The Unintended Consequences of State Ownership: The Brazilian Experience

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Despite waves of privatization around the world, state ownership of enterprise remains significant. The focus of scholars and policymakers has accordingly shifted from the defense and promotion of privatization to the design and improvement of corporate governance practices in state-owned enterprises (SOEs). A broad consensus has emerged suggesting that state-owned firms should be corporatized, publicly traded and subject to the greatest extent possible to the same legal regime applicable to private firms. However, by focusing exclusively on what corporate and securities laws can do to increase the efficiency of state enterprise, this view ignores the other side of the problem: How does the presence of SOEs affect the efficiency of corporate and securities laws as they apply to private firms?

Brazil's long historical experience with SOEs suggests that state ownership of listed firms can have unintended consequences that go beyond the potential firm mismanagement if the state pursues political goals inconsistent with shareholder wealth maximization. The state's financial interest as the controlling shareholder of listed firms can lead it to disfavor legal reforms that improve minority shareholder rights, thus impairing the ability of private firms to raise outside financing. In ignoring the conflicts of interest inherent in the state's dual role as shareholder and regulator, the conventional wisdom has likely overestimated the aggregate benefits of a unitary corporate law regime for both state-owned and private firms.

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Introduction

For all the turmoil involving global financial markets, 2010 witnessed the largest share offering in history. In September of that year, Brazilian state-owned oil giant Petrobras raised a record sixty-seven billion dollars from local and foreign investors, as well as the government itself, in order to finance the exploration of recently discovered oil fields. President Lula bragged about the achievement by proclaiming that "[i]t wasn't in Frankfurt, it wasn't in New York, it was in our São Paulo exchange that we carried out the biggest capitalization in the history of capitalism."[1]

State-owned enterprises have dominated Brazil's capital markets for the most part of the twentieth century, figuring among the "blue chips" of local stock exchanges. And despite a major wave of privatizations in the 1990s and a recent boom in Brazil's capital markets, their presence remains significant. Listed SOEs currently account for roughly thirty-five percent of the market capitalization of São Paulo's BM&F Bovespa, the world's ninth largest stock exchange.[2]

Yet the recent incursion of state-owned enterprises (SOEs) into capital markets is not unique to Brazil. Despite waves of privatization around the world, state ownership of enterprise remains significant. According to a recent survey, state-owned enterprises accounted for approximately twenty percent of global stock market value in 2010, which is more than two times the level observed just one decade earlier.[3]

In light of the persistence and apparent expansion of state ownership, the focus of scholars and policymakers has recently shifted from the defense and promotion of privatization to the design and improvement of corporate governance practices in SOEs.[4] Although the desirability of state ownership

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1 Peter Millard, *Petrobras Raises $70 Billion in World's Largest Share Sale*, Bloomberg (Sept. 25, 2010, 12:12 AM), http://www.bloomberg.com/news/2010-09-24/petrobras-raises-70-billion-in-world-s-largest-share-sale-to-fund-fields.html.

2 *The Company that Ruled the Wave*, The Economist, Dec. 17, 2011, http://www.economist.com/node/21541753.

3 *Chinese Acquisitions: China Buys Up the World*, The Economist, Nov. 11, 2010, http://www.economist.com/node/17463473.

4 Maria Vagliasini, *Governance Arrangements for State Owned Enterprises* (World Bank Policy Research, Working Paper No. 4542, 2008) ("We are now getting into the third wave of reforms, and the focus seems to be shifting back to the improvement of SOEs while maintaining public ownership"). For examples of academic studies and policy recommendations on corporate governance practices of state-owned enterprises, see, for example, OECD, OECD Guidelines on

remains a hot button issue on which reasonable minds may differ (especially in emerging markets), access to equity markets by state-owned firms is viewed across the board as a positive development. Indeed, from the numerous recommendations produced by this growing literature, at least two stand out. First, SOEs should adopt the corporate form and be governed, to the greatest extent possible, by the same legal regime applicable to private business corporations. Second, SOEs should welcome private investors, preferably by trading their shares on public securities markets.[5] The rationale behind these proposals is that the incorporation and public listing of SOEs can effectively promote efficient management and boost firm performance.

This Article challenges that conventional wisdom as overly shortsighted. By focusing exclusively on what corporate and securities laws can do for the efficiency of SOEs, it pays no attention to how SOEs affect the efficiency of corporate and securities laws as they apply to private firms. I explore this theme by examining Brazil's long-term experience with government control of publicly traded corporations.

The Brazilian experience suggests that government control of publicly traded corporations can have unintended consequences that go well beyond the potential for political interference that hurts the firm's performance and investor returns. An important but so far overlooked byproduct of government ownership of listed firms stems from the conflict of interest that arises when the state is simultaneously a player and a referee. That is, the state's interests as controlling shareholder may lead it to disfavor a legal regime that could limit its prerogatives by offering strong minority investor rights. While conventional wisdom assumes that general corporate laws will constrain the behavior of the state as shareholder, quite the reverse can be true, with the state shaping and constraining the development of corporate laws — with possible negative consequences for the corporate governance environment of private firms.

CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES (2005) [hereinafter OECD GUIDELINES] (including various recommendations of corporate governance best practices for SOEs); Francisco Flores-Macias & Aldo Musacchio, *The Return of State-Owned Enterprises: Should We Be Afraid?*, HARV. INT'L REV. (online ed.) (Apr. 4, 2009), http://hir.harvard.edu/the-return-of-state-owned-enterprises (describing improvements in the internal corporate governance of SOEs since the 1990s); Simon C.Y. Wong, *Improving Corporate Governance in SOEs: An Integrated Approach*, 7 CORP. GOVERNANCE INT'L 6, 13 (2004) (arguing that "poor corporate governance lies at the heart of the poor performance of state-owned enterprises (SOEs) around the world," and listing clear objectives, transparency and political insulation as the three main pillars of SOE reform).

5 *See infra* notes 68-69 and accompanying text.

This Article proceeds as follows. Part I describes the rise of publicly traded SOEs in postwar Brazil, and investigates how the interests of the state as the controlling shareholder of the country's largest corporations have shaped the content of corporate laws. Part II examines the effects of a major government-sponsored corporate law reform in the 1990s, which eliminated various minority shareholder rights in order to maximize the control premium obtainable by the state during the privatizations process. Part III draws on the Brazilian experience to counter influential OECD guidelines on the corporate governance of SOEs. In particular, it suggests that, by overlooking the political role of the state as shareholder, these mainstream recommendations have overstated the benefits of a unitary legal regime for state-owned and private enterprise. On the contrary, a dual legal regime that provides for separate corporate law rules for SOEs can effectively mitigate the state's interests as a controlling shareholder in general corporate laws.

I. The Brazilian State as Shareholder: The Rise of Listed SOEs

As in most other jurisdictions around the world, state-owned corporations in Brazil became dominant during and after World War II. Through a combination of nationalist ideology and a lack of private capital markets to finance industrialization, the government established national giants such as steel company Companhia Siderúrgica Nacional (1941), mining firm Companhia Vale do Rio Doce (1942), and oil corporation Petrobras (1953), among others, as *sociedades de economia mista* (mixed enterprises), which are government-controlled corporations in which the state shares ownership with private investors. Initially by practice, and later by law, mixed enterprises in Brazil had necessarily to be organized as a *sociedade anônima* (business corporation).[6] As such, mixed enterprises were by and large subject to general corporate laws, except to the extent in which their statutory corporate charters abrogated the standard private law regime.

Nevertheless, even Brazil's lax corporate law rules turned out to be too inconvenient for the government as the controlling shareholder of a growing number of mixed enterprises. At the time, the government's solution was to enact *ad hoc* special decrees exempting the companies it controlled from the legal requirements it found most cumbersome. For example, in the same year

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6 Decreto-Lei No. 200, de 25 de Fevereiro de 1967, Diário Oficial da União [D.O.U.] de 27.2.1967, art. 5, III (Braz.). In the vast majority of countries, mixed enterprises are organized as business corporations.

of the enactment of the new Corporations Law of 1940,[7] the President issued a decree that exempted business corporations owned by the federal government from the provisions of the corporate statute that authorized members of the supervisory board to examine the corporation's books and records, as well as from the rule mandating the allocation of five percent of net profits to minimum reserve funds.[8] The federal government defended the soundness of special legal treatment of state-owned enterprises on the grounds that it was necessary to protect public institutions from "shareholder curiosity" leading to pressures for dividend payments.[9] Miranda Valverde, the draftsman of the Corporations Law of 1940, subsequently voiced the criticism that this decree was aimed at avoiding public disclosure and investor pressure in light of the "astronomical reserves" of *Banco do Brasil* (the Bank of Brazil), a mixed enterprise.[10]

A few years later, the federal government enacted still another decree exempting government-controlled corporations from the provision of the Corporations Law that capped the issuance of nonvoting preferred shares at one-half of the firm's total equity capital.[11] The Exposition of Motives to this decree asserted that, while the statutory cap on the issuance of preferred nonvoting shares was a reasonable one when applied to private sector corporations, this rule was unnecessary when the state was in control. Government-controlled corporations, it was argued, enjoyed greater favors and guarantees than private firms, hence justifying an exception to the general rule. Such an exception, in turn, would permit mixed enterprises

> to expand their business without the obligation to use budgetary resources to subscribe for new shares to maintain government control over these firms, especially in the current moment in which there are great sums of inactive private capital and a growing interest in the industrial and commercial initiatives of the state.[12]

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7 Decreto-Lei No. 2.627, de 26 de Setembro de 1940, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 1.10.1940 (Braz.).

8 Decreto-Lei No. 2.928, de 31 de Dezembro de 1940, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 4.1.1941 (Braz.).

9 MARIA BÁRBARA LEVY, A INDÚSTRIA DO RIO DE JANEIRO ATRAVÉS DE SUAS SOCIEDADES ANÔNIMAS [THE INDUSTRY OF RIO DE JANEIRO THROUGH ITS BUSINESS CORPORATIONS] 257 (1994) (Braz.).

10 TRAJANO DE MIRANDA VALVERDE, SOCIEDADE POR AÇÕES [BUSINESS CORPORATIONS] 37 (3d ed. 1959) (Braz.).

11 Decreto-Lei No. 6.464, de 2 de Maio de 1944, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 4.5.1944 (Braz.).

12 Exposição de Motivos ao Decreto-Lei No. 6.464, de 2 de Maio de 1944, *quoted in* J.C. SAMPAIO DE LACERDA, NOÇÕES FUNDAMENTAIS SOBRE SOCIEDADES ANÔNIMAS

Starting in 1964, the ruling military government inaugurated an ambitious program to develop Brazil's capital markets, which relied heavily on fiscal incentives in the form of favorable tax treatment for both investors and publicly traded companies.[13] These governmental policies led to a great expansion of state-owned firms with publicly traded shares, both because a large number of existing or newly created SOEs sold shares to the public for the first time, and because SOEs that were already listed sold additional shares. Indeed, state-controlled corporations turned out to be the foremost beneficiaries of the captive demand created by the government's program to foster capital market development through forced savings.[14]

Government-controlled firms figured among the "blue chips" traded on Brazil's stock exchanges and were responsible for seventy-five percent of the market's trading volume.[15] The magnitude of the expansion of state-owned enterprises is striking, with 231 public enterprises created between 1966 and 1976 alone.[16] By 1974, twenty-two out of the top twenty-five companies in the Brazilian economy were controlled by the government; in fact, SOEs were responsible for 49.7% of the total net book value of the top thousand Brazilian firms.[17]

In the 1970s, academics and policymakers came to recognize that tax incentives alone were insufficient to foster capital market development in Brazil; legal reforms to increase minority shareholder protection were also deemed to be crucial to strengthen investor confidence and interest in corporate securities. Economist Mário Henrique Simonsen, then Treasury Secretary, resented Brazil's dearth of large private enterprises: Out of the twenty largest Brazilian companies in 1972, eleven were SOEs, seven were controlled by foreign investors and only two were controlled by Brazilian private capital.[18] Simonsen attributed the absence of large private firms in Brazil not to a

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[FUNDAMENTAL CONCEPTS ON BUSINESS CORPORATIONS] 169 (1956) (Braz.).

13 For a detailed description of these policies, see David M. Trubek, *Law, Planning and the Development of the Brazilian Capital Market*, 72-73 N.Y.U. GRADUATE SCH. BUS. ADMIN. INST. FIN. BULL. 1 (1971).

14 José Roberto Mendonça de Barros & Douglas H. Graham, *Brazilian Economic Miracle Revisited: Private and Public Sector Initiative in a Market Economy*, 13 LATIN AM. RES. REV. 5, 20 (1978).

15 LUCIANO MARTINS, ESTADO CAPITALISTA E BUROCRACIA NO BRASIL PÓS-64 [CAPITALIST STATE AND BUREAUCRACY IN BRAZIL POST-64] 71 (1985).

16 THOMAS J. TREBAT, BRAZIL'S STATE-OWNED ENTERPRISES 36 (1983).

17 VISÃO, BRAZIL REPORT: A WHO'S WHO OF THE BRAZILIAN ECONOMY 45 (1974); Mendonça de Barros & Graham, *supra* note 14, at 8.

18 MÁRIO HENRIQUE SIMONSEN, A NOVA ECONOMIA BRASILEIRA [THE NEW BRAZILIAN ECONOMY] (1974) (Braz.).

lack of private savings (which in fact abounded), but to the absence of legal mechanisms to protect minority shareholders from expropriation and thus encourage capital aggregation.

Proponents of a new legal framework viewed the development of capital markets as the only means of slowing down the state's growing incursion into economic activity, which was widely attributed to the existing capital market failure to finance necessary investments. In a 1975 op-ed, José Luiz Bulhões Pedreira, one of the draftsmen of the new Corporations Law, declared that "the alternatives are simple, clear, obvious: either we manage to create in the country a primary market for securities, or the process of statization of the economy will continue to accelerate exponentially."[19] The proposed Capital Markets Law, which was enacted in the same year as a companion to the new Corporations Law, had the explicit goal of supporting capital markets development in order to "strengthen the position of large private national capital."[20]

Nevertheless, having just used generous tax incentives and captive demand policies to induce a large number of companies to go public — virtually all of which had controlling shareholders — Brazil's legal reform process faced an uphill political battle.[21] Not only controlling families but also the state had a vested interest in preventing the adoption of sweeping legal reforms that could redistribute corporate wealth and power away to minority shareholders. More government-controlled corporations had been created in the decade preceding the adoption of Brazil's 1976 Corporation Law than in the previous hundred years, and many such firms figured among the largest listed companies in the country.[22]

Given the prominence of SOEs in Brazil's corporate landscape, some scholars had defended the adoption of a separate statute to suit the peculiar needs and characteristics of government-controlled firms, a proposal that was

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19 José Luiz Bulhões Pedreira, *A Reforma da Lei das S/A* [*The Reform of the Corporations Law*], JORNAL DO BRASIL, Aug. 24, 1975 (Braz.), *reprinted in* FUNDAMENTOS DA REFORMA DAS SOCIEDADES ANÔNIMAS [FOUNDATIONS OF THE REFORM OF THE CORPORATIONS LAW] 158 (Associação de Estudos de Direito de Empresa ed., 1976) (Braz.).

20 Exposição de Motivos ao Decreto-Lei No. 196, de 24 de Junho de 1976 (pelo Ministro da Fazenda).

21 For a more thorough description, see Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the U.S. and the EU*, 63 STAN. L. REV. 475 (2011).

22 MARTINS, *supra* note 15, at 61.

nevertheless defeated.[23] In the absence of special legislation, the prevailing approach was to have a single Corporations Law apply to private and state-owned companies alike. As explained in the Exposition of Motives to the new statute, "in addition to regulating this form of organization when used by the private sector, the Corporations Law is the general law of mixed enterprises, which are governed by its provisions, subject to the derogations set forth in the special statutes that authorize their creation." The Exposition further noted that "in resorting to the corporate form for the enterprises it promotes, the state seeks to assure private parties, to whom it offers association, the same rights and guarantees enjoyed by shareholders of other companies, without prejudice to the special provisions of federal law."[24]

The new Corporations Law of 1976[25] also included a new, though remarkably lean, chapter devoted to *sociedades de economia mista* (mixed enterprises).[26] According to the justification of the bill advanced by its draftsmen, the goal of the chapter was to limit itself to the "minimum necessary" to "protect minority shareholders" of mixed corporations.[27] The chapter made clear that, except as otherwise specified therein or in federal law, publicly traded mixed enterprises were subject to the same corporate law rules and regulations of the newly created *Comissão de Valores Mobiliários* (Securities Commission — CVM) as private issuers.[28]

Interestingly, the new chapter expressly imposed on directors and controlling shareholders of mixed enterprises the same fiduciary duties applicable to privately owned corporations (thus incorporating the relevant provisions by reference), even though it specifically permitted the government to "steer the company's activity toward the public interest that justified its creation."[29] But what may have looked like an intractable tension between standard fiduciary duties and government control was more apparent than

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23 *See, e.g.*, José Cretella Junior, *Sociedades de Economia Mista no Brasil* [*Mixed Enterprises in Brazil*], 80 REVISTA DE DIREITO ADMINISTRATIVO 37 (1965) (Braz.).

24 Exposição de Motivos ao Decreto-Lei No. 196.

25 Lei No. 6.404, de 15 de Dezembro de 1976, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 17.12.1976 (Braz.).

26 The new Chapter IX on mixed enterprises contained only eight out of the statute's 300 articles. A 2001 law reform further eliminated two of them, with only six remaining in force.

27 Alfredo Lamy Filho & José Luiz Bulhões Pedreira, *Justificação do Anteprojeto* [*Justification to the Draft Bill*], *in* FUNDAMENTOS DA REFORMA DAS SOCIEDADES ANÔNIMAS, *supra* note 19, at 25.

28 Lei No. 6.404, art. 235.

29 *Id.* art. 238.

real. As eventually adopted, Brazil's Corporations Law proved to be quite accommodating to the needs of the government as controlling shareholder.

The general fiduciary duties created by the 1976 Corporations Law were exceedingly broad — indeed, probably too broad to effectively constrain the extraction of private benefits by controlling shareholders. The pertinent provisions of the statute provide that controlling shareholders shall protect the interests not only of shareholders, but also of employees, the community, and even the national economy.[30] Not only was the statutory language defining fiduciary duties too expansive to effectively constrain behavior, but a sophisticated fiduciary duty regime that could parse complicated controlling shareholder tactics required a degree of technical ability and the willingness of Brazil's judiciary to constrain controlling shareholders which was not present at the time.

Moreover, a closer look at the new fiduciary regime applicable to controlling shareholders reveals that, to the extent that it conflates corporate control with public interest, it is not merely innocuous, but positively detrimental. In elevating not only the state, but also private controlling shareholders to the legal position of guardians of a diffuse notion of public good, the new Corporations Law would ultimately strengthen their position *vis-à-vis* that of the minority, which stood for merely private and egoistic interests.

It is difficult to overstate the dominance of state ownership in Brazil's stock markets in that period. A study commissioned by the newly-created CVM in 1978, just two years after the enactment of the Corporations Law, revealed that government-controlled corporations accounted for 70.8% of Brazil's market capitalization and sixty-one percent of the stock market value held by minority shareholders.[31] This meant that, under a unitary corporate and securities law system, the credibility of Brazil's regulatory regime depended on its binding force *vis-à-vis* SOEs.

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30 *Id.* art. 116 ("[T]he controlling shareholder must use its influence so as to make the company fulfill its purpose and its social function, and has duties and responsibilities to the other shareholders, employees and the community in which it operates, whose rights and interests he must loyally abide by and respect"); *id.* art. 117 § 1°, *a* (listing as an instance of controlling shareholder abuse the act of "steering the company towards a purpose foreign to its corporate object or damaging of national interest, or leading it to favor another Brazilian or foreign company, to the detriment of the minority's shareholder's participation in the profits or assets of the company, or to the national economy").

31 Commissão de Valores Mobiliários, *Valor de Mercado do Capital das Companhias Abertas Brasileiras* [*Market Capitalization of Brazilian Publicly-Traded Companies*], 11 Revista Brasileira do Mercado de Capitais 283, 289-91 (1978) (Braz.).

Nevertheless, despite the express statutory language subjecting listed SOEs to the same securities law rules governing private sector corporations, the state as controlling shareholder blatantly ignored existing regulations. The CVM, in turn, proved to be unwilling to reprimand the actions of the government as controlling shareholder when they ran afoul of securities regulations. Consequently, the integrity of Brazil's capital markets and the CVM's reputation as an effective sheriff thereof suffered significant damage.

The notorious *Caso Vale* (Vale Case), involving state-controlled mining giant Companhia Vale do Rio Doce (CVRD), is illustrative of this risk. Just a few years after the enactment of the 1976 Corporations Law, the federal government instructed a brokerage firm to secretively sell a massive number of shares it owned in CVRD in the open market. In doing so, the government intentionally failed to previously disclose its intent to sell a large block of stock as required under Brazil's Capital Markets Law and CVM regulations. The government justified its action by appealing to the "public interest" involved in the stock sale, which entailed stabilizing stock market prices and raising much-needed funds to finance Brazil's ethanol subsidization program.[32] In an announcement issued shortly after the incident, the CVM attributed the massive stock sales to the government's attempt to alleviate the monetary needs of the Treasury, explaining that, for this reason, the "interest of the nation had prevailed over the principles of market offer."[33]

This case generated significant controversy among market participants and legal experts. Regulators argued that the credibility of Brazil's capital markets as an effective financing source for Brazilian companies required that all firms — including the listed SOEs that dominated Brazil's equity markets — strictly comply with securities regulations.[34] Other commentators, however, contended that the state qua controlling shareholder was not, and should not be, subject to the same legal requirements applicable to private controlling shareholders. They appealed to the public interest associated with state action — and, in particular, with the financial interests of the state as

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32 Nelson Laks Eizirik, *As Lições do "Caso Vale"* [*The Lessons from the "Vale Case"*], 16 Revista Brasileira de Mercado de Capitais 12, 18 (1980) (Braz.) (quoting the justifications advanced by the Treasury Secretary for the stock sale transaction).

33 *Id.* at 17.

34 Comissão de Valores Mobiliários, Inquérito Administrativo 04/80 (Oct. 10, 1980), Diário Oficial da União [D.O.U.] de 29.10.1980, at 21581 (Braz.) (noting that according to a then recent survey, state-owned companies accounted for fifty-five percent of the market capitalization in Brazil, with the state owning approximately three-quarters of these firms' capital).

selling stockholder — in justifying the government's behavior in the Vale Case.[35]

The CVM ultimately undertook an administrative investigation of the Vale Case, but its enforcement action was exceedingly lax.[36] The only person punished was the manager of the brokerage firm that performed the stock sales, who was at the same time chairman of the board of the Rio de Janeiro Stock Exchange. Even so, the commission opted not to inflict the maximum possible fine, reasoning that "Brazil's market culture — which needs to be changed — has been used to thinking that client orders, especially from the government, are not to be discussed, but to be followed."[37]

The CVM decision reprimanded the defense attorneys for suggesting that the government is immune from securities regulations and that "government orders must be complied with regardless of other considerations."[38] It reasoned that "the existence of a free market, and of an effective and reliable regulatory agency, is not viable if the application of market rules is limited to private participants."[39] The commission added that "there is no doubt that the government itself, as the major shareholder of publicly-traded companies, will be the greatest beneficiary of the development of an active and disciplined stock market."[40] While the CVM was right in recognizing that the failure of the government to comply with securities regulations (and the commission's own difficulty, or unwillingness, to punish such violations) was harmful to market confidence in Brazil, its diagnosis of the state's interests under a rigorous legal regime was perhaps less accurate. As the controlling shareholder of numerous listed firms, the government often stood to profit by disregarding or even opposing effective corporate law rules, even if it was to the detriment of the country's capital market development.

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35 Arnoldo Wald, *Do Regime Legal da Venda das Ações de Sociedades de Economia Mista Pertencentes à União Federal* [*The Legal Regime for the Sale of Shares in Mixed Enterprises Belonging to the Federal Government*], 16 REVISTA BRASILEIRA DE MERCADO DE CAPITAIS 27, 28 (1980) (Braz.).

36 *See* IV MODESTO CARVALHOSA, COMENTÁRIO À LEI DE SOCIEDADES ANÔNIMAS [COMMENTARY TO THE CORPORATIONS LAW] 361 (4th ed. 2009) (Braz.) (criticizing the under-enforcement of violations of Securities Law in the Vale Case).

37 COMISSÃO DE VALORES MOBILIÁRIOS, *supra* note 34, at 21574.

38 *Id.* at 21582.

39 *Id.* at 21581.

40 *Id.*

II. Privatizations in the 1990s: Changing the Rules of the Game

Brazil's SOEs entered a period of crisis in the late 1970s, but it was not until the 1990s that a large-scale privatization movement finally took off. While the influence of state interests in the development of the 1976 Corporations Law was subtle, the legal reforms implemented in connection with Brazil's privatization process would provide a textbook example of the influence of the state qua shareholder in corporate lawmaking. While in the 1940s the state had addressed its interests as a shareholder by exempting itself from restrictive corporate law rules, this time around the Brazilian government promoted amendments to general corporate law rules, applicable to all business corporations in the country, with the object of maximizing its revenues from the privatization process in order to repay the public debt and rebalance the government's finances.[41]

Nevertheless, in the Brazilian context of low investor protection and, consequently, low stock valuations, public offerings were unlikely to lead to revenue maximization absent major legal reforms. In the 1990s price-equity ratios were extremely low, with three-quarters of firms having a PE ratio below nine (against an average of twenty-one for the S&P 500 during the same period), and more than half of such firms displaying share prices of less than fifty percent of book value.[42] Brazilian policymakers at the time reasoned that public share offerings would not only fail to maximize government revenue, but were also unlikely to generate sufficient levels of ownership dispersion and capital market development to justify the effort.[43]

Empirical studies would later find that jurisdictions displaying low levels of legal investor protection and high levels of private benefits of control were more likely to sell SOEs through private block sales than through share

41 Indeed, "the reduction of public debt and the balancing of public finances" was one of the key stated objectives of Brazil's National Denationalization Program, enacted by Lei No. 8.031, de 12 de Abril de 1990, Diário Oficial da União [D.O.U.] de 13.4.1990 (Braz.).

42 Soluções para o Desenvolvimento do Mercado de Capitais Brasileiro [Solutions for the Development of Brazilian Capital Markets] 55 (Carlos Antonio Rocca ed., 2001).

43 Luciano Coutinho & Flavio Marcilio Rabelo, *Brazil: Keeping It in the Family*, *in* Corporate Governance in Development 35, 47 (Charles P. Oman ed., 2004); *see also* Lucian Bebchuk & Mark Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 Stan. L. Rev. 127 (1999) (noting the instability of dispersed ownership structures in jurisdictions where private benefits of control are high).

issuance privatizations (SIPs), thus signaling revenue-maximizing behavior by privatizing governments.[44] This is precisely what Brazil did as a country that had, at an estimated sixty-five percent of firm value, the highest private benefits of control among thirty-nine sampled countries between 1990 and 2000, according to a study by Alexander Dyck and Luigi Zingales.[45] According to William L. Megginson et al.'s study on the choice of the method employed to divest the government's equity stakes, Brazil was one of the countries with the lowest ratio of SIPs to privatizations worldwide.[46]

Nevertheless, while the existing studies on the choice of sales method in privatization proceedings take the level of investor protection as given, that was not the case in Brazil.[47] Brazil's government had profit-maximizing ambitions similar to those of a typical private controlling shareholder, but it had more powerful weapons at its disposal to achieve its objectives. While the political influence of controlling families over the content of corporate and securities regulations is a well-known phenomenon (in Brazil as elsewhere), the government's proximity and sway over the lawmaking process is unparalleled.

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44 *See* Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 69 J. FIN. 537, 539 (2004) (finding that privatizations through block sales are more common among countries displaying high private benefits of control); William L. Megginson et al., *The Choice of Private Versus Public Capital Markets: Evidence from Privatizations*, 59 J. FIN. 2835 (2004) (finding a direct relationship between the share of SIPs over total privatizations and the level of legal investor protections in a given jurisdiction). *But see* Assaf Hamdani & Ehud Kamar, *Hidden Government Influence over Privatized Banks*, 13 THEORETICAL INQUIRIES L. 567 (2012) (arguing that the government's desire to exert informal influence over the financial sector best explains the prevalence of block sales in bank privatizations in Israel).

45 Dyck & Zingales, *supra* note 44. According to a different study, which used dual-class price differentials to estimate private benefits of control, an average Brazilian controlling shareholder could expect to extract up to 33.3% of the value of the company by holding as little of one-sixth of total cash flow rights, *see* Tatiana Nenova, *The Value of Corporate Votes and Control Benefits: A Cross-Country Analysis*, 68 J. FIN. ECON. 325, 327 (2003).

46 Megginson et al., *supra* note 44.

47 While the choice of private block sales as a privatization method led Brazil to weaken minority shareholder rights upon control sales, the adoption of share offerings by Italy and Germany prompted their governments to improve minority rights and the governance environment of privatized firms in order to maximize their privatization proceeds, *see* Mariana Pargendler, *State Ownership and Corporate Governance*, 80 FORDHAM L. REV. 2917 (2012).

Taking full advantage of its ability to reshape corporate law rules to further increase the already ample opportunities for extraction of private benefits of control, in 1997 the Brazilian government went on to promote a so-called "mini-reform" of the Corporations Law of 1976.[48] The subject matter of the new law was not salient enough to attract the attention of broad segments of the Brazilian population, which, in any case, would likely have been sympathetic to the government's attempt to maximize its privatization proceeds to cover the country's sizable external deficit.[49] In turn, controlling families, which paid close attention to any and all corporate law reforms, stood to benefit from the new statute, and therefore had no reason to oppose it.

Prior to the reform, Brazil's Corporations Law granted statutory appraisal rights to dissenting minority shareholders from spin-off transactions, and imposed a mandatory bid requirement (dubbed as "tag-along" rights in Brazil) for common shares held by minority shareholders at the same share price paid to the controlling block in the event of a sale of control. The new law, while also officially meant to "stimulate capital market development in Brazil," did away with both of these protections.[50] The removal of appraisal rights allowed the government to carry out cheaply its planned strategy of spinning off portfolio companies prior to their sale, thus avoiding out-of-pocket payments to dissenting shareholders and judicial disputes over the amounts due. The elimination of the mandatory bid requirement, in turn, permitted the state to appropriate the totality of the control premium to itself. As described in greater detail below, the elimination of the mandatory bid rule in Brazil allowed many recently acquired companies to go private by buying out the minority at a price below the book value of the company, thus contributing to a deterioration of investor confidence in the country's capital markets.

Nonetheless, lawmakers defended the reform as attending to "the greatest interests of the nation: privatizations and the protection of minority shareholders, by reconciling the interests of the latter with those of majority

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48 Lei No. 9.457, de 5 de Maio de 1997, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 6.5.1997 (Braz.).

49 The purchase price to be paid for privatized firms was a hot button issue in the sales process. Numerous media reports and labor groups at the time expressed concern that the government would "give away" state-owned firms to foreign capitalists, *see, e.g.*, ALOYSIO BIONDI, O BRASIL PRIVATIZADO: UM BALANÇO DO DESMONTE DO ESTADO [PRIVATIZED BRAZIL: AN APPRAISAL OF THE DISASSEMBLY OF THE STATE] (1999) (Braz.) (stressing numerous variations on the argument that state-owned enterprises were sold at an unfairly low price).

50 *See, e.g.*, NELSON EIZIRIK, A REFORMA DAS S.A. E DO MERCADO DE CAPITAIS [CORPORATE AND CAPITAL MARKETS REFORM] 2 (2d ed. 1998) (Braz.).

shareholders."[51] The new statute sought to compensate for the elimination of shareholder rights upon control sales by granting preferred nonvoting shareholders a right to dividends at least ten percent greater than those paid to common shareholders. The fact that this provision passed without significant opposition — and that the Brazilian Association of Public Companies, Brazil's main lobby group for controlling shareholders, supported its applicability to shares already outstanding[52] — was in itself a warning that the mandatory dividend requirement did not adequately protect minority investors. In fact, one expected consequence of the requirement of a higher dividend rate to preferred (usually minority) shareholders is to discourage meaningful dividend distributions in the first place. In a legal environment that offers insufficient investor protection, controlling shareholders do not depend on dividend distributions to receive a return on their investment, since other means, ranging from outright tunneling to inflated salaries and perquisites, are available.

Following the enactment of the 1997 statute, the Brazilian state went on to sell the cream of its holdings, especially in the telecommunications sector, in return for a significant premium. The crown jewel of the privatization process was telecom company Telebras, which alone accounted for approximately sixty percent of all trades in the São Paulo Stock Exchange prior to its privatization in 1998. In an attempt to create competition in the newly privatized industries, the government's divesting model contemplated the spin-off of Telebras's subsidiaries prior to a control sale. The figure below provides an organizational chart of Telebras and its publicly traded subsidiaries prior to privatization.

If eliminating appraisal rights in spin-off transactions addressed the government's goal of increasing competition following its divestiture,[53] the elimination of mandatory bid requirements following a control transfer was designed to increase the control premium obtainable by the state. The expected government gains from the legal reform abolishing premium-sharing requirements were substantial. Through the ample use of preferred nonvoting shares and, to a lesser extent, a pyramidal structure, the government was in a position to transfer uncontested control of Telebras's subsidiaries by selling less than one-fifth of their total equity capital.[54] When the company was privatized,

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51 *Id.* at 15.

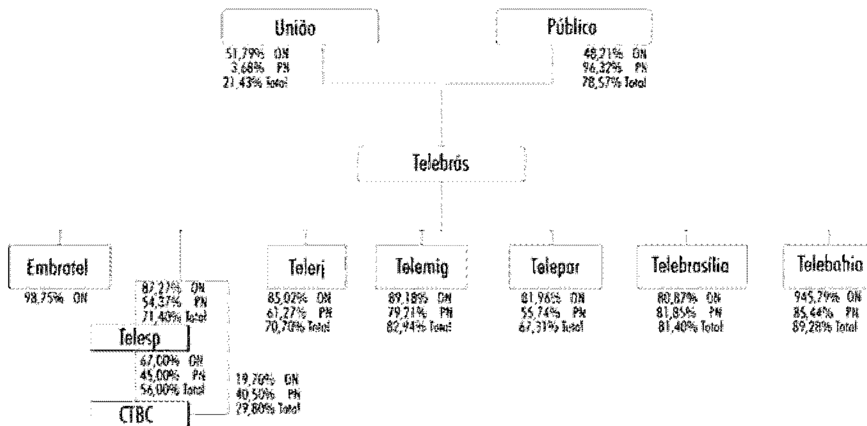
52 *Id.* at 51.

53 Telebras was broken into twelve different companies prior to its privatization, which were gathered into three different regional groups as part of the sales process. A single controlling shareholder could acquire no more than one company in each group, *see id.* at 172.

54 Telebras's pyramidal structure was a result of its historical self-financing model, in which the sale of telephone lines was financed by the consumers themselves in exchange for shares of stock in the local company. The telephone company would

the federal government held 51.79% of Telebras common shares, amounting to 19.26% of the company's total capital, while foreign shareholders held roughly forty percent of the company's total equity.[55] Telebras's ownership structure, which allowed the state to exercise uncontested control while holding only a minority of the company's cash-flow rights, distorted the government's incentives as the controlling and selling shareholder by encouraging it to appropriate a disproportionate amount of the firm's value.[56]

Telebras Organizational Chart Prior to Privatization[57]



ON: common stock *União*: Federal government
PN: nonvoting preferred stock *Público*: public float

As planned, the Brazilian government succeeded in obtaining a substantial premium in the sale of Telebras. The aggregate purchase price of $19,000,000,000 paid for the control of companies belonging to the Telebras group exceeded by sixty-four percent the minimum auction price set by the government, which in turn already included a significant premium over the

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then install the line within twenty-four months of the purchase/subscription, *id.* at 151.

55 *Id.* at 153.

56 For a model showing the exponential increase in agency costs in controlling-minority structures, see Lucian A. Bebchuk, Reinier H. Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Creation and Agency Costs of Separating Control from Cash Flow Rights*, *in* Concentrated Corporate Ownership 295 (Randall Morck ed., 2000).

57 Ana Novaes, *Privatização do Setor de Telecomunicações no Brasil* [*Privatization of the Telecommunications Sector in Brazil*], *in* A Privatização no Brasil 165 (2000) (Braz.).

share market price on the day of the announcement.[58] Economists estimate that the price received by the government represented a premium of roughly 160% over the price of Telebras nonvoting preferred stock.[59]

The 1997 reform to Brazil's Corporations Law provides a paradigmatic example of the risks that state ownership under a unitary corporate law regime poses to the overall corporate governance environment. Since the new statutory amendments were general in nature and by no means restricted to state-owned enterprises, they also benefited controlling shareholders of private firms to the detriment of their outside investors. Consequently, control sales of government and privately owned firms alike were made at substantial premiums to majority shareholders and at the expense of the minority. There were several instances in which controlling shareholders sold their stakes at a premium of over 200% compared to the market price of minority shares.[60]

Tatiana Nenova's study on the impact of the 1997 reform on the level of private benefits finds that control value increased more than twice following the enactment of the statute.[61] This rapid rise in the level of private benefits, in turn, decreased investors' confidence, hence leading to a sharp reduction in the number of listed firms in Brazilian capital markets. The trading volume on the São Paulo Stock Exchange fell from more than $191,000,000,000 in 1997 to $65,000,000,000 in 2001.[62] Between 1995 and 2000, only eight companies went public on the São Paulo Stock Exchange.[63] In an attempt to reverse the damage, the Brazilian Congress amended the Corporations Law once again in 2001 to reinstate some of the protections eliminated in the late 1990s, but the reform fell short of expectations.[64]

Ronald J. Gilson, Henry Hansmann and I have noted that although that was not the primary intent of contemporary policymakers, the elimination of

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58 *Id.* at 172-74.

59 *See* Bruno Rocha & Iam Muniz, *Casos Brasileiros* [*Brazilian Cases*], *in* GOVERNANÇA CORPORATIVA NO BRASIL E NO MUNDO [CORPORATE GOVERNANCE IN BRAZIL AND AROUND THE WORLD] 73 (Ricardo P.C. Leal et al. eds., 2002) (Braz.).

60 Mark Mobius, *Getting Brazil to Clean Up Its Act*, LATIN FIN., Dec. 1, 2000, http://www.latinfinance.com/ArticlePrint.aspx?ArticleID=1438044.

61 Tatiana Nenova, *Control Values and Changes in Corporate Law in Brazil* 4 (World Bank, South Asia; World Bank — Policy Unit; Harvard University — Department of Economics, Working Paper, 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=294064.

62 Maria Helena Santana, *The Novo Mercado*, *in* FOCUS: NOVO MERCADO AND ITS FOLLOWERS 1, 7 (2008).

63 *Id.* at 9.

64 Lei No. 10.303, de 31 de Outubro de 2001, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 1.11.2001 (Braz.).

minority shareholder rights upon control sales and going-private transactions in Brazil in 1997 can be interpreted as an attempt to buy off existing political and economic elites by granting them a temporary right to exit public markets by extracting substantial premiums.[65] Such a "grand bargain" strategy, if successful, could significantly decrease the presence of incumbents in the market and, therefore, their opposition to investor protection reforms.

In the event, however, the results of Brazil's accidental "grand bargain" experiment were partial at best. While many firms did take up the opportunity to go private in opportunistic transactions, a significant number of Brazilian corporate giants opted to remain listed on the exchange. Government-controlled corporations that remain traded and continue to resort to equity markets in Brazil and internationally include such giants as Banco do Brasil, the largest bank in Latin America by assets, and Petrobras, one of the world's biggest oil companies, showing that the state's role as a shareholder, and its interest in an inefficiently weak corporate governance regime, are not going away anytime soon.

III. Challenging Standard Recommendations on SOE Governance

The financial interests of the Brazilian state as the controlling shareholder of the country's largest business corporations have made it a particularly influential actor in corporate law reforms, with negative consequences for the development of legal investor protections. Yet, as I have argued in greater detail elsewhere, the Brazilian state is by no means exceptional in facing conflicts of interest arising out of its dual role as shareholder and corporate governance regulator. On the contrary, the pecuniary interest of the government as a shareholder has also shaped important features of corporate law in the nineteenth-century United States, twentieth-century Europe and modern-day China.[66]

The existing literature on SOE governance and capital market development has nevertheless failed to account for the state's conflicts of interest in corporate lawmaking. Mainstream recommendations on best corporate governance practices for SOEs, as reflected in the highly influential *OECD Guidelines on Corporate Governance of State-Owned Enterprises*,[67] have two core components. First, with respect to *ownership structure*, they view partial

65 Gilson, Hansmann & Pargendler, *supra* note 21.

66 Pargendler, *supra* note 47.

67 OECD Guidelines, *supra* note 4.

state ownership as preferable over whole state ownership.[68] Second, with respect to the *legal regime*, they advocate that SOEs should be governed, to the greatest extent possible, by the same corporate and securities rules applicable to private sector corporations.[69] The combination of private ownership and corporate law, the argument goes, creates the necessary market checks and legal constraints to curb inefficiencies and boost firm performance.

However, once the political role of the state as controlling shareholder is taken into account, the benefits of these prescriptions seem dubious, for they magnify the government's financial stake in corporate law reforms in at least two ways. First, whole ownership is preferable over partial ownership by the government when it comes to eliminating conflicts of interest in corporate lawmaking.[70] As the sole owner of the enterprise, the state as shareholder will lack an interest in most governance rules that typically apply to multi-owner

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68 *See* OECD, SOEs OPERATING ABROAD (2009) ("[T]he listing of a minority stake in SOEs is considered a good practice both in establishing credibility and in dealing with a host of other corporate challenges"); *see also Stakes and Mistakes: India's Government Is Privatising Companies for the Wrong Reasons*, THE ECONOMIST, Nov. 12, 2009, http://www.economist.com/node/14845283 ("Listing even a small stake helps keep managers on their toes, by subjecting them to the scrutiny of the stockmarket. But the bigger the float, the better").

69 *See* OECD GUIDELINES, *supra* note 4 (prescribing that "[w]hen streamlining the legal form of SOEs, governments should base themselves as much as possible on corporate law and avoid creating a specific legal form when this is not absolutely necessary for the objectives of the enterprise," and suggesting that "SOEs should be subject to the same high quality accounting and auditing standards as listed companies" and that "[l]arge or listed SOEs should disclose financial and non-financial information according to high quality internationally recognised standards").

70 To be sure, the benefits that whole over partial state ownership may bring to the political economy of corporate governance by eliminating the government's conflict of interest will have to be balanced against the implications of different ownership structures for corporate performance. The available empirical evidence on the relative efficiency of mixed enterprises *vis-à-vis* wholly-owned SOEs is however mixed, but overall seems to provide mild support for the performance advantages of mixed enterprises, *see, e.g.*, Stavros Gadinis, *Can Private Investors Discipline State-Appointed Managers? Evidence from Greece Privatizations*, 13 THEORETICAL INQUIRIES L. 525 (2012) (finding performance improvements following partial privatizations in Greece, even though corruption was not eliminated); Aidan R. Vining & Anthony E. Boardman, *Ownership Versus Competition: Efficiency in Public Enterprise*, 73 PUB. CHOICE 205 (1992) (finding that SOEs and mixed enterprises are less profitable than private companies, and that wholly owned SOEs are less profitable than mixed enterprises).

firms, such as those concerning shareholder voting rights, self-dealing by controlling shareholders, remedies against minority oppression, and so on. Second, a separate and different legal regime for SOEs can alleviate the state's interest as shareholder in the general corporate law regime, permitting the latter to develop along more efficient lines. But these standard recommendations for a single corporate law regime for state-owned and private firms are not without difficulties either.

One traditional argument in favor of a dual legal regime is that private firms and SOEs have different functional characteristics and objectives and would therefore be best served by different legal regimes.[71] The Brazilian case suggests another overlooked justification for establishing a distinct corporate regime for SOEs, which is to relieve state interests in corporate lawmaking. The creation of a dual regime can be a second-best solution when powerful political actors effectively block the enactment of a single efficient legal regime.[72] As a variation on regulatory dualism, the regime applicable to state-owned and private firms would be separate and different from the legal regime governing private sector corporations precisely to permit the private regime to develop along more efficient lines by exempting it from the interests and pressure of the government as shareholder. Conversely, even if a unitary corporate law regime may turn out to improve the corporate governance of SOEs, it can be ultimately damaging to the corporate governance of private firms.

A potential alternative to the proposal for a different legal regime for state-owned and private firms discussed above, which conflicts with conventional best practices recommendations, is the separation of regulatory authorities within a given jurisdiction, as advocated by the *OECD Guidelines*. The guidelines endorse a "strict separation of the state's ownership and regulatory functions" as a "fundamental prerequisite for creating a level playing field for SOEs and private companies and for avoiding distortion of competition."[73]

Yet the Brazilian experience also suggests that recommendations for institutional separation within the same jurisdiction as a solution to conflicts

71 *See* Gilson, Hansmann & Pargendler, *supra* note 21, at 480 (terming this rationale for a dual regulatory regime "regulatory diversification," which occurs when "[t]he actors being regulated are not homogeneous in their needs for regulation," so that efficiency requires "two or more parallel forms of regulation, with each form designed to deal with the characteristics of a distinct set of actors").

72 *Id.*

73 OECD GUIDELINES, *supra* note 4; *see also*, OECD, *supra* note 68, at 12 ("The annotations to the SOE Guidelines particularly recommend the creating of a centralised ownership entity as an effective way to clearly separate the exercise of ownership functions from other activities performed by the state").

in corporate governance regulation should be taken with a grain of salt. In virtually all cases of conflicts of interest in corporate law reforms in Brazilian history, the public bodies in charge of elaborating corporate laws (usually Congress or the courts) and those responsible for managing the government's equity holdings (the executive branch) were already distinct, but this separation was insufficient to eliminate the stAte's conflicts of interest and influence over the legal regime. Even though the state is certainly not a unitary actor, its different agencies and branches often behave as such when it comes to defending the government's interests as a shareholder.[74]

Conclusion

The conflict of interest stemming from the state's two roles as shareholder and regulator — that is, as a simultaneous player and referee in the corporate arena — was particularly acute in Brazil due to the predominance of mixed enterprises in the country. The tension between the state's interest as controlling shareholder and its role as a corporate regulator were manifest from the outset. In the 1990s, the government's financial interests as a selling shareholder during privatizations led it to promote a major reform to the Corporations Law that eliminated various minority investor rights during control sales. While the state succeeded in appropriating to itself a hefty control premium in privatization transactions, investor confidence in the country's capital markets suffered as a result.

Standard recommendations on the corporate governance of SOEs constantly prescribe partial privatizations and a unitary legal regime in order to improve the performance of state-owned firms. The Brazilian experience, however, shows the dark side of these prescriptions. At least with respect to corporate law, a unitary regime may not so much constrain the government as controlling shareholder of public companies, but in fact be constrained and compromised by state interests, thus putting the very integrity of the general private regime at risk. A modest and politically promising solution to this problem is to mitigate the negative externalities generated by state ownership on general corporate laws by creating a dual regulatory regime that supplies a separate and different set of rules for government-controlled and private corporations.

74 See *supra* notes 31-39 and accompanying text, for a paradigmatic example of the securities' commission reluctance to enforce its regulations against SOEs.