The End of Limited Liability in Brazil

Bruno Meyerhof Salama
Good afternoon. It’s pleasure to be here at the Harvard School of Law in order to share with you some ideas in regards to the book I am currently writing and which I hope to soon conclude. It is particularly gratifying to have professors Mark Roe and Reinier Kraakman as discussants, as they are two of the world’s most important and creative scholars in corporate law and some of its related topics. I am grateful for the presence of you all, and of my discussants in particular.

The topic that I bring to you today – which is also, by the way, the title of my book – is the end of limited liability in Brazil. Under a system of limited liability, the company is liable for its debts – save for exceptional cases, where the liability extends to third parties, especially its partners and managers. Under a system of unlimited liability, third parties hold co-liability for company debts – save for exceptional cases where the liability or debt exhausts the company itself.

My book begins with an observation: although the Brazilian legal system still contains formal rules governing the so-called limited liability company, in practice this limitation on liability no longer prevails. Today, on the contrary, within the current business reality, there exists a system of unlimited liability as a general rule. This is particularly true for privately-held companies (that is, those not listed on the stock exchange), which serve as my main focus. However, to be noted, in the labor sphere unlimited liability exists in listed companies as well.

The first aim of my book is to explain this transition of corporate liability systems in Brazil. To do so, I conduct a historical analysis whose key variable is the evolution of the Brazilian political and economic arena. It is, simply put, the use of political economy to explain legal evolution and legal change. The second goal of my book is to formulate an economic critique of the present regime of unlimited corporate liability in Brazil, pointing out its advantages, disadvantages, and specific opportunities for improvement. At this point, this is a book for a Brazilian audience, particularly judges and legislators. Hopefully, a broader generalization focused on the international audience will follow suit.

The basic feature of a limited liability company is that the partners risk nothing more than the value invested in the purchase or subscription of shares. If business goes well, the partners divide the profits among themselves; if it goes wrong, well then, too bad for the creditors – whether they be the State, employees or commercial creditors. In Brazil, this system was in force until 1930, and then started to be relaxed. I trace this relaxation to a change in the political sphere.

Just as had happened elsewhere, the economic crisis of the 30s brought to Brazil an important political shift. The 1930 Revolution and Getúlio Vargas’ rise to power
 ushered in the era of a Brazilian-style welfare state. With Vargas, the Brazilian state began performing compensatory policies directed to the poorest levels of the population. In this context, a new field of Brazilian law was created: labor law. Of particular interest for our present purpose was the creation in 1943 of a rule according to which companies in the same business group would be required to respond jointly for debts related to labor relations. Thus, if a company defaulted on its obligations to its workers, the other companies of the same business group would respond jointly.

The creation of this rule represented a paradigm shift, in at least three senses. In the first place, it established the possibility of strict liability of shareholders (that is, liability regardless of negligent conduct). Second, for the first time legal regulation of corporate liability moved away from the realm of corporate law, and then came to incorporate novel political assumptions. Third, it crystallized a tendency of allowing the state to become increasingly involved in the re-allocation of risks associated with business activity, a phenomenon sometimes referred as the “publicization” of private law.

As can be seen, the first push toward relaxation of the liability regime can be traced to labor law in the 1930s and 1940s. The second push can be traced to tax law in the 1960s and 1970s.

Led by Vargas until his suicide in 1954, and then by the democratically-elected presidents that followed, the Brazilian state grew both in size and ambition. As a result, a need for increased taxation arose. The fiscal crisis, high inflation and political and economic crises that followed at the beginning of the 1960s created conditions for the military to seize power in 1964. The re-organization of public finances was a top priority of the military government. They implemented tax reform anchored, in the first place, in the modernization of the administrative machinery of tax collection and enforcement. Secondly, it was anchored in the utilization of criminal prosecution for fraud – and it is certain that from that moment on, the use of penal law as a means for social engineering has become an increasingly present feature in all areas, just like in most parts of the Western world. And third, and in conflict with increased taxation levels and stricter enforcement, but as a reflection of the anti-communist and pro-market ideology that animated the military regime, the tax reform was created a National Tax Code that reflected classical liberal principles of protecting the taxpayer against government will.

The Brazilian economic miracle soon followed, unfortunately followed later by the oil crisis of 1973, and then soon followed by the government’s budget and inflationary financing crisis, difficulty in paying foreign debt, and finally a grave economic crisis. The lack of resources led the military government to adopt a policy of increasingly aggressive tax collection and enforcement. The situation included legislative actions to close loopholes that were being exploited by companies. As part of this process, the government sought to increasingly hold partners and managers liable for tax debts. The Judiciary Power was, on the one hand, pressed by
the Executive Power to relax the principle of limited liability. And, on the other, it also realized that the occurrence of tax fraud was very broad and that the liability scheme under the Tax Code, besides protecting good taxpayers, also frequently served to protect the bad ones. Thus, under tax law partners and managers of insolvent companies found themselves increasingly threatened.

A less formalist legal position adopted by courts and officials in the sphere of tax law paved the way for the increased risk of liability for third-parties in corporate and labor spheres as well. As regards corporate law, this started in the 1970s with the importation of the so-called doctrine of piercing the corporate veil to Brazil. As regards labor law, with the creation of several new doctrines based on which, in the 1980s, partners began to have unlimited and full (rather than pro-rata) liability for labor debts of companies, even in the so-called limited liability companies.

The re-democratization in 1988 brought institutional foundations for the creation of a Democratic Welfare State endowed with a fair amount of political stability and legitimacy. From the standpoint of its purpose, this Democratic Welfare State would aim primarily at social inclusion. However, social change was set to take place within a context of rule of law. The political tension enshrined in the Federal Constitution of 1988 can thus be summarized as follows. On the one hand, the political compromise of 1988 prevented a swing toward socialism. On the other, it established a series of collective guiding principles and endowed the state with broad powers of intervention in the private sphere. As a result, the legal system of private enterprise emerged increasingly as a point of contention between two facets of the Brazilian state: that which was intended to be transformative and what was intended to be evolutionary. One result of this process was the end of limited liability.

Evidently, the change in the liability regime was not the same in all branches of law. In matters of civil and commercial law, a liberal legacy of liability attached to negligence is still present. Tax and regulatory law has, in general, slipped dangerously toward unlimited liability. And in the area of labor law, unlimited liability is most significantly expressed. Today in Brazil partners and former partners, managers and former managers – including those engaged in activity only to guide the company as board members – have been held liable for the total value of the company’s labor debts. The situation is so unusual that today even legal counsels holding powers of attorney to act on behalf of the partners have repeatedly been held liable for the full amount of labor debts of insolvent companies.

There is no way to recount here all the particular details of the research I am conducting, which in the book I refer to as the legal and political genealogy of the end of limited liability in Brazil. For the sake of brevity, I will instead illustrate the point with a general observation and a metaphor. The observation is as follows. Today, the main focus of liability has shifted away from negligence toward debt: while the former had to be proved, the latter needs only to be paid. This shift in focus was not decreed, nor can it be expressly found in the rules of corporate law or
in the rules of any other branch of law. So to use a metaphor, the shift from a regime of limited to one of unlimited liability is similar to Proust's description in *Swann's Way* of certain natural processes, that would be so gradual that *even if we are able to distinguish successfully each of the different states, we are still spared the actual sensation of change.*

Although gradual, this change in the regime of corporate liability has been quite traumatic. Nor could it be different: the company is the heart of economic activity. Inevitably, changes in its liability structure create legal uncertainty, political activity and eventual breaking of legitimate expectations, redounding in situations that can comfortably be qualified as _unjust_ in a colloquial sense. An additional point is that the regime of unlimited liability generates a set of incentives whose aggregate results, if they cannot yet be quantified, can at the least be discussed rationally.

There is today a large body of literature suggesting that the limitation of liability facilitates the diversification of investments. This means that under unlimited liability, there tends to be a reduction in levels of investment in general and discouragement for certain financial vehicles like private equity and venture capital. The literature also points out other advantages of limited liability as an incentive for investments among risk-averse investors, as a means of reduction in monitoring costs for business and in facilitation of the transfer of shares and corporate control. For all these reasons, limited liability can potentially function as a mechanism to encourage investment, entrepreneurship, free enterprise, and to a certain measure, even innovation.

On the other hand, the limitation of liability may allow partners to externalize business risks. That is, they receive profits if the company prospers, but will not bear the negative consequences if the business runs into trouble. If the company goes under, the limitation of liability of a partner for losses is partly shouldered by the company's creditors, both creditors with contractual obligations and non-contractual obligations, such as torts and tax debts.

From a pragmatic standpoint, the observation that the limited liability of partners has advantages and disadvantages leads us to search for solutions of compromise that seek to maximize the former and minimize the latter. That is why in the book I provide elements of an economic analysis to guide judges and legislators to refine the system of corporate liability. In this way I trace by type of creditor, type of partner, the type of company. For example, for reasons related to differences in information and bargaining power, it makes more sense to hold partners liable in the case of claims made by employees rather than claims made by the businesses. On the other hand, it makes more sense to hold liable partners who are directly involved with the company management, rather than passive or minority partners. Furthermore, it makes more sense to hold liable partners of privately-held companies rather those of public companies with shares listed on the stock exchange – although a pro-rate rule in this case could perhaps work.
I also discuss the rules and limits for the co-responsibility for company debt by managers, companies in the business group and contractors. But I’d rather stop here in order to hear your comments and suggestions, because many here have much to add. Let me also thank students Gisela Mation and Gustavo Ribeiro, as well as the Harvard Law School Brazilian Studies Association, for the kind invitation to be here today, which I was happy to receive.