HOW ARE MINORITY SHAREHOLDERS OF LISTED COMPANIES PROTECTED IN BRAZIL?

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Shareholders are stupid and impertinent: stupid, because they buy shares, and impertinent, because they demand a return.[1] This is how Carl Fuerstenberg, a high profile German banker of the between-wars period once referred to minority shareholders. Since then, a lot has changed. Today, nobody seriously argues that speculation makes minority shareholders mere opportunists or questions the notion that minority shareholders deserve to have their rights protected.[2] In recent years, a number of studies have showed that better minority shareholder protection is associated with higher valuation of corporate assets and with more developed and valuable capital markets.[3]

This paper examines the legal mechanisms that protect the interests of minority shareholders of listed companies in Brazil. The paper is divided into five sections. Section 1 poses a theoretical problem, namely the longstanding concern with private benefits of control in the Brazilian stock market. Section 2 examines how this problem is intertwined with the political economy of the relationship between controlling and minority shareholders in Brazil and its interplay with the Brazilian legal framework since the mid 1970s. Section 3 describes the legal framework of the protection of minority shareholders under the Brazilian Corporations Law and the BOVESPA regulations (BOVESPA is the São Paulo Stock Exchange). Section 4 discusses the degree of enforcement of the laws and regulations that protect minority shareholders, and Section 5 concludes.

1. Agency relationships and private benefits of control in the Brazilian stock market

The field now known as corporate governance dates back to 1932 when Adolf Berle and Gardiner Means published *The Modern Corporation and Private Property.* [4] Interpretations of this book have gone through numerous waves, but virtually all commentators have acknowledged that Berle and Means' basic insight had to do with the consequences of the separation between ownership and control in modern corporations.

The separation of ownership and control gives rise to an intricate set of interdependent relationships: the returns of the company's shareholders and creditors depend upon the

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[1] "Aktionaere sind dumm und frech. Dumm, weil sie Aktien kaufen, und frech, weil sie dann auch noch Dividende haben wollen", Carl Fuerstenberg (1850-1933). *Apud* Theodor Baums e Kenneth Scott, Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany. 53 Am. J. Comp. L. 31 (2005).

[2] In older texts, it is common to find minority shareholders portrayed on a negative light. See for example Walter Rathenau, *Vom Aktienwesen*, translated into Portuguese in 2002 (in Revista de direito mercantil, v. 128, 2002, São Paulo, Brasil, p. 202).

[3] Rafael La Porta, Florencio Lopez-de Silanes and Andrei Shleifer, Corporate Ownership around the World. Journal of Finance, vol. 54, p. 471 (1999); Rafael La Porta, Florencio Lopez-de Silanes, Andrei Shleifer, and Robert Vishny, Investor Protection: Origins, Consequences and Reform. NBER Working Paper, n. W4728 (1999); Edward Glaeser, Simon Johnson, and Andrei Shleifer, Coase versus the Coasians.The Quarterly Journal of Economics, Vol. 116, No. 3., pp. 853-899 (2001); Andrei Shleifer and Daniel Wolfenzon, Investor Protection and Equity Markets. Harvard Institute of Economic Research Paper No. 1906 (2000); Robert D. Cooter, Innovation, Information and the Poverty of Nations. Florida State University Law Review (2005).

[4] Adolf. A. Berle and Gardiner C. Means, The modern corporation & private property. New Brunswick, London: Transaction Publishers, 1999.

performance of the company's managers; in turn, the performance of the company's managers depends upon the performance of the company's employees; finally, the returns of minority shareholders depend upon the decisions of the company's controlling shareholders. Ultimately, the study of corporate governance is the study of this set of relationships.[5]

Economic theory illuminates a great deal about the problems raised in corporate governance debates. It suggests that the aforementioned relationships give rise to agency costs. Agency costs are a type of internal cost that arises from, or must be paid to, an "agent" acting on behalf of a "principal".[6] Agency costs arise where a principal compensates an agent for performing certain acts that are useful to the principal and are costly to the agent, and where there are elements of the performance that are costly to observe (so contracting fails because investing in monitoring is not cost-effective).

The relationship between employer (as principal) and employee (as agent) is the classic example used to illustrate agency costs.[7] If all of the employee's actions could be cheaply monitored, there could be an employment contract where the employee would be compensated for all of his effort units.[8] But in reality monitoring is expensive and employees typically receive a fixed wage that varies very little depending on their effort level. A fixed wage can create an incentive for the employee to shirk because his compensation will be the same regardless of the quality of his work or his effort level.[9]

If employers and employees had perfectly aligned interests, expensive monitoring would not be a problem because both parties would invest to create value for the company. But in reality their interests are not the same. While the employer typically receives profits and is the residual claimant[10] to the company's assets, the employee typically receives a fixed wage. This changes their incentives to work: put simply, while the former strives to create value for the company, the latter strives to keep his job.

Berle and Means were particularly concerned with the agency costs that arise in the relationships between shareholders and managers in modern corporations. They started out by

[5] The Brazilian Securities Commission (CVM) has defined corporate governance in the following terms: "Corporate governance is a set of practices aiming to optimize a company's performance and protect stakeholders such as investors, employees, and creditors, thus facilitating access to capital. The analysis of corporate governance practices applied to the securities markets involves: transparency of ownership and control, equal treatment of shareholders, and disclosure." CVM Recommendations on Corporate Governance, June 2002, available at www.cvm.gov.br/ingl/public/publ/governanca/recomen.doc.

[6] Agency theory deals with the organization of relationships in which one party (the principal) determines the work which another party (the agent) undertakes. The theory argues that under conditions of incomplete information and uncertainty, which characterize almost any business setting, two agency problems arise: adverse selection and moral hazard. Adverse selection is the condition under which the principal cannot ascertain if the agent accurately represents his ability to do the work for which he is being paid. Moral hazard is the condition under which the principal cannot be sure if the agent has put forth maximal effort. See Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976); Kathleen M. Eisenhardt, Control: organizational and economic approaches. Management Science, 31(2): 134-149 (1985); and Kathleen M. Eisenhardt, Agency theory: an assessment and review. Academy of Management Review, 14(1): 57-74 (1989).

[7] Other classic examples of agency relationships include student-teacher, client-lawyer, patient-doctor, stockholder-CEO etc. The problem of motivating one party to act on behalf of another (the "principal-agent problem") is the core problem of the theory.

[8] So the employee would continue investing the marginal effort unit until it became too costly for him to keep increasing effort, and that is also the efficient point.

[9] When agents have incentives to shirk it may be more efficient to replace fixed wages with compensation based on residual claimancy on the profits of the firm Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, American Economic Review, American Economic Association, vol. 62(5), pages 777-95 (1972).

[10] The residual claimant (or equity claimant) is the person who receives the remainder of a random amount once predictable payments are made. For example, consider a company with creditors and shareholders. The creditors receive the predictable amount they are owed. The shareholders can claim the residual, that is, the amount left over (which may even be a negative amount, but it may also be large).

arguing that capital had become greatly concentrated during the period of industrialization of the United States, but as these companies grew it became increasingly difficult for the original owners to sustain their majority shareholdings, so stocks became progressively dispersed amongst a large number of small shareholders.[11] This was problematic because the interests of managers and shareholders do not necessarily coincide: managers usually want to satisfy their own objectives (particularly job-guarantee and high salaries) while shareholders want to maximize profits and stock value. Berle and Means suggested that oftentimes the consequence of this dispersal was that company managers were running the companies to suit their interests and not those of the shareholders.

Agency costs also arise in the relationship between controlling and minority shareholders because the interests of these two groups do not always coincide. Growth and profitability of a company generally benefit controlling and minority shareholders alike, so in most cases the decisions of self-interested controlling shareholders will also benefit minority groups. For instance, when controlling shareholders decide to fire an incompetent manager or to approve a new investment that is expected to generate large profits for the company, they are benefiting controlling and minority shareholders alike.

But in some circumstances, controlling and minority groups will have conflicting interests, and in these cases the controlling groups may try to take actions to capture advantages of the business for themselves at the expense of the interests of the remaining shareholders. These captured advantages are commonly referred to as “private benefits of control”. Examples of private benefits of control range from engaging in self-dealing with the company and trading based on confidential information, to appointing family members to key positions or using the company’s facilities and assets for private businesses.

There are now empirical works suggesting that the private benefits of control are large in Brazil. Dyck and Zingales (2004)[12] analyzed a sample of 412 control transactions which took place in thirty-nine countries between 1990 and 2000, and found that the private benefits of control comprise 65% of the firm equity value in Brazil, which was highest percentage in their sample. Tatiana Nenova (2000)[13] followed a different methodology and found that the average control value in Brazil is 16% to 23% of a company market value. Although these two studies apply different methodologies, both analyses show that private benefits of control in Brazil are large enough to be a significant deterrent to a well-functioning stock market. Brazilian scholar Érica Gorga[14] also suggested that Brazilian cultural values reinforce this dynamics where control remains a crucial objective of shareholders because of its “amenity potential”.[15]

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[11] Recent studies showed that large shareholders control a large number of firms even in wealthy countries. La Porta, Lopes-de-Silanes, Shleifer, and Vishny (Corporate Ownership around the World, Journal of Finance, vol. 54, 1999) identified the ultimate owners of capital and voting rights of firms in 27 developed countries and found that, except in economies with very good shareholder protection, relatively few firms are widely held. Most firms are controlled by families or by the state. Controlling shareholders typically have control over firms considerably in excess of their cash flow rights, mainly through the use of pyramid structures. This sharply contrasts with the Berle and Means’ picture of modern corporations.

[12] Alexander Dyck & Luigi Zingales, Private Benefits of Control: An International Comparison, 59 J. Fin. 537, 539 (2004)

[13] Tatiana Nenova, The Value of Corporate Votes and Control Benefits: A Cross-Country Analysis (2000), available at http://ssrn.com/abstract=237809 (her study was based on a sample of 661 dual-class firms in 18 countries using data for 1997).

[14] Érica Rocha Gorga, Culture and corporate law reform: A case study of Brazil, 27 U. Pa. J. Int'l Econ. L. 803 (2006).

[15] The amenity potential are nonfinancial benefits, such as fame and influence, that can obtained by controlling a company. See Harold Demsetz & Kenneth Lehn, The Structure of Corporate Ownership: Causes and Consequences, 93 J. Pol. Econ. 1155, 1161-62 (1985).

According to Lucian Bebchuk's rent-protection theory of corporate ownership structure, when private benefits of control are large, controllers will tend to lock-up control, keeping the ownership of the company concentrated in their hands even when going public. This is so because leaving control up for grabs would entice rivals to try to capture control by takeover bids or by purchasing stocks in the market. As a result, disperse ownership of stocks would not create a stable equilibrium because one would have incentives to buy blocks of shares in order to control the company and extract the available private benefits of control.[16]

Recent empirical work enhances the explanatory power of such theory in the context of the Brazilian stock market. In general, the control power in Brazilian listed companies is indeed very concentrated. Using data of 2002, Leal & Silva[17] concluded that minority shareholders directly held on average 71% of the voting stocks and 50% of the total capital of the companies listed at the BOVESPA, Brazil's main stock exchange. When accounting for indirect holding of stocks, controlling shareholders held on average 68% of the companies' voting capital and 34% of total capital. Moreover, the three larger shareholders directly held on average 89% of the voting stocks and 60% of the total capital of the companies listed at BOVESPA. The three larger shareholders also indirectly held 85% of the voting stocks and 51% of the total capital.

Things may however be starting to change. Although stock ownership is still concentrated, dispersed ownership is now slowly turning into a reality in the Brazilian market. Only in 2007, there were 17 of the companies that joined the Novo Mercado had a dispersed shareholding structure.[18] As so, there are now 34 companies with disperse ownership.[19] These numbers might be a signal that a silent revolution is underway.[20]

2. The political economy of the protection of minority shareholders in Brazil

The Brazilian Corporations Law of 1976[21] governs joint stock companies and contains the most important legal provisions for the protection of minority shareholders. The law was enacted during the military regime and sought to strengthen large Brazilian economic conglomerates[22] by fostering investments on the stock markets. The intellectual foundations of the Corporations Law can be traced to the Second Plan of National Development ("PND II"),[23] a set of guidelines for national industrial policies that were put in place during the second half of the 1970s decade. The

[16] Lucian Arye Bebchuk, A Rent-Protection Theory of Corporate Ownership and Control (Nat'l Bureau of Econ. Research, Working Paper No. 7203, 1999), available at http://papers.nber.org/papers/W7203. See also Erica Gorga, Culture and Corporate Law Reform: A Case Study of Brazil, 27 U. Pa. J. Int'l Econ. L. 803, 2006

[17] Ricardo P.C. Leal e André L. Carvalhal-da-Silva. Corporate Governance and Value in Brazil (and in Chile), Inter-American Development Bank Research Network Working Paper #R-514, http://www.iadb.org/res/publications/pubfiles/pubR-514.pdf (also showing that 58.2% of Brazilian listed companies are controlled by families, 24.9% are controlled by foreigners, 8.9% are controlled by institutional investors, 8.0% are controlled by the government).

[18] Source: Boletim Informativo da BOVESPA, Year 7, No. 115, January of 2008, Retrospectiva, Fatos Marcantes de 2007, p. 5.

[19] Id.

[20] These companies include Embraer (aeronautics), American Banknote, (graphic sector), BrasilAgro (agricultural real estate), Dasa (clinic diagnostics), Datasul (IT), Eternit (construction materials), Gafisa (real estate development), Lojas Renner (retail), Lupatech (mechanic products), Perdigão (food), a Rossi Residencial (construction), o Submarino (on-line retail), and Totvs (softwares). Eternit and Renner are however the only companies whose stocks are 100% dispersed (meaning that all their stocks are in free float). Source: Boletim Informativo da BOVESPA, Year 7, No. 114, January of 2008.

[21] Federal Law No. 6,404 of 1976.

[22] See Mário Henrique Simonsen e Roberto de Oliveira Campos, A nova economia brasileira, 3rd ed., Rio de Janeiro, José Olympio, 1979, p. 206-207.

[23] See chapter IV of the PND II (Economic strategies: basic options. Strengthening of the national company and foreign capital). See also Alfredo Lamy Filho e José Luiz Bulhões Pedreira, A Lei das S.A.: pressupostos, elaboração e modificações. 3rd ed. Rio de Janeiro, Ed. Renovar, 1997. v. 1; Egberto Lacerda Teixeira e José Alexandre Tavares Guerreiro, *Das sociedades anônimas no direito brasileiro*. São Paulo, Ed. José Bushtsky, 1979, pp. 3-12; and Orlando Gomes, Fontes e significado das inovações da L. n. 6.404. *Revista Forense*, ano 77, v. 275, 1981.

resulting legislation mirrored the political and economic dynamics of the time.[24] The then incumbent military regime was striving to develop the economy without sharing political power. Similarly, the Corporations Law enacted in 1976 intended to spread capital ownership of listed companies without democratizing the political power within these companies.

On one hand, the Corporations Law of 1976 allowed companies to issue up to 2/3 of nonvoting stocks,[25] but on the other hand it strove to compensate minority shareholders by granting them legal protections that were designed to hinder controlling shareholders from grabbing private benefits of control.[26] The law gave minority shareholders a set of individual rights and established fiduciary duties and obligations for the company's administrators and controlling shareholders. In parallel, the government created the Brazilian Securities and Exchange Commission (*Comissão de Valores Mobiliários* - CVM) which was – and still is – in charge of regulating and supervising the capital markets.[27]

The Brazilian Corporations Law suited well the economic and political models prevailing in the mid-1970s it was not substantially amended until those models changed. These changes gained momentum with the country's democratization and the liberalizing economic reforms that were championed by President Collor (1990-1992) and consolidated by Presidents Itamar Franco (1992-1994) and Fernando Henrique Cardoso (1995-2003). As a result, the Corporations Law was twice reformed, first in 1997 and then in 2001.[28]

The 1997 reform[29] to the Corporations Law aimed at facilitating the then ongoing Brazilian privatization program. The most relevant change brought about was the elimination of tag along rights of minority voting shareholders, and that was a dramatic change. The Corporations Law as originally enacted in 1976 provided for a mandatory tender offer for all of the outstanding voting stocks in case of a control transfer.[30] The tender offer should be made for a price equal to that paid for the controlling block (nonvoting stocks have never had the privilege of being submitted to mandatory tender offers). Tag alongs effectively obliged the controlling shareholders to include the holdings of the minority shareholders in the negotiations and forced controlling shareholders to share the control premium with all of the remaining voting shareholders. They thus placed an important check on the controlling groups' actions to capture private benefits of control.

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[24] A military coup set the military forces in power in Brazil in 1964. The country remained under a military regime until 1985, when civil government was reinstated. A new Federal Constitution was enacted in 1988 and has been in full force ever since.

[25] The permission to issue up to 2/3 of nonvoting stocks means that in the simplest ownership structure a company could be controlled with just one sixth of its capital. Using layered structures, control could in theory be exercised with an insignificant capital stake.

[26] This dual concern for strengthening of the Brazilian conglomerates and protecting minority shareholders can be found in the Motives ("Exposição de Motivos") of the Corporations Law (EM No. 196/76) written by the Mário Henrique Simonsen, then Minister of Finance: "4. The project basically aims at creating the legal structure necessary for strengthening of the country's capital markets, which in the current stage of the development of the Brazilian economy is indispensable for the survival of private companies. The voluntary mobilization of savings toward the productive sector requires the establishment of a system that ensures minority shareholders the observance of clear and equitable rules, that are appealing in terms of security and profitability without paralyzing the business community."

[27] The CVM was created by Federal Law No. 6,385 of 1976. It is a federal agency linked to the Ministry of Finance.

[28] The Corporations Law was also amended in 2007 through Federal Law No. 11,638. That amendment changed accounting rules applicable to Brazilian corporations mostly with a view to bringing Brazilian GAAP closer to international accounting standards.

[29] Federal Law No. 9457/97.

[30] "The transfer of the control of a listed company shall be subject to the prior authorization of the Securities Commission. Paragraph 1. - The Securities Commission shall ensure that the minority shareholders receive equitable treatment by means of a simultaneous public offer for acquisition of shares." (Corporations Law, article 254).

Many of the state-controlled companies being privatized towards the end of the 1990s decade had minority voting shareholders, and the removal of tag along rights meant that the new owners could buy the controlling block without having to make tender offers for the stocks of minority groups. That allowed the government to cash the entire control premium in the privatizations that took place in the Brazil in the late 1990s.

The 1997 reform also abolished other minority protection mechanisms. It eliminated withdrawal rights in many cases, including most mergers, and spin-offs, and lowered the price at which shareholders could withdraw in the cases in which withdrawal rights were still effective.[31] It also abolished existing requirements to disclose the price of sales of 5% blocks of voting stock or more, including control sales. As put by Tatiana Nenova, this kind of information "even in the absence of specific regulations on minority protection, increases the costs of expropriation, and the likelihood of a lawsuit brought upon a dominant owner attempting to buy out minority shareholders at lower than fair market price. The lifting of this regulation lowers the cost of extracting private benefits, and therefore increases private benefits enjoyed by dominant owners".[32]

Although the CVM soon reinstated the requirement to disclose price sales of blocks of voting stocks,[33] the upshot of the 1997 reform was that immediate impact of the Brazilian privatization program on the development of the local capital market was at best discrete, if not negative.[34] As a matter of fact, by the end of the 1990s decade the Brazilian stock market was facing a serious crisis. The number of companies listed at BOVESPA dropped from 550 in 1996 to 440 in 2001. The trade volume retreated from US$ 191 billion in 1997 to US$ 101 billion in 2000 and US$ 65 billion in 2001.

The plunge of Brazilian capital markets can be explained by a number of factors. To begin with, the state of affairs of the world economy did not help.[35] As of 1995, a number of emerging economies faced serious liquidity crisis (Mexico in 1995, Korea and Thailand in 1997, Russia in 1998, Brazil in 1999, Turkey in 2000-01, and Argentina in 2001-02). In all of these countries, a combination of large short-term liabilities and relatively scarce internationally liquid assets resulted in extreme vulnerability and eventually in a confidence crisis and a reversal of capital flows. As international financial conditions worsened, Brazil experienced a recession and its currency devalued rapidly. In 1998-99, the average annual growth rate fell to 0.5%, the Brazilian currency lost approximately one-third of its purchasing power from April 1998 to April 1999, and fiscal deficits skyrocketed. Distortionary taxation (particularly the tax on financial

[31] Before the 1997 reform, dissenting shareholders had the right to withdraw at a price equal to the book value of their stocks. The reform allowed the bylaws to establish that the redemption amount could be lower than book value if such redemption amount is calculated based on the economic value of the company, which would be based on forecast profits assessed through a discounted cash flow valuation or other criteria as set forth in the bylaws.

[32] Nenova, Tatiana, "Control Values and Changes in Corporate Law in Brazil" (September 25, 2001). EFMA 2002 London Meetings. Available at SSRN: http://ssrn.com/abstract=294064.

[33] In early 1999, the CVM issued Ordinance No. 299 in part as an attempt to remedy the deleterious effects of the 1997 reform on the Brazilian stock market. In 2002, Ordinance No. 299 was partially revoked by Ordinance No. 358, which in turn was amended by Ordinances No. 369 in 2006 and 449 in 2007. The requirement to disclose the price of sales of 5% blocks of voting stock was maintained (in fact, enhanced) throughout all of this process.

[34] Érica Rocha Gorga, Direito societário brasileiro e desenvolvimento do mercado de capitais: Uma perspectiva de "direito e economia". Doctoral thesis presented to the Law School of the University of São Paulo in 2005, p. 93 ("the Brazilian privatization program, [contrary] to similar programs in other parts of the world, did not result in the consistent development of the national capital markets").

[35] Nelson H. Barbosa Filho, International Liquidity and Growth in Brazil. Central for Economic Policy Analysis Working Paper, 2001, available at http://newschool.edu/cepa/publications/workingpapers/archive/cepa200104.pdf.

transactions that was then levied on every sale of stocks)[36] contributed to further depress the local stock markets and, to make matters worse, a number of Brazilian companies were given the possibility to negotiate American Depositary Receipts (ADRs) in New York.[37]

The low levels of protection of minorities then prevailing were also a cause of the stock markets crisis of the late 1990s. The lack of transparency in management and the absence of adequate instruments for the supervision of the companies influenced the perception of risk increased the companies' capital cost. A case in point - the removal of tag along rights in 1997 - did more than hurt the interests of the minority voting shareholders of the time; it reinforced a perception that in the Brazilian stock market a shareholder was either part of the controlling block or a foul.

That situation brought about the second reformation of the Brazilian Corporations Law in 2001. Originally, that reformation aimed at reinstating full fledged tag along rights to all shareholders and at eliminating nonvoting stocks, but the reforms eventually put in place by Congress accomplished much less.[38] Instead of eliminating nonvoting stocks, Congress only reduced the limit for nonvoting stocks from 2/3 to 1/2 of the total capital stock. Most importantly, existing listed companies were exempted from the new limit.[39] As to tag along rights, they were reinstated, but only for holders of voting stocks and limited to 80% of the price paid for the controlling stocks (no tag along rights were extended to holders of preferred stocks).[40]

Considering other amendments to the Corporations Law that were the introduced in 2001,[41] such as the request for making a tender offer to minority shareholders in case of delisting,[42] the enactment of provisions expressly prohibiting insider trading,[43] and increased representation of

[36] The tax on financial transactions (named CPMF) was levied on every debit (withdrawals and transfers, for example) made to a bank account. It was originally charged at 0.2% but with time that rate went up to 0.38%. It was created in 1997 as a temporary tax and remained in force and effect until 2007, although an exemption for investments in the stock markets was in place since 2004.

[37] In July of 2002, the New York Times wrote that the CPMF had made BOVESPA's transaction costs as much as 165% higher than those of the New York Stock Exchange. Between 1997 and 2002, about 40% of BOVESPA investors migrated to American Depository Receipts of blue-chip Brazilian companies (The New York Times, July 30, 2002, Stoking a Stock Market 'Revolution').

[38] Commenting on the 2001 reformation, Erica Gorga states that "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 to drop amendments aimed at increasing minority shareholders' rights […] 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." Érica Rocha Gorga, Culture and corporate law reform: A case study of Brazil, 27 U. Pa. J. Int'l Econ. L. 803 (2006).

[39] Corporations Law, art. 15.

[40] "The direct or indirect transfer of control of a listed company can only be effected under the condition that the purchaser agrees to conduct a public offer to acquire the voting stocks owned by the remaining shareholders. The offer price for such shares shall be at least 80% of the amount paid for the voting stocks comprising the controlling block." Corporations Law, art. 254A.

[41] To compensate for not eliminating the existence of preferred stocks, the 2001 tried to actually give palpable advantages for such kinds of stocks. Accordingly, the reform established that preferred stocks could only be accepted for trading in the stock market if they are afforded at least one of these preferences or advantages: (i) the right to have an interest in the dividend to be distributed corresponding to at least 25% of the net income for the year calculated pursuant to certain specific criteria, (ii) the right to receive dividend, for each preferred share, at least 10% higher than the dividend assigned to each voting share, or (iii) the right to be included in the tender offer in the case of sale of company control in addition to the right to receive dividends at least equal to the voting shares dividend. On the other hand, the 2001 reform also created the possibility that the government could have a golden share in the companies being privatized (Corporations Law, art. 17).

[42] "The registration of a listed corporation for stocks to be traded in the market may only be canceled if the corporation that issued the stocks, the majority shareholder or the controlling corporation directly or indirectly makes a public offering to acquire the entirety of outstanding stocks for a fair price, at least equal to the appraised worth of the corporation, calculated based on one or more of the following criteria: net assets appraised at market value, discounted cash flow, comparison by multiples, stock quotation in the securities market, or another criteria adopted by the Brazilian Securities Commission." […] Shareholders holding at least 10% of outstanding stocks of a listed corporation may request the officers to call a special shareholders' meeting with holders of outstanding shares in order to determine a new appraisal, based on the same or different criteria from those originally adopted, for purposes of determining the valuation of the company as provided for [above]". Corporations Law, art. 4.

[43] Corporations Law, art. 155.

minority shareholders in the Board of Directors of listed companies,[44] it is fair to say that the 2001 reformation of the Corporations Law increased the level of protection of minority shareholders. However, this was done in a smaller degree than that boasted by the politicians of that time.

It was self-regulation – not state legislation – that created the conditions for truly enhanced corporate governance practices and higher protection of minority shareholders. In December of 2000, right before the enactment of the 2001 reform of the Corporations Law, the São Paulo Stock Exchange (BOVESPA) created three special corporate governance listing segments. In these new listing segments, companies could voluntarily agree to adopt governance practices that went far beyond those established in the Brazilian Corporations Law, thus providing greater transparency and strengthening the rights and protections of minority shareholders.[45]

The three listing segments were named Novo Mercado (literally, "new market"), Level 2 and Level 1. The Novo Mercado's biggest advance was to do away with the nonvoting stocks that had caused so much controversy in the past. Companies listed in the Novo Mercado were required to grant unrestricted tag along rights to all of their shareholders[46] and have to fulfill a number of additional obligations such as maintaining a minimum of 25% of capital stock in free float, establishing a unified one-year term for the entire Board of Directors with at least 5 directors, submitting yearly financial statements pursuant to US GAAP or IAS norms, improving the disclosure of information in the quarterly financial statements,[47] and making tender offers based on economic value to holders of stocks in free float both in case of delisting and of withdrawal from the Novo Mercado. Moreover, any disputes between company and shareholders must be solved by binding arbitration.

The key distinction between the Novo Mercado and Level 2 is that the latter allows the companies to have nonvoting, preferred stocks in the company's capital structure. Still, holders of preferred stocks of companies listed in Level 2 must be granted the right to vote in certain matters such as the incorporation, merger, spin-off and the approval of contracts entered into between the company and firms of the same holding group. Moreover, in case controlling shareholders sell their stake, a tender offer must be presented to the preferred shareholders in the amount of at least 80% of the value/conditions paid to the controlling group (remember that under the Corporations Law preferred shareholders have no tag along rights).[48] As to Level 1, which is the less stringent of the special listing segments, the adhering companies have to fulfill less rigorous variations of obligations that apply to the Novo Mercado and to Level 2 (but these variations are in any case at least as stringent as those set forth under the Corporations Law).[49]

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[44] Corporations Law, art. 141.

[45] The creation of these special listing segments partly inspired by the Germany's *Neuer Markt*, France's *Nouvéau Marché*, England *TechMark* and Italy's *Nuovo Mercato*. However, these European segments were exclusively founded to attract companies from fast-growing markets and high tech areas, such as Internet, telecommunications, media, biotechnology, et cetera. Converselly, BOVESPA's segments place no restriction on field of activity, nor are they reserved for small companies.

[46] Meaning that in the event of sale of control the buyer must make a tender offer to buy all outstanding shares under equal terms (with no 80% ceiling).

[47] Including the preparation of consolidated balance sheets, cash flow statements and a special independent auditor's report.

[48] It comes as no surprise that the percentage of companies where nonvoting preferred stocks represents less than 20% sharply increased, from 17.9% in 1998 to 39.6% in 2007 (according to Ricardo Leal & André Carvalhal da Silva, Prêmio IBGC de Governança Corporativa, 2007).

[49] Level 1 only contains rules that enhance transparency and disclosures.

After a slow start, BOVESPA's new listing segments eventually took off. In January of 2008, almost half of BOVESPA's 449 companies were listed in a special segment: 92 companies were listed in the Novo Mercado, 20 in Level 2, and 44 in Level 1.[50] The remaining 293 companies are still listed at BOVESPA pursuant to traditional, legally required levels of corporate governance, but most of them have gone public in the past. Indeed, in all of the numerous IPOs that took place at BOVESPA in the last years the companies voluntarily adhered to some of these listing segments.

In fact, since 2002 the recovery of the Brazilian stock market has been impressive. In November of 2007, the Financial Times wrote: "not long ago the São Paulo Stock Exchange (BOVESPA) was a sleepy backwater, much like any other stock exchanges in Latin America. [...] Since then, things have changed. By 2006, average daily trading had risen to R$2.4bn ($1.1bn). Last month it was R$6.7bn ($3.7bn). The BOVESPA's extraordinary initial public offering on October 26 shot it into the top rank of world capital markets." BOVESPA closed 2007 with an accumulated rise of 72% in U.S. dollars, the third biggest rise among the world's stock exchanges.[51]

A number of factors lie behind this astonishing ascension of the Brazilian stock market. They are for sure not limited to enhanced corporate governance – although this is most certainly a relevant factor. High global liquidity, high commodity prices and the expectation that Brazil will soon be given an investment grade rating by the big ratings agencies – in recognition of the macroeconomic stability and improvements in Brazil's debt profile that have helped stimulate investors interest in the country. Political stability helped too. Although the worldwide impacts of the American mortgage crisis are yet unclear, the fact is the profile of the Brazilian capital markets has improved dramatically.

3. Protection of minority shareholders under the Brazilian Corporations Law and the BOVESPA's regulations

The Corporations Law grants minority shareholders specific rights that give "teeth" to shareholders within the corporate dynamics. In Brazil, these rights are typically referred to as "individual rights". Some of these individual rights apply to all minority shareholders (e.g. the right to receive dividends); others apply only to qualified minorities that meet certain thresholds (e.g. holders of at least 15% of the voting stock capital or 10% of the total stock capital have the right to appoint a member to the Board of Directors).

Some individual rights are mandatory (or "essential", as they are called in Brazil) meaning that they cannot be eliminated by the company's bylaws nor by resolution of the company's shareholders. There are five essential rights: the right to receive profits, the right to participate in the sale of the company's assets if the company is wound up, the right to supervise the company's bodies, the right to exercise a preference in the subscription when the company issues new stocks or securities convertible into stocks, and the right to withdraw from the company in the specific cases set forth under the law.[52] As to the content of the individual rights, they are

[50] Source: Boletim Informativo Bovespa, Year 8, Nr. 114, January of 2008. Available at www.bovespa.com.br.
[51] Source: http://www.zibb.com/article/2426335/Bovespa+up+72+percent+in+2007. The annual rise was overcome only by China's Shenzhen (180.84%) and Shanghai (110.15%). BOVESPA's main competitor in Latin America, Mexico's BMV accumulated a rise of 11.32% in 2007.
[52] Corporations Law, art. 109.

typically divided into political rights, economic rights, oversight and information rights, and procedural rights.

Political rights

The main political rights set forth under the Corporations Law are the right to vote on Shareholders' Meetings and the right to appoint members to the Board of Directors. The right to vote is not "essential" because the bylaws can restrict them giving rise to preferred stocks with no voting or limited voting rights. Brazilian law contains a number of provisions governing the formalities that have to be followed for voting in shareholders' meetings, including prior public notice of the meetings, minimum quorum for the holding of valid shareholders' meetings, and minimum percentage of votes for the approval of certain topics.[53]

The 2001 reform of the Corporations Law established that minority shareholders representing 15% of the voting stocks can elect a member for the Board of Directors, and this same right was extended to shareholders having nonvoting preferred stocks that represent at least 10% of the company's total stock capital.[54] The Board of Directors of companies listed in the Novo Mercado and in Level 2 must be composed of at least 5 members, 20% of which must be independent directors.[55]

Minority shareholders representing at least 10% of the voting capital have the right to request a multiple voting ("voto múltiplo") for the election of the members of the Board of Directors. Multiple voting is a mechanism whereby each voting stock is given the right to make as many votes as the number of vacant positions in the Board of Directors (for instance, if the shareholders are electing 5 board members, each voting stock will cast 5 votes). This procedure empowers minorities to elect at least a small number of Board members because shareholders can accumulate all the votes in one single candidate.[56]

Economic rights

Stock value is a function of the basket of rights contained in each stock; thus, most (if not all) of the individual rights contained in the Corporations Law are in some sense "economic" rights. But here we use the expression "economic rights" in the narrower sense typically used in Brazilian doctrinal studies of corporate law, and as so the main economic right – which is also an essential right – is the right to receive dividends.

The payment of dividends is mandatory but the percentage of the net profits that have to be paid out as dividends is flexible.[57] Nonvoting preferred stocks can however only be accepted for trading in the stock market if they are afforded at least one of these three advantages: a

[53] Corporations Law, arts. 121 to 137.
[54] Corporations Law, art. 141.
[55] The controlling shareholders have the right to appoint the majority of the members of the Board of Directors.
[56] However, the Corporations Law establishes that even if the election of the Board of Directors is conducted through multiple voting, the shareholder or shareholders bound by voting agreements representing more than 50% of voting stocks will 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. Corporations Law art. 141.
[57] Corporations Law art. 202.

compulsory dividend of at least 25% of the company's yearly net profits,[58] dividends at least 10% higher than the dividend assigned to the voting stocks, or the same tag along rights as those held by voting shareholders (that is, tag along rights with tender offer valued based on 80% of the price paid to controlling shareholders).[59]

The Corporations Law also establishes a dissent and appraisal right ("direito de recesso") for shareholders dissenting from certain corporate resolutions, namely: a change in the proportion of classes of stocks that causes a loss to the dissenting shareholder (unless this is expressly allowed for in the bylaws), a change in the redemption or amortization terms of one or more classes of preferred shares, or the creation of a new, more favored class, so long as this causes a loss to the dissenting shareholder. The dissent and appraisal right will also be triggered by a reduction of the compulsory dividend and a change in the corporate object.

Dissenting shareholders of listed companies that own illiquid stocks[60] can also request the appraisal of their stocks in case of incorporation by another company or participation in a "group of corporations". The same appraisal rights also kick-in in case of a spin-off of the company, but only if the spin-off results in a change in the corporate purposes (except when the spun-off company is transferred to a corporation with a main line of business that coincides with the line of business of the spun-off company).[61]

The bylaws can establish the criteria for appraisal of the stocks of dissenting shareholders, subject to a minimum value based on the book value of the company as recorded in the latest financial statements.[62] For companies listed in the Novo Mercado or in Level 2, the minimum value to be paid to dissenting shareholders is the economic value.

As of 2001, delisting is only possible if the corporation that issued the stocks, the majority shareholders or the controlling corporation makes a tender offer to acquire the outstanding stocks.[63] The price of the tender offer will be calculated based on one or more of the following criteria: net assets appraised at market value, discounted cash flow, comparison by multiples, share quotation in the securities market, or other criteria adopted by the Brazilian Securities Commission.[64] Again, for companies listed in the Novo Mercado or in Level 2, the valuation for the tender offer cannot be lower than the economic stock value.[65]

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[58] The net income of the year should be calculated as set forth under article 202 of the Corporations Law and according to the following criteria: (i) a priority in the receipt of dividends corresponding to at least 3% of the stock's net worth; and (ii) the right to have interest in the profit distributed in conditions equal to the common shares, after a dividend equal to the minimum priority as set forth in item a is assured. Corporations Law art. 17.

[59] Corporations Law art. 17.

[60] The Corporation Law states that in these cases, the holders of stocks of a class or type that have market liquidity and dispersion shall not have the right to withdraw, provided that: liquidity is evidenced when the type or class of share, or the certificate that represents it, is part of a general index representing a portfolio of securities in Brazil or abroad, defined by the Brazilian Securities Commission; and dispersion is evidenced when the majority shareholder, the controlling corporation or other corporations under their control hold less than half of issued shares of the applicable type or class. Corporations Law, art. 137.

[61] Corporations Law arts. 136 and 137.

[62] Corporations Law art. 45.

[63] There is no distinction between admission to listing and admission to trading. Once a company is registered as a public company it is entitled to have all its securities admitted to trading, at least in the over-the-counter (OTC) market. Brazil does not have registered or unregistered securities; therefore, if a company becomes a public company all of its securities may be freely negotiated on a stock exchange (or on the OTC market) as long as the relevant trading requirements are met. Currently the only Brazilian stock exchange on which shares are traded is BOVESPA. To be admitted to listing and, consequently, to have its securities admitted to trading, a company must be registered with the CVM as a listed company have its securities admitted to trading on BOVESPA.

[64] Corporations Law, art. 4.

[65] The 2001 reform to the Corporations Law has also established that if the controlling shareholder acquires stocks of a listed company under his control, and these stocks increase his interest in a certain class of stocks in a way that hinders the market liquidity of the remaining stocks, the

Shareholders have a right of first refusal for the subscription of a capital increase proportionally to the number of stocks they currently own.[66] In order to avoid capital increases made only for the purpose of diluting minority holders, the Corporations Law also requires that every proposal to increase the company's capital contain a detailed explanation of why the capital increase is necessary and the criteria used for the calculation of the price of the stocks being issued.[67]

Oversight and information rights

Minority shareholders typically exercise their oversight and information rights through the statutory Audit Committee ("Conselho Fiscal"). When the Audit Committee is not permanent,[68] it can be put in action upon the request of shareholders representing 10% of the company's voting stocks or 5% of the company's nonvoting stocks.[69] All of the preferred shareholders holing nonvoting or restricted voting stocks can jointly appoint a member for the Audit Committee in a separate voting session, and that same right is granted to minority shareholders that own voting stocks representing at least 10% of the voting stocks. A critical point that impairs the ability of minority shareholders to tame the controlling group is that the law guarantees the right for the controlling group to appoint the majority of the members of the Audit Committee.[70]

The Audit Committee does not have powers to take corporate resolutions but its members can individually give an opinion about certain topics, particularly as regards the integrity of the management's actions and the fulfillment by the managers of their legal duties. Upon the request of any of its members, the Audit Committee can request information from the management and the preparation of special financial or accounting statements. The Audit Committee should also opine on the management's annual report and on the management's proposals and plans to increase corporate capital, make new investments, distribute dividends and undergo incorporations, mergers or spin-off transactions. It is also in charge of calling shareholders' meeting if the managers fail to timely do so and of examining the company's books on a quarterly basis.[71]

Minority shareholders can also act without resorting to the Audit Committee. At the request of shareholders representing at least 5% of the total stock capital, a complete inspection of the books of the corporation may be ordered by the court, whenever acts contrary to the law or to the bylaws occur, or there are grounds to suspect that serious irregularities have been committed by the corporation.[72]

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controlling shareholders must make a tender offer for such remaining stocks. Corporations Law, art. 4. CVM Ordinance No. 361 of 2002 established that such tender offer should be performed "whenever the controlling shareholder, the person entailed to him, and other people which actuate together with the controlling shareholder or person entailed to him, acquire, by other means different from an IPO, stocks which represent more than a 1/3 of the total stocks of each type or class of stocks of the company".

[66] Corporations Law arts. 171.

[67] The criteria for calculation of issuance price can only be the expected profitability of the company, the equity value of the stock or the market price of the stock. Corporations Law art. 170.

[68] The Audit Committee does not have to operate on a continuous basis, unless this is expressly required by the company's bylaws.

[69] Corporations Law art. 161.

[70] Corporations Law art. 161.

[71] Corporations Law art. 163.

[72] Corporations Law art. 105.

Brazilian listed companies must publish annual financial statements that should include a balance sheet, a statement of retained earnings, a statement of income and a statement of changes in financial position.[73] In December of 2007, the section of the Corporations Law dealing with financial statements was amended with a view to bringing Brazilian GAAP closer to international accounting standards. The amendments created the statement of cash flows and the value added statement, changed rules concerning accounting criteria and methods, classification of assets, restrictions for the use of deferred asset accounts, established criteria for valuation of cash equivalents, intangible assets, and assets allocated to long-term operations and long-term liabilities.[74]

Companies listed on BOVESPA's special segments face higher disclosure requirements. At the Novo Mercado and at Level 2, companies have to prepare annual balance sheets pursuant to international accounting standards (US GAAP or IFRS), thereby improving the quality (and quantity) of information available to the market. These companies have to inform the market of the securities issued by the company that are held by the controlling shareholders, the members of Board of Directors, officers and the members of the Audit Committee. These companies must also hold public meetings with analysts and investors at least once a year; present an annual calendar with the relevant events for the forthcoming year (such as the dates of shareholders' meetings, release of financial results, etc.), present detailed information about the contracts entered into between the company and its related parties, and disclose on a monthly basis a summary of the transactions with derivatives and securities of the company that were carried out by the controlling shareholders.

Officers of listed companies have to inform the stock exchange and publish in the press any resolution of a general meeting or of the corporation's managing bodies or any material events which occur in the course of the business affairs that may substantially influence the market price of the securities issued by the company or the decision of investors to sell, buy, or exercise any right pertaining to the company's securities.[75]

Under current CVM regulations, material events include the signature of contracts for the transfer of the control of the company (even if under conditional provisions), changes in the control of the company (including through the execution, or amendments to a shareholder agreement), the authorization for listing securities issued by the company (in any domestic or foreign markets, changes in accounting criteria, and approval of stock options plans, among a number of others.[76] CVM regulations also require the disclosure of information about sales of 5% blocks of voting stock or more. Disclosure is also necessary when the owner in a type or class of stocks reaches 5% (or is reduced by 5%) of the total of such type or class.

Procedural rights

[73] Corporations Law, art. 176. In addition, CVM regulations require listed companies to publish the Annual Information Form (IAN) and the Quarterly Information Form (ITR), which are standardized forms where the company presents its operational, corporate and financial information respectively for the previous year and for the previous quarter.
[74] Federal Law No. 11,638 of 2007. Furthermore, CVM Ordinance No. 457 of 2007 has established that "listed companies shall, starting from reporting periods ending in 2010, present their consolidated financial statements according to International Financial Reporting Standards – IFRS, as issued by the International Accounting Standards Board – IASB […]Until the reporting period ending in 2009, public companies may, optionally, present their consolidated financial statements in accordance with IFRS as issued by IASB, in lieu of Brazilian accounting standards.
[75] Corporations Law, art. 157. Officers may however refuse to disclose such information when they feel that such disclosure would subject a legitimate interest of the corporation to risk (CVM Ordinance No. 258 of 2002).
[76] CVM Ordinance No. 358 of 2002.

Procedural rights are instrumental abilities to litigate and to demand legal remedies in court. Lawsuits against managers can be brought to court by the company upon the request of the minority shareholders, similarly to American-style derivative lawsuits.[77] However, these lawsuits are curtailed in Brazil by the fact that the Shareholders' Meeting (and not the Board of Directors, as typically occurs in the United States) has to approve them, and controlling shareholders have historically disfavored such lawsuits.[78] This trend is reinforced by the fact that in Brazil it is still common that managers have close personal ties (sometimes family ties) with the controlling group.

If the Shareholders' Meeting fails to approve the filing of such derivative lawsuits, then minority shareholders representing at least 5% of the company's aggregate stock capital can file the claim.[79] But the incentives for minority shareholders to file such claims are low, because they will bear the initial costs of the lawsuit and yet the verdict – which is uncertain and takes a long time – will go to the corporation. Hence, derivative lawsuits against managers tend to be rare and ineffective.

The procedural mechanism that could really protect minority shareholders – i.e., class actions – does not exist in Brazil. The upshot is that minority shareholders remain more likely than controlling shareholders to be hurt by actions of the managers. After all, if managers hurt the controlling group they can be easily dismissed, but if they hurt only the minorities they remain unlikely to be sued.

Indirect protection

Minority shareholders may also be indirectly protected through a number of legal remedies that aim at safeguarding the company from value-destructing actions of its controlling shareholders and managers. They are means of "indirect" protection because the immediate focus is on the protection of the company, and the minority shareholders only benefit from such actions to the extent that the improvement of the company's state of affairs enhances their stock value and dividends payments.

The Corporations Law disciplines the exercise of voting in Shareholders' Meeting and the exercise of controlling power in the course of the company's businesses. The shareholder must exercise the right to vote in the corporation's interest. The vote will be deemed "abusive" if it is exercised with the intent to cause damage to the corporation or to other shareholders, or of obtaining an advantage for the shareholder or for a third party to which neither is entitled, and which results or may result in damage to the corporation or to other shareholders.[80]

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[77] A shareholder derivative suit is a lawsuit instigated by a shareholder of a corporation, not on the shareholder's own behalf, but on behalf of the corporation. The shareholder brings an action in the name of the corporation against the parties allegedly causing harm to the corporation. Often derivative suits are brought against officers or directors of a corporation for violations of fiduciary duties owed to the shareholders vis-a-vis the corporation. Any proceeds of a successful action are rewarded to the corporation.

[78] Any shareholder may bring the action if proceedings are not instituted within three months from the date of the resolution of the shareholders' meeting approving the lawsuit. Corporations Law, art. 159.

[79] Corporations Law, art. 159.

[80] Corporations Law, art. 115.

Each shareholder is barred from voting on a corporate resolution dealing with the evaluation report on the property which he contributed to form the corporation's capital, with the approval of his own accounts as officer, or with any other resolution which may benefit him personally or in which he and the corporation may have conflicting interests.[81]

Controlling shareholders are required to use their controlling powers in order to make the corporation accomplish its purpose and perform its "social function", and shall have duties and responsibilities towards the other shareholders of the corporation, those who work for the corporation and the community in which it operates, the rights and interests of which the controlling shareholder must loyally respect and heed.[82]

The Corporations Law also contains a detailed description of the duties and responsibilities of the companies' managers.[83] Managers generally have fiduciary duties of diligence[84] and loyalty as is common in modern corporate legislation around the world.[85] There are also some responsibilities that apply to the corporation itself. For instance, the corporation is liable for any loss caused to interested parties by errors or irregularities found in its corporate books.[86]

4. The level of enforcement of the mechanisms for the protection of minority shareholders in Brazil

In developing countries it is not uncommon to have fairly modern legislations that do not work well in practice. In fact, Brazil's corporate law is no exception. Brazilian courts lack the necessary sophistication to understand the intricacies of securities laws and the economic dynamics of securities transactions, courts are remarkably slow and their decisions are fairly

[81] Corporations Law art. 115.

[82] Examples of actions deemed to be abusive include when controlling shareholders (i) guide the corporation towards an objective other than in accordance with its corporate purposes clause or harmful to national interest, (ii) provide for the liquidation of a viable corporation or for the transformation, merger or spin-off of a corporation in order to obtain, for itself or for a third party, any undue advantage to the detriment of the other shareholders, of those working for the corporation or of investors in securities issued by the corporation, (iii) to provide for a statutory amendment, an issue of securities or an adoption of policies or decisions which are not in the best interests of the corporation but are intended to cause damage to the minority shareholders, to those working for the corporation or to investors in securities issued by the corporation, (iv) elect a corporation officer or audit committee member known to be unfit for the position or unqualified, (v) induce, or attempt to induce, any officer or audit committee member to take any unlawful action, or, contrary to their duties under this Law and under the bylaws, and contrary to the interest of the corporation, to ratify any such action in a general meeting, (vi) sign contracts with the corporation directly, through a third party or through a business in which the controlling shareholder has an interest, incorporating unduly favorable or inequitable terms, (vii) approve, or cause to be approved, irregular accounts rendered by corporation officers as a personal favor, or to fail to verify a complaint which he knows, or should know, to be well founded, or which gives grounds for a reasonable suspicion of irregularity, and (viii) subscribe stocks with the contribution of property unrelated to the purpose of the corporation. Corporations Law art. 116.

[83] Corporations Law arts. 153 to 160.

[84] Case law on the duty of diligence is murky and there is no clear articulation of a Business Judgment Rule or similar doctrine in Brazil. The Corporations Law states that "officer shall not be personally liable for the commitments he undertakes on behalf of the corporation and by virtue of action taken in the ordinary course of business; he shall, however, be liable for any loss caused when he acts: (i) within the scope of his authority, with fault or fraud; (ii) contrary to the provisions of the law or of the bylaws." Corporations Law, art. 158.

[85] Accordingly, each manager is prohibited from performing any act of generosity to the detriment of the company; borrowing money or property from the corporation or using its property, services or taking advantage of its standing for his own benefit or for the benefit of a corporation in which he has an interest or of a third party, without the prior approval of a general meeting or the administrative council; by virtue of his position, receiving any type of direct, or indirect, personal advantage from third parties, without authorization in the bylaws or from a general meeting; usurping a commercial opportunity which may come to his knowledge, by virtue of his position, for his own benefit or that of a third party (even if this is not harmful to the corporation); failing to exercise or protect corporation rights or, in seeking to obtain advantages for himself or for a third party, failing to make use of a commercial opportunity which he knows to be of interest to the corporation (although the law allows managers to contract with the company on arm-length basis); acquiring for resale at a profit property or rights which he knows the corporation needs or which the corporation intends to acquire. Corporations Law, arts. 154 and 155. The 2001 reform to the Corporations Law also included an express prohibition against insider trading, which is something that had been left out from previous reforms based on doubtful justifications. Art. 155 of the Corporations Law now states that "any officer who may receive any confidential information not yet revealed to the public shall not make use of such information to obtain any advantages for himself or for third parties by purchasing or selling securities."

[86] Corporations Law art. 104.

unpredictable. As so, the interpretation and systematization by legal scholars of corporate law – an exercise similar to the one we have made in the previous section – does not necessary reflect the reality of the protection of minority shareholders. The analysis of black letter law needs to be complemented with a discussion of its level of enforcement both in court and at the administrative level with the Brazilian Securities Commission.

Analyzing trends in Brazilian case law is difficult. The country does not adhere to principles of *stare decisis* and adopts a diffuse system of judicial review (meaning that any judge can deem that a certain piece of a law is unconstitutional).[87] The upshot is that case law can become very inconsistent and it is hard to pinpoint what cases serve better to reflect the positions that are most commonly adopted in courts. This situation reinforces the usefulness of conducting statistical analysis to understand case law.

Corporations case law

In a recent study, Viviane Muller Prado e Vinícius Buranelli analyzed a sample of 50 cases and 92 appeals[88] that examined topics pertaining to the protection of minority shareholders.[89] This sample was comprised only of decision given between 1998 and 2005 by the Superior Court of the State of São Paulo,[90] which is the appellate level court of São Paulo, the wealthiest state of the Brazilian Federation and also the state where BOVESPA is located.

As illustrated in Table 1, most of the cases (66%) were brought to court by individuals, and institutional investors were the plaintiffs in only 18% of the cases. This finding contradicted the expectations of the researchers because the absence of class action mechanisms and problems of "rational ignorance"[91] would suggest that the institutional investors – who have higher stakes and are more sophisticated than the individuals – would be the plaintiffs in most cases. The explanation could be that institutional investors have enough powers to engender political arrangements with the controlling groups that avoid the need of going to court, or perhaps it has to do with the kinds of issues being litigated.

The companies that issued the stocks were the defendants in most cases (88%). Controlling shareholders were the defendants in only 10% of the cases and the managers in only 2%. In an environment where private benefits of control have historically been so pervasive, the small amount of lawsuits against controlling shareholders suggests that the regulations are lax on

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[87] The most distinctive feature of Brazilian judicial review is the coexistence of the decentralized system and the centralized system. Brazil has followed the decentralized American model in the sense that private parties bring constitutional issues before ordinary courts in regular judicial proceedings. At the same time, Brazil has another type of judicial review; that is, certain authorities have competence to bring actions in relation to constitutional issues directly to a special decision-making organ. Other characteristics of Brazilian judicial review are that there is no special court to deal with constitutional issues outside or inside the judiciary, and that the Federal Supreme Court (*Supremo Tribunal Federal, STF*) has jurisdiction to examine the constitutionality of statutes *in abstracto*. Therefore, the Federal Supreme Court is not only the top and final tribunal for decentralized review but also the single tribunal for centralized review. Sato, Miyuki (2003) "Judicial Review in Brazil. Nominal and Real," Global Jurist Advances: Vol. 3 : Iss. 1, Article 4. Available at: www.bepress.com/gj/advances/vol3/iss1/art4.

[88] A case often has many appeals, many of which deal with interlocutory orders, and this is why there are more appeals than cases).

[89] Viviane Muller Prado e Vinícius Correa Buranelli. Relatório da pesquisa de jurisprudência sobre direito societário e mercado de capitais no Tribunal de Justiça de São Paulo, *Cadernos Direito GV. Relatório de Pesquisa* , n. 09, São Paulo, January of 2006, available at www.direitogv.com.br.

[90] Tribunal de Justiça do Estado de São Paulo (TJSP).

[91] Ignorance about an issue is said to be "rational" when the cost of educating oneself about the issue sufficiently to make an informed decision can outweigh any potential benefit one could reasonably expect to gain from that decision, and so it would be irrational to waste time doing so. This has consequences for the quality of decisions made by large numbers of people, such as general elections, where the probability of any one vote changing the outcome is very small.

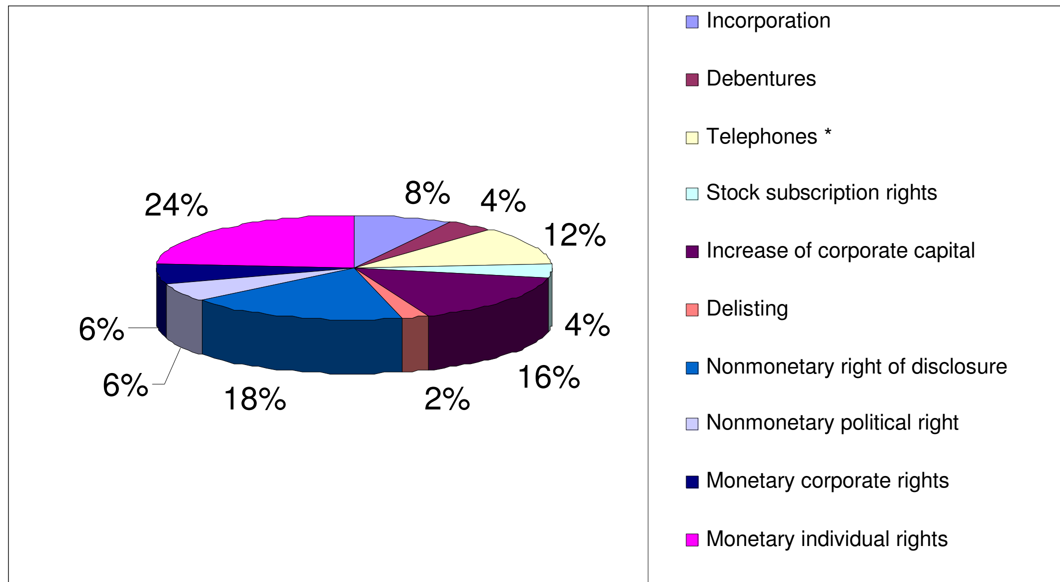
taming controlling shareholders, and/or that proving a case against controlling shareholders is very difficult.

Table 1: Plaintiffs and Defendants

Plaintiffs	Percentage
Institutional investors	18
Legal entities	14
Individuals	66
Public Prosecutor's Office	2
Total	100

Defendant	Percentage
Company	88
Controlling shareholder	10
Manager	2
Total	100

The research also tried to identify the specific questions that were being litigated. The sample indicated a larger proportion of lawsuits where shareholders tried to enforce their own direct interests and a lower proportion of lawsuits trying to hold managers or controlling shareholders liable. Accordingly, common topics included the request for recognition of dissent and appraisal, request for higher dividends payments, the request for the exhibition of company’s documents, etc.



* Legal disputes with shareholders who received stocks of the telecom public utilities when they bought new telephone lines in the past.

Administrative proceedings conducted by the Brazilian Securities Commission - CVM

The CVM is in charge of supervising, investigating and punishing irregular acts that occur in the Brazilian capital market. In a recent study, Maria Cecília Rossi, Viviane Muller Prado and Alexandre Di Miceli have analyzed 101 CVM's decisions dealing with corporate law issues in the period of 2000 up to 2006.[92] Approximately one in every four investors in the Brazilian market is an individual[93] and that highlights the importance of the CVM because individual shareholders tend to be less sophisticated and less powerful than corporate shareholders.

The CVM is in most cases responsible for initiating the investigations that eventually lead to an administrative proceeding seeking to punish some player in the capital market. In 61 of the cases (around 60% of the sample), CVM became aware of some alleged wrongdoing by means of its own initiatives. Only in 29 cases (29%) did the CVM start the investigation after it was notified by minority shareholders, by investors in securities other than stocks, or by associations representing minority shareholders. Moreover, in 4 cases the CVM acted upon a notification by the Central Bank of Brazil, in 3 cases upon a notification of a member of an Audit Committee, and in 1 case the CVM acted upon a joint notification given by a member of the Board of Directors together with the company. In the remaining 7 cases the CVM acted by because of other initiatives.

Officers, directors, controlling shareholders were the main targets of the CVM's administrative processes. Here there is a sharp distinction with the judicial proceedings, in which the company itself was most often the defendant. Accordingly, the CVM has filed 80 proceedings against officers, 66 against directors, 40 against the controlling shareholders, 11

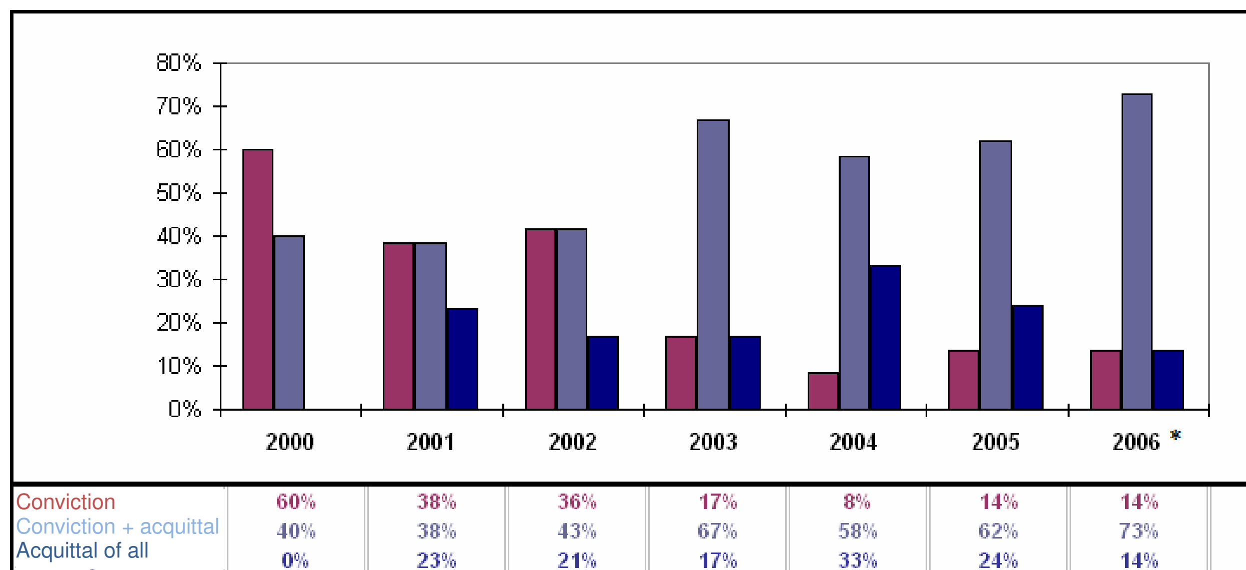
[92] Maria Cecília Rossi, Viviane Muller Prado, Alexandre Di Miceli, Decisões da CVM em matéria societária no período de 2000 a 2006, p. 88 (unpublished).
[93] Source: http://www.ini.org.br/ini/site/informativo/Informativo_janeiro_2006.pdf.

against auditors, and 27 proceedings were filed against members that are not in any of these categories.

The length of time between the date of the infraction and the conclusion of the administrative proceeding lasted on average 6 years. In spite of some investments that had been made by the government to strengthen the CVM the study could not identify any trend for the decrease in the duration of the proceedings.

Alleged infractions to disclosure requirements, abuse of controlling powers and wrongdoings by managers were the themes that appeared most frequently in the administrative proceedings. The high number of disclosure issued being litigated can be partially explained by the fact that these kinds of infraction are the ones most easily detected by the CVM, yet that does not mean that disclosure problems are the most relevant ones. Moreover, the degree of acquittal of the individuals being prosecuted for disclosure mistakes is rather high.

Table 2 below shows that the proportion of convictions over time has increased for certain groups and decreased for others. This is due to a change in the pattern of issuances of subpoenas by the CVM, because in recent times the CVM has been adopting the strategy of sending subpoenas to a large number of individuals who can be potentially involved in a wrongdoing even if it does not hold clear evidence against each one of them to start a proceeding.



	2000	2001	2002	2003	2004	2005	2006 *
Conviction	60%	38%	36%	17%	8%	14%	14%
Conviction + acquittal	40%	38%	43%	67%	58%	62%	73%
Acquittal of all	0%	23%	21%	17%	33%	24%	14%

**Updated as of June 2006*

The main reasons for acquittal of the defendants were the inapplicability of the specific legal provision to the conduct that gave rise to the investigation, absence of responsibility of the defendant for the specific conduct being prosecuted, and absence of sufficient evidence. The cases of insider trading presented higher levels of acquittals, and this is probably due to the fact that they are harder to prove. In the cases where there was a conviction, the penalties most commonly applied were fines.

Arbitration

The relatively low levels of enforcement of the law and the legal uncertainties prevailing in Brazil with respect to corporate matters have contributed to the expansion of alternative dispute resolution methods (ADRs), particularly through arbitration proceedings. Historically, Brazilian courts have been refractory to arbitration, so the 2001 amendment to the Corporations Law has expressly permitted that the company's bylaws elect arbitration to resolve on disputes involving shareholders. Moreover, BOVESPA has made the use of arbitration mandatory for companies listed in the Novo Mercado and Level 2.

While we could not find statistical evidence about the performance of arbitration proceedings, we know that the use of arbitration remains problematic. For one, the election of arbitration does not preclude the parties from requesting precautionary injunctions in court. Moreover, the arbitral award may have to be enforced by the courts when the defeated party does not spontaneously comply with it. In both cases, the sluggishness and lack of predictability of the Brazilian courts end up playing an important role again. This is also true because it is not uncommon to find cases where judges disregard the requirement of submission to arbitration and unilaterally decide to rule on the conflicts, particularly when small investors are involved. All of that suggest that the improvement of Brazilian courts remains an important bottleneck in the legal infrastructure of the Brazilian capital markets.

5. Conclusion

By providing mechanisms for intermediation over the long term between financial surplus units and financial deficit units, dynamic capital markets allow individuals, companies and governments to spread risks, finance long-term projects and finance innovation. International economic experts and policy-makers now agree that the enhancement of the protection of minority shareholders is an important ingredient for the development of capital markets.

Brazilian policy makers have consistently been trying to revamp the legal framework of local capital markets, but entrenched interests of controlling groups (including the government, as was the case during the privatizations of the mid-1990s) have caused a number of drawbacks in the process. The most important of them is the authorization for companies to issue 50% of nonvoting stocks. But the laxity of the Corporations Law is in sharp contrast with the stringency of the rules established by BOVESPA, particularly within the Novo Mercado.

In a sense, the relative failure of legal reform and the success of auto-regulation are rather unsurprising. A legal reform that completely eliminated nonvoting stocks would probably have led to a massive wealth transfer from controlling shareholders to minority investors (and possibly to a reduction of the political clout of controlling groups too).[94] But voluntary adherence to better governance practices does not bring with it the political resistance that comes with legal reform and that often weakens and renders reforms ineffective.

The fact is that the Brazilian capital markets are now flourishing at an unprecedented pace in the country's history. Taking advantage of high international liquidity and also of internal

[94] Ricardo P. C. Leal, Entrenchment, Incentives, Corporate Valuation and Dividend Payout Policy in Brazil and in Chile. A proposal presented to the IADB as a reply to the Corporate Governance in Latin American and the Caribbean call for research proposals of June 2003.

macroeconomic stability, built after years of prudent fiscal policy, cautious monetary stance, and a relatively strong export-driven sector, Brazil is moving closer to its much coveted investment grade rating. Brazilian companies now often prefer to raise money domestically instead of doing it in foreign markets and an unseen wave of IPOs, a growing fixed income private market, and a strong real estate sector do account for big changes in the country's capital markets.

Still, the extent to which the Brazilian legal framework fosters or besets the development of local capital markets is an open issue. Brazilian Law provides minority shareholders with a fairly broad set of rights that would in theory grant them relatively high levels of protection, but the enforcement of such rights is seriously impaired by the sluggishness of the courts. The absence of class actions mechanisms and absence of a meaningful risk of liability for lawyers, accountants, bankers and company insiders are other problems. The CVM has a limited staff and budget and suffers from the political problems that typically affect regulatory agencies.

All of that should not obscure the fact that corporate governance practices have dramatically improved in Brazil. BOVESPA would not have gone so far had it not been for a major change in attitudes toward corporate governance, and that change would not have come about without a powerful stimulus from the BOVESPA itself.