend is not specified.[94]	Article 17 § 1 Law provides that preferred shares will only be accepted for trading in the securities market if they have the right to an interest in the dividend to be distributed, corresponding to at least twenty-five percent of the net income for the year, calculated as set forth in article 202,[95] according to the following criteria,[96] or a right to receive dividends at least ten percent higher than the ones assigned to common shares, or a right to be included in the public offering for alienation of control, receiving eighty percent of the price paid to the voting shares of the control block.

[94] Article 17 of Lei No. 6.404, de 15 dezembro de 1976 (amended by Lei No. 9.457, de 5 maio 1997) states:

> The advantages of a preferred share:
>
> I - consist of a right to a dividend at least ten percent higher than the dividend attributed to the common shares, except in the case of preferred shares with fixed or minimum dividends;
>
> II - notwithstanding the provision of item I, above, and in accordance with its terms, the advantages of preferred shares may consist of:
>
> a) priority in the distribution of dividends;
> b) priority in the refund of capital, with or without a premium; or,
> c) a combination of the above-mentioned advantages.

[95] Article 202 of Lei No. 6.404, de 15 dezembro de 1976 (amended by Lei No. 10.303, de 31 outubro de 2001) states:

> In every fiscal year, the shareholders shall be entitled to receive as a compulsory dividend the portion of the profits as may be stated in the bylaws or, in the event the latter is silent in this regard, the amount to be determined as follows:
>
> I – half of the net profit as increased or reduced by:
>
> a) the amount intended to form the legal reserve (Article 193); and
> b) the amount intended to form the reserves for contingencies (Article 195) and any written-off amounts of the same reserves formed in previous fiscal years;
>
> II – the payment of dividends provided for in item I may be limited to the amount of net profits realized during the fiscal year, provided that the difference is recorded as a reserve for realizable profits (Article 197).

Board Seat for Nonvoting Preferred Shareholders	<u>Article 18</u> The bylaws may provide for one or more classes of preferred shares to have the right to elect one or more members of the administrative bodies by separate ballot. <u>Article 141</u> Whether or not provided for in the bylaws, when electing the members of the board, shareholders representing at least one-tenth of the voting capital may request that a multiple voting procedure be adopted to entitle each share to as many votes as there are board members, and to give each shareholder the right to vote cumulatively for only one candidate or to distribute his votes among several candidates.	<u>Article 141 § 4</u> Shareholders representing the majority of the following shares shall have the right to elect and remove from office a member and his substitute to the board of directors, in a separate election during the general meeting, being excluded from such election the controlling shareholder[97]: (I) shares issued by a publicly-held corporation which represent at least fifteen percent of shares with voting rights; and (II) preferred shares without voting rights or with restricted voting rights, issued by a publicly-held corporation, which represent at least ten percent of the share capital, provided that they have not exercised the right set forth in the bylaws under the terms of Article 18. <u>Article 141 § 5</u> If neither the holders of shares with voting rights, nor the holders of preferred shares without voting rights, or with restricted voting rights, are sufficient to achieve the quorum required under items I and II of § 4, they shall be allowed to aggregate their shares in order to jointly elect a member and his substitute for the board of direc-

[96] According to Article 17 section 1° I a of Lei No. 6.404, the criteria is:

a) a priority in the receipt of dividends mentioned in this item, corresponding to at least three percent (3%) of the share's net worth; and b) the right to have interest in the profit distributed in conditions equal to the common shares, after assured a dividend equal to the minimum priority as set forth in item a.

[97] Article 116 of Lei No. 6.404, de 15 dezembro de 1976 states:

A controlling shareholder is defined as an individual or a legal entity, or a group of individuals or legal entities by a voting agreement or under common control, which: (a) possesses rights which permanently assure it a majority of votes in resolutions of general meetings and the power to elect a majority of the corporation officers; and (b) in practice uses its power to direct the corporate activities and to guide the operations of the departments of the corporation.

Board Seat for Nonvoting Preferred Shareholders (cont.)	<u>Article 141 § 1</u> The right provided by this article shall be exercised by the shareholders not later than forty-eight hours before the general meeting; after consulting the attendance book, the board conducting the meeting shall inform the shareholders in advance of the number of votes required to elect each member of the council. (Note: these provisions were not revoked by the new reform)	tors, under these circumstances, a quorum will be determined according to paragraph II of § 4. <u>Article 141 § 6</u> The right afforded by § 4 can only be exercised by shareholders that have continuously held their shares for at least three months prior to the general meeting. <u>Article 141 § 7</u> Whenever the election of the board of directors is conducted through multiple voting and the holders of common shares or preferred shares exercise the right to appoint a member of the board as well, the shareholder or shareholders bound by voting agreements representing more than fifty percent of voting shares shall have the right to appoint the same number of members appointed by the remaining shareholders plus one, regardless of the number of board members specified in the bylaws. <u>Article 147 § 3</u> Directors shall have unblemished reputations and are ineligible for election, unless an applicable waiver is granted by the general meeting, in the following cases: (I) having a position in a competing company, especially on a management board or advisory or finance committees; and (II) conflicting interests with the company. <u>Article 8 § 4</u> Until the annual general meeting is held to approve the financial statements of the 2004 fiscal period, the director elected according to Law No. 6.404 of December 15, 1976, Article 141, § 5 or item II, §4 (see provisions above), *shall be chosen from a triple list prepared by the controlling shareholder*; and as of the 2006 annual general

Board Seat for Nonvoting Preferred Share-holders (cont.)		meeting, such director shall be elected as set forth in this Law, regardless of office term of the director to be replaced. (emphasis added)
Takeout Rights	<u>Article 254 of Law 6404/76</u> Full tag along rights are guaranteed to minority voting shareholders (one hundred percent of the price paid to controlling shareholders). <u>Law 9457/97</u> The above-described tag along right is revoked.	<u>Article 4 § 6</u> If the majority shareholder, or the controlling corporation, acquires shares of a publicly-held corporation under its control, and these shares directly or indirectly increase their interest in a certain class of shares in a way that hinders the market liquidity of the remaining shares, they shall be required to publicly offer to purchase all shares remaining in the market. <u>Article 254-A</u> The direct or indirect transfer of control of a publicly-held corporation can only be effected under the condition that the purchaser agrees to conduct a public offer to acquire the voting shares owned by the remaining shareholders. The offer price for such shares shall be at least eighty percent of the amount paid for the voting shares comprising the controlling block. <u>Article 254-A § 4</u> The purchaser of control of a publicly-held corporation may offer the minority shareholders the option to keep their holdings in the company in exchange for payment of a premium equivalent to the difference between the market value of the shares and the amount paid for shares comprising the controlling block.

Shareholder Agreements	Article 118 Shareholders' agreements for the purchase or sale of shares, options to acquire stock, or relating to the exercise of the right to vote, must be recognized by the corporation when filed at its headquarters. Note that there has been a shareholder agreements provision - still in force after the 2001 change, but directors were not legally bound to vote according to a shareholders agreement provision.	Article 118 § 8 The president of the meeting or of the decision making body of the corporation shall not compute a vote that infringes a duly filed shareholders agreement. Article 118 § 9 Failure to attend a general meeting or meetings of the corporation's management bodies, as well as failure to vote on matters specified in the shareholders agreement by any party or by members of the board of directors elected under the terms of the shareholders agreement assures the damaged party the right to vote with the shares belonging to the shareholder who is absent or remiss and, in case of a member of the board of directors, by the board member elected by the votes of the damaged party. Article 118 § 10 Shareholders bound to the shareholders' agreement shall indicate, in the act of filing, a representative to communicate with the corporation to provide or to receive information upon request. Article 118 § 11 The corporation may request the members from the agreement to explain its clauses.

2.3. *Analysis of the Reform Impact*

2.3.1. *Preferred stocks*

2.3.1.1. *Limit of issuance*

According to the law and economics literature, the principle that each share carries one vote is an important rule that protects investors. This rule ties voting power with economic incentives in order to maximize company value.[98]

Brazilian firms, however, are not subject to the one share-one vote principle.[99] As previously discussed, firms can issue preferred shares without voting rights, thereby insulating capital investment from voting rights. Preferred shares can be characterized as "non-voting common shares." In exchange for voting rights, these shares have certain pecuniary advantages over common shares.[100] Preferred stocks allow controlling parties to control the company by investing a small share of a firm's total capital. The large disparity between total capital stock and voting rights can produce adverse incentives for those running the business because managers are not constrained by the market for corporate control.[101]

The recent legal reform reduced the number of preferred shares

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98 *See* Black & Kraakman, *supra* note 72, at 1933 (discussing how a one share-one vote rule safeguards the voting mechanism); Ronald J. Gilson, *Evaluating Dual Class Common Stock: the Relevance of Substitutes*, 73 VA. L. REV. 807 (1987) (discussing the benefits of dual class common stock); Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1 (1988) (arguing that limited voting stocks imposes economic costs on public shareholders); Sanford J. Grossman & Oliver D. Hart, *One Share-One Vote and the Market for Corporate Control*, 20 J. FIN. ECON. 175 (1988) (explaining the implications of the one share-one vote rule); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny ("LLSV"), *Law and Finance*, 106 J. POL. ECON. 1113, 1127 (1998) (defending the one share one vote rule).

99 LLSV wrongly affirmed that Brazil applies one share-one vote in their articles "Legal Determinants of External Finance" and "Law and Finance." La Porta et al., *supra* note 98; Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1138 (1997) (stating that Brazil applies the one share-one vote rules).

100 There are exceptional situations in which preferred shares can conquer voting rights. The law assures that preferred shares can have voting rights at the general meetings of a corporation under liquidation. Lei No. 6.404, de 15 dezembro de 1976, Art. 213, para. 1. Another case is paragraph 1 of Article 111, which provides:

> A preferred share without a right to vote shall acquire such a right if, during a period provided for in the bylaws, which shall not exceed three consecutive fiscal years, the corporation fails to pay the fixed or minimum dividend to which the share is entitled, and the right shall continue until payment has been made, if the dividend is not cumulative, or until all cumulative dividends in arrears have been paid.

Id. art. 111(1).

101 *See* Gilson, *supra* note 98. Gilson argues that nonvoting common stocks provide an effective defensive tactic as they protect management from the discipline of the market for corporate control. Nonvoting common shares allow controlling shareholders to reduce their proportion of stock ownership and therefore the risk they bear, without diluting their control.

that could be issued during a public offering. Before the corporate law reform, firms could issue preferred stocks encompassing up to two-thirds of the total shares issued. Now firms can issue up to one half of the total shares as preferred stocks (Article 15, section 2 of Law 6.404/76 amended by Law 10.303/01). The law will not produce retroactive effects changing an existing firm's capital composition. However, as highlighted, this rule does not apply to existing publicly held corporations. Therefore, the law provides special treatment to existing publicly held corporations. Article 8, section 1, subsection III states that "existing publicly-held companies may maintain the proportion of up to two-thirds of preferred shares to the total issued shares, including in relation to new issuance of shares."

Companies that have not already issued 2/3 of their shares as preferred shares in their capital structure will be able to augment the proportion of preferred shares up to 2/3 in future public issuances. For example, a publicly held company that has already issued 50% of its shares as preferred shares has the right to issue preferred shares constituting up to 2/3 of the total capital of the company, despite the fact that the new law has set the limit of 50% for issuance of preferred shares. This policy was justified by the nonsensical argument that the public companies which have already issued any preferred shares have "acquired the rights" to issue 2/3 of their stock as preferred, as the old law provided.[102] Therefore, things are unlikely to change for existing publicly held companies. The 50% limit on preferred shares will apply to closely held companies that choose to open their capital, and to corporations incorporated after the passing of the law.[103]

Interestingly, minority rights were strongly diminished in 1997 when, because of the ban in their tag-along right during control sales, there was no discussion regarding their previous "acquired rights." Therefore, in practice, legal principles are manipulated to serve particular interest groups, like the government itself and the industrial elite of the country.[104] For this measure to achieve a

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[102] CARVALHOSA & EIZIRIK, *supra* note 81, at 72.

[103] Some scholars argue that the rule applies to existing corporations that have just issued common voting shares in a public offering before the approval of the Law, because these corporations would not have "acquired rights" to issue preferred shares before the 2/3 limit went into effect. *See* CARVALHOSA & EIZIRIK, *supra* note 81, at 70.

[104] Paul Kahn severely criticizes this manipulation of the law: "Law cannot appear to be a product of particular class or factional interests. Nor can it appear

positive effect in the market, a significant number of new companies must go public, which is also unlikely in the near future.[105]

In any case, a question to be addressed is whether this measure reducing the issuance limit of preferred shares would provide better prices for these shares if it was also mandatory for existing companies. One would expect that preferred stocks would receive better prices once the law diminished the gap between future capital flow and voting rights. For each preferred share issued, a common share would have to be issued, and the controller would have to invest more capital in the firm to maintain its voting control. Theoretically, this should lower agency costs because the controller would have fewer incentives to divert shareholder value.

In reality, however, the issue is not that simple. As mentioned above, Valadares and Leal found that although 90% of Brazilian firms issue nonvoting preferred shares, in the great majority of these firms, control is maintained with more than the minimum necessary level of ownership.[106] In 203 companies controlled by a single shareholder (out of a sample of 325) the controlling shareholder owns on average 50% of the total capital of the company. In the entire sample, the largest shareholder owns, on average, 36% of the total capital of the company, while the three largest shareholders retain 53% of the total capital. This data provides strong evidence that firms generally have not issued the maximum limit of 2/3 preferred stocks allowed by law. 62% of the firms in the sample have issued just 50% of preferred shares. Empirically we can say that, before the reform took place, the majority of firms issued preferred shares up to one half of the total capital.[107] In conclusion, even if the 50% limit on preferred shares issuance was mandatory, this requirement would not produce a *consistent* change in the *general* pattern of ownership in possible future issuances because the majority of firms would just maintain their previous balance between voting and nonvoting shares.[108]

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as the arbitrary product of a particular historical moment." PAUL W. KAHN, THE CULTURAL STUDY OF LAW: RECONSTRUCTING LEGAL SCHOLARSHIP 9 (1999).

105 See Chart No. 2, which shows the going private trend after the passing of the new legislation. *See infra*, Appendix.

106 Valadares & Leal, *supra* note 48, at 22.

107 *Id.*

108 It could be argued that if the 50% limit were mandatory for existing companies, some firms that enjoy high stock trading volume would have to change their balance between preferred shares and common shares in future issuances, which would benefit minority shareholders. While this result would be positive,

2.3.1.2. Dividend rights

Preferred shares usually receive higher dividends than common shares and have a high priority in the payment of dividends. Brazilian corporate reform aimed to provide more protection for preferred shareholders by increasing the minimum value of dividends that a company has to distribute to preferred shareholders. The law envisioned the creation of bright line rules that would provide mandatory standards of distribution of capital to investors. Previously, the law only required that preferred shares receive at least a 10% higher dividend than that paid to common stocks, if the dividend was variable. The preferred shares with minimum or fixed dividends did not have this guarantee, and the law did not establish a minimum dividend.

The problem with such a dividend (10% higher for preferred shares) is that the controlling shareholder, who usually has the majority of common shares, in practice, does not necessarily rely on the distribution of dividends to be compensated. He or she can use other mechanisms (high salary, perquisites, self-dealing) to receive profits, and if common shares receive small dividends (or don't receive dividends at all), preferred shares will also be scarcely compensated.

The new law requires that preferred shares will only be accepted for trading in the securities markets if they receive *either:* (1) the old guarantee of a 10% higher dividend; (2) the guarantee of an interest in the dividend to be distributed, corresponding to at least 25% of the net income for the year; or (3) the right to receive the same treatment as common shares during a sale of control (the tag along right to receive 80% of the price paid to the shares comprising the control block). The initial proposal for dividend distribution did not permit the adoption of the 10% higher dividend, which was included during the legislative process, making possible the maintenance of the *status quo.*

as, *ceteris paribus,* the control value would diminish, this measure would be insufficient to promote the *development of the capital markets as a whole.* The ownership structure in the majority of companies would be maintained. My argument here is that, putting the controllers' perceptions aside, if a consistent change in governance practices was to be achieved, then, the limit for issuance of preferred shares should have been dramatically diminished. However, when we consider the subjective perceptions of Brazilian entrepreneurs, a significant decrease in this limit would produce a backfired scheme once controllers were likely to prefer that their companies go private instead of issuing more voting stocks to sell in the market and lose the company control.

Note that preferred shares traded in the securities market can no longer have *ex ante* fixed dividends. However, it is doubtful whether establishing a mandatory dividend, as set by the new option provided by the law (option 2 discussed above),[109] will guarantee that preferred shareholders receive dividends profitable enough as compared to the dividends paid to common shareholders. The gain for preferred shareholders will only be effective if the company, which has opted to pay compensation with this method, has a high share's net worth.[110] Nevertheless, in this case, if the dividend established by the new option is higher, the most plausible hypothesis is that most companies will tend to maintain their current system, by paying just a 10% higher dividend to preferred shareholders than that paid to common shareholders (option 1 discussed above). This right was already provided by the previous law. Companies are not likely to pay a higher compensation to preferred shareholders when they have a legal alternative to pay less.

The third option provided by the law (option 3 discussed above), the possibility of preferred shares being included in the public offering for the sale of control, receiving 80% of the price paid to the voting shares of the control block, would provide sizeable advantages to preferred shares from a control sale.[111] For this same reason, however, it is doubtful that a significant number of companies will adopt this alternative.[112] If controllers believe they may sell the control of the company in the near future, it is unlikely they will be willing to share their private benefits of control with preferred shareholders. Another possibility is that control will never be sold and the preferred shareholders would then never receive any other pecuniary advantages compared to holders of common shares.

The gain of preferred shares might still be small compared to the returns provided by fixed income investments (titles of public debt, funds of fixed income, etc.). One of the biggest institutional constraints on the development of Brazilian capital markets is the

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109 I am referring to the possibility of having an interest in the dividend to be distributed, corresponding to at least 25% of the net income for the year.

110 CARVALHOSA & EIZIRIK, *supra* note 81, at 95.

111 I thank Professor Bernard Black for raising this point.

112 At the time this article was written, there were thirty-eight companies that provided tag along rights for preferred shareholders, in other words, less than 10% of listed companies.

extremely high interest rate. When interest rates are high, the investor may not be willing to look for equity investments because he or she can find other investments with fixed income returns high enough to discourage him or her from looking for more profitable (and therefore riskier) returns. High interest rates provide an additional incentive for investors to adopt risk-averse behavior because they can make enough profit by being risk-averse.

In conclusion, the reform may not change the existing situation. Preferred shares are likely to receive dividends that are at least 10% percent higher than the dividends of common shares, a practice already largely used before this reform.

2.3.1.3. *Board seat for preferred and minority voting shareholders*

An ideal corporate law should provide mechanisms that permit large minority shareholders to elect a representative on the board of directors. Scholars argue that minority board representation serves useful functions. It provides access to company information, ensures that the company has an "outside" director, independent of current management, who will owe loyalty to shareholders, not to officers.[113]

Brazilian corporate law already provides a mechanism for cumulative voting (multiple voting) for minority voting shareholders who have 10% of the voting capital of the company. The reform envisioned expanding rights so that preferred shareholders (and minority voting shareholders) could elect a board representative. New paragraph 4 of Article 141 requires that shareholders of a publicly-held corporation representing (1) at least 15% of shares with voting rights, or (2) preferred shares without voting rights which represent at least 10% of the shared capital, shall have the right to elect a member to the board of directors in a separate election at the general meeting; the controlling shareholder is excluded from this election. This rule is a considerable achievement because it helps minimize the information asymmetry between controlling and preferred shareholders, and provides an additional opportunity for minority voting shareholders to elect a board representative. Nevertheless, this change concerned controlling shareholders,

[113] Black & Kraakman, *supra* note 72, at 1947. *See also* Gainan Avilov et al., *General Principles of Company Law for Transitional Economies*, 24 J. CORP. L. 190, 282 (1999) (discussing alternative mechanisms of board membership election and their relative benefits and shortcomings).

and prompted them to adopt safeguards so that their control on the board of directors could not be challenged.[114]

Paragraph 7 of Article 141 provides that whenever the election of the board of directors is conducted through multiple voting and holders of common or preferred shares exercise the right to appoint a member of the board, the controlling shareholder(s) "shall have the right to appoint the same number of members appointed by the remaining shareholders plus one, regardless of the number of board members specified in the bylaws."[115] It is worthwhile to discuss how this situation can work in practice. Suppose that the bylaws of a company state that the board of directors will be composed of five directors. Suppose also that one of them is elected through the mechanism of multiple vote,[116] and suppose further that two other directors are elected according to Article 141 section 4.[117] The result would be that three of the directors would be elected by preferred and minority voting shareholders, and the controlling shareholder would elect the other two directors. Thus, the controlling shareholder would not be able to appoint the majority of the board members. Under this scenario, paragraph 7 of Article 141 applies, providing the controlling shareholder the right to elect the same number of directors appointed by the minority and preferred shareholders *plus one*. So the controlling shareholder

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[114] However, this rule may not present such a problem *ex ante*, as I explain *infra* note 118.

[115] *See* Article 141 section 7 (Lei No. 6.404, de 15 de dezembro de 1976 amended by Lei No. 10.303, de 31 outubro de 2001).

[116] Article 141 (Lei No. 6.404, de 15 de dezembro de 1976) provides for the election of directors through multiple voting:

> Whether or not provided for in the bylaws, when electing the members of the administrative council, shareholders representing at least one-tenth of the voting capital may request that a multiple voting procedure be adopted to entitle each share to as many votes as there are council members and to give each shareholder the right to vote cumulatively for only one candidate or to distribute his votes among several candidates.
>
> Para. 1. The right provided by this article shall be exercised by the shareholders not later than forty-eight hours before the general meeting; after consulting the attendance book, the board conducting the meeting shall inform the shareholders in advance of the number of votes required to elect each member of the council.

[117] Article 141 section 4 (Lei No. 6.404, de 15 de dezembro de 1976 amended by Lei No. 10.303, de 31 outubro de 2001), as described in Table 2, grants to shareholders who own at least 15% of voting shares and shareholders who have preferred shares that represent at least 10% of the share capital of the company the right to elect and remove a director.

would be able to elect four *directors*, despite the fact that the bylaws stated that the board would be composed of five directors. The company would end up having seven directors, three appointed by non-controlling shareholders in the terms described above and four elected by the controlling shareholder. Paragraph 7 of Article 141 guarantees that the board of directors will always be constituted by a majority of directors appointed by the controlling shareholder.[118]

Moreover, Black has already discussed how the issue of the election of one representative director for preferred shareholders was weakened during the legislative process by the following constraints: (a) the director elected by the preferred shareholder must have "unblemished reputations" (whatever this means) according the provision of Article 147 section 3; (b) only shareholders who have held preferred shares for at least three months preceding the election have the right to vote, according to Article 141 section 6; and (c) shareholders cannot elect two directors in companies that are competitors, a possible interpretation of Article 147 section 3, II.[119]

Article 8 section 4 provides that the director elected by preferred shareholders shall be chosen from a triple list temporarily prepared by the controlling shareholder "until the annual general meeting is held to approve the financial statements of the 2004 fiscal period."[120] Scholars argued that this provision is unconstitutional.[121] This provision also creates a strange temporary situation in which the minorities must inevitably be represented by the majority.[122]

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[118] *Ex ante*, controlling shareholders would not have contested their ability to determine the majority of board members because they already have the power to amend the bylaws. Consequently, they could increase the number of directors on the board in order to insure their control anyway. The law only makes the process easier for majority shareholders by reducing costs that would be incurred to call a general meeting and make it public. I thank Professor Bernard Black for raising this point.

[119] Black, *supra* note 78, at 48.

[120] *See* Article 8 § 4 (Lei No. 6.404, de 15 de dezembro de 1976 amended by Lei No. 10.303, de 31 outubro de 2001).

[121] CARVALHOSA & EIZIRIK, *supra* note 81, at 289.

[122] *See id.*, *supra* note 81, at 293 (arguing that the minorities are treated as if they were incompetent by the legal system).

2.3.2. Takeout rights

Minority shareholders should be protected by takeout rights during a change of control when the private benefits of control are high. This protection would prevent inefficient control transactions from occurring.[123]

According to Nenova, changes in the legal protection of minority shareholders directly affect the control value for Brazilian listed firms.[124] Analyzing legal changes in Brazil, Nenova finds that the control value increased more than twice during the second half of 1997, after the enactment of the Law 9457/97 which weakened minority shareholder protection as discussed in the previous Section. At the beginning of 1999, control value decreased because of another change in the legal regulation provided by CVM Instruction 299/1999, which reinstated some of the minority protections lifted in 1997.[125] As a result, control values dropped significantly to pre-1997 levels. This empirical evidence suggests that the law impacts the value of private benefits of control, and that when the law is more protective of minority rights, the gap between the value of control shares and minority shares diminishes.

The new law provides that if the majority shareholders increase their number of shares in a way that hinders the market liquidity of the remaining shares ("freezeout transaction"), they will be required to make a public offering for the acquisition of all shares remaining in the market. This device is designed to protect minority shareholders from liquidity loss of their shares. Thus, because the purchaser will be required to disclose the increase of his or her participation in the firm, minority shareholders will have a protection against the diversion of their share value.

Regarding control transfer, Article 254-A requires that the direct or indirect transfer of control of a publicly-held corporation only occur if the purchaser agrees to make a public offer to acquire the voting shares owned by the remaining shareholders. The offer

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[123] Black & Kraakman, *supra* note 72, at 1961.

[124] Tatiana Nenova, *Control Values and Changes in Corporate Law in Brazil* (EFMA 2002 London Meetings, Sept. 25, 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=294064 (arguing that changes in the legal protection afforded minority shareholders directly affect firm control value).

[125] The Instruction 299/99 reinstated mandatory offer rules for minority shares. It established disclosure requirements about the intention of delisting the company. It required a mandatory offer for minority shareholders upon an increase of 10% in the acquirer current shares.

price for such shares shall be at least 80% of the price paid for the voting shares comprising the controlling block.

With regard to this measure, it is worth stressing that the pre-1997 Article 254 of Law 6404 provided for a mandatory offer at the *same price* as was paid for the control block for all outstanding voting shares. The new disposition of Article 254-A just guarantees 80% of the price paid by the control block, thus providing weaker rights than what minority shareholders had before 1997, as discussed above.[126] This outcome is the result of pressure from interest groups that fought against the readoption of the minority rights *in totum*.

By stipulating mandatory tag along rights of just 80%, the law expressly admits that the control block has more value, endorsing the extraction of private benefits of control by controllers. Black criticizes the takeout bid requirement because it is not mandatory for preferred shares. Since this does not apply to preferred shares, the most useful application is lost because these shares may be the majority of the share capital of major companies.[127] As discussed above in Section 2.3.1.2., controllers can choose whether to provide tag along rights for preferred shares as an alternative form of compensation. While this is one of the three compensation alternatives that the company can offer to preferred shares traded in the securities market, this option is not likely to be chosen.

Lopez-de-Silanes has questioned the benefits of imposing a mandatory tag along right by the new corporate reform. He supposedly argued that the 80% tag along provision would be too onerous to the prospective purchaser, which would impede sales of control.[128] However, one has to take into consideration the particulars of the economic environment when analyzing this legal change. Although tag along rights might hinder efficient sales of

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[126] The new law also provides an exception in case of privatizing companies, stating "the provisions of Article 254-A of Law No. 6.404 of 1976 are not applicable to corporations under privatization process and which, as of the date of the enactment of this Law, have published their invitation to bid."

[127] Black, *supra* note 78, at 48.

[128] *See* Daniela Milanese, *Governança Brasileira Está em Primeiro na AL* [*Brazilian Governance Is the First in Latin America*], ESTADO DE SÃO PAULO, Nov. 11, 2002, *available at* http://www.ibgc.org.br/ibConteudo.asp?IDp=109&IDArea=534 (reporting comments made by Professor Florencio López-de-Silanes during his trip to Brazil in 2002).

control in some cases,[129] mandatory tag along rights are necessary in the Brazilian corporate environment.

Private benefits of control are extremely high in Brazil. When there are no tag along rights, prospective purchasers have strong incentives to buy control and expropriate value from minority shareholders. Nenova's study confirmed that private benefits of control greatly increased after the revocation of tag along rights in 1997.[130] There is a trade off between adopting or not adopting mandatory tag along rights.[131] The important question is which rule (the market rule or mandatory tag along rights rule) provides better incentives in the aggregate number of cases.

In an environment where the potential for minority value expropriation is high, the expected benefits of imposing tag along rights supplant the costs that tag along rights might impose on efficient control sales. The market rule has proved to be inefficient in the Brazilian case.[132] Therefore, tag along rights are indispensable in this context in order to protect minority shareholders' share value. The law reform should have reinstated tag along rights of 100%, because tag along rights of 80% still permit minority value expropriation and encourage private benefits of control to remain high.

The new Paragraph 4 of Article 254-A states that the purchaser of a control block of shares may offer minority shareholders the option to keep their shares in exchange for payment of a premium equivalent to the difference between the market value of the shares and the price paid for shares comprising the controlling block. Currently there is a discussion regarding how this requirement should be interpreted.

Some scholars argue that the purchaser of control has to make a public offer to acquire minority shares paying 80% of the price offered to the control block. Additionally, the purchaser can also offer an alternative to minority shareholders in which they could keep their shares and receive the difference in value between their

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129 *See* Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q. J. ECON. 957, 957 (1994) (comparing the market and equal opportunity rules with an analysis of controlling block transfers to reveal their overall strengths and weaknesses).

130 Nenova, *supra* note 124, at 4.

131 *See* Bebchuk, *supra* note 129, at 961.

132 Nenova, *supra* note 124, at 2.

shares and the price paid for the controlling shares.[133] If the purchaser provides this second alternative, the minority shareholders will choose the option they prefer. I call this interpretation *minority shareholder choice*. However, if the purchaser decides not to offer the second alternative, he or she will be obliged to offer the 80% tag along right.

Another interpretation of the Paragraph 4 of Article 254-A requirement is that the purchaser of control can choose whether to make a public offer to acquire minority shares *or* to pay the premium to minority shares.[134] According to this interpretation, the prospective control purchaser makes the choice, not the minority shareholders. If the control purchaser decides to pay the premium to minority shareholders, these will have no option except to stay in the company (or sell their shares on the market). According to this hypothesis, the public offer to acquire minority shares is not mandatory, but is a choice for the purchaser. I call this interpretation *purchaser choice*.[135]

It is not difficult to see that the *minority shareholder choice* is the better interpretation. Formally, the *purchaser choice* argument subverts the hierarchy between Article 254-A and its paragraph 4, by giving as much force to the paragraph as to the article. Article 254-A has more force and clearly states that the control transfer "can only be effective on condition that the purchaser agrees to conduct a public offering." Paragraph 4 has lower priority and cannot make Article 254-A non-mandatory. It just provides the alternative for purchasers to offer minority shareholders the *option* to keep their shares and receive a premium.

If we consider the incentive framework of these two interpretations we can hypothesize what the parties would have agreed *ex ante*, if they had the opportunity to choose a default rule that would maximize the total value of the transaction for both parties. Under the *minority shareholder choice*, shareholders will be able to choose whether they want to keep or to sell their shares. They will

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133 CARVALHOSA & EIZIRIK, *supra* note 81, at 410.

134 LUIZ LEONARDO CANTIDIANO, REFORMA DA LEI DAS S.A. COMENTADA [COMMENTS ON THE CORPORATE LAW REFORM] 248 (2002).

135 Note that in both interpretations the purchaser actually chooses whether he or she will offer the possibility of paying only the premium. However, according to the *minority shareholder choice* interpretation, minority shareholders choose whether to accept the offer of purchasers. According to the *purchaser choice interpretation*, once the purchaser has chosen to pay the premium, minority shareholders will have to keep their shares and receive the premium.

be able to evaluate the purchaser proposals. If they trust the purchaser, expecting the sale to be efficient and to increase shareholder value, they will keep their shares and receive the premium. If the minority shareholders don't trust the purchaser and don't expect future gains, they will prefer to sell their shares. Under this hypothesis, purchasers have an extra incentive to disclose information regarding their plans. If the purchaser convinces minority shareholders that he or she will run the firm better, minority shareholders will keep their shares and the purchaser will save money in his or her purchase of control. If the purchaser can offer to pay the premium and minority shareholders don't have the choice to sell their shares to him or her, then minority shareholders won't be able to evaluate the purchaser anymore. The purchaser will have no incentive to disclose his or her plans and to manage the firm more efficiently. On the contrary, if all shareholders have to keep their shares and receive the premium, the purchaser has more incentive to expropriate minority value afterward to recuperate the amount of the premium he or she paid to them. It seems like the *minority shareholder choice* is a possible alternative that the parties would have contracted *ex ante* in order to induce the maximizing outcome for both parties. The *purchaser-choice*, in contrast, provides incentives to the purchaser that would make the minority shareholders worse off. Additionally, the *purchaser-choice* would reinforce controllers culture of expropriating value from minority shares. Obviously, the parties would not agree *ex ante* on a rule that makes just one party better off, by expropriating the opportunity of gain for the other party.

2.3.3. *Shareholder agreements*

Shareholders' agreements can serve to organize the interests of both the controlling and minority shareholders. Shareholders' agreements, as with all agreements, are supposed to bind the parties who have signed the agreement.

The new law has created a new type of shareholder agreement that can obligate third parties that are not signatories to the agreement. Article 118 section 8, of the new law states that "the president of the meeting or of the decision-making body of the corporation shall not compute a vote that infringes a duly filed shareholders agreement." Article 118 section 9 states that "failure to attend a general meeting or meetings of the corporation's management bodies, as well as failure to vote on matters specified in the shareholders' agreement by any party or by members of the board of directors elected under the terms of the shareholders' agreement assures the damaged party the right to vote with the shares belonging to the shareholder who is absent or remiss and, in case of a member of the board of directors, by the board member elected by the votes of the damaged party."[136] The wording of this new provision is confusing, and must be analyzed further.

The amendment establishes a mandatory rule that if a shareholder who is part of a shareholder agreement is absent to a general meeting, and if he or she does not vote on matters specified in the shareholders agreement, *any* damaged party will have *the right* to vote *with the shares belonging to the shareholder* who is absent. Moreover, the new law states that the president of the meeting, or of the board of directors, cannot compute a vote that disobeys a shareholders' agreement. Under this provision, the law has conferred to the shareholders a remedy to make their agreements enforceable.[137] The combined interpretation of Article 118 paragraph 8 and Article 118 paragraph 9, however, also provides that the directors of the company will be obligated to vote according to the terms of the shareholder agreement signed by the shareholders who have elected them. Therefore, directors will have to follow the terms of a shareholders agreement as if they were parties to the agreement. Even though directors are not parties to shareholder agreements, according to the new law their votes will be bound by the agreement. Hence, directors will not be independent to decide on matters that have already been considered by shareholders' agreements.

Directors are personally liable by their actions according to the Brazilian law. Article 154 of the Law 6404, still in force, reads as follows:

> Article 154. An officer shall use the powers conferred upon him by law and by the bylaws to achieve the corporation corporate purposes and to support its best interests, including the requirements of the public at large and of the social role of the corporation.

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[136] Art. 118 § 9, Lei No. 10.303, de 31 dezembro de 2001, D.O.U. de 1.11.2001. (Brazil).

[137] *See* CARVALHOSA & EIZIRIK, *supra* note 81, at 225-26 (defending the view that this provision is beneficial, because it makes possible effective enforcement of the agreement).

> Paragraph 1. An officer elected by a group or class of shareholders shall have the same duties toward the corporation as the other officers *and shall not fail to fulfill such duties, even at the expense of the interests of those who elected him.*[138]

The new provision of the law regarding shareholders' agreements conflicts with paragraph 1 of article 154. Regarding liability, Paragraph 2 of Article 158 provides that directors and officers "shall be jointly liable for the losses caused by failure to comply with the duties imposed by law to ensure the normal operation of the corporation, even when in accordance with the bylaws such duties do not devolve upon all officers." Who carries the liability for a vote made by a director that was legally obligated to vote according to a shareholders' agreement? This liability question is an important issue that the law does not address. If the director is not independent to make decisions how can he or she be held liable for his or her vote?

The result of this irrational situation is that the power of the board of directors to make independent decisions to run the company is considerably weakened. This outcome is bizarre considering that the reform to the law was intended to promote good corporate governance practices. Although there are divergent arguments regarding the desirable number of outside, independent directors on a board, no one would advocate for a passive director.[139]

It is worthwhile to discuss what caused the inclusion of such an amendment to the law. According to an article published in the newspaper *Folha de São Paulo*, Opportunity Bank, on one hand, and

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138 Lei No. 6.404, de 15 dezembro de 1976, D.O.U. de 1.12.1976. (Brazil) (emphasis added).

139 The literature regarding the appropriateness of outside directors is now vast. *See, e.g.*, Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831 (1993) (discussing the failure of corporate internal control systems to manage economic changes), Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898 (1996) (reviewing of the literature); Black, *supra* note 77, at 800. Although the discussion of whether board independence affects firm performance is inconclusive and recent studies find no correlation, it is uncontested that directors should not be considered legal representatives of the shareholders who have elected them. This issue is discussed next. *See, e.g.*, Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002) (finding that firms with more independent boards do not perform better than other firms).

pension funds, TIW (Telesystem International Wireless), and Telecom Italia on the other hand, were fighting for control of the companies Brasil Telecom, Telemig Celular and Tele Norte Celular.[140] Opportunity Bank's actual control of these three companies by means of shareholders' agreement was being contested by institutional investors. For example, a shareholders' agreement signed by shareholders of Invitel, a company that owned Brasil Telecom shares, forced the directors of Brasil Telecom that were appointed by institutional investors to vote in accordance with Opportunity Bank's interests. In this shareholders' agreement, there was a clause stipulating that the partners of Invitel—Opportunity Bank and institutional investors—would meet prior to any vote in Brazil Telecom, in order to decide how they would vote. Because Opportunity had the majority of voting shares at Invitel, it decided how the institutional investors would vote at the board of directors of Brasil Telecom. The institutional investors subsequently pursued legal action against Opportunity Bank, and received an injunction allowing them to maintain their appointees in the board of directors.[141]

The inclusion of paragraphs 8 and 9 in the Article 118 of Law 6404 would benefit Opportunity Bank and its contested actions would be endorsed by the provision that provides for the director representing the damaged party to vote in place of the board member who did not vote under the terms of the shareholders' agreement. Opportunity's lawyer, Mr. Paulo Aragão, argued for the inclusion of this article in the law, claiming that in Brazil there are no independent directors who could represent the interest of all shareholders in practice.[142] Before approved, paragraphs 8 and 9 of Article 118 were criticized. Investment funds lobbied the president to veto these provisions. However these efforts were not successful and the provisions were still present in the law that was passed.

According to the prevalent view in international practice, board members should not be required to act according to the will of the shareholders who have elected them. Board members have

[140] Leonardo Souza & Elvira Lobato, *Lei das S.A. pode beneficiar Opportunity* [*Corporate Law May Benefit Opportunity*], FOLHA DE SÃO PAULO, Nov. 1, 2001, *available at* http://www1.folha.uol.com.br/folha/dinheiro/ult91u34367.shtml.

[141] *Id.* The article also mentions that the director of the pension fund Previ, Henrique Pizzolato, was dismissed from the Brasil Telecom's board of directors because he did not vote as the officer appointed by Opportunity.

[142] *Id.*

more information about the business and are in a better position to make decisions considering the interests of the company and not just the interests of the majority shareholders. Hence, directors should make their decisions according to the interests of the company and should not be obliged to act like agents of the shareholders who have elected them.[143]

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[143] A New York case is on point:

> It has long been the law in this State that a corporation must be managed by the board of directors . . . who serve as trustees for the benefit of the corporation and all its shareholders (see, e.g., *Billings v. Shaw*, 209 N.Y. 265, 103 N.E. 142). To prevent control of the corporation from being diverted into the hands of individuals or groups who in some cases might not be subject to quite the same fiduciary obligations as are imposed upon directors as a matter of course, the courts have always looked unfavorably towards attempts to circumvent the discretionary authority given the board of directors by law. . . . Such matters normally arise in the context of an agreement between shareholders to utilize their shares so as to force the board of directors to take certain actions. . . .
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> It is, of course, proper for shareholders to combine in order to elect directors whom they believe will manage the corporation in accord with what those shareholders perceive to be the best interests of the corporation. Thus, an agreement between two shareholders to vote for a particular director or directors is not illegal and may be enforceable in an appropriate case. . . . If some shareholders seek to go beyond this, however, if they agree to vote their shares so as to impose their decisions upon the board of directors, such an agreement will normally be unenforceable. . . .
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> . . . .
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> . . . In those cases in which the agreement is made by less than all the shareholders, almost any attempt to reduce the authority granted to the board by law will create a significant potential for harm to other shareholders even if the potential for harm to the general public is minimal. This is so because the effect of such an agreement is to deprive the other shareholders of the benefits and protections which the law perceives to exist when the corporation is managed by an independent board of directors, free to use its own business judgment in the best interest of the corporation.

Triggs v. Triggs, 385 N.E.2d 1254, 1257–58 (N.Y. 1978) (citations omitted).

Consider also the English Appellate decision *Automatic Self-Cleansing Filter Syndicate Co., Ltd. v. Cuninghame*, [1906] 2 Ch. 34 (Eng.). Judge Collins wrote:

> No doubt for some purposes directors are agents. For whom are they agents? You have, no doubt, in theory and law one entity, the company, which might be a principal, but you have to go behind that when you look to the particular position of directors. It is by the consensus of all the individuals in the company that these directors become agents and hold their rights as agents. It is not fair to say that a majority at a meeting is for the purposes of this case the principal so as to alter the mandate

Even if one considers that it is not inherently improper for a director to carry out the wishes of a controlling group of shareholders (as long as their interests do not damage minority shareholders interests),[144] legislation that binds directors *ex ante* to vote according to the terms of a shareholder agreement does not provide good incentive, particularly in light of the Brazilian corporate governance environment. This rule might induce majority shareholders to contract agreements in their favor at the expense of minority shareholders.

2.3.4. Summary conclusions

My analysis of the Brazilian corporate reform shows that most of the measures do not adequately promote better corporate governance practices, or strengthen capital markets. Regarding the limit for issuing preferred shares, the amendment maintains the status quo for existing firms. Dividend rights of preferred shares will likely remain the same. Concerning takeout rights, the amendment only established partial tag along rights, which may be perverse considering the particulars of the Brazilian corporate environment. Regarding the remedy to enforce shareholders' agreements, this measure binds the director's decisions to the decisions made in the shareholders' agreement, which will make directors less independent in practice.

Although the reform is inadequate in many areas, it is important to note that the reform does achieve some progress. The most significant achievement stems from the rule that provides board representation to both minority voting and nonvoting shareholders. However, considering the initial proposals envisioned to restructure the law, there is little doubt that the most beneficial changes were lost during the legislative process. The ultimate version of the new corporate law and its reforms are far short of the reforms that would have been possible in a different social envi-

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> of the agent. The minority also must be taken into account. There are provisions by which the minority may be over-borne, but that can only be done by special machinery in the shape of special resolutions. Short of that the mandate which must be obeyed is not that of the majority—it is that of the whole entity made up of all the shareholders.

Id. at 42. *See also* FRANKLIN A. GEVURTZ, CORPORATION LAW 500 (2000).

[144] *See* Edmund T. Delaney, *The Corporate Director: Can His Hands Be Tied in Advance*, 50 COLUM. L. REV. 52, 65 (1950) (arguing that it is not inherently improper for a director to carry out the wishes of a controlling group of stockholders as long as these do not unfairly damage minority interests).

ronment. Thus, I will now examine how Brazilian society and culture affected the corporate reform.

3. WHAT CAN EXPLAIN THE REFORM FAILURE?

3.1. *A Theoretical Framework to Evaluate the Incentives that Matter for Developing Strong Capital Markets*

Several theories have emerged recently to explain the preconditions necessary for a country to develop strong capital markets. One theory argues that law is the main condition that can provide for greater separation of ownership and control, leading to dispersed share ownership and ultimately to the strengthening of capital markets. Disputing this argument, other theories highlight the role played by political and cultural conditions in the development of capital markets. These arguments are briefly discussed below.

3.1.1. *The law matters hypothesis*

In a series of empirical articles, La Porta, Lopez-de-Silanes, Shleifer and Vishny ("LLSV") present strong evidence that formal law matters in the development of liquid capital markets. Their arguments refute the traditional view of the Law and Economics literature that condemned the public regulation of securities markets.[145] In fact, traditional law and economics tended to regard the Law as an antagonist of the invisible hand of the market and its free development.

LLSV show that countries that provide investors with better public regulation by legal rules, and quality enforcement of these rules, have more external financing with higher valued and broader capital markets.[146] LLSV focus on the link between the legal environment and the financial markets, arguing that the tradition of Law (common versus civil law) plays an important role in developing efficient capital markets. According to their argument,

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145 *See generally* George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973) (discussing the disclosure requirements of the SEC); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964) (analyzing SEC policymaking).

146 *See generally* La Porta et al., *supra* note 98 (examining legal rules and their enforcement in forty-nine countries); La Porta et al., *supra* note 99 (showing that countries with poorer investor protections, measures by legal rules and enforcement, have smaller and narrower capital markets).

civil law countries (mainly those following the French legal system) tend to have weaker investor protection and less developed capital markets when compared with common law countries. Consequently, common law countries enjoy more developed capital markets than do their civil law counterparts.[147]

When shareholders and creditors are strongly protected by law from expropriation by managers and controlling shareholders, as is the case in the common law countries, shareholders pay a higher price for securities. These higher valued securities are more appealing to entrepreneurs seeking investment capital. This relationship, governed by investor protections, results in a stable environment with disperse ownership. According to LLSV, "the evidence rejects the hypothesis that private contracting is sufficient. Even among countries with well functioning judiciaries, those with rules and regulations more protective of investors have better developed capital markets."[148] Therefore, "leaving financial markets alone is not a good way to encourage them,"[149] and the Law is a pivotal factor in determining the conditions that will lead to the development of the markets.[150]

Consistent with this view that corporate law affects economic outcomes and firm value, Daines shows that when rules reduce transaction costs they improve firm value.[151] Analyzing the corporate legislation of different states in the United States, Daines presents evidence of the superiority of Delaware corporate law, where firms are likely to incorporate when going public. The rules provided by Delaware (takeover law, specialized corporate courts) improve the securities prices of the firms incorporated under its law.[152] Modigliani and Perotti also argue that the development of the securities market is affected by the quality of the public law enforcement. They argue that "lack of reliable enforcement may lead to a degeneration in private transacting" and "private enforcement mechanisms are necessarily less efficient than a reliable common legislation, since agents unconnected through a scheme are unable

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147 La Porta et al., *supra* note 99, at 1997.

148 La Porta et. al., *supra* note 3, at 7.

149 *Id.* at 24.

150 *Id.*

151 Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001).

152 *Id.*

to transact."[153] The enactment of formal norms and their enforcement may originate significant economies of scale, which would compensate for any losses provided by these public regulations.[154]

LLSV's theory that the development of financial markets relies on the protection of outside investors by formal laws has been severely criticized. Berglöf and Von Thadden, for example, maintain that the theory's focus is too narrow, mainly when applied to developing and transition countries, because it is concerned with just one group of agents, the small investors.[155] Berglöf and Von Thadden propose a broader model that includes the analysis of a specific situation in a given country with regard to its particular institutions. For example, a policy recommending more protection to investors in civil law countries is too general to be useful.[156] One has to look at the context to see exactly what is going on in the corporate environment before making such a general policy recommendation. Formal institutions are just one part of the rules that limit institutional development. Scholars have overemphasized the role played by the law in the development of financial markets, while neglecting other important variables such as informal norms (social norms and cultural beliefs) and the political environment. There is growing evidence that formal laws, private order, culture, and political institutions are complementary to each other, and that

[153] Franco Modigliani & Enrico Perotti, *Security versus Bank Finance: The Importance of a Proper Enforcement of Legal Rules* 8 (FEEM Working Paper No. 37.99, 2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=200559.

[154] *Id.*

[155] Berglöf and Von Thadden insist:

> Any statement about corporate governance and possible intervention through the legal system must, therefore, be preceded by careful analysis of the specific institutions of the country concerned. The optimal governance arrangements reflect delicate tradeoffs between the benefits and costs of concentrated holdings, employee participation, management structures, corporate networks, and other institutional features of the economy. For example, concentration of ownership improves incentives to monitor management and align incentives of owner/managers with those of the rest of shareholders.

Erik Berglöf & Ernst-Ludwig Von Thadden, *The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries* 21 (Conference Paper, Annual World Bank Conference on Development Economics, Washington D.C., June 1999), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=183708.

[156] *Id.*

all these elements matter for the development of capital markets.[157] In the following, I present some of the criticisms of the "law matters hypothesis."

3.1.2. *The informal norms and culture hypothesis*

If one observes the historical causes that led to the great dispersion of corporate ownership in the United States and England,[158] one will find that these countries did not have a consistent formal legal apparatus providing for protection of minority investors. After analyzing the institutional environment in which dispersed ownership grew, Coffee concludes that the U.S. and U.K. experience are contrary to the "law matters" hypothesis and suggests that functional substitutes for close governmental regulation can be developed.[159] In fact, the main claims made by Berle and Means when they identified the phenomenon of the separation of ownership and control in the United States were regarding the poor protection of minority shareholders in their time. This caused them to propose the creation of a legislation that could protect the interest

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[157] *Cf.* Black, *supra* note 77 (developing a framework to analyze the conditions that matter for developing securities markets that includes political, legal and cultural institutions).

[158] These are the countries where the "Berle-Means corporations," with scattered ownership and management control, most dominate.

[159] John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 76 (2001):

> If this Article's assessment is correct that strong self-regulation was the principal catalyst for the appearance of an active and liquid market in equity securities and the arrival of dispersed ownership, then very practical implications follow. Even in countries with weak legal protections for minority shareholders, it may be possible for those firms that are prepared to bond themselves, install credible monitoring controls, and meet higher standards of disclosure to sell stock to dispersed public shareholders at prices exceeding that which a controlling shareholder would pay. Similarly, the void created by weak formal law can be at least partially filled by a functional substitute: strong stock exchange rules .... These claims do not deny the desirability of strong formal legal rules or the likelihood that shareholder values will be further maximized by such legal changes. But the thrust of this Article is to suggest that a very real payoff can be obtained from private ordering and credible corporate governance.

of minority shareholders.[160] Their efforts influenced, as a matter of fact, the enactment of the Securities Acts of 1933 and 1934.[161]

According to Cheffins, despite the fact that in the past the "English judicial system had . . . commendable features, in most respects [England was not exactly] a protective jurisdiction for outside investors."[162] The author points out the role of alternative institutional safeguards, apart from protective legal regimes, in developing the market. An example is the work done by financial professionals, who, motivated by reputation concerns, perform quality control when they organize public offerings of shares for companies in the United Kingdom ("U.K.").[163] Another example is the intervention by the London Stock Exchange as a self-regulatory private body that bolsters investor confidence by examining public offerings of shares.[164] Cheffins's work corroborates Coffee's thesis that extralegal institutions can act as substitutes for providing the incentives necessary to improve the development of the market.[165] Therefore, if the formal law was not a key factor for the development of dispersed ownership in the countries where it first happened, one could imagine that other causes led the way to this outcome. These causes may be the private order rules and social norms existing in the society.

Coffee showed that "compliance with nonlegally enforceable social norms can significantly affect market value. . . ."[166] For instance, social norms regarding the behavior of controlling shareholders differ significantly across jurisdictions. The author relates the differences in private benefits to other social variables such as the level of crime and the law compliance within the jurisdiction. Societies with high crime rates are also characterized by high pri-

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160 *See* BERLE & MEANS, *supra* note 65, at 68 (noting that in the absence of protection by enforceable law, minority shareholders are likely to suffer "when the interests of majority and minority are in a measure opposed").

161 *See* William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 738 n.10 (2001) ("*The Modern Corporation and Private Property* is credited with having laid the foundation for the federal securities laws.") (citation omitted).

162 Brian R. Cheffins, *Does Law Matter? The Separation of Ownership and Control in the United Kingdom*, 30 J. LEGAL STUD. 459, 469 (2001).

163 *Id.* at 471–74.

164 *Id.* at 480–81.

165 Coffee, Jr., *supra* note 159, at 76.

166 John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151, 2152 (2001).

vate benefits of control in the corporation. Analyzing the data provided by Nenova,[167] Coffee points out that the "Scandinavian legal systems seem to outperform both common law and French and German civil law systems in terms of reducing the private benefits of control."[168] Therefore, considering that Scandinavian countries use civil law, the explanation broadly used in the literature concerning the common law superiority for shareholder protection could be misleading regarding this issue.[169] Coffee suggests that "social cohesion [can produce] greater conformity with social norms."[170] This phenomenon could explain the better performance of Scandinavian countries, which have greater social cohesion than their counterparts, French civil law countries.[171] This possibility seems to show that law is not the whole story, and that social norms play an important role in shaping corporate governance.

Licht argues that culture can be analyzed using a broad array of statistically testable hypotheses derived from the theories of cultural dimensions provided by Schwartz and Hofstede.[172] Licht states that each society has its own values that reflect its preferences and priorities concerning interactions between individual members. Licht, Goldshmidt & Schwartz apply statistical analysis to quantify the influence of national cultures on corporate governance.[173] They conclude that LLSV's argument that common law is superior can be misleading and that the legal approach is only a

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[167] Nenova, *supra* note 61.

[168] Coffee, Jr., *supra* note 165, at 2160.

[169] Coffee, Jr. states that "the assumed superiority of common law to civil law represents a gross oversimplification," *id.* at 2162, and "one must look beyond law to social norms to explain the very different performance of firms in Scandinavian, German, French and Common Law countries," *id.* at 2165.

[170] *Id.* at 2167.

[171] *Id.*

[172] Amir N. Licht, *The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147, 176–80 (2001); *see also* GEERT HOFSTEDE, CULTURES AND ORGANIZATIONS: SOFTWARE OF THE MIND (1997) (examining the various dimensions in organizational culture and how misunderstandings arise when these dimensions interact with those of other national cultures); Shalom H. Schwartz, *A Theory of Cultural Values and Some Implications for Work*, 48 APPL'D PSYCHOL. INT'L REV. 23 (1999) (using a theory of value dimensions to compare national cultures and exploring how this relates to work goals in varying societies).

[173] Amir N. Licht, Chanan Goldschmidt & Shalom H. Schwartz, *Culture, Law and Finance: Cultural Dimensions of Corporate Governance Laws* (Soc. Sci. Research Network, Working Paper, 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=277613.

partial explanation for the development of equity and debt markets. Licht, Goldshmidt & Schwartz contend that cultural values can impede legal reforms that conflict with these values. They emphasize that a study of both culture and legal history is necessary for a better understanding of corporate governance structures.[174] Eisenberg argues that social norms play an important part in the conduct of corporate actors in matters of fiduciary duties, corporate governance and takeover bids.[175] He points out that the increased level of directorial care over the last ten years in the U.S. cannot be explained by a tougher liability rule or by the prospect of gain. Rather, he argues it is the result of a shift in social norms regarding the directorial role. This shift in social norms may be introduced by the media, by pressure of institutional investors, and, above all, by a change in the belief system of the business community concerning the nature of the obligations associated with the directorial role.[176]

3.1.3. The political hypothesis

This hypothesis argues that favorable political conditions are necessary for a country to develop its capital markets. Roe argues that there are situations in many countries that cannot be explained by "the law matters hypothesis." Some well-developed countries such as Sweden, Denmark, Finland, and Norway provide significant protection for minority shareholders but still have highly concentrated levels of ownership. In these countries, there must be factors other than the deficiency of the law itself impeding the separation of ownership and control.[177]

According to Roe, there are some types of behavior that are not constrained by formal laws. For instance, the law can control some costs such as those caused by managerial embezzlement in the form of self-dealing or insider trading. Laws, however, are unable to control a second type of cost that comes from mismanagement. Because the corporate law is not able to reduce shirking, mistakes, and bad business decisions that squander shareholder value,

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[174] *Id.*

[175] Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1265-91 (1999).

[176] *Id.* at 1268-69.

[177] *See* Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 258 (2002) (noting that "[when the law] is good enough, subtle gradations in its quality do not determine whether ownership diffuses").

managerial costs can be high even in the presence of a corporate law well-protective of shareholders.[178] The political hypothesis argues that ownership cannot be separated from control when managerial agency costs will be especially high after full separation. Consequently, concentrated ownership will persist. In this sense Roe contradicts the basic premise of the LLSV work, stating that high quality law is not only consistent with dispersed ownership but it is also consistent with concentrated ownership.[179] Because social democracies consistently raise managerial agency costs, one will expect concentrated ownership to become stable in these environments. Social democracies do not strongly control dispersed ownership agency costs because they do not support unbridled shareholder wealth maximization. Social democracies tend to widen the gap between managers and dispersed stockholders, by weakening shareholder wealth maximization institutions.[180] If managers have few incentives to manage a firm accord-

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[178] *Id.*

[179] According to Roe, "When managerial agency costs are high but containable by concentration, concentrated shareholding ought to persist even if corporate law fully protects minority stockholders from insiders' overreaching." *Id.* at 240. In addition:

> Blockholders provide critical good services to the firm and one powerful bad service: the good ones are monitoring managers, facilitating information flow from inside the firm to capital owners, and making implicit deals with stakeholders when soft deals are efficient; their one big bad activity is their stealing from the minority stockholders. But if a nation's laws limit their potential to do bad without diminishing their ability to do good, then one could expect that nation's firms to get more blockholders, not fewer.

Id. at 247–48 (citations omitted).

[180] Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 602–03 (2000):

> Social democracies raise the agency costs to shareholders in the Berle-Means public firm. They exacerbate managerial tendencies to expand unprofitably, to avoid risk at all costs, and to avoid biting the bullet and forcing organizational change when markets and technologies have shifted. In each case incumbent employees would often prefer that these changes not go forward, incumbent employees have had a strong political voice in social democracies, and managers have had a rougher time bringing about organizational change in the social democracies . . . .
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> . . .
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> Shareholder-wealth maximization norms have been weaker in the social democracies. The strong control mechanisms of the hostile takeover and publicly known incentive compensation have been harder or impossible to implement in the social democracies.

ing to shareholders interests, the costs of separating ownership from control will be prohibitive. Hence, politics is important in providing the basic conditions for prosperous capital markets.

3.1.4. Path dependence and public choice hypothesis

A country's institutional structure and its historical circumstances are additional factors that affect capital markets. North argues that a defined institutional structure constrains future choices, and historical circumstances can determine solutions that are path determinative.[181] Thus, institutional change is constrained by path dependence, and inefficient outcomes can persist in a world with high transaction costs. Corporate structures can also be path determinative because the modern corporate structures are the result of the original corporate structures that were established in the early stages of development.

Bebchuk and Roe identify two sources of path dependence: structure-driven and rule-driven.[182] Structure-driven path dependence explains how ownership structures at a time T_1 depend on the pattern of ownership structures in a previous time T_0, because of efficiency factors such as sunk adaptive costs, complementarities, network externalities, endowment effects and multiple optima, or inefficiency factors such as rent-seeking.

The rule-driven path dependence focuses on how the initial structure of corporate ownership and the initial legal rules shape future legal rules. For example, Bebchuk and Roe argue that

> [r]ules that enable controllers to extract large private benefits of control are beneficial to controllers of existing publicly traded companies. In a country in which ownership is largely concentrated at T_0 (with or without such rules), controlling shareholders of existing companies will be a powerful interest group with substantial resources. The influence of this group will make it more likely that this country will have or maintain such rules at T_1. And because such rules encourage the use or retention of concentrated ownership, the presence of such rules at T_1 will in turn help maintain or even strengthen the initial dominance of concentrated ownership.[183]

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[181] NORTH, *supra* note 7, at 92–104.

[182] Lucian A. Bebchuk & Mark Roe, *A Theory of Path Dependence in Corporate Ownership and Governance,* 52 STAN. L. REV. 127, 137–38 (1999).

[183] *Id.* at 159 (citations omitted).

The path dependence hypothesis helps explain the persistence of corporate structures. The theory, however, neglects the fact that even countries such as the United States and the U.K., that have stable diffuse ownership now, had concentrated ownership during the development period T_0.[184] These countries were able to avoid path dependence, and establish other forms of business organization.[185] Institutional change can supersede path dependence depending on the existing incentives of a particular environment.

3.2. *Culture as a Key Variable to Explain Institutional Change*

Having analyzed the theories that explain the conditions for the development of capital markets, this paper undertakes the social norms approach by analyzing how culture can influence the legislative process. Recent literature argues that culture affects economic and corporate performance.[186] Culture can diminish transaction costs[187] and influence entrepreneurs' decisions.[188] Some

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184 Bebchuk & Roe assume an initial position T_0 in which a country has dispersed ownership. *Id.* at 158–59. However, this initial condition is contrary to the historical evidence which demonstrates that all countries had concentrated ownership in the initial position.

185 For a study of the incentives that led to this outcome, see Coffee, Jr., *supra* note 159, at 76–77.

186 *See, e.g.*, Andy C. W. Chui, Alison E. Lloyd & Chuck C. K. Kwok, *The Determination of Capital Structure: Is National Culture a Missing Piece to the Puzzle?*, 33 J. INT'L BUS. STUD. 99, 99 (2002) (arguing that national culture affects corporate capital structures, as "countries with high scores on culture dimensions of 'conservatism' and 'mastery' tend to have lower corporate debt ratios"); Bruce Kogut & Harbir Singh, *The Effect of National Culture on the Choice of Entry Mode*, 19 J. INT'L BUS. STUD. 411, 429 (1988) (explaining how cultural distance between countries and attitudes towards uncertainty avoidance influence a country's choice of entry mode); Sang M. Lee & Suzanne Peterson, *Culture, Entrepreneurial Orientation and Global Competitiveness (Analysis of the Relationship of Culture and Entrepreneurship)*, 35 J. WORLD BUS. 401, 415 (2000) (proposing that a society's entrepreneurship is dependent upon its cultural foundation); Jan Pieter van Oudenhoven, *Do Organizations Reflect National Cultures? A 10-Nation Study*, 25 INT'L J. INTERCULT'L REL. 89, 102 (2001) (supporting Hofstede's four dimensions of classification of national cultures through a study of advanced students of economics, business administration, and management from ten countries); *see generally* CULTURE MATTERS: HOW VALUES SHAPE HUMAN PROGRESS (Lawrence E. Harrison & Samuel Huntington, eds., 2000) (providing a more general overview of how national cultures develop).

187 *See* MARK CASSON, THE ECONOMICS OF BUSINESS CULTURE: GAME THEORY, TRANSACTION COSTS, AND ECONOMIC PERFORMANCE 3 (1991). According to Casson:

> Overall economic performance depends on transaction costs, and these mainly reflect the level of trust in the economy. The level of trust depends in turn on culture. An effective culture has strong moral content. Morality can overcome problems that formal procedures – based on

of this recent literature analyzes social norms, in addition to the traditional Law and Economics approach, in order to bridge the gaps that emerge from the Law and Economics behavioral assumptions.[189]

However, the difficulty in quantifying the impact of culture[190] has led economists to largely ignore its influence on human behavior. Greif poses the following critique:

> Lacking an appropriate theoretical framework, economists and economic historians have paid little attention to the relations between culture and institutional structure. This limits the ability to address a question that seems to be at the heart of developmental failures: Why do societies fail to adopt the institutional structure of more economically successful ones?[191]

Greif shows that cultural beliefs influence coordination processes, thereby generating different paths of development. In a comparative study on the organization of the commercial society of the Maghribis and the Genoese, Greif explains how these people, who were constrained by the same technology and environment, developed different cultural beliefs that brought about different solutions to the same organizational problems.[192]

> monitoring compliance with contracts - cannot. A strong culture therefore reduces transactions costs and enhances performance—the success of an economy depends on the quality of its culture.

188 Casson further argues:

> the personality of the founder can exert a cultural influence within the firm . . . [and that] entrepreneurs themselves are strongly influenced by their own cultural environment. They intermediate not only in the production and exchange of goods but also in the transmissions of cultural values. These values are developed principally within religious, ethnic and national groupings, and seem to exert a major influence on the economic performance of these groups. The economic analysis of culture should therefore be able to shed light on a wide variety of contemporary social and business problems.

Id. at vii.

189 *See* Ellickson, *supra* note 12, at 537 (analyzing social norms in conjunction with studying Classical Law and Economics).

190 Today, this has changed significantly, notably, with the progress of Behavioral Economics. *See also* Licht et al., *supra* note 172 (measuring the impact of culture on corporate governance).

191 Avner Greif, *Cultural Beliefs and the Organization of Society: a Historical and Theoretical Reflection on Collectivist and Individualist Societies*, 102 J. POL. ECON. 912, 912 (1994).

192 *Id.*

The collectivist cultural beliefs of the Maghribis produced a collective enforcement mechanism based on high investment in information, collective punishment by informal methods, and segregation. These features contributed to maintaining a stable pattern of wealth distribution in the society, restricting economic interactions to small groups linked by network connections and in-group communication.[193]

In contrast, individualist cultural beliefs of the Genoese led to low levels of communication, which led to the development of formal legal codes and public system of enforcement as a means of coordinating collective actions. These values brought about more social and economic integration, making possible the transfer of wealth to relatively poor people in a way that weakened the dependence of each individual on group specific connections.[194]

These different forms of organizations had different efficiency implications and Greif conjectures that "the Maghribi's societal organization resembles that of contemporary developing countries, whereas the Genoese societal organization resembles the developed West, suggesting that the individualistic system may have been more efficient in the long run," because formal enforcement institutions support anonymous exchange, which is conducive for economic development.[195]

Similarly, North includes perceptions and beliefs systems developed in England, Netherlands, and Spain, in his explanation for their political and economic development paths.[196] While the belief structure that evolved in England and Netherlands shaped ideas of independence, liberty of trade and rule of law, the Spanish belief systems supported personalized exchange, kinship ties and status systems. Furthermore, the Spanish and Portuguese process of cen-

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[193] *Id.*

[194] *Id.*

[195] *Id.* at 943. The author also mentions that "individualistic society entails less social pressure to conform to social norms of behavior and hence fosters initiative and innovation." *Id*.

[196] *See* North, *supra* note 2, at 6 (explaining that "the lack of large scale political and economic order" created an "environment hospitable to political/economic development," resulting in the "the successful development of the Netherlands and England in early modern Europe"); *see also* Douglas C. North, *Transaction Costs through Time* (University of Connecticut Department of Economics Internet Documents in Economics Access Service, Paper No. 9411006, 1994), *available at* http://129.3.20.41/eps/eh/papers/9411/9411006.pdf (studying the costs of human cooperation and coordination, or 'transaction costs,' through time).

tralized government decision-making did not provide incentives for anonymous exchange. This system was reproduced in Latin America with more perverse results.[197]

Introducing culture and ideology as a central feature, instead of as a residual variable, in the study of corporate outcomes can shed light on why nations have different patterns of corporate governance. Ideology, for example, can explain the existence of an inefficient system of property rights. A particular set of legal rules may reflect the ideology of a particular group of actors. Forms of economic organization and enforcement of agreements also depend on the way people perceive their relative costs. Culture and ideology can enrich traditional economic analysis, providing alternative explanations where the standard model of the rent-seeking and wealth-maximizing behavior fails to account for a comprehensive analysis of real world conditions.

The subjective perceptions of the actors influence the relationships between the CEO, directors, officers, and workers, as well as the perception of the press and the public opinion.[198] Subjective perceptions also affect the relationship between the private sector and the government. Entrepreneurs and organization members can revise their evaluations of opportunities and bring about the alteration of rules or gradual change of informal constraints.[199] Ideologies and subjective mental models determine the choices the actors make by forming their informal constraints.

3.2.1. *The insufficiency of the public choice argument: securities reform in the United States and Brazil*

The interest group branch of public choice theory considers the legislature as a marketplace where self-interested rational individuals influence the political process. Self-interested legislators are likely to focus principally on getting re-elected, and interested

[197] *See* North, *supra* note 2, at 10 (referencing the failure of economies to develop in Latin America).

[198] To be sure, there are scholars who challenge the influence of norms to corporate governance. *See, e.g.*, Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869 (2001).

[199] *See* Douglass North, *Institutions and Credible Commitment* (University of Connecticut Department of Economics Internet Documents in Economics Access Service, Paper No. 9412002, 1994), *available at* http://129.3.20.41/eps/eh/papers/9412/9412002.pdf, (analyzing wealth-maximization in terms of the balance of interests at stake between a hypothetical ruler and his constituents based on his own "subjective perceptions").

groups focus on capturing economic rents. Because interest groups provide important sources of political funding, they are able to bribe legislators and, therefore, purchase political outcomes from political actors. The interest group theory of legislation predicts that laws are passed to transfer wealth to organized interest groups.[200]

Interest groups face different organizational costs. A group will form an active political coalition when the benefits of obtaining rents from the legislature outweigh the costs of organizing the group. Some groups can organize themselves more cheaply than others, and thus, can obtain more advantages in the political process. Scattered groups, even if they have much more at stake overall, will lose wealth to smaller and more organized groups.

Although public choice framework is very appealing to explain legislative outcomes,[201] many scholars argue that this traditional economic model does not provide satisfactory explanations for historical change and development.[202] Scholars question the behavioral assumptions that public choice makes and the quality of its empirical studies.[203] The public choice argument generally as-

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[200] A number of articles discuss the main principles and results of the public choice literature. *See, e.g.*, David A. Skeel, Jr., *Book Review: Public Choice and the Future of Public-Choice-Influenced Legal Scholarship*, 50 VAND. L. REV. 647 (1997) (describing public choice and its implications for the legal system); Maxwell L. Stearns, *Restoring Positive Law and Economics: Introduction to Public Choice Theme Issue*, 6 GEO. MASON L. REV 709 (1998) (providing a general overview of law and the public choice); Robert D. Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339 (1988) (reviewing public choice contributions to the positive analysis of legislation process).

[201] *See* Saul Levmore, *The Public Choice Threat*, 67 U. CHI. L. REV. 941, 957 (2000) (arguing that the public choice is appealing and threatening because "it offers simple, unifying models where [other branches of political science] have invested in institutional details that are more valuable if rules have more to do with local history and culture and are not predicted by fairly universal functional or 'rational' explanations").

[202] According to North, *supra* note 13, at 58:

> [T]he simple fact is that a dynamic theory of institutional change limited to the strictly neoclassical constraint of individualistic, rational purposive activity would never allow us to explain most secular change ranging from the stubborn struggle of the Jews in antiquity to the passage of the Social Security Act in 1935. Secular economic change has occurred not only because of the changing in relative prices stressed in neoclassical models but also because of evolving ideological perspectives that have led individuals and groups to have contrasting views of the fairness of their situation and to act upon those views.

[203] *See, e.g.*, Louise A. Halper, *Parables of Exchange: Foundations of Public Choice Theory and the Market Formalism of James Buchanan*, 2 CORNELL J.L. & PUB. POL'Y 229,

sumes that the preferences of interest groups are income-maximizing. Preferences are held fixed. North emphasizes that "the composition and actions of interest groups themselves are not explicable in terms of interest group pressure that excludes ideological convictions."[204] Mental models determined by ideological concerns guide the choices that agents make.[205] Therefore, a model that can explain change with regard to preferences is necessary. Culture, in this respect, is a necessary variable to explain endogenous preferences and change in tastes.

Traditional interest group theory frequently underestimates the degree to which ideology affects the legislation process.[206] I believe

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270 (1993) (criticizing public choice and, in particular, the work of Buchanan); Mark Kelman, *On Democracy-Bashing: A Skeptical Look at the Theoretical and 'Empirical' Practice of the Public Choice Movement*, 74 VA. L. REV. 199, 206 (1988) ("[E]conomists who embrace public choice theory are generally skeptical of explanations of human motivation that are not readily reducible to income-maximizing."); *see also id.* at 219-20 ("[L]eaders quite frequently sacrifice financially when entering public life or care less about money than people who stay in the private sector, but this evidence is largely ignored [by public choice theorists], accumulated without comment, by what amounts to ideological fiat.") (citations omitted); Edward L. Rubin, *Beyond Public Choice: Comprehensive Rationality in the Writing and Reading of Statutes*, 66 N.Y.U. L. REV. 1, 57 (1991) (criticizing the adoption of the re-election maximizing assumption by public choice and proposing a framework of comprehensive rationality that includes other factors than self-interest).

204 NORTH, *supra* note 13, at 56.

205 *See generally* Denzau & North, *supra* note 1, at 14-15 (arguing that institutions and the belief structure are critical constraints on those making choices). This hypothesis is particularly important to explain the behavior of the elite in Brazil, as discussed in the next Section.

206 *See, e.g.*, Sam Peltzman, *An Economic Interpretation of the History of Congressional Voting in the Twentieth Century*, 75 AM. ECON. REV. 656, 671 (1985) ("We already know that the restricted model (i.e., only economic change matters) explains virtually all the change in political behavior."); Tollison, *supra* note 199, at 352 (arguing that vote trading and logrolling can be the real causes for votes supposedly being cast on ideological grounds). *But see* Kelman, *supra* note 202, at 217:

> [I]t is simply not the case that self-interest dominates wherever voters would rationally assume that their economic interests can be affected, and that they 'rationally' remain essentially uninterested in all other cases. First, and most generally, as the level of sophistication or issue-awareness rises, the general importance of ideology seems to *increase* relative to self-interest; thus, the idea that *either* self-interest dominates or one is unconcerned is dubious. . . . [T]he basic message is a simple one: no one-dimensional model of human motivation is likely to tell us much about why people feel as they feel and act as they act.

(citations omitted); Rubin, *supra* note 202, at 29-30 (criticizing the cost-benefit explanation that public choice offers to incorporate ideologically motivated action in its model). Empirical studies also confirm that ideology significantly affects the that, contrary to the argument that public choice presents, politicians can and do vote in accordance with ideological conviction, *even if it causes harm to their constituents' economic interests.* Ideology can influence not only general bills whose implementation effects are unknown,[207] but also narrowly focused bills whose distribution of funds may harm powerful interest groups. Ideology of dispersed interest groups, therefore, can play as important a role as the self-interest of concentrated interest groups in legislative outcomes. Understanding the preferences of interest groups, and of society as a whole, is tantamount to understanding the legislative process.

Public choice theory, for example, does not adequately explain the enactment of the Securities and Exchange Act of 1933 and 1934 in the United States. In this context, independent managers had already established a powerful interest group and minority shareholders were considerably disorganized.[208] Why couldn't managers bar the enactment of the Acts by exerting pressure on the political system? The probable answer is that the stock market crash of 1929 produced an important change in cultural beliefs regarding the way government ought to regulate the market. After the crash, there was strong demand for legislation protecting investors. This demand for reform was able to overcome the efforts of powerful interest groups trying to block reform. In this example,

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course of public policy. *See* James B. Kau & Paul H. Rubin, *Self-Interest, Ideology and Logrolling in Congressional Voting*, 22 J. L. & ECON. 365, 368 (1979) (proposing that, despite the relatively under-developed body of research surrounding the nature of ideology, some empirical evidence does support that ideology is a significant variable in influencing legislation); Joseph P. Kalt & Mark A. Zupan, *Capture and Ideology in the Economic Theory of Politics*, 74 AM. ECON. REV. 279, 297–98 (1984) (presenting empirical evidence that ideological shirking significantly impacted public policy when Congress passed the Surface Mining Control and Reclamation Act (1977)).

207 This is the usual opinion of public choice scholars on the influence of ideology in the enactment of bills. *See, e.g.*, Douglas Nelson & Eugene Silberberg, *Ideology and Legislator Shirking*, 25 ECON. INQUIRY 15, 17 (1987):

> [B]ills on general expenditures have much less cohesive and less well organized constituents, since the final distribution of funds is not generally known at the time of the vote. *We should therefore expect to find a stronger influence of a senator's own ideology on votes on bills pertaining to general as opposed to specific expenditures.*

208 *Cf.* BERLE & MEANS, *supra* note 64; ALFRED D. CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977).

the existing method of regulation was no longer viable because ideological change demanded institutional reforms.[209]

Roe places ideology at the center of his political theory to explain the particular governance structure of the large American firm.[210] He explains that ideology influenced politicians to enact rules that diminish the power of banks and pension funds, by prohibiting them from acquiring large ownership shares of a corporation. According to Roe, "Technology combined with *diversification demands of investors* to yield the fragmented ownership of the public firm and the shift to centralized managerial authority . . . ." [211]

Likewise, Chandler argues that legal differences based on cultural values were particularly important in making the separation between ownership and control possible in the U.S.[212] Chandler suggests that cultural differences in Europe may have delayed the spread of managerial enterprise there:

> In Europe, class distinctions may have made a difference. Families identified themselves more closely with the firm that provided the income with which to maintain their

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[209] NORTH, *supra* note 13, at 205, explains further:

> Moreover institutions that are viable within a consensus ideology are no longer viable as diverse ideologies evolve since rules must be formalized and compliance procedures developed with an eye to the costs of detecting and punishing violations. It is the combination of constitutional rules with the associated moral and ethical codes of behavior that underlies the stability of institutions and makes them slow to change.

[210] MARK J. ROE, STRONG MANAGERS, WEAK OWNERS 27 (1994). According to Roe:

> The simplified political picture I shall use is of politics as the interplay between selfish economic interests and ideology on the playing field of the nation's institutions. Policy choices depend on ideology and interest group power, each of which is impeded or enhanced by existing political institutions. . . .
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> . . . .
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> Ideology is not central in public choice stories about financial rules. This is understandable, but incorrect. . . . when the broad mass of people have *even a weak preference, and that preference is the same* for most people, than ideology matters. For fragmenting financial institutions, broad public preferences mattered.

Id.

[211] *Id.* at 283 (emphasis added).

[212] *See* CHANDLER, *supra* note 208, at 499. ("The Sherman Act and its interpretation by the courts provided a powerful pressure that did not exist elsewhere to force family firms to consolidate their operations into a single, centrally operated enterprise administered by salaried managers.").

> status more than did families in the United States. In those large enterprises that did integrate mass production and mass distribution and in which the owners hired middle managers to coordinate flows, the family continued to dominate top management. Often the family preferred not to expand the enterprise if it meant the loss of personal control.[213]

Krugman advocates that the erosion of social norms created during the New Deal has led to the explosion of executive pay that may be connected to the recent corporate scandals:

> [T]he New Deal had a more profound impact on American society than even its most ardent admirers have suggested: it imposed norms of relative equality in pay that persisted for more than 30 years, creating the broadly middle-class society we came to take for granted. But those norms began to unravel in the 1970's and have done so at an accelerating pace.
>
> Exhibit A for this view is the story of executive compensation. In the 1960's, America's great corporations behaved more like socialist republics than like cutthroat capitalist enterprises, and top executives behaved more like public-spirited bureaucrats than like captains of industry. . . .
>
> . . . .
>
> But then why weren't executives paid lavishly 30 years ago? Again, it's a matter of corporate culture. For a generation after World War II, fear of outrage kept executive salaries in check. Now the outrage is gone. That is, the explosion of executive pay represents a social change rather than the purely economic forces of supply and demand. We should think of it not as a market trend like the rising value of waterfront property, but as something more like the sexual revolution of the 1960's—a relaxation of old strictures, a

[213] *Id.* at 500. Chandler defends the use of a comparative approach in research concerning the modern business enterprise:

> Describing and analyzing the history of the new institution and the ways in which it has carried out its basic functions in different nations can help to define the organizational imperatives of modern economies and reveal much about the ways in which cultural attitudes, values, ideologies, political systems, and social structure affect these imperatives.

Id..

new permissiveness, but in this case the permissiveness is financial rather than sexual.[214]

I do not argue that the political role of ideology conflicts with the emphasis the public choice places on the role of organized economic interests.[215] Rather, I contend that accounting for the role of ideology complements the public choice approach even when self-interested interest groups successfully capture legislation to their benefit. This type of interaction between ideological convictions and private interests has not been fruitfully examined by the public choice literature.[216]

The public choice approach provides a simplistic explanation for why Brazilian corporate law reform has failed to provide significant changes capable of promoting the development of capital markets. The controllers' interest group was able to capture the legislation in important aspects.[217] However, public choice still

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214 Paul Krugman, *For Richer: How the Permissive Capitalism of the Boom Destroyed American Equality*, N.Y. TIMES MAGAZINE, Oct. 20, 2002, at 62, 66–67.

215 It is not that public choice is wrong. As Rubin, *supra* note 202, at 30, put it: "Public choice is 'wrong' only when it makes claims to be the one true approach to politics."

216 Dwight R. Lee has already advanced in part the thesis that I defend here:

> Organized groups often do little to oppose legislation that is potentially adverse to their interests, *especially when public opinion strongly favors the legislation*. Well-organized groups often will 'get on board' and 'support' legislation that is inimical to their economic interests. But, as opposed to individuals who voted for the legislation and who quickly forgot it once it was passed, the affected organized interests will be unrelenting in their efforts to influence the day-to-day details of the legislation's implementation. This influence will typically not be exerted on behalf of the broad public interest. Government attempts to help the poor, protect the consumer, and regulate business pricing and practices provide additional examples of supposedly general interest legislation that is subverted by organized interest groups. The initial motivation for the legislation may have been dominated by ideological considerations, but narrow economic concerns motivate the special interest influence that does so much to determine its effect.

Dwight R. Lee, *Politics, Ideology, and the Power of Public Choice*, 74 VA. L. R. 191, 197 (1988) (emphasis added). However, the author fails to perceive that the level of legislation enforcement also depends on the preferences and outrage that exists in the society, overestimating the power of interest groups in constraining enforcement in practice.

217 This is the usual interest group explanation for legislative outcome. *See, e.g.*, Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L. J. 325, 363–65 (1995) (concluding that, despite a near consensus in favor of reform, double taxation results from the resistance to change by a small group of managers).

does not explain why some countries pass laws that conflict with the interests of powerful interest groups, while other countries are unable to pass such laws. One possible explanation for these different outcomes is that culture can act as a deterrent to rent-seeking pressures. On one hand, culture can constrain rent-seeking interests and can make possible institutional changes that are not explained by the traditional economic model. On the other hand, culture can make interest groups even more powerful and impede institutional change.

The following propositions might explain institutional change more completely: (1) Culture can compensate for rent-seeking interests and provoke institutional change; and (2) culture can enhance rent-seeking interests, thereby making institutional changes impossible. The next Section applies the second hypothesis to the Brazilian efforts to reform its corporate law.

The following examples further develop the hypothesis that culture can enhance rent-seeking interests, thereby making institutional change impossible. Example 1 shows that one must include culture and ideology in the economic model to explain successful institutional change.[218] The example argues that interest group theory is an insufficient explanation. I consider two scenarios under which legislative reforms occurred: the passing of the Securities Act in the United States and the Corporate Law reform in Brazil. In these scenarios, α represents the lobbying efforts of powerful interest groups to prevent changes that are in conflict to their interests. β represents society's demand for change, manifested by the press, by the pressure for reform which is placed upon legislators, and by the public response to a particular event or situation. If $\beta > \alpha$ we can expect successful institutional change. This hypothesis explains the enactment of the Securities Act in the United States. If $\beta < \alpha$ we can expect no significant institutional change to happen, which means that the situation after the change is likely to maintain the status quo. This condition explains the outcome of the Brazilian Corporate Law Reform. My argument calls the attention to *demanding* mechanisms for better legislation by the society.

[218] In this context, successful institutional change refers to a change that promotes efficiency and effectively changes the status quo.

EXAMPLE 1: PUBLIC CHOICE AND CULTURE/IDEOLOGY CAN JOINTLY EXPLAIN INSTITUTIONAL CHANGE

Consider:

α = lobbying of powerful interest groups against change

β = society's pressure for change (informal constraints, subjective perceptions, role of the press, culture, reaction to scandals)

Question: All other things equal, will institutional change succeed?

2 scenarios:

Powerful interest groups (example: managers in the U.S. in 1920's)	Powerful interest groups (example: majority shareholders in Brazil)
if	if
$\beta > \alpha \rightarrow$ institutional change	$\beta < \alpha \rightarrow$ no significant institutional change
Outcome: American Securities Acts (1933, 1934).	Outcome: failure of 2001 Corporate Securities Act Law Reform in Brazil

The next example explores a situation in which there has been a transplant of efficient legal rules, however, there is poor enforcement of the transplanted rules. This example addresses the claim made by Berkowitz, Pistor, and Richard who conclude that one can expect less enforcement in countries with transplanted legal rules because there is less correlation between transplanted rules and the social environment where the transplant took place.[219] θ represents the general tendency in society to adhere to the law on the books. θ captures whether actors are inclined to act according to the law on the books, that is, whether the rules can attach to the

[219] *See* Daniel Berkowitz, Katharina Pistor & Jean-Francois Richard. *Economic Development, Legality, and the Transplant Effect*, 47 EUR. ECON. REV. 165 (2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=290000 (concluding that a country which has a population that is familiar with a transplanted legal principle is more likely to enforce the legal system than countries that received a foreign law without similar predispositions).

prevalent social environment. θ_x represents the critical point where enforcement of the law becomes possible.

This example reveals that in order for enforcement to be practical, society must have some adhesion to the law on the books, that is, society's preferences have to be aligned with the legal rules. This hypothesis could explain why some laws are not enforced in Brazil. Another illustrative example is the case of Russia. Black, Kraakman, and Tarassova provide evidence on failures in the Russian privatization process and corporate governance system.[220] Their evidence shows that society does not adhere to the corporate laws, and the result is that these laws are not enforced. According to this paper's argument, social norms may be a possible explanation for the widespread corruption found in Russia, in spite of its good laws on the books.[221]

[220] *See, e.g.*, Black et al., *supra* note 6 (explaining that the failures of the privatization process were mainly the result of widespread corruption and extensive self-dealing by managers and controlling shareholders of the privatized firms).

[221] The former Soviet Union maintained a communist economy based on the collective ownership of economic assets for approximately 75 years. In this economy, people were severely constrained. When the Soviet Union fell, its society experienced a collapse of the established social norms that restricted their behavior. In the transition, Russians were not able to develop social norms that would support the establishment of a system of private property rights. They were unable to distinguish boundaries between perceptions of public and private ownership. Russian society's lack of adhesion to written laws made those laws ineffective in practice. Russians have struggled in a somewhat Hobbesian context, where theft and corruption could easily spread throughout all of the economy. It is easy to understand this drastic response to the tremendous revolution in their organization system over such a small period of time. So far, Russians have failed to develop a set of social norms and culture supportive of the transplanted capitalist rules. Despite the fact that a change in formal rules could be achieved with relative ease, enforcement of new rules critically depends on the adhesion ability of a society's preferences to the written law (θ_x). *See* Kenneth J. Arrow, *The Role of Time*, *in* THE NEW RUSSIA: TRANSITION GONE AWRY 85, 88 (Lawrence R. Klein & Marshall Pomer, eds., 2001) (arguing that the "readjustment of institutions is an extended process" and "[e]ntrepreneurs have to learn [the] meaning [of legal instruments such as credit instruments, stocks, bonds and mortgages]"); Georgi Arbatov, *Origins and Consequences of 'Shock Therapy,' in* THE NEW RUSSIA: TRANSITION GONE AWRY 171, 173-75 (Lawrence R. Klein & Marshall Power, eds., 2001) (describing the failures of the transition program and the growth of crime and corruption).

EXAMPLE 2: TRANSPLANT OF (GOOD) LAWS AND POOR ENFORCEMENT IN PRACTICE

Consider:

Law on the books (Example: Brazilian rules market manipulation, white collar crime; corporate law in Russia)

But enforcement is rare (Example: Nahas case in Brazil, cases in Russia)

Question: If all other things equal, is enforcement going to happen?

θ = general tendency in society to adhere to the law on the books

θ_x = critical point to make enforcement feasible against corporate insiders

2 scenarios:

if $\theta > \theta_x \rightarrow$ some enforcement
if $\theta < \theta_x \rightarrow$ no or negligible enforcement

3.3. *The Brazilian Institutional Evolution*

An evaluation of Brazilian corporate governance has to take into account the cultural preferences created during Brazil's development process. In this Section, I delineate the essential characteristics of the ideological trap that hinders institutional change in Brazil. Ideology and culture refer to the common values and system of beliefs that shape social interactions, and consequently, influence and constrain the decisions of actors.[222] I will mainly focus on the elite's ideology.[223]

A historic approach is used to describe the prevalent ideology in Brazil. This historical approach is supported by anthropological

[222] GEERTZ, *supra* note 13, at 89 (asserting that the concept of culture "denotes an historically transmitted pattern of meanings embodied in symbols, a system of inherited conceptions expressed in symbolic forms by means of which men communicate, perpetuate, and develop their knowledge about and attitudes toward life").

[223] This paper does not analyze corporate cultures, the concept of business values developed in specific organizations. *See* HOFSTEDE, *supra* note 172, at xiii (arguing that corporate cultures can bridge national value differences and can develop particular rules of the game).

and sociological studies developed by prominent Brazilian scholars.[224]

3.3.1. *Historical roots and formation of the ideology: "patrimonial" and "personal relations"*

Analyzing Brazil's historical evolution helps explain the development of its business culture. It is important to investigate the unusual role played by two elements in the social environment: *property* and the *person*. These elements give substance to the concepts of "patrimonial" and "personal" relations, which I will discuss in this Section.

The colonization process in Brazil was initiated by the Portuguese and their cultivation of sugar in the 1530s.[225] Because sugar was a highly valuable commodity in Europe, the Portuguese decided to establish plantations in order to produce sugar for exportation on a large scale. Later, the large-scale cultivation of coffee was introduced for the same reason.

This economic activity (sugar and coffee) was based on a patriarchal and slave-holding regime of land exploitation.[226] The plantations (called *latifúndios*) were small complex societies with a rigid social hierarchy: the masters, the free workers, and the slaves. Many of the distinctive features of the Brazilian character today owe their origins to the living conditions in these large rural properties.[227]

There were virtually no internal markets in the colonial economy. The colonial system was designed to drain the resources of the colony for the benefit of the colonial power. The small urban

[224] *See* Robert C. Ellickson, *Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics*, 65 CHI.-KENT L. REV. 23, 23 (1989) (asserting that law and economic scholars should "increasingly look to psychology and sociology in order to enrich the explanatory power and normative punch of analysis"); *see also* Kenneth G. Dau-Schmidt, *Economics and Sociology: The Prospects for an Interdisciplinary Discourse on Law*, 1997 WIS. L. REV. 389, 390 (1997) (reviewing the development of economics and sociology, and arguing that scholarship in both disciplines can have an interdisciplinary discourse on law).

[225] The Portuguese "discovered" Brazil in 1500, but the colonization process *per se* started just some decades later. *See, e.g.*, FERNANDO AZEVEDO, A CULTURA BRASILEIRA [THE BRAZILIAN CULTURE] 90 (Edições Melhorametos ed., 5th ed. 1971) (1943) (stating that the colonization started with the sugar cycle).

[226] *Id.* at 103.

[227] *See* GILBERTO FREYRE, THE MASTERS AND THE SLAVES (Alfred A. Knopf ed., 2d ed., 1956) (1946) ("It is in the Big Houses that, down to this day, the Brazilian character has found its best expression of our social continuity.").

villages were dependent on the landowners.[228] The master had a traditional view of life that excluded other economic activities and any innovations.[229] Free workers, who were a minority, were forced to adapt to the culture of paternalism imposed by the moral codes of the slave society.[230]

Portugal originally divided Brazil into fifteen hereditary *capitanias*, assigned to captains, who had individual prestige and discretionary power.[231] Problems with this form of governance led the colonial power to adopt a centralized government called *Governo Geral* (General Government).[232] The *capitanias* were subject to this central government. This political mechanism was based on a system of domination by the political elite who came from the rural aristocracy.[233] According to the sociologist Gilberto Freyre, "[t]he

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228 *See, e.g.*, AZEVEDO, *supra* note 225, at 103–04 (stating that all the economical activity developed according to a patriarchal regime of land exploration).

229 *See* FLORESTAN FERNANDES, A REVOLUÇÃO BURGUESA NO BRASIL: ENSAIO DE INTERPRETAÇÃO SOCIOLÓGICA [THE BURGEOISIE REVOLUTION IN BRAZIL: A SOCIOLOGICAL INTERPRETATION ESSAY] 151 (3rd. ed. 1981) (1976) (asserting that the colonial masters' style of government did not easily open itself to economic changes and when it did inefficiencies were created). The term "traditionalistic" refers to Max Weber's notion that a man wants to live as he is accustomed to living and to earn as much as is necessary for that purpose. MAX WEBER, THE PROTESTANT ETHIC AND THE SPIRIT OF CAPITALISM, 58–59 (Talcott Parsons trans., Charles Scribner's Sons 1958) (1930) ("The most important opponent with which the spirit of capitalism, in the sense of a definite standard of life claiming ethical sanction, has had to struggle, was that type of attitude and reaction to new situations which we may designate as traditionalism.").

230 *See* AZEVEDO, supra note 225, at 168 (stating that the psychology of the big house spread to the social relations of the free workers); *see also* SÉRGIO BUARQUE DE HOLANDA, RAÍZES DO BRASIL [ROOTS OF BRAZIL] 55–57 (1975) (noting that the mentality of the plantations owners conquered the cities and all the professions).

231 There are discussions of whether this can be classified as a feudal economy. For conflicting positions in the literature see RAYMUNDO FAORO, OS DONOS DO PODER: FORMAÇÃO DO PATRONATO POLÍTICO BRASILEIRO [THE OWNERS OF POWER: FORMATION OF THE BRAZILIAN POLITICAL PATRONS] 176–240 (1958) (arguing that the political institutions determined by the metropolis preceded any forms of social organization). *See also* FREYRE, *supra* note 226 (arguing that the family was the key aspect in the organization of the society).

232 Some land owners abandoned the land, because of difficulties in managing large parcels of land and defending the land from Indians and foreigners. *See* AZEVEDO, *supra* note 225, at 129, 164.

233 *See id.*, at 101–02 (explaining that the most influential politicians were descendents from the system of *latinfúndio* monoculture and slavery—the aristocracy of the sugar farms in the northern region and aristocracy of the coffee farms in the south during the second half of the nineteenth century). The monarchy was founded upon the regime of patriarchal economy. The political domination of the masters consolidated mainly after the independence.

colonization in Brazil proceeded aristocratically—more than in any other part of the Americas."[234]

The abolition of slavery in 1888 broke up the organizational structure of the sugar *latifúndios* and enabled the development of urban life and trade, by shaking the bases of the aristocratic-agrarian economy. However, even after this critical institutional change, much of the social and economic structures persisted. The farmers in the south maintained monoculture *latifúndios* by using immigrant labor and by acquiring foreign loans to solve their financial problems.

The masters of the large rural properties, who were assigned high positions in the central government, maintained substantial prestige in the society. Laws preserving the rights of the masters perpetuated the power of the elites. It is important to note that the emerging urban *bourgeoisie* adopted the attitudes and ideas of the agrarian oligarchies. The lack of an independent and strong *bourgeoisie* meant that modern ideas were to be dominated by traditional norms.[235] This was evident from the persistence of the ethics and norms of the old masters' system in the administrative body of government long after the colonial era and well into the Republican era.[236]

The promulgation of the Republic in 1889 seemed to be a victory for democracy. Until that time, the main economic activity was the exportation of agricultural products. Thus, the Republic was based on the economic structure of the *latifúndio.* The traditional economic power was linked to the new political power as the new political elite searched for political support in the old aristocracy.[237] The power of the oligarchies remained in democratic institutions as the regional political parties were still dominated by the traditional families. This newfound political power was then used to strengthen the economic power of the elites. Thus, cultural standards and traditional economic power limited the development of democratic ideals.

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[234] FREYRE, *supra* note 227, at 186, 256.

[235] *See* WEBER, *supra* note 229, at 78 (noting that the spirit of capitalism, as an attitude that seeks profit rationally and systematically, requires specific psychological conditions such as avoidance of traditional norms).

[236] *See* DE HOLANDA, *supra* note 230, at 57.

[237] *See* AZEVEDO, *supra* note 225, at 186 (commenting that the new middle class still was helped by the rural aristocracy, which in turn continued to be associated with the old source of power).

Brazilian laws were largely influenced by the laws of France. French laws are based on the principles of "freedom, equality and fraternity" (*"liberté, égalité et fraternité"*) that were implemented after the French Revolution, when the *bourgeoisie* successfully overthrew the rural aristocracy. Thus, Brazilian legal principles are based upon an idealized capitalistic order. However, it seems clear that an extremely hierarchical society, with slaves constituting a majority of the population, could not easily apply the experience and principles of the French Revolution.[238]

Laws introduced during the founding of the Brazilian Republic reflected relations that were quite different from those that actually existed in Brazil. This is why Brazilian laws appear detached from its social context. Berkowitz, Pistor, and Richard argue that the way in which a formal legal order is transplanted to another country is crucial in the determination of its enforcement and its effect on economic development.[239] For the law to be effective it must fit within the social context by finding support in the predominant cultural beliefs of the society.[240] Brazil's formal legal system was transplanted, that is, its basic juridical order was conceived prior and external to the actual foundation of the country. Many scholars have pointed out the existence of an imbalance between political and legal order in Brazil. For example, laws were constantly ignored whenever it contradicted the interests of the aristocracy.[241]

Some of the immigrants who replaced the slaves as laborers were able to accumulate some capital. They started to explore new economic opportunities and used their experience from better-developed markets to open businesses. They were the original

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[238] *Cf.* DE HOLANDA, *supra* note 230, at 53–54.

[239] Berkowitz et. al., *supra* note 219.

[240] *See id.* at 2. Berkowitz notes that "[i]f the transplant adapted the law to local conditions, or had a population that was already familiar with basic legal principles of the transplanted law, then we would expect that the law would be used." *Id.* If not, like when the law was imposed by colonization, we can expect the initial demand for using the law to be weak. *Id.* The social environment in which these rules emerged cannot be duplicated in the context where the rules are transplanted. As a consequence, the legal order will function less effectively. The authors argue that the gap between formal law on the books and law in action exists even in countries that conceived their law internally. Therefore, this gap should be much larger in countries which had their laws transplanted. *Id.* at 8.

[241] *See* FERNANDES, *supra* note 229, at 44, 68 (describing the persistent disequilibrium between the political elite and the requirements of justice under a political system of a national state); DE HOLANDA, *supra* note 230, at 119–20 (arguing that the impersonal ideology of democratic liberalism has never prospered in the Brazilian context).

paid workers who enabled the formation of an internal consumer market. Fernandes contends that the immigrants were the "heroes of the industrialization."[242]

The immigrants were able to foster a capitalistic mentality, breaking with some of the traditional values. During the World Wars, the stagnation in international trade stimulated the development of the Brazilian national industry. The State was absent in the beginning of this process. In the thirties, the exportation model of agricultural products started to crumble due to the effects of the Great Depression in the United States and the international markets. As a result there was a great demand to industrialize. However, immigrants lacked the political power necessary for their economic aspirations. Immigrants had few opportunities to gain political power unless they were allied to the old oligarchies. Hence, they accepted the ideology of the political elites. This development is consistent with the immigrants' wealth maximizing rationale. These immigrants were able to establish large enterprises because they could defend their interests by using political means to their advantage.[243] The oligarchies and the *bourgeoisie* created a system of paternalistic government, using the State to serve their own private interests. This point concerning the role of the state is discussed below.

Many scholars contend that the ruling elite play an important role in developing the stability of the institutions and providing the conditions necessary to foster economic and social progress. The elite's cultural background and its manner of internalizing rules influence its behavior and political decisions.[244] Patrimonial

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[242] FERNANDES, *supra* note 229, at 133; *see also* LUIZ CARLOS BRESSER PEREIRA, EMPRESÁRIOS E ADMINISTRADORES NO BRASIL [ENTREPRENEURS AND MANAGERS IN BRAZIL] 79 table 16 (1974) (pointing out that 84.3% of the entrepreneurs in São Paulo descended from immigrants).

[243] Fernandes demonstrates that the new capitalist bourgeoisie was able to join the conservative elites, sharing forms of leadership that were in conflict with the establishment of a competitive market. FERNANDES, *supra* note 229, at 138–49, 183–84. Pereira remarks that by the 1950's the entrepreneurs were linked to the oligarchies and adopted a position of dependence in relation to foreign capital. The entrepreneurs could not develop a strong ideology. PEREIRA, *supra* note 242, at 18, 219.

[244] *See* FERNANDO HENRIQUE CARDOSO, EMPRESÁRIO INDUSTRIAL E DESENVOLVIMENTO ECONÔMICO NO BRASIL [INDUSTRIAL ENTREPRENEUR AND ECONOMIC DEVELOPMENT IN BRAZIL] 84 (1972). According to Cardoso, economic development implies, above all, the formation of new classes capable of breaking economic stagnation and reorganizing the traditional balance of power. *Id.* at 62. He defends that the industrial system is molded by the particular strategies

relations have mainly anchored the ideology of Brazilian elite. According to Eisenstadt "the term 'patrimonial' is used to designate not a level of 'development' of differentiation of political regimes, but rather a specific *way* of coping with the major problem of political life which may cut across different levels of 'development' or structural complexity."[245]

Whether a society establishes a patrimonial form of organization depends on the specific 'codes' or cultural orientations that, similar to what Weber calls "Wirtschaftsethik," provide ways of looking at organizational problems.[246] The elites can internalize "patrimonial codes," and rule the society in a particular path mainly when there is a relative weakness of independent, middle class sectors.[247]

Land ownership in Brazil has always provided power and status. This is especially true in the Northeast region of the country where land ownership is still strongly connected to political power. Later in Brazil's development, ownership of industry became one of the main forms of achieving status. When the traditional elites shifted towards ownership of industry, they sought to maintain the traditional form of organization by keeping full control of their new companies.[248] Even today, modern entrepreneurs

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adopted by the elites. *See also* CASSON, *supra* note 187, at 20–21 (stating that the "moral rhetoric," necessary to build trust in economic relationships, has to be implemented by a leader and will largely depend on the leadership strategy for its success).

245 S. N. EISENSTADT, TRADITIONAL PATRIMONIALISM AND MODERN NEOPATRIMONIALISM 60 (1973) ("The most important common characteristics of traditional and modern patrimonial regimes are: the basic modes of coping with political problems; the relations between center and periphery; the major types of policies developed by their rulers; and the general format of political struggle and process.").

246 *Id.* at 64. Eisenstadt notes that:

> The common characteristics of traditional and modern political regimes are at least partially explained by some condition of their emergence, by the nature, composition and internal solidarity of *the major groups and elites,* and by the basic codes or orientations prevalent within these groups. *It is such groups and elites with such orientations that tend to develop those types of patterns of activity and organization which give rise to crystallization of patrimonial regimes,* and they also tend to develop policies which can assure that the interaction between such groups and between the center and periphery will facilitate the continuity of their regimes.

Id. at 60 (emphasis added).

247 *Id.* at 47.

248 According to Ellickson, "property that is psychologically vested is more worthy of protection than is property that is psychologically on the horizon." El-

fight all reductions of their control "rights." Many opportunities for growth were lost because the controlling family "feared" losing control of the business,[249] and decided to maintain their control.[250]

The dominant *bourgeoisie* class retains aristocratic values and the traditional mentality of the "large house" in its business organizations.[251] One aspect of this patrimonial system is the role of

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lickson, *supra* note 224, at 38. *See also* Richard H. McAdams, Comment, *Accounting for Norms*, 1997 WIS. L. REV. 625, 636 (1997) ("Explaining norms requires either greater attention to social forces like status or the psychological forces by which obligations are internalized.").

249 *See* CARDOSO, *supra* note 244, at 104. It seems that this fear is well connected to non-pecuniary returns of property, such as achieving status and esteem, not only to pecuniary claims.

250 *Id.* at 109, 112. Cardoso mentions resistance to practices that could diminish the power exercised by the family in the firm. The interviewed entrepreneurs claimed that it was hard to find loyal persons ("pessoas de confiança") to work with. *Id.* at 113. The search for "loyal persons" demonstrates that entrepreneurs want to have personal relations with directors and managers. An interesting example is given by Trompenaars:

> A Dutch delegation was shocked when the Brazilian owner of a large manufacturing company introduced his relatively junior accountant as the key coordinator of a $15 million joint venture. The Dutch were puzzled as to why a recently qualified accountant had been given such weighty responsibilities, including the receipt of their own money. The Brazilians pointed out that the young man was the best possible choice among 1,200 employees since he was the nephew of the owner. Who could be more trust-worthy than that? Instead of complaining, the Dutch should consider themselves lucky that he was available.

CHARLES HAMPDEN-TURNER & FONS TROMPENAARS, RIDING THE WAVES OF CULTURE: UNDERSTANDING DIVERSITY IN GLOBAL BUSINESS 158–59 (1993). It is not surprising that Brazil was located in the "company triangle" that had the largest distance between the top and the bottom of the pyramid in Trompenaars' assessment. *Id.* This means that Brazil's companies have the most hierarchical structure. According to Hampden-Turner and Trompenaars:

> [Some] culture[s] might see nepotism as corruption and conflict of interest, [however] a family culture could see it as reinforcing its current norms. A person connected to your family at home and at work has one more reason not to cheat you. Families tend to be strong where universalism is weak.

Id. at 158.

251 *See* CULTURA ORGANIZATIONAL E CULTURA BRASILEIRA [ORGANIZATION CULTURE AND BRAZILIAN CULTURE] [hereinafter CULTURA ORGANIZATIONAL] (Fernando C. Motta & Miguel P. Caldas eds., 1997) (offering perspectives from various authors on organizational culture through the lens of Brazilian popular culture and common sociological experiences); *see also* Jose Mindlin, *É Tempo de Dar Adeus ao Macunaíma* [It Is Time to Say Goodbye to Macunaíma], *in* O EMPRESÁRIO E A SOCIEDADE [THE ENTREPRENEUR AND THE SOCIETY] (Luiz Cesar Telles Faoro, ed., 1995) (arguing that entrepreneurs want a paternalistic State); Maria da Conceição Tavares, *A Velha Burguesia Ainda Dá as Cartas* [The Old Bourgeoisie Still Rules]

"personal relationships."[252] Organizations usually are characterized by a highly-hierarchized structure of power. In these structures, personal relationships tend to be more important than impersonal relationships. This importance of personal relationships traces its roots as far back as Brazil's colonization.[253] Organizations often felt the need to adopt new strategic plans, but were unable to implement them because this would require a change in values and expectations.[254]

The preferences of controlling shareholders influence their business decisions. Controlling shareholders tend to value non-pecuniary returns of control, deriving satisfaction and status from controlling the business. According to a survey recently conducted

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(arguing that the Brazilian culture is profoundly patrimonial) *in* O EMPRESÁRIO E A SOCIEDADE [THE ENTREPRENEUR AND THE SOCIETY] (Luiz Cesar Telles Faoro ed., 1995). Roberto Magliano, Bovespa Chairman, has recently affirmed: "We are revolutionaries, and we are going to spark a cultural revolution." Tony Smith, *Stoking a Stock Market 'Revolution,'* N.Y. TIMES, July 30, 2002. This clearly manifests the desire to change the mindsets of entrepreneurs regarding the new listing requirements of *Novo Mercado.*

252 *See* DE HOLANDA, *supra* note 230, 96–99 (arguing that some personal practices restrained business and that nepotism was common among individuals who performed public functions); *see also* EISENSTADT, *supra* note 245, at 11 (noting that the role of "personalism" is important when discussing the dynamics of patrimonial regimes).

253 Fernando C. Prestes Motta, *Cultura e organizações no Brasil* [Culture and organizations in Brazil], *in* CULTURA ORGANIZATIONAL, *supra* note 251, at 31–34.

254 HOFSTEDE, *supra* note 172, at 27, develops proxies for measuring differences among cultures, based on the following dimensions: power distance (from large to small), collectivism versus individualism, femininity versus masculinity, and uncertainty avoidance (from weak to strong), and long-term orientation versus short-term orientation. According to his results, Brazil scored sixty-nine points in the power distance dimension, while Malaysia, first in the group, scored the highest with 104, and Austria scored the lowest with eleven. The United States, thirty-eighth on the list, scored forty, and Germany, forty-second, scored thirty-five. Brazil was the fourteenth out of fifty-three countries. *Id.* at 26. This means that Brazilian society is characterized by high hierarchy. Hofstede also mentions some characteristics that may exist in the workplace in societies with a high power distance rating: organizations centralize power as much as possible, there is a wide disparity in salary between the top and bottom, manual work has a much lower status than office work, superiors are entitled to many privileges, and the ideal boss, from the subordinates point of view, is a benevolent autocrat or "good father." *Id.* at 35. People that can handle a high degree of inequality and dependence on bosses are unlikely to contradict their boss directly. *Id.* at 35. Also, a large degree of power distance might be connected to military dictatorships and scandals involving persons in power. There is an expectation that wrong-doings by these persons will be covered up, and they will not be adequately punished. *Id.* at 38. The lower people in the hierarchy tend to be punished much more easily.

by Korn Ferry International and Mckinsey & Company, Brazilian entrepreneurs face a dilemma between maintaining control and maximizing economic value. This survey reveals that "many controlling shareholders would still prefer to keep control of their companies, even at the cost of achieving higher ambitions and with the possibility of restricting the long term value maximization of the company."[255] Controlling shareholders avoid issuing public stock offerings because they will maximize value so long as their control is not threatened. They continue to perceive their firms as personal property to be personally managed. These preferences form the "culture" of controlling shareholders. The perceived costs of altering business organizations and control are high. These costs are direct functions of the preferences of the actor.

With this strong interest in maintaining their power, entrepreneurs are opposed to greater levels of disclosure. According to the Korn Ferry and McKinsey survey, 78% of directors:

> feel that [the current] market communication is satisfactory, as they believe that excessive communication would result in providing valuable information to their competitors in a market that is as yet informal. Even traded companies will not reveal information so long as their competitors, many of which are closed companies, are not obliged to do the same.[256]

The lack of satisfactory information, on the other hand, is identified as a barrier to greater levels of investments by minority shareholders.

As part of those subjective perceptions by entrepreneurs, the following statements collected for the Korn Ferry and McKinsey study are also illustrative:

> As long as I own this company I don't want any board bothering me. (Owner/Executive)

> Brazilian corporate governance continues to demonstrate a strong vocation for authoritarianism. (Board director)

[255] KORN FERRY INTERNATIONAL & MCKINSEY & COMPANY, AN OVERVIEW OF CORPORATE GOVERNANCE IN BRAZIL (2001), *available at* http://www.kornferry.com.br/upload/informacao/KF_McK_govern_Ing.pdf (on file with author).

[256] *Id.*

> Family member and internal board directors clearly do not want to lose or cede control of their companies. (Board director)
>
> Until capital markets change significantly it makes no sense to talk about corporate governance. (Owner/Executive)[257]

Controlling shareholders are usually identified as the largest barrier to change because they want things to stay as they are. The considerable overlap between ownership and executive leadership shows that there are few formal structures in the business decision process. Independent directors tend to be not so independent because they usually have personal relationships with the controlling shareholders. Shareholders and the press do not play active roles that could demand significant change.[258] For example, issues such as executive compensation and extraction of perquisites have not been seriously publicly discussed, as illustrated by the Diniz case discussed earlier.

Another illustrative example is the story of megabroker Naji Nahas. Nahas artificially inflated share prices in Rio de Janeiro's Stock Exchange (BOVERJ) in 1989. His scheme was supposed to be the cause of the crash of BOVERJ. Nahas has already been charged by American regulators and fined $250,000 for his speculative actions in the silver market. In Brazil, he was convicted but was granted an injunction against his incarceration so that he can enjoy his liberty while he awaits his appeal. Ultimately, in 1998 his convictions for white collar crime and crime against the public economy were annulled by the Superior Court of Justice. Curiously, the appeals court refused to permit evidence from employees of the CVM, Brazil's Securities Exchange Commission, because the CVM had brought a separate civil suit against Nahas.[259] The appeals court argued that the CVM officers had a conflict of interest because of the civil suit, which prevented the CVM from produc-

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257 *Id.*

258 Obviously, shareholders face the problem of collective action and shareholder's apathy.

259 The author does not have access to the judicial decision. This information comes from Américo Chaves & Associados Advogados, Newsletter No. 24 (Aug. 20, 2001), http://www.americochaves.adv.br/NewsLetter24.htm (last visited Oct. 28, 2006). *See also* Mariângela Gallucci, *Justiça Anula Condenação de Naji Nahas* [Justice Annuls Naji Nahas Condemnation], AGÊNCIA ESTADO, November 18, 1998, *available at* http://www.terravista.pt/meiapraia/1796/nahas1.html (reporting that the Courts decided that other experts were going to provide the evidence).

ing evidence of Nahas' crimes. This conflict of interest argument is weak because the law assigns power for the governmental agency to regulate the market. This example also shows how decisions can be manipulated to hinder the enforcement of laws.[260] Usually persons who are well connected are able to skirt the law and avoid sanctions.

3.3.2. *The main role of the government: the father of the fathers of family*

Brazilian history is marked by the central role of the State as a coordinator of economic activity. The patriarchal family provided the political model that has guided the relations between government and the governed.[261]

Historically, the market has been largely controlled by the State. The financial system was officially established during the nineteenth century to transform the economy after the end of slavery. The infrastructure of a complex system of industry could not be built by private initiative. It was the State, under the authoritarian and populist regime of Getúlio Vargas, which guided the creation of Brazil's heavy industry. The enactment of Brazil's first Corporations Law occurred in 1940 under this regime. There has been an evolution toward monopolistic capitalism since the Fifties, a policy explicitly promoted after the establishment of the military dictatorship in 1964.

I now turn to the development of capital markets, which began with the organization of the brokerage industry. It is important to understand how the active role played by the State in the development of the capital markets shaped low expectations between the players of the market: stockbrokers and stockholders. The capital markets' development did not come from the brokers themselves, but rather was done by the State because brokers were civil servants. They benefited from the exclusive right to trade, and es-

[260] See Keith S. Rosenn, *The Jeito: Brazil's Institutional Bypass of the Formal Legal System and its Development Implications*, 19 AM. J. COMP. L. 514 (1971), for a comprehensive analysis of legal enforcement problems in Brazil.

[261] This kind of paternalism is opposite to the French ideals and the principles that guided the Americans in the foundation of their republics. While in the United States the state emerged as a conscious creation of the individuals who did not want the state to interfere in their private lives, in Brazil the state precedes the individuals who turn to it to search for help and protection from it. *See* DE HOLANDA, *supra* note 230, at 53–54.

tablished an exchange (*bolsa*).[262] The French model of a publicly administered exchange influenced this first phase of the capital markets development.[263] The official brokers[264] were closely supervised by the government. Their activities were regulated by decrees that determined the number of brokers in each locality. The President of the Republic appointed them by a decree enacted by the *Ministro da Fazenda* (Minister of Finance). The *Ministro* granted a permit to transact, and levied annual taxes for the permit. All the brokerage fees and the formal proceedings were established by government rules.[265] Another important feature was that the permit had a lifelong validity, prompting the brokers to employ their sons and close relatives as their assistants. This situation encouraged strong nepotism, creating a tradition of lineage among the brokers.[266]

Monopolies and legal privileges were assigned to the brokers, who became a distinguished class always ready to protect their privileges. There was no competition as they had the exclusive right to operate.[267] As civil servants, they would basically earn the same salary no matter how well they performed their job.

Levy points out that the State regulation of this market was inefficient. The regulatory gaps permitted the creation of a parallel market that operated without any legal supervision. This black market consisted of unofficial brokers (*zangões*) and grew to be significant.[268] Because the prices were not disclosed on the official exchange, there was an information asymmetry problem that gener-

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[262] MARIA BÁRBARA LEVY, HISTÓRIA DA BOLSA DE VALORES DO RIO DE JANEIRO 67 (1977).

[263] *See id.* at 159, 190, 197, 341 (noting the influence of French legislation and commerce on early Brazilian stock exchanges). *See also* Coffee, Jr., *supra* note 159, at 45-51 (discussing civil law systems by examining the French experience).

[264] They were the people given the duty of running transactions involving commodities and debt.

[265] LEVY, *supra* note 262, at 71.

[266] *Id.* at 71, 238-39.

[267] *Id.* at 74-75, 366. Levy explains that the richest brokers formed a close alliance and connected themselves to the political control of the state. The main interest of the official brokers was the preservation of their privileges. This kept the official brokers from developing efficient practices. *Id.*

[268] These markets grew to be significant even though there were legal provisions that considered the transactions of bonds legally void if they were handled by unofficial brokers. LEVY, *supra* note 262, at 249.

ated distrust about the price information provided by the official exchange.[269]

The government did not regulate the quality of the transactions for a long time. This meant that investors did not have accurate information to rely on.[270] Additionally, there was a lack of stability and legal certainty due to the uncertain regulatory policy. At times the regulatory policy infringed on a broker's autonomy, while at other times it was very permissive. The laws regulating brokers changed constantly, assigning liability of transactions to the committee and, at other times, to the brokers. Brokers were sometimes considered the delegates of the transacting parties; at other times, they were considered traders.[271] Exchange rules were restructured by the State whenever the government felt the need. These constant legal changes made by the State brought about uncertainty and instability.

It has been a common practice throughout Brazilian history for economic groups to use government-subsidized debt to finance their enterprises.[272] In contrast, the model adopted by developed countries, such as the United States, uses private capital markets as the main source of finance to industry development. The dictatorial government wanted a change, based on the American practice, and decided to develop capital markets.

This dictatorial will and pressures for the creation of a federal authority like the Securities and Exchange Commission in the United States led to the establishment of the CVM, Brazil's Securities Commission, in 1976. The enactment of a new Corporations Law (Lei No. 6.404) occurred in 1976. With these reforms, official brokers were displaced and a private broker industry controlled by banks and financial groups emerged. Meanwhile, the economic policy of the dictatorship encouraged the formation of large Brazilian conglomerates with many types of incentives designed to foster the national industries. Scholars, such as Carvalhosa, argue that the main objective of the Corporations Law was to promote the interests of the large business groups.[273]

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[269] *Id.* at 235, 336.

[270] *Id.* at 76.

[271] *Id.* at 157-59.

[272] *Id.* at 570.

[273] *See generally* MODESTO CARVALHOSA, A NOVA LEI DAS SOCIEDADES ANÔNIMAS [The New Corporations Law] (2d ed. 1977) (demonstrating the detri-

The Corporations Law was conceived as an effort to provide the conditions for financing businesses. However, entrepreneurs did not want to lose control of their businesses, as discussed earlier. Lei No. 6.404 tried to reconcile both objectives by permitting the issue of preferred shares that could provide capital without changing the control of the firms. The 1997 reform, as discussed earlier, was basically the result of government pressures during the privatization process.[274]

The military dictatorship did not end until 1985. The 1980s are known as the "lost decade" because inflation reached huge peaks,[275] and Brazil declared a moratorium on debt to foreign creditors. In the beginning of the 1990s, President Collor cut import rates and opened the markets. He started the privatization process that was discussed in Section 2.1.[276]

The State engaged in many attempts to encourage the development of capital markets. It granted fiscal incentives to firms that became public and also to the purchasers of shares. The state bank, BNDES, acquired shares and helped firms place the shares in the market by providing credit with a subsidized interest rate to buyers. The government also created an obligatory demand for shares by establishing a minimum percentage of portfolio investment for pension funds and insurance companies. Additionally, the government permitted workers to use their mandatory social security deposits (*FGTS*) to invest in stocks.[277]

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mental intent and effect the new corporations law had on small and medium-sized private enterprises in Brazil).

[274] *See* discussion *supra* Sections 2.2, 2.3.1.1 & 2.3.2.

[275] *See* Keith S. Rosenn, *Adaptations of the Brazilian Income Tax to Inflation*, 21 STAN. L. REV. 58, 61-64 (1968) (analyzing the inflation problem in its early origins). The inflation process causes a serious income redistribution problem because some groups increase their share of national income at the expense of other groups. *Id.* at 60.

[276] Some months later he was accused of being involved in a fraudulent scheme and was impeached.

[277] This investment opportunity for workers occurred during the public offering of Companhia Vale do Rio Doce, when television advertisements encouraged workers to use their funds from *FGTS* to purchase stocks. Workers were explicitly encouraged to put 50% of funds of their entire life savings in the stocks of just one company. These potential investors would face a sector risk because his or her investment would not be diversified. The result of this advertising campaign was an over-subscription of stocks. The advertisements did not discuss the nature of the investment or its potential risks. *See, e.g.*, Sérgio Ripardo, *TV Será A Arma do Governo para Popularizar Venda das Ações da Vale* [TV Will Be the Weapon of the Government to Make the Offer of Vale Shares Popular], Folha On line, Feb. 7,

This analysis demonstrates that the State was the main actor during the capital market development process. The State shaped the exchanges, being largely interventionist in their activities. At the same time the State provided incentives to help develop the market, and endorsed the interests of the elites, who did not want to share firm control. Private initiative was largely absent in this process. In fact, private exchanges and private brokerage industries are a recent phenomenon established in the late seventies and early eighties. Shareholders have been encouraged to buy stocks due to tax incentives. They have low expectations and are badly informed and organized. There is no societal outrage due to bad corporate governance practices. People accept the fact that a huge concentration of wealth and economic power is in the hands of a small elite. Therefore, majority shareholders are not significantly constrained. There has been continuous distrust among the middle class regarding stock investment. This distrust was corroborated by the lack of adequate supervision and regulation of the securities markets in its early development phase.[278] Consequently, a "stock culture" has failed to emerge.

3.3.3. *The positivist view of the legal elites*

In this Section, I briefly describe a problem negatively affecting economic and capital markets development. This problem arises from the strong positivist view of the legal elites. There is a lack of an interdisciplinary approach in Brazilian legal education. Most legal studies are restricted to inquiries about the dogmatic study of law. Positivism, or the formal study of law, is the main approach

2002, *available at* http://www1.folha.uol.com.br/folha/dinheiro/ult91u41301.shtml; Sérgio Ripardo, *Venda de Ações da Vale Deve Começar Dia 18, Diz Caixa,* [Offer of Vale Stocks Will Start Day 18th, Says Caixa] Folha On Line, Feb. 7, 2002, *available at* http://www1.folha.uol.com.br/folha/dinheiro/ult91u41313.shtml; Fabiana Futema, *Termina Nexta Sexta Prazo Para Comprar Ações da Vale* [The Term for Buying Vale's Shares Finishes This Friday], Folha On Line, Mar. 15, 2002, *available at* http://www1.folha.uol.com.br/folha/dinheiro/ult91u43565.shtml.

278 Some speculation bubbles, such as the *Encilhamento,* corroborated the lack of confidence in the securities markets. The middle class tended to view the stock market as a game. After that bubble, in 1916, a provision was included in the Civil Code that prohibited the judicial enforcement of contracts offset by difference, a practice to be used in future contracts. The rationale behind this rule was that law cannot enforce debts contracted from gambling. *See* Brazilian Civil Code of 1916, art. 1479. The new Brazilian Civil Code of 2002, art. 816, now expressly permits the enforcement of contracts offset by difference in case of securities transacted in commodity or stock exchanges.

used in law schools. Scholars tend to see the law as a closed system, isolated from the inputs of other social sciences.[279]

Legal scholars largely neglect economic issues related to law. They don't study the economic impacts of the laws. They also neglect normative inquiries that could analyze how law could change in order to promote economic development. The study of law and economics is viewed negatively because many scholars believe that this approach is a form of imperialism of economics over law.

This subjective model greatly affects the view of legal practitioners. Consider two different methods of teaching corporate law. One approach is to discuss what the law is, what its possible interpretations are, how the law fits within the legal order and what are the relevant judicial cases. This is the approach largely adopted in Brazil. Another approach is to discuss what the law is, how it affects the behavior of economic agents, what its possible interpretations that tend to maximize total value are, what the incentives that the law could provide to make organizational structures more efficient are, what the relevant judicial cases are, and how the cases interfere in the corporate context. Do these judicial cases provide solutions that lead parties to adopt adequate incentives? Do these judicial decisions increase transaction costs? Does the law provide good incentives to discourage opportunistic behavior? This second approach is more advantageous because it links the study of the corporate law with the actual business environment. Nevertheless, Brazilian law schools ignore this second method of teaching law.

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[279] *See* Keith S. Rosenn, *The Reform of Legal Education in Brazil*, 21 J. LEGAL EDUC. 251 (1969) (giving a comprehensive study of Brazilian legal education and its failures). According to Rosenn:

> [t]he failure of the system to provide the law students with a solid cultural background exacerbates the tendency to view legal rules as totally abstract propositions. The student who has little or no acquaintance with economics, sociology, political science, or psychology can hardly be expected to consider the implications of insights derived from these disciplines upon the legal rules being studied.

Id. at 257. I believe that Rosenn's characterization of Brazil's legal education remains largely accurate today. *See also* Henry J. Steiner, *Legal Education and Socio-Economic Change: Brazilian Perspectives*, 19 AM. J. COMP. L. 39, 72 (1971) ("The law school does not move beyond rule description to inquiry about what the rules should be."). de Holanda criticizes the success of the positivist perspective of Comte among the elites. He argued that ideas adopted in advanced nations were transplanted to Brazil without a discussion of whether those laws would effectively apply to the peculiarities of the Brazilian social conditions. DE HOLANDA, *supra* note 230, 115–19.

3.4. *How do these Brazilian Hallmarks Restrain the Development of Capital Markets?*

This part of the paper goes back to the discussion of corporate governance problems in Brazil identified by Black.[280] These problems are discussed with an explanation of how they are directly or indirectly related to the cultural and ideological features described above.

(1) *There are no specialized prosecutors with the skill to bring complex securities cases.* In Brazil, legal practitioners have an exaggerated positivist view. In practice legal practitioners mostly ignore economic aspects of business and fail to understand complex business transactions. The study of law in Brazil neglects important features of the actual institutional environment and is restricted to the analysis of how the existing laws work in an ideal environment. Thus, prosecutors and regulators are not prepared to deal with complex securities cases.

(2) *The courts lack sophistication.* The same reasons given above apply to this problem. Judges are not prepared to understand complex business transactions. Judges are circumscribed by the formalities of the law. They tend not to perceive subtle forms of expropriation of minority shareholders' value. They ignore the possible economic impacts of their decisions. Furthermore, Brazilian judges neglect what is going on in the real institutional environment.[281]

(3) *There are no class action mechanisms.* There is no significant demand for effective means for minority shareholders protection.[282]

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[280] Black, *supra* note 78, at 6–7. See discussion *supra* Section 2.1, which discusses problems 2–17.

[281] *Cf.* Armando Castelar, Judiciário, Reforma e Economia: A Visão dos Magistrados [Judiciary, Reform and Economics: The Vision of Judges] 43, Dec. 2002, *available at* http://epge.fgv.br/portal/arquivo/1462.pdf (stating that the majority of the judges believe that they have to accomplish social justice, by protecting the weaker parties in contract relations). Castelar defends that this posture generates a backfire effect once it diminishes legal certainty, precludes markets to develop and impacts negatively the same groups that judges aim at protecting.

[282] *See* Friedman, *supra* note 80, at 771 ("The main motor force of legal change derives from concrete demands on the institutions that make up the legal system."); Douglass North, *Institutional Change: a Framework of Analysis* 5 (Economics Working Paper Archive at WUSTL, 1994), *available at* http://econwpa.wustl.edu/eps/eh/papers/9412/9412001.pdf. ("Deliberate institutional change will come about therefore as a result of the demands of entre-

(4) *Brazil does not yet have a strong culture of compliance with disclosure rules.* Brazilian controlling shareholders feel as if they own the firms even though a significant part of the firm's capital is publicly held (psychologically vested ownership). Thus, the controlling shareholders believe there is no reason to disclose their operations or "strategic plans." There is still no strong demand for disclosure and the government agency CVM has not taken strong actions to improve disclosure levels.

(5) *There are no strong rules for disclosure of self-dealing transactions.* The same reasons mentioned above apply to this problem. Because entrepreneurs believe they own their firms, they do not feel pressure to refrain from engaging in self-dealing transactions. In Brazil, self-dealing managers usually get away with their transactions. Disclosure is not pervasive and monitoring is incipient. Also, neither society nor the press strongly condemns the extraction of perquisites at the expense of the company.

(6) *There is a disincentive for private companies to prepare audited financial statements because it is more difficult for a company with audited statements to hide income from the tax collector. Additionally, lenders do not require audited financial statements as is the case in the United States.* Neither the regulatory body nor banks require strict disclosure. Society does not strongly demand institutional change and controllers will not change behavior they believe they have the right to engage in (wealth maximizing behavior applies).

(7) *There is no meaningful risk of liability for bad audits by accountants; there are no cases when accountants are found liable for violations.* Accountants are often used in order to flout the law because evasion of some amount of tax is common in Brazil.[283] Kahan's con-

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preneurs in the context of the perceived costs of altering the institutional framework at various margins.").

[283] Rosenn connects the problem of tax evasion with the inflationary process in Brazil:

> [U]nreasonabl[y] high levels of real tax rates exaggerated the predisposition of many Brazilian firms and individuals to understate their income for tax purposes. The tradition that one ought to pay taxes has never been firmly implanted in Brazilian soil, and the exorbitant real rates attributable to the inflation have served as both an incentive and rationalization for defrauding the tax authorities.

Rosenn, *supra* note 279, at 73. Although Brazil does not have today a serious inflationary problem like it did in the past, tax evasion persists as a core problem.

cept of social influence applies because there is little risk of liability.[284]

(8) *The São Paulo Exchange (BOVESPA) does not have strong listing rules and relies mostly on CVM to establish rules for listed companies.* Historically, the government was the leader in promoting economic activity in Brazil, as discussed earlier. There is a lack of private initiative. An exception to this point, however, is the *Novo Mercado* at BOVESPA exchange. *Novo Mercado* is a listing segment created within BOVESPA, based on the model of the German Neur Market. A company that wants to trade its shares at *Novo Mercado* has to adhere to a series of rules that are more stringent than the rules established by Brazilian legislation. Some of the *Novo Mercado*'s rules are: prohibition of nonvoting shares, tag along rights extended to all shareholders, balance sheets are required to be in accordance with US GAAP or IAS, detailed quarterly financial statements, arbitration panel for resolution of disputes. Although the creation of *Novo Mercado* is a positive initiative, only two companies were listed at *Novo Mercado* at the time of the passing of the new legislation.[285]

(9) *Publicly held companies make little use of independent directors, and nominally independent directors may not be so independent in practice.* Controllers act as if they own the enterprise, and they expect directors to follow their recommendations. This expectation now has legal force under the new legal reform. The legal reform makes directors agents of the shareholders who have elected them, binding their votes to the shareholders' agreement, as discussed in Section 2.3.3. Usually, even when directors seem to be independent, they tend to have personal relationships with the majority shareholder and/or CEO.

[284] Kahan argues that social influence contributes to individual decisions to commit infractions. Kahan *supra* note 12, at 350. A person's belief about whether or not others in her situation are expropriating plays a significant role in her decision to comply with legal standards. *Id.* at 352–65. If potential law-breakers observe that persons who committed crimes usual get away with it, this social perception will encourage them to engage in illicit practices. *Id.* If citizens learn that convictions are not reached due to "technicalities" in the law, this will bring about distrust in the legal environment. *Id.* According to Kahan, "[t]he fundamental principle of the social influence conception of deterrence is that a community is more likely to be law-abiding when its members perceive that it is." *Id.* at 395 (emphasis omitted). If the members perceive that the law is only on the books, distrust will augment and a vicious cycle can emerge. *Id.* at 352–65.

[285] The listed companies were CCR Companhia de Concessões Rodoviárias and Companhia de Saneamento Básico do Estado de São Paulo (SABESP).

(10) *Insiders of companies face limited risks of civil sanctions, either from lawsuits brought by investors or by the regulatory authority (CVM).* Insiders can skirt the law relatively easily, avoiding legal condemnations. There are no strong social norms to support effective sanctions because society does not strongly condemn self-dealing practices. Kahan's concept of social influence applies to this problem because there is little risk of liability.[286] Controllers have prestige and high status in society.[287]

(11) *Insiders also face little risk of criminal liability for self-dealing or disclosure violations.* The same reasons described above apply to this problem with the caveat that criminal liability is even rarer than civil liability. Even in the case of scandals involving bankers that are widely reported by the press, the accused are usually not condemned ("*tudo acaba em pizza*").

(12) *Bankers do not face liability for frauds in practice.* The same reasons described above apply to this problem. There are more cases of civil liability due to frauds committed against the banking system, but usually violators are able to transfer their properties to members of their family in order to circumvent sanctions. Potential costs of engaging in illegal practices are not high enough because enforcement is not strong.

(13) *There is no risk of civil liability for independent directors who approve gross self-dealing.* The same reasons described above apply to this problem. Directors considered independent tend to be not so independent in practice. Society does not strongly condemn self-dealing practices. There are no appropriate disclosure rules, making it easier for controllers to embezzle funds. Kahan's concept of social influence applies to this problem because there is little risk of liability.[288]

(14) *There is no significant number of cases seeking sanctions for market manipulation.* The same reasons described above apply to this problem. The most famous case against market manipulation was the case of mega-investor Naji Nahas described above. Usually the persons involved in such manipulations are well connected and are able to skirt the law and avoid sanctions.

(15) *There are no sufficient procedural controls on self-dealing transactions and there are no rules requiring accountants to review self-dealing*

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[286] *See* Kahan, *supra* note 12; *see also supra* text accompanying note 276.

[287] *See generally* Rosenn, *supra* note 260 (providing a comprehensive analysis of legal enforcement problems in Brazil).

[288] *See* Kahan, *supra* note 12. *See also supra* text accompanying note 277.

transactions. The same reasons described above apply here. Although the law prohibits self-dealing transactions,[289] enforcement in practice is not common. There has been no significant demand for changing procedural rules on self-dealing transactions.[290]

(16) *There is a problem with enforcing civil sanctions against insider traders.* The same reasons described above apply to this problem. To be sure, there has been an effort to require disclosure of insider ownership positions. However, there are still problems with enforcing civil sanctions because of the same reasons discussed above.

(17) *Brazil does not currently have a good accounting standards body.* Good accounting standards would make it harder for controllers to evade taxes. However, neither controllers nor accountants will initiate a change when society does not strongly demand it.

3.5. *Why Culture Is Path Dependent*

Social norms are important driving forces of human behavior. Informal rules at work can set aside behavior established by legal rules. Taking norms into account in legal analysis is important because (1) norms can control behavior to the exclusion of law, (2) norms and law can together influence behavior, and (3) norms and law can influence each other.[291]

The majority of the work developed in the field of social norms

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[289] *See* Article 115, § 4, Lei No. 6.404, de 15 dezembro de 1976, D.O.U. de 17.12.1976. (Brazil) ("Resolutions passed with the vote of a shareholder who has interests which conflict with the interests of the corporation can be made void; the shareholder shall be liable for any damage caused and shall be required to transfer to the corporation any benefits he may have obtained.").

[290] In fact, Law 10.303 included Article 115 section 5, which proposed to reform the law by permitting shareholders who represented 10% of the company's total capital to call a general meeting to examine possible conflicts of interest. However, this proposal was vetoed by the President, who argued that once the controlling shareholders would be able to vote in such a meeting, the rule would not protect minority shareholders. He also argued that if majority shareholders were precluded from voting in these meetings, then minority shareholders would be able to veto any deliberations by alleging that the majority shareholder had a conflict of interest. *See* Presidência da República, Casa Civil, Subchefia para Assuntos Jurídicos, Mensagem No. 1.213 de 31 de outubro de 2001, *available at* http://www.planalto.gov.br/CCIVIL/LEIS/Mensagem_Veto/2001/Mv1213-01.htm.

[291] *See* McAdams, *supra* note 12 (analyzing the relationship between law and norms).

concerns social norms that impose sanctions. Little analysis has been done on the role of belief systems, or ideology, in the origin and persistence of social norms.[292] This paper provides analysis on this topic to fill this gap. The analysis focuses on the formation of the Brazilian elite's ideological orientations and provides insight on the question of how ideology impacts economic outcomes.

Social norms regarding moral obligations tend naturally to be loose in economic environments. The concept of fairness is context-dependent because the morality of an economic actor in isolation may be quite different from his morality in the market: "What may be considered unfair when two people meet face to face or in a bilateral manner may be considered fair in a market context where economical survival is at stake."[293] Consequently, a strong ideology or belief system should be in place to build trust and good governance practices in economic markets.

Inefficient norms may persist, even though they benefit a small group of actors to the detriment of a larger group. According to Cooter, "[t]he efficiency or inefficiency of social norms often depends upon the incentive structure that produced it."[294] When groups interact with each other, social norms may arise so that one group can benefit at the expense of the other. As Cooter says:

> Within a group, social norms may arise that benefit its members at the expense of nonmembers. These social norms generate a consensus within the group of beneficiaries, but not within the group of victims. Groups often create norms that benefit their members by reducing competition with people outside the group.[295]

Norms or belief systems tend to be created in small groups and only afterwards might they spread to large populations by other

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292 This point has already been made by Eisenberg, *supra* note 175, p. 1262.

293 Andrew Schotter, Avi Weiss & Inigo Zapater, *Fairness and Survival in Ultimatum and Dictatorship Games*, 31 J. ECON. BEHAV. & ORG. 37, 38 (1996).

294 Robert Cooter, *The Theory of Market Modernization of Law*, 16 INT'L REV. L. & ECON. 141, 148–49 (1996).

295 Robert Cooter, *Normative Failure Theory of Law*, 82 CORNELL L. REV. 947, 977 (1997). Eisenberg also explains that "[b]ad or inefficient social norms may result from a variety of causes, including self-interest, inertia, and bad or inefficient belief systems. Bad or inefficient belief systems, in turn, may result from bad information or from persuasion that is founded on false premises or developed by fallacious or incomplete reasoning." Eisenberg, *supra* note 175, at 1271.

mechanisms such as an evolutionary process.[296] Small groups (elites) can develop social norms and impose them on large groups who face collective action problems.[297] Established belief systems are difficult to change because they are public goods. It is costly for individuals to engage in collective action, and large groups may lack the incentives to do so.[298] For these reasons, it is difficult for large groups to replace belief systems originated in small groups. Thus, the ideology of elites can persist once it is disseminated more broadly.[299]

Subjective perceptions and culture can be self-reinforcing. According to Black:

> The cultural preconditions for strong or weak securities markets can also be self-reinforcing. In a strong market, good disclosure and limited self-dealing become self-reinforcing norms because they are how must businesspeople behave, regulators can aggressively pursue the few departures from the norm, and there is political support for the funding to maintain the enforcement that reinforces the cultural norm. In a weak market, weak disclosure and extensive self-dealing become self-reinforcing norms. Many businesspeople behave this way, many of them get away with self-dealing because regulators (even if honest and decently funded) can address only the most egregious cases,

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[296] *See generally*, Cristina Bicchieri, *Learning to Cooperate*, *in* THE DYNAMICS OF NORMS 17 (Cristina Bicchieri et al. eds., 1997).

[297] For an explanation of the idea that closure of relations can facilitate the adoption of norms see JAMES S. COLEMAN, FOUNDATIONS OF SOCIAL THEORY 277 (1990). According to Coleman, "closure of social networks can overcome free-rider activity through the creation of norms and sanctioning systems." *Id.* at 277.

[298] *See generally* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1971) (providing a classical analysis of collective action problems faced by large groups).

[299] *See* Douglass North, *The Historical Evolution of Polities* 4–5 (Economics Working Paper Archive at WUSTL, 1994), *available at* http://econwpa.wustl.edu:8089/eps/eh/papers/9411/9411007.pdf. According to North,

> [i]t is belief systems that are the underlying determinant of path dependence, one of the most striking regularities of history. It is not simply the fact that the organizations that arise as a result of a given institutional structure have a vested interest in perpetuating that institutional structure, an argument I have advanced in the past. The argument goes deeper than that. The way the institutions evolve reflects the ongoing belief systems of the player.

Id.

and the self-dealers oppose stronger rules or better funded regulators.[300]

Everything considered, culture and belief systems tend to be path dependent, that is, changes will basically be achieved by an incremental learning process.

4. CONCLUDING REMARKS

Although the new Brazilian corporate law reform is being described as a considerable advancement, I have argued that this is not exactly the case. The legal reforms basically maintain the status quo and are not likely to improve the performance of the Brazilian capital markets. The legal reforms lack ambition and do not address the key issues that could promote efficient institutional change. They are far short of the reforms that would have been possible in a different cultural environment.

In addition, this paper suggests that subjective perceptions, reflected in culture and informal constraints, play a major role in shaping patterns of firm governance, rather than just a residual influence as typically assumed. Cultural conditioning can affect the press and public perceptions so that the demand for institutional change will be constrained.

Culture and ideology can explain the failure in many countries to create efficient laws and in achieving adequate levels of enforcement. Culture can enhance the ability of interest groups to seek rents in the legislative process. Policymakers must understand that subjective perceptions vary and may be at the heart of policy implementation success or failure.[301]

This research raises many issues that call for further empirical and theoretical study. Both avenues are open for future research. How can ideology change over time? What are the necessary conditions to provoke ideological change? How do preferences change? What legal changes would provide incentives for the development of the capital markets in Brazil?

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[300] Black, *supra* note 77, at 840.

[301] *See* North, *supra* note 7, at 21 ("Successful restructuring of an economy entails a restructuring both of property rights to provide the "correct" incentives and of the mental models of the players to induce choices that are complementary to such incentives.").

5. REFERENCES

CHART 1: PRIVATIZATION PROCEEDS (1991-2001)

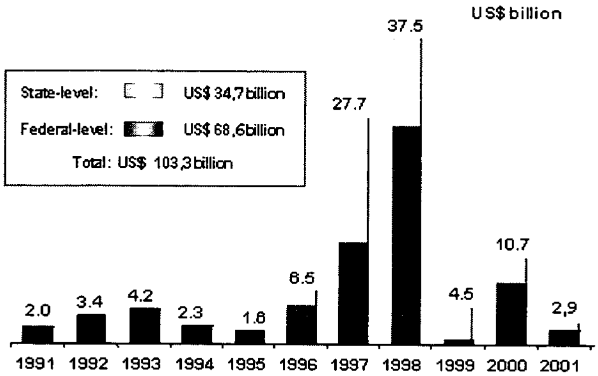
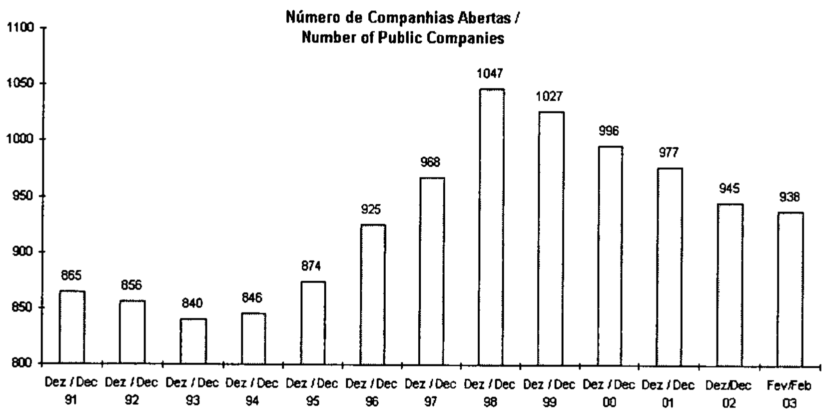


CHART 2: EVOLUTION OF BRAZILIAN REGISTERED PUBLIC COMPANIES (1991-2003)



Source: CVM

TABLE 3: BRAZILIAN CAPITAL MARKETS ISSUES OF SHARES, CONVERTIBLE CORPORATE BONDS, AND NONCONVERTIBLE BONDS, (1995–2002)

Primary Market										
Item	1998		1999		2000		2001		2002	
	QT	R$ Millions	QT	R$ Millions	QT	R$ Millions	QT	R$ Millions	QT	R$ Millions
Shares	20	4,112.10	10	2,749.45	6	1,410.17	6	1,353.30	4	1,050.44
Convertible Corporate Bonds	20	3,360.74	9	1,592.00	4	1,435.00	4	586.84	2	64.60
Noncon-vertible Corporate Bonds	41	6,296.56	29	5,084.38	38	7,313.00	37	14,575.29	23	4,571.00

TABLE 4: BRAZILIAN TOTAL TURNOVER ON SECONDARY MARKET IN ALL STOCK EXCHANGES ($ MILLIONS)

Year	Total	Daily Average
1992	23,754.3	96.2
1993	39,590.8	161.6
1994	98,409.2	406.6
1995	79,515.9	327.2
1996	115,587.3	466.1
1997	216,100.6	867.9
1998	172,499.4	701.2
1999	91,278.6	369.5
2000	104,655.4	422.0
2001	65,252.9	265.3
2002	49,297.3	198.8
2003 (Jan-Mar)	9,438.7	154.7