

## SOME INFERENCES CONCERNING BRAZILIAN CORPORATE GOVERNANCE

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*“Power tends to corrupt, and absolute power corrupts absolutely.” - Lord Acton - 1887*

*“In the anxiety to discover the miracle of development, economists are always adding new explanatory variables. In the end, perhaps they will learn they cannot forecast such exact outcomes as the laws of physics permit in relation to rockets. We always come back to the old fundamentals known since Adam Smith: small and honest government, moderate taxation, respect for property rights and improvement of economic agents by competition and education. It’s not enough just to invest, it’s necessary to invest wisely.” - Roberto Campos – 2000*

### **1. Introduction**

In general terms, it is acknowledged that the profitability of an investment is inversely proportional to the risk assumed by the investor. In practice, there is no way to feel comfortable investing in a determined financial product without knowledge or a reasonable estimate of a likely return, in an ethical<sup>2</sup>, efficient and responsible manner.

From this standpoint, much of the disrepute in which Brazilian investors hold the country’s capital market is due to repeated poor corporate governance practices and the absence of a tradition of shareholder activism<sup>3</sup>.

In counterpart to the lack of belief of the holders of public savings in participating in the Brazilian capital market, we can state that the tools for good corporate governance have ceased to be a mere promise and are now in place, providing mechanisms for: (i) efficient company administration; (ii) independent and harmonic management of resources; (iii) transparency in the decision-making process among the stockholders, board of directors and executive board; (iv) ethical conduct of officers and stockholders; and (v) company perennality.

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<sup>2</sup> J.P. Morgan was asked in a famous exchange whether commercial credit was based on money or property, and answered that character was the primary consideration “Character comes before money or property or anything else. Money cannot buy it.”

<sup>3</sup> On the theme of shareholder activism, the story is told in *A Traitor to His Class - Robert A.G. Monks and His Battle to Change Corporate America* that once the “chief executive officer of Stone & Webster, the old-line engineering firm, had just finished the annual exercise of touting the year’s accomplishments to a packed shareholders’ meeting in a Wilmington, Delaware, hotel ballroom. When he finally opened the floor to comments, a man in the back raised his hand and was called on. Dressed in a dark suit and conservative tie, hair neatly combed back, he appeared to be just another in the legions of investment managers doing his fiduciary duty by attending yet another annual meeting. The man stood up and took a microphone that had been handed him. And when those in the ballroom recognized him, they fell into a respectful silence. ‘Listening to the president,’ he began in a steady voice. ‘I kept wondering, when is he going to commit this company to create value for shareholders? A day late and a dollar short? No. A year late and \$60 million short. Please, Mr. CEO, make yourself accountable. When are you going to achieve these things?’ He approached the front of the room to direct questions to the three nominees to the board who were seated in the first few rows. The man in the dark suit got a bit too close for comfort that sunny day in May 1995. Although he did not share the podium, he, or more exactly his investment fund, the Lens fund, managed to win 36 percent of all votes cast for a proxy resolution to hire an investment bank to study the idea of selling part or all of the underperforming company—an impressive result for a shareholder-sponsored resolution.”

In recent years questions have been raised about the real influence of legal structures in the national and international economic scenario. Therefore, one should bear in mind that business enterprises, and corporations in particular, must rise above the pervading contractualist spirit<sup>4</sup> and must be conceived in a more efficient and flexible manner, as an effective instrument to harmonize apparently external and conflicting interests to the company, with redefinition of the corporate interest from that starting point<sup>5</sup>.

Corporate governance, from this perspective, serves as a source of organizing the various interests involved inside and outside the corporate environment and is revealed as an important mechanism to facilitate access to capital, so necessary for firms to survive in the current globalized world.

A large part of the Brazilian literature on the subject shows a trend to absorb and transpose American and British<sup>6</sup> corporate governance models to the Brazilian situation, which can be misguided. Corporate governance in Brazil must be studied and practiced with maximum respect for the country's unique economic reality<sup>7</sup>, where direct corporate control is highly concentrated, generally resting in a single major shareholder, or controlling group acting through a shareholders' agreement. This reveals an undeniable characteristic of the Brazilian corporate structure: the tendency to concentration of power<sup>8</sup> (low shareholding diffusion).

So, the purpose here is to demonstrate that corporate law in Brazil needs to be more aimed at broadening and developing the country's capital market, as a condition for sustainable growth of the national economy. In this aspect, it is a foregone conclusion that ensuring good corporate governance as an essential element of this new legal framework, leading to a corporation no longer satisfied with merely serving its shareholders – the old maxim of shareholder value – but instead undertaking to satisfy various social interests.

## 2. Corporate Governance – General Notions

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<sup>4</sup> The “pervading contractualist spirit” mentioned regards the current of legal thinking by which a company is primarily an instrument to pursue the interests of its owners (present and future). An interesting example of satisfying the owners' interests is given by Paulo César Gonçalves Simões in his book *Governança Corporativa e o Exercício do Voto nas S/A*. In 1919, in the United States, the famous case of *Dodge v. Ford Motor Company* involved the controversial insistence of magnate Henry Ford on maintaining a hundred million dollars in reserves in a company with capitalization of two million dollars, under the argument that the company had a commitment to create and maintain jobs rather than pay dividends to stockholders. The case was decided in the sense that a company's overarching objective is to produce profits for its stockholders, and administrators must exercise their duties seeking means to meet this goal.

<sup>5</sup> Filho, Calixto Salomão. *O novo direito societário*. 2nd Ed. São Paulo: Malheiros, 2002. p. 23.

<sup>6</sup> The Anglo-Saxon corporate governance model is very focused on shareholders' interests (shareholder system) and control of company activities via equity, i.e., through buying and selling shares in the market. In countries using this model, it is very common to find extremely diffuse shareholding patterns. It is uncommon to find a single shareholder owning more than ten percent of one of the top 500 American companies, and shareholder disputes often involve intense proxy fights.

<sup>7</sup> An important study carried out by Korn/Ferry International and McKinsey & Company of 74 Brazilian companies, both government and privately owned, with minimum annual turnover of US\$ 250 million and having boards of directors, gave a picture of the corporate governance panorama in Brazil. The study clearly showed the concentrated ownership pattern in this country, with a single shareholder owning on average more than half (61%) of the common shares, a percentage that reaches 85% if considering the three largest shareholders.

<sup>8</sup> In this form, the board of directors plays a secondary role in the decision-making process of Brazilian corporations, because of the concentration of corporate power in large shareholders or controlling blocks. In this context, most shareholder disputes, rather than being fought out within the board of directors or at the general meeting, occur between majority and minority owners.

The corporate governance movement gained real strength in countries like England, and especially the United States, in response to the wave of corporate accounting scandals, of which Enron<sup>9</sup> and MCI WorldCom<sup>10</sup> immediately leap to mind. Although these cases involved criminal conduct and collusion within management, they called attention to the fact of widespread and longstanding poor corporate governance inside many of the largest American companies, marked by a tendency to unprofessional administration and confusion of interests and duties among owners, administrators and the company itself.

In the case of MCI WorldCom, for example, in the report entitled *Restoring Trust*, prepared for the United States District Court for the Southern District of New York, Richard C. Breeden, Corporate Monitor, points out that “*The events at WorldCom, Inc. transformed one of the largest companies in America, possessing one of the two largest and most comprehensive communications networks in the world, into the scene of one of history’s largest frauds. In WorldCom’s saga approximately \$200 billion in shareholder value was first created, and then destroyed. The accounting fraud and governance abuses at the old WorldCom were by any measure reprehensible, and can never be justified. After exhaustive multiple investigations, the fraudulent accounting activities seem to have involved fewer than 100 persons out of the entire employee base.*”<sup>11</sup>

Occurrences like the MCI WorldCom case serve to alert the global market that something is wrong and that new attitudes need to be taken, new paths need to be followed. In the United States, there have been numerous concepts of corporate governance. But the spirit of the concept this brief article examines is well demonstrated by Robert Monks, one of the precursors of the corporate governance movement in the United States, who affirms he only really identified what corporate governance meant when Peter Drucker, his professor, asked him: “Don’t you see that governance is best understood as a subset of investment?”<sup>12</sup>

So, we must start from the premise that, besides a change in business culture, governance is without doubt an important investment tool, which enables efficient resource allocation and satisfaction of both owners and stakeholders<sup>13</sup>. In Brazil, we certainly cannot define corporate governance as merely a legal institute, since it is deeply related to other areas, although the notion initially intended to increment the relations established between holders of public savings and holders of power within companies, to where this demand is channeled<sup>14</sup>.

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<sup>9</sup> Enron had announced profits of US\$ 1 billion and occupied seventh place in the ranking of the top 500 American companies prepared by *Fortune* magazine. However, in the middle of a due diligence process it was found that manipulation had occurred in the accounting practices, which touched off a massive investigation by the Securities and Exchange Commission (SEC) and the American Congress. The company was forced to admit that in reality its profits between 1997 and 2001 had been US\$ 600 million less than disclosed, which destroyed the company’s credibility in the global market and led to its implosion.

<sup>10</sup> In 2002, MCIWorldCom announced that some of its employees had been involved in accounting fraud, to the tune of US\$ 3.8 billion.

<sup>11</sup> *Restoring Trust*. Available at <<http://www.news.findlaw.com>>. Accessed on September 12, 2004.

<sup>12</sup> Monks, Robert A.G. *The New Global Investors* 1st Ed. Oxford: Capstone, 2001. p. 11.

<sup>13</sup> A stakeholder is defined as all parties that have interests related to the company, among them employees, customers, suppliers and creditors.

<sup>14</sup> Simões, Paulo César Gonçalves. *Governança Corporativa e o Exercício do Voto nas S/A*. 1st Ed. Rio de Janeiro: Lúmen Juris, 2003. p. 1.

The stance of the Brazilian Securities Commission (*Comissão de Valores Mobiliários*, or CVM) is in the same vein, as can be seen by its “letter of corporate governance recommendations”, which states that governance is the set of practices aiming to optimize the company’s performance by protecting all the interested parties, facilitating access to capital.

The Brazilian Corporate Governance Institute (*Instituto Brasileiro de Governança Corporativa*) takes much the same stand, in its Best Corporate Governance Practices Code<sup>15</sup>, which is centered on the idea that corporate governance is the system by which companies are directed and monitored, involving the relations among the stockholders, board of directors, executive board, oversight board and independent auditors. Good corporate governance seeks to increase the company’s value, facilitate its access to capital and contribute to its perennality<sup>16</sup>.

The above discussion demonstrates that corporate governance, within the “execution-supervision” dualism, involves the creation of internal and external mechanisms to ensure that corporate decisions will be taken in the best interests of the company and to maximize the probability that suppliers of funding will obtain the best return on their investments. Good corporate governance generates confidence, which in turn generates credibility to attract funding from public savings.

It is certain that in accordance with the current Brazilian corporate scenario, one must keep in mind that corporate governance can no longer be seen as just another business fad, or as if its implementation were a response to a novel problem.

Despite the shortsighted tendency to believe that these subjects related to corporate governance are something new, we should be aware that Fábio Konder Comparato already posited in 1977 in his book *O Poder de Controle na Sociedade Anônima* that one of the main problems of the modern economy was the control over property rather than precisely the ownership of the portions of the stock capital<sup>17</sup>.

He pointed out that “dynamic ownership, or the control of production goods, does not seek fruition, but instead the production of other goods and services, and for this it necessarily implies a relation of power over other men, to the extent that production moves from the handcraft to the industrial phase. Dynamic ownership of production goods is what the company does. Faced with ownership of this type, the basic problem is not protecting ownership against outside perturbations, but rather oversight and discipline in its exercise, to avoid abuse or deviation of power. The ‘control of control’, as said at the beginning, is the permanent challenge that faces us on this matter. The 1965 bill for the new Civil Code correctly stressed this distinction, in announcing in its Article 377, that ‘ownership, principally when

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<sup>15</sup> Examples of best corporate governance practices in the world are: Code of Conduct (Italy), Corporate Governance in the Netherlands, European Corporate Governance Institute – ECGI, Hermes Statements on Corporate Governance and Voting Policy, Korean Code of Best Practice for Corporate Governance, Manual de Governança dos Investimentos – Petros (Petrobras pension fund, Brazil), Principios de Buen Gobierno del Peru, Cadbury Report – Code of Best Practice, Report on the Belgian Commission on Corporate Governance and Swedish Corporate Governance Policy.

<sup>16</sup> Best Corporate Governance Practices Code. Available at <<http://www.ibgc.org.br>>. Accessed on October 10, 2004.

<sup>17</sup> Comparato, Fábio Konder. *O Poder de Controle na Sociedade Anônima*. 2nd Ed. São Paulo: Revista dos Tribunais, 1977. p. 96.

exercised in the form of a company, must conform to the needs of the common good and be subject to the legal provisions that limit its content, impose obligations and suppress abuses.’ ”<sup>18</sup>

In this sense, Ricardo Ferreira de Macedo<sup>19</sup> stresses that corporate governance arises essentially because of what are called agency problems, which involve the conflict of interests between who effectively owns a determined asset (the shareholder) and who controls it directly. This agency problem was originally popularized in American business thinking in 1932 by Adolf A. Berle Jr. and Gardiner C. Means, in their classic *The Modern Corporation and Private Property*, which touched off important legal treatments of the separation between ownership and control.

Macedo goes on to cite Jensen and Meckling, who say in their important work entitled *Theory of the firm: managerial behavior, agency costs and ownership structure*, that it involves “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.”<sup>20</sup>

Alexandre Di Miceli da Silveira also mentions that according to Jensen and Meckling, “if both parties act to maximize their personal utilities, there is good reason to believe that the agent will not always act in the best interests of the principal. In the case of the relationship between shareholders and management, the former can limit these divergences by monitoring the executives’ activities and establishing appropriate contractual incentives for them.”<sup>21</sup>

Aline de Menezes Santos, in her excellent article “Reflexões sobre a governança corporativa no Brasil”, says that studies of agency conflicts arise because “the interests of those who administer an asset is not always aligned with those of its owner. There are problems of asymmetrical information between the agent and principal and concerns over monitoring the agent’s behavior to ensure his actions will be carried out in the best interest of the principal rather than in benefit of his own interest.”<sup>22</sup>

### 3. Conclusion

From the above, we can infer that corporate governance has come to be seen as an efficient tool in organizing the various interests involved in the corporate landscape, since in contemplating the interests of the diverse stakeholders, the contemporary corporation has established itself as an effective instrument to gather resources and a viable alternative for investments. By instituting transparent and independent management, it aggregates value and stimulates investor confidence.

<sup>18</sup> Comparato, Fábio Konder. op. cit. p.97.

<sup>19</sup> Macedo, Ricardo Ferreira de. *Controle não societário*. 1st Ed. Rio de Janeiro: Renovar, 2003. p. 2.

<sup>20</sup> Macedo, Ricardo Ferreira de. op. cit. p.3.

<sup>21</sup> Silveira, Alexandre Di Miceli. *Governança Corporativa e o Valor da Empresa no Brasil*. 150 pp. Masters Monograph – Faculdade de Economia e Administração, Universidade de São Paulo. São Paulo, 2002.

<sup>22</sup> Santos, Aline de Menezes. Reflexões sobre a governança corporativa no Brasil. *Revista de Direito Mercantil*, v. 130, p.186, June 2003.

Moreover, in times of imbuing corporate law with eminently public premises, corporate governance starts to perform a central role in developing the capital market and becomes engaged in development of the stock market and the nation's overall economy. Currently, the rules of corporate governance are intimately linked to mechanisms of voluntary adhesion, by executing agreements with the São Paulo Stock Exchange (*BOVESPA*) to allow listing in the so-called New Market (*Novo Mercado*), reserved for companies that meet the highest standards.

This effort to improve corporate governance in Brazil cannot only be left to private initiative. Lawmakers must get involved as well, to increase the protection of non-controlling shareholders in corporate legislation, adopting, as fitting for the local situation, advanced practices of disclosure and accountability and developing a basic set of rules that heed the economic effects of legal structures, transforming the Brazilian corporation into a true mechanism for raising funds in the open market.

#### 4. References

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