The role of informal institutions in the enforcement of rules and how to improve corporate and public governance in Brazil: studies based on a set of corporate governance cases involving State-owned companies.

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Abstract: This paper aims to evaluate how informal institutions affect the formal ones and how legal proposals may improve both corporate governance and public administration. Through a set of corporate governance cases, especially the recent cases on Petrobras, the state-owned company involved in accusations of illegal bribery and corruption schemes, we examine how minority shareholders' protection rules are affected by informal institutions, such as political and social norms. After that, this paper points out the institutional proposals that policymakers, academics, and organizations are recommending to improve corporate governance in Brazil and how such institutional mechanisms may also be useful in public governance. It concludes that the state, reinforced by informal institutions and acting as the controlling shareholder of companies such as Petrobras, has been a leading player in the expropriation of minority shareholders' rights in Brazil. Moreover, its actions have also caused economic and social problems for the stakeholders of the state-owned companies, mainly suppliers and workers. Finally, the author further believes that the outcome of interaction between formal and informal institutions in corporate and public governance is under-researched in Brazil. Hence, to promote its social and economic development, this interaction between institutions must be studied in greater depth, and, consequently, its negative effects can be minimized through better institutional design.

Keywords: corporate governance; informal institution; Petrobras; developmentalism; state-owned companies.

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1. Introduction

State-owned companies are responsible for a significant part of Brazilian economic activity. In August 2015 there were 30 state-owned companies listed on the Brazilian Stock Exchange[2]. These companies represented almost 15% of market capitalization and over 20% of average daily trading volume[3]. Due to the importance of these companies, a significant impact was made by the announcement by Petrobras, the giant Brazilian state-owned oil company, of its consolidated financial statements for the third quarter of 2014. Petrobras disclosed to its investors a write-off of US$ 2.53 billion related to an illegal payment scheme uncovered by the investigations carried out by the *Operação Lava-Jato (Brazilian Car Wash Operation)*[4].

These facts suggest a representative scenario of issues involving the corporate governance of Brazilian state-owned companies where the capital is held by the State and private shareholders, the State being the controlling shareholder (as represented by the National Treasury). Based on the above, this paper aims to discuss the corporate governance of state-owned companies in Brazil and to evaluate by means of the institutional framework the reasons that could lead to the expropriation of minority shareholder rights by the State. Furthermore, we evaluate proposals that aim to improve the corporate governance of such companies, also identifying those that could be applied to public governance, helping to improve the management of public service in Brazil.

The hypothesis is that informal institutions, as described by economists and political scientists, are one of the main causes that undermine the enforcement of rules in Brazil, negatively affecting its economic development and the management of its natural resources. Therefore, based on such hypothesis, it will be evaluated how the interaction between formal and informal institutions affects the enforcement of corporate rules in Brazil and the consequences of this interaction. In order to perform

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[2] Cf. Securities, Commodities & Futures Exchange - BM&FBOVESPA S.A. (2015). State-Owned Enterprises Governance Programme. São Paulo: Department of Regulation Affairs. Available at: http://www.bmfbovespa.com.br/pt-br/noticias/2015/BMFBOVESPA-apresenta-Programa-Destaque-em-Governanca-de-Estatais-2015-09-30.aspx?tipoNoticia=1&idioma=pt-br. (Accessed: 15th December 2015).

[3] Idem.

[4] A federal police investigation into fraud, corruption, and money laundering involving former executives of Petrobras and the main Brazilian construction companies. Cf. http://lavajato.mpf.mp.br/todas-noticias.

this investigation, a specific typology will be employed – through a set of case studies – for the analysis of informal institutions, created by Helmke and Levitsky in 2003[5].

Thereby, this paper is organized into four parts. In the first part, in order to establish a minimum theoretical framework to evaluate such institutions in action, we will define formal and informal institutions and the importance of enforcement to this study. Then, in the second part, based on the analysis of specific cases and under different political and economic scenarios known as "Developmentalism" (1960-1980), "Neoliberalism" (1990-2003), and "New Developmentalism" (2004-2015), we will identify the formal and informal institutions and how the outcome of their interaction affects the effectiveness of the corporate governance rules.

In the third part, we will describe and comment on possible institutional solutions proposed to mitigate the problems that were found in the corporate governance cases involving State-Owned Companies. Finally, still in the third part, we will evaluate which of these institutional proposals applied to corporate governance of State-Owned Companies can be useful to public governance in Brazil, aiming for its improvement. In the fourth part, we will draw conclusions.

2. Institutions and the role of enforcement in the effectiveness of formal institutions

In order to evaluate how formal and informal institutions interact and affect corporate governance in Brazil, the main concepts regarding institutions and the role that enforcement plays in the effectiveness of formal institutions will be highlighted.

What can we consider as institutions, both formal and informal, which can help us to evaluate corporate governance in Brazil through the institutional lens? According to North (1990, p. 3) "Institutions are the rule of the game in a society or, more formally, are the humanly devised constraints that shape human interaction". Institutions constrain or enable specific humans' behavior, reducing uncertainty "…by establishing a stable – but not necessarily efficient - structure to human interaction" (North 1990, 3-

[5] Cf. Helmke, G. and Levitsky, S. (2003) "Informal Institutions and Comparative Politics: A Research Agenda". *The Helen Kellogg Institute for International Studies*, Working Paper No. 307. Available at: <https://www3.nd.edu/~kellogg/publications/workingpapers/WPS/307.pdf>. (Accessed: 15th December 2015).

6; and Helmke and Levitsky 2006). They can be created or evolved over time, such as formal rules embodied in the common law systems or cultural norms (North 1990; and Lal 1999).

Additionally, institutions can be formal or informal. Following North, formal institutions are written laws, administrative rules created by securities commissions, political and judicial rules formally created by official channels, economic rules that deal with property rights of minority shareholders, bylaws that organize corporations and firms in general, contracts that regulate particular interests between individuals and so on.

However, the difficulty lies in defining informal institutions, as the definition of such varies among economic and political scientists around the world. We may start such definition by suggesting informal institutions are socially shared rules, usually unwritten, that are created, communicated, and enforced outside of the coercive power of the State (Estrin & Prevezer, 2011; Helmke & Levitsky, 2004; and North, 1990).

North (1990, p. 36), highlighting the significance of informal institutions, argues that in the western world we do think that our life and the economy are organized and ordered by written and formal laws, and that property rights are duly preserved by specific and clear judicial and administrative rules, for example. Nevertheless, formal rules, in the most developed countries, make up a small – although very important – part of the sum of constraints that shape choices (North 1990, p. 36).

From a political point of view, Helmke and Levitsky (2006) clarify that informal institutions are also vital to understand how democracy in Latin American countries work – for both good and ill. According to them, studies[6] have emphasized ways in which some informal institutions – corruption, clientelism, and patrimonialism – damage the effectiveness of democracy, eroding the quality of formal state and market institutions, which include economic and political rules, such as corporate laws and written constitutions.

Culture is also an important source of informal institutions; however, it cannot be defined as an informal one per se. Informal constraints – materialized by unwritten codes of behavior rooted in the political, social or economic culture of a country – are

[6] Cf. such studies in HELMKE, Gretchen and LEVITSKY, Steven (2006). *Informal Institutions and Democracy – Lessons from Latin America*. Baltimore: The Johns Hopkins University Press.

pervasive features of modern economies as well (North 1990, p. 39). Culture defines the manner that individuals process and apply information, creating specific informal institutions, such as unwritten conventions and social norms (North 1990, p. 42).

Organizations, in turn, distinguishing "rules" from "players" (North 1990, 3-4), are not institutions. They are the players of the game or even the victims of bad institutions, such as systematic corruption entrenched in a company. Organizations may include political bodies (the Executive branch, a regulatory agency, and political parties) and economic associations (companies, trade unions, and state-owned companies, for example).

Finally, enforcement is acknowledged as a key instrument to create an effective environment of good corporate governance, compared to regulations, laws, or voluntary codes (Berglöf and Claessens 2006). After all, the lack of enforcement can strengthen informal institutions – for example: corruption and excessive political power – that, consequently, will undermine the formal ones. In the analysis of the specific cases involving State-Owned Companies, we will notice that rules and laws – formal institutions – that cannot be well enforced, will result in negative impacts on the Brazilian environment of corporate governance.

3. Interaction between formal and informal institutions and the corresponding outcomes on the Brazilian environment of corporate governance

Based on the definitions and concepts of the first part, we move toward to the identification of formal and informal institutions and their interaction. Thus, in each case analyzed below, having a specific macroeconomic and political scenario as a background, the outcomes of institutional interactions will be examined.

In order to clarify some important aspects of Brazilian corporate governance, we stress that all studied cases are based on the premises that: a) a healthy Brazilian capital market requires good corporate governance practices and rules, including, but not limited to, the protection of the minority shareholders' rights in relation to the State, which is the controlling shareholder of State-Owned Companies; and b) Brazilian companies have a highly-concentrated ownership structure, with the presence of a controlling shareholder or controlling group that elects the majority of the board of

directors and that frequently operates in the daily management through offices on the executive board (Silveira 2015, p.12). Thus, the primary conflict of corporate governance in Brazil occurs between the controlling shareholders and the other shareholders.

4. Developmentalism (1960-1980) – *the Vale Case*

Between the 1960s and 1970s, Brazil witnessed the consolidation of developmentalist economic thought, focused on an industrialization project as a way to overcome underdevelopment and poverty (Giambiagi and Além 2011, p. 64). This project is known as "Latin American import-substitution industrialization"[7]. Such a strategy resulted in higher government intervention in the Brazilian economy, which started playing a major role in the conduction of economic development. This development model, in turn, strengthened State-Owned Companies, which preliminarily aimed to supplement the weakness of the private sector in the energy, telecommunications, transport, and mining sectors.

Facing the limitation of the Brazilian capital market and the absence of large private companies, the Brazilian Congress enacted two laws in 1976 that are characterized as the pillars of the legal discipline of the Brazilian capital market (Prado and Mattos Fillho 2012, p. 208): a) Law 6.385/76, which created the Brazilian Securities Commission – CVM, an agency in charge of regulating, overseeing, and punishing, among others, brokers and controlling shareholders that breach minority shareholders' rights; and b) Law 6.404/76, which established the principle that State-Owned Companies shall be subject to the same legal rules of the corporate law and capital market that rule privately-owned companies. This law sets forth the governance structure of the Brazilian publicly-held companies, including State-Owned Companies. The rules that seek to protect the shareholders' rights include those that set forth the regime of fiduciary duties and liability for controlling shareholders, including, with respect to the State, the minority shareholders' right to participate in the Board of Directors, transparency and to access information.

[7] "Import substitution consists of establishing domestic production facilities to manufacture goods which were formerly imported" (Baer 1972).

Pargendler (2013, p. 198) clarifies that two years after the enactment of these laws, the recently created capital market regulatory agency revealed that publicly-controlled companies represented 70.8% of the Brazilian market value and 61% of the share value held by minority shareholders. In practice, that means that the same law of publicly-controlled companies was applied to privately-controlled companies, and that it could only demonstrate its binding power with respect to government-controlled companies. However, notwithstanding this reality, "...the State, as the controlling shareholder, expressly ignored the rules" (Pargendler 2013, p. 198).

In fact, in March 1980, the federal government, representing the Executive Branch, required a brokerage firm to sell a substantial number of shares of Vale[8] (then Companhia Vale do Rio Doce – CVRD), a company that was controlled by the federal government. The transaction occurred deliberately on the part of the government, which failed to previously disclose its intention to sell a large lot of shares, as required by the administrative rules issued by the Brazilian Securities Commission – CVM[9]. As reported by the major newspaper at that time, it was an irregular procedure that adversely affected millions of investors that did not have access to confidential information, which was then shared only by the government, which profited from the transaction (Barcellos 2011, p.99).

The *Vale Case* was also paradigmatic with respect to the lack of enforcement of corporate governance rules in Brazil and the power of influence of the federal government over the agency that regulates and oversees the capital market. The CVM did not inhibit or condemn the transaction carried out by the government, arguing that, in accordance with its administrative decision, in the culture of the Brazilian capital market, the orders of clients, especially from the government, should not be discussed but just enforced, and that social interests were involved in the government's decision[10]. The Federal Supreme Court (STF), the highest Brazilian court, did not even evaluate a

[8] Vale is a Brazilian company, which is one of the largest metals and mining company in the world. Vale has a market capitalization of around US$ 27 billion, with approximately 310,000 shareholders from all continents. Available at: <http://www.vale.com/PT/investors/company/fact-sheet/Documents/factsheet1Q16_i.pdf>. (Accessed: 15th December, 2015).

[9] Item 10 of the CVM Circular Letter number 303/78.

[10] CVM Administrative Inquiry 04/80, p. 21571 – Section 1/Diário Oficial da União. Available at: http://www.jusbrasil.com.br/diarios/3473553/pg-35-secao-1-diario-oficial-da-uniao-dou-de-29-10-1980. (Accessed: 15th December, 2015).

charge against the finance minister, (brought against him due to his involvement in the *Vale Case*) promptly dismissing it (Barcellos 2011, p. 99).

Regarding the institutional aspect, based on the foregoing, it is possible to clearly identify, from the *Vale Case*, the breached formal institution, that is, the CVM administrative rule, the primary purpose of which was to establish adequate parameters for the carrying out of transactions that could affect a large number of investors, including minority shareholders of State-Owned Companies.

On the other hand, it is possible to identify at least one informal institution that negatively affected the performance of the economic rule enacted by the CVM.

The existence of excessive political power over the management of the capital market in Brazil was demonstrated by the federal government in the *Vale Case*. Such political power influenced the actions of the government and statements with respect to the *Vale Cas*e, consequently damaging the minority shareholders' rights. The federal government, or the executive branch, demonstrated excessive political power with respect to the other instances of the Brazilian political system, such as the judicial and legislative branches. It can be said that the executive branch demonstrated, in the *Vale Case*, hypertrophic political authority with respect to the others.

Acemoglu (2004, p.71) clarifies that this unwritten rule of excessive political power in fact unbalances the relationship with other political and market agents. Such power usually has as its source in the economic and/or also in the military power, which fits into the Brazilian political reality of the 1970s and beginning of the 1980s, in which Brazil was under the political tutelage of a military regime (military dictatorship), which, likewise, had access to a large tax payment source, which did not fail to provide it with economic power.

With respect to the interaction between this informal political institution and the CVM rule, it is possible to observe that the result of such interaction was the inefficacy of the formal institution. Helmke and Levitsky (2003) established a specific typology for the analysis of informal institutions that, among other classifications, typify them as complementary, accommodating, competing, and substitutive. In this case, shareholders and the State act with identical purposes, aiming, for example, at the growth of the company and not its expropriation. On the other hand, the State – through its political power reinforced by the military, political and social rules – can act with a different

purpose, which is the opposite to that of the minority shareholders. Thus, the role of the presented informal institution is not to complete but to *compete*, by acting in opposition to the purposes of formal institutions, the result of which is verified from the *Vale Case.*

5. Neoliberalism (1990-2003) – *the Tag-Along Case*

At the end of the 1980s, the economic development model adopted during the prior decades started showing signs of exhaustion, with the consequent stagnation of the Brazilian capital market.

Thus, by virtue of the worsening of the external economic scenario, inflation, increase in external debt, and low financial return of the model based on the import-substitution industrialization system, Brazil set out a systematic quest for external financing from the international financial market. This financing, however, was subject to decreasing the role played by the State in the economy and infrastructure companies, such as Petrobras and Vale. Additionally, with this external movement, scholars, politicians, and bureaucrats in Brazil fostered a shift in the paradigms required for the economic development of the country, which included reducing the role played by the State and increasing that of the private sector in the economy as well as opening the Brazilian market to international investors. The result was a radical change in the political policies directed toward development, which included deregulation, privatization of state-owned companies, tax discipline, financial and import liberalization, and promotion of foreign investments (Trubek 2013, p. 6).

Thus, Brazil initiated a privatization process in state-owned companies, and the height of this privatization process was reached in 1997 with the sale of the shares held by the government in Vale, Telebrás, and Petrobras (Silveira 2015, p. 218). In the case of Petrobras, even after the privatizations, the federal government remained the controlling shareholder[11].

However, from the minority shareholders' perspective, the privatization process resulted in the elimination of certain rights. In 1997, the federal government, which was at that time under the administration of President Fernando Henrique Cardoso, who had

[11] The composition of the capital stock of Petrobras can be referred to at: <http://www.investidorpetrobras.com.br/pt/governanca-corporativa/capital-social>. Accessed on 15th, December 2015.

formed a majority alliance in the Congress (Figueiredo 2009), led the proposition for a revision of the Brazilian Law of Corporations (Law 6.404/76), aiming to suppress minority shareholders' rights in corporate transactions designed for the sale of controlling groups.

Prior to the reform, the Brazilian law imposed a tag-along right aimed to protect the minority shareholder. If a majority shareholder sells his take, this legal measure gives the minority shareholder the right to join the transaction and sell his minority stake in the company at the same price as paid to the controlling group in a transfer of controlling shares. In this case, the majority shareholder is obliged to include the holdings of the minority holder in the negotiations in order to facilitate the possibility of this tag-along right being exercised. Nevertheless, Law 9.457/97, enacted by the Congress in accordance with Cardoso's economic team, amended the Brazilian law of corporations (Lei 6.404/76), by removing such protection. Thus, according to the federal government, after the legal amendments, the sale of the controlling group at privatization auctions on the part of the State – as the controlling shareholder – allowed it to increase its profits[12].

From an institutional point of view, this case reveals that the existing rules or formal institutions designed for the protection of minority shareholders were eliminated by the Law 9457/97, a rule that may have resulted, however, from at least one of the main informal political institutions that features in the Brazilian political system. The country just had experienced a re-democratization process, resulting in the militarists' leaving power, and the adoption in 1988 of a new federal constitution. Then, the Brazilian political system reemerged on the basis of the so-called *coalitional presidentialism*[13], an informal political institution, which is a typical characteristic of the exercise of the political power in Brazil, that is not formally established in the constitution of the country.

[12] Cf. economic academic assessment from: a) <http://www.brasil-economia-governo.org.br/wp-content/uploads/2011/04/valeu_privatizar_a_vale.pdf>;b)<http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes_pt/Galerias/Arquivos/conhecimento/livro/eco90_05.pdf>; and c) <http://bibliotecadigital.fgv.br/ojs/index.php/rbe/article/view/898/72>. Accessed on 15th, December 2015.

[13] This is an expression crafted by a Brazilian political scientist called Sérgio Abranches (1988, 5-32) in *"Presidencialismo de Coalizão: Dilema Institucional Brasileiro"*. Published in the ***Dados*** Magazine, Vol. 31, No. 1, 1988, 5-32.

According to Levistky (2012, chapter 7): "Informal institutions are pervasive in contemporary Latin American democracies. In multiparty presidential systems, executives rely on informal institutions such as coalitional presidentialism (Brazil) to build and sustain legislative majorities". In practice, it works based on the role played by the President of the Republic and on the existence of coalitions that support their government. Thus, political parties that take part in the government offer a majority in the Congress to support the agenda of the President or the chief of the Executive Branch. Consequently, *coalitional presidentialism* can assure significant political power in the hands of one person or cause the President to be subject to the wills of the Congress in the event of loss of the parliamentary support, which may hinder or even inhibit the public administration of the country (Aragão 2015). Abranches (1988, p. 5-32), explaining *coalitional presidentialism*, clarifies that "Brazil is the only country that, in addition to combining proportionality, a multi-party system, and an "imperial presidential system", organizes the Executive Branch based on large coalitions" [14].

Therefore, based on *coalitional presidentialism*, a large alliance formed with the Congress and with the power of legislative initiative, the federal government, allied to its interests of revenue from the sale of its equity interests, obtained the approval of a law that was contrary to the minority shareholders' interests (Law 9457/97).

Based on the Helmke and Levitsky (2003) typology, it can be theoretically inferred that the aforesaid political institution acted in opposition - *competing* – against the interests represented by the tag-along rules – formal institutions. The federal government – supported by *coalitional presidentialism* acted against the minority shareholders' property rights.

[14] Although Abranches was right on its conclusion in 1988, there are other recent studies showing that Brazil is no longer the only country in Latin America that has Coalitional Presidentialism. Cf.: a) FIGUEIREDO, A. 2007. Government Coalitions in Brazilian Democracy. Brazilian Political Science Review. v. 1, n. 2, p. 182-16, 2007; b) FIGUEIREDO, A. et al. Political and Institutional Determinants of the Executive's Legislative Success in Latin America. Brazilian Political Science Review. v. 3, n. 2, p. 155-71, 2009; and c) Routledge Handbook of Latin American Politics by Peter Kingstone, Deborah J. Yashar in LEVISTKY, Steven. Informal Institutions and Politics in Latin America, 2012.

6. New Developmentalism (2003 – 2015) – *the Petrobras Capitalization Case and the Pasadena Case*

Although the new government – under Lula's administration – inherited a country with inflation under control, a suitable environment for foreign investments, macroeconomic stabilization and fiscal discipline, (which is not little for a country with the geographical, social and political dimensions of Brazil), the results of neoliberal policies, however, did not produce the expected rapid growth. Compared to the developmentalism period, when the country grew at an average over 3% from 1950 to 1980, after 1990 growth dropped significantly (Trubek 2013, p. 7). Thus, it was necessary to maintain the positive macroeconomic fundamentals implemented by the previous government and, at the same time, employ new economic policies, aimed at the development of the country. This new macroeconomic period with bolder industrial policies and maintenance of the strategic role of the private sector, became known by scholars in the area of Law & Development as *New Developmentalism* (Trubek 2013, p. 7).

We can say that until mid-2012, from the social standpoint, the result of this new macroeconomic policy was the diminution of inequality[15] and, from the economic perspective, it is possible to see the growth of the Brazilian capital market, along with the improvement of corporate governance mechanisms aimed at companies under private control[16]. Yet, when we look at the corporate governance of State-Owned Companies, in which the State exercises the role of controlling shareholder, we still see frequent violations of the rights of these companies' minority shareholders. These violations have been committed "in broad daylight" by the State itself, the best-known example of which translates into the worst corporate scandal of the Brazilian capital market, involving one of the largest oil and energy companies in the world, that is, Petrobras.

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[15] Cf. Getulio Vargas Foundation Survey – March 2012 – http://www.cps.fgv.br/cps/bd/ncm2014/NCM2014_TextoCompleto_Fim_sumario.pdf.

[16] Cf. a) SILVEIRA, Alexandre Di Miceli da. *Governança Corporativa no Brasil e no mundo: teoria e prática* – 2nd Ed. – Rio de Janeiro: Elsevier, 2015; and b) Valor Econômico - *Evolução do Mercado de Capitais amplia perspectivas de empresas*. 17/12/2010 by Fernando Torres. http://www.valor.com.br/arquivo/863261/evolucao-do-mercado-de-capitais-amplia-perspectivas-das-empresas. Access in December/2015.

The Petrobras Capitalization Case. Based on Lazzarini, Mussacchio and Pargendler (2013, p. 83), we shall now describe the Brazilian case known as the capitalization of Petrobras (*Petrobras Capitalization Case*). In September 2010, the Brazilian stock exchange – BM&FBOVESPA – was considered the second largest exchange in the world in terms of market value, reaching R$30.4 billion Brazilian Reais[17]. This auspicious fact was partly due to the capitalization of Petrobras with the stock market in 2010. Such a transaction, however, was a result of a corporate deal designed by the State to maximize its earnings, expropriating funds of minority shareholders and of the company itself. Such a deal had the dual purpose of transferring the rights to exploit newly discovered pre-salt deposits to Petrobras and thus raise funds in the Brazilian and international stock market, aiming for technological investments required for oil extraction. In short, on the one hand, the State – the federal government – would assign to Petrobras the rights to exploit the pre-salt area, and the company, which is controlled by the state, in turn, would transfer its shares to the government.

The government's interest was in requiring the highest possible price for the assignment of its exploitation rights, while the interest of Petrobras and of its shareholders was precisely the opposite, that is, disbursing as little as possible. It revealed an obvious conflict of interest, and the State – the controlling shareholder – was on both sides of such deal.

According to Brazilian corporate law, controlling shareholders cannot vote in the resolutions of a meeting concerning the appraisal report of assets which they contribute to form the capital. In this case, this means that the federal government could not take part in the resolution on the evaluation of the price of the exploitation rights. The State was – at the same time – the assignor of the rights and the controlling shareholder who would exercise its decision-making power in the meeting against the rights of the other shareholders, aiming at inflating the value of the rights it had assigned to Petrobras. Therefore, only the other shareholders – minority ones – could vote in that meeting. "(…) the legal rule would leave no room for doubt: the Federal Government could not decide on the price of rights that it was transferring to Petrobras in exchange for shares of the company" (Lazzarini, Mussacchio and Pargendler 2013, p. 83).

[17] Cf. Economic News – BM&FBOVESPA - http://www.abril.com.br/noticias/economia/bm-fbovespa-torna-se-segunda-maior-bolsa-mundo-599151.shtml.

However, the government had no interest in leaving the pricing to the minority shareholders (mostly foreign investors), especially in a presidential election year. Through a complex legal transaction, the Ministry of Energy established the price and it was approved by the Board of Directors of Petrobras, politically controlled by directors appointed by the government.

The Pasadena Case. Based on Silveira (2015, p. 265), another case involving Petrobras, refers to the controversial purchase of a "North American" refinery, located in Pasadena, in the United States, for US$360 million with the Belgian company Astra Oil (*Pasadena Case*). Petrobras' purchase contract, unanimously approved by its Board of Directors, provided that the Brazilian company would be required to ensure a minimum yield of 6.9% to Astra Oil, also including a *put option clause* that would require Petrobras to acquire full control of the refinery in case of disagreement between the members. Based on these clauses, Petrobras was ordered by the court to pay US$820 million. At the end of this shady deal, Petrobras disbursed US$1,18 billion for the refinery, about 27 times the price paid by the Belgian refinery in 2005. The discussion on the economic and legal feasibility of the deal intensified when a former officer of Petrobras, who was charged by the Federal Prosecution Office with corruption and money laundering[18], *confessed that he had received bribes of as much as R$1,5 million Brazilian Reais due to his involvement in the Pasadena deal.*

6.1. Formal Institutions

These cases show the breach of at least one rule of Law 6.404/76 and a rule of the Brazilian Criminal Code on solicitation of a bribe by a public officer (two formal institutions). We can argue that their effects were neutralized as a result of their interactions with social and political norms. The first one, related to the protection of minority shareholders in the *Petrobras Capitalization Case* (the *Corporate Rule*), in which the State – acting as controlling shareholder – interfered with the decision of the price of exploitation rights, using its political power by means of the Board of Directors, caused distortion in the price of the exploitation rights assigned to the company. In the *Pasadena Case*, the statement of the former officer of Petrobras about receiving bribes

[18] Cf. Federal Prosecution Office - http://lavajato.mpf.mp.br/atuacao-na-1a-instancia/denuncias-do-mpf.

(misconduct/corruption), suggests that Petrobras was the target of a criminal action by former directors and officers politically appointed by the controlling shareholder itself, the federal government[19] (the *Bribe Rule*).

6.2. Informal Institutions

In relation to the informal institutions, the *capitalization of Petrobras* and the *Pasadena Case* suggest the strong presence of at least four informal institutions acting through the State and that affected the effectiveness of the identified rules – formal institutions. Such cases suggest that the exploitation of the State had been implicitly authorized by social and political norms, embedded in the actions of the State, and that impacted on the effectiveness of the laws concerning corporate governance and criminal liability.

That said, we enter a more detailed assessment of these informal institutions.

6.2.1. Applying Informal Institutions - social norm: *social disapproval of a conduct*

Research carried out by the Law School of the Getulio Vargas Foundation in São Paulo on the Rule of Law in Brazil and the degree of respectability of a law (IPCL Brazil Report)[20], reveals that: *the lower the social criticism of a conduct, the lower the possibility of a law – on that specific conduct – being obeyed (the "Social Norm 1")*. It is a social norm that may have influenced the actions of the State in the capitalization of Petrobras. The reviews and comments of experts showed that the federal government – because the elections for President would take place in October/2010 – was equally pressed by the media and by the society itself in the sense that the earnings of the State in the capitalization of the company would be maximized (Lazzarini, Musacchio and

[19]Idem.

[20] Research on the Rule of Law in Brazil (rule of law state) - *Index of Perception of Law Enforcement (IPCLBrasil)*. According to the researchers from the Law School of Getulio Vargas Foundation in São Paulo: "The goal of the Index of Perception of Law Enforcement (IPCLBrasil) is to measure systematically the perception of Brazilians in relation to respect for the laws and for some authorities that are directly involved with the enforcement of laws". Available at: http://bibliotecadigital.fgv.br/dspace/bitstream/handle/10438/12243/Relat%C3%B3rio%20IPCLBrasil%20-%20ANO%201.pdf?sequence=5&isAllowed=y. Access in January/2016.

Pargendler 2013). We could also question whether there are means to mitigate the impact of this type of social norm. Musacchio (2007, p. 503-506) clarifies that this kind of social norm or informal institution can be mitigated if more citizens have greater participation in the development of financial and capital markets, so that weakening the protections of minority shareholders will end up causing politicians greater cost. In this way, workers and the middle class in general will be more inclined to defend corporate rules if they can reap more benefits from the financial and capital markets.

6.2.2. Applying Informal Institutions - social norms: *the certainty of impunity and corruption*

Another Brazilian social norm that may have influenced the actions of the State is the certainty that any illegal or irregular acts committed by the State itself would hardly ever be punished, whether in court or administratively. It is the practical application of the well-known popular expression in Brazil called *certainty of impunity*. According to the same study conducted by the Getulio Vargas Foundation in São Paulo (IPCL Brazil Report): *the lower the likelihood of being punished perceived by the respondent, the higher the frequency of an illegal conduct (Social Norm 2)*. In fact, in the case of the *capitalization of Petrobras*, Lazzarini, Musacchio and Pargendler (2013, p. 83), clarify that the minority shareholders had no choice but go to court, in order to invalidate or modify the result of the transaction, given that they found the value of the exploitation rights excessively high. However, the judicial alternative was not employed due to the possibility that the judges and/or regulators – for example: CVM – would not interfere with the decisions of the federal government, reinforcing the argument of the lack of enforcement faced by the Brazilian corporate governance environment.

As for the *Pasadena Case*, *Social Norm 2* on the certainty of impunity seems to be applicable to directors who at the time of the facts (members of the board of directors and of the executive board) were indifferent to the commitment of the crime of solicitation of a bribe by a public officer (Article 317 of the Brazilian Criminal Code). Governance best practices aimed at the control of processes for approval of contracts and transactions and compliance with fiduciary duties of diligence and loyalty and ethical behavior were ignored in the *Pasadena Case*. If there was not so much certainty of impunity, the actions of the directors that led Petrobras to incur losses of billions of

Brazilian Reais could have been avoided. In this sense, Eisenberg (1999), in a study on the importance of social norms for the formation of the American corporate structure, confirms that these standards influence the behavior of the directors of publicly-held companies, especially on issues involving compliance with fiduciary duties, the rules of corporate governance and corporate crimes.

In addition, it is worth noting that *corruption* has been equally considered by scholars from the fields of economics and political science as an informal institution itself that harms the effectiveness of governance rules. In research on the effects of informal institutions on the effectiveness of corporate governance rules of emerging countries, Estrin and Prevezer (2010) clarified that in the case of Russia, corruption is an informal institution that competes with formal institutions, undermining the effectiveness of the rules and best corporate governance practices. Levitzky (2012) in a study on the role of informal institutions on the formal political rules of the countries in Latin America, clarifies *corruption* as an informal institution that harms and interferes with the performance of constitutions, harming the quality of democracies in Latin America.

Ultimately, *corruption* will eventually affect the governance of legal entities themselves (Carvalhosa 2015, p. 99). That is what could have happened in the *Pasadena Case*. *Corruption* would be a good example to be studied in Brazil about the damaging effects that corruption can cause on the good economic fundamentals of a company.

6.2.3. Applying Informal Institutions – political norm: *the presidential coalitional system*

As studied in section 2.2, we can regard the *Coalition Presidential System* as an informal political institution that, in addition to other social norms, equally harms the effectiveness of rules. In what way? Through the political division of the Board of Directors and of the executive boards of Petrobras. Given that in the Coalition Presidential System the executive branch must form political alliances with political parties of a different ideological base, which is necessary for the ability to govern the country, it ends up assigning offices in State-Owned Companies in exchange for

political support to govern the country. In the case of Petrobras, any appointment of technical and ethical professionals was disregarded in favor of the appointment of executives representing "quotas" of the political parties of the allied base. This typical Brazilian institutional arrangement turns out to allow voting in line with the interests of the controlling State and, perhaps worse, it can facilitate and promote the practice of corruption within the State-Owned Companies.

6.2.4. Interaction between formal and informal institutions

As to results concerning the interactions, we can also see that the institutions do not complement each other. On the contrary, we found that the effects of formal institutions were undermined by the State itself, backed by unwritten social and political norms (informal institutions), which relied on the deficiency of enforcement of corporate governance rules and laws applicable to the capital market in Brazil (Lazzarini, Musacchio and Pargendler 2013; Ester and Prevezer 2010; and Berglöf and Claessens 2006). Also, based on the model of analysis of informal institutions of Helmke and Levitzky (2003), we can conclude in relation to the *capitalization of Petrobras* and *Pasadena Case* that informal institutions can be classified as competing.

7. Proposals for improving the corporate governance of State-owned companies and the possible improvement of Brazilian public governance

Let us now evaluate the alternatives proposed to improve the corporate governance of State-Owned Companies, choosing those that might equally be used by the government.

7.1. Adoption of a specific legal regime

Lazzarini, Musacchio and Pargendler (2013, p. 88) suggest the adoption of a specific legal regime to regulate the governance of State-Owned Enterprises. It is difficult to use the same legal regime, which is also aimed at privately-controlled companies to mitigate or prevent the abuses practiced by the government as the controlling shareholder. The professors remind us that Constitutional Amendment No.

19/98 to the Brazilian Federal Constitution provides that a law should establish the legal status of the State-Owned Company, which would include government controlled private companies and their subsidiaries – Petrobras.

In this regard, including on the grounds of Petrobras' scandal, the interim Brazilian President, Michel Temer, sanctioned on July 1st, 2016, the Law No. 13.303/2016 - Public Companies General Law - that provides for the statute of state-owned and state-controlled companies, as well as their subsidiaries. This law aims to regulate and balance the relationship between public interests of the State and private interests of minority shareholders in State-Owned Companies.

The various legal mechanisms aimed at improving this relationship include: (i) the administrative boards must include at least 25% of independent members (people linked only through participation in the capital); (ii) new requirements were introduced for occupying positions in the administrative boards and board of directors: a) an academic education that is compatible with the position to which one was nominated; and b) 10 years of prior experience in the same area of activity, or a related one, of the company; or 4 years in leadership positions in a company of equal size or with similar corporate activities; or 4 years in positions of commission/trust in the public sector; or 4 years in a teaching/research position in the same field of activity of the company or as a professional in the area; (iii) those that will not be able to take on positions in the administrative board and board of directors: a) ministers; b) officers of regulatory bodies; c) state and municipal secretaries; d) those with mandates on the Legislative Power; e) occupants of superior positions in public administration that are not public employees; and f) leaders of or those who have relevant roles in political parties; (iv) state-owned and/or state-controlled companies will have to create specific compliance areas and statutory audit committees; (v) expenditures with publicity and sponsorships shall not exceed 0.5% of the prior fiscal year's gross revenue (this limit can be extended to up to 2%). In election years, such values cannot exceed the average expenditure verified in the last three years prior to the election.

The Stock Exchange of São Paulo – BM&BOVESPA and the Brazilian Institute of Corporate Governance – IBGC, have taken voluntary private initiatives with the aim of setting standards of governance to State-Owned Enterprises, including those listed on the stock exchange, as is the case of Petrobras. Among the initiatives, the Program of

State Governance of the Stock Exchange[21] and the Handbook of Best Practices of Corporate Governance for Government Controlled Private Companies stand out[22]. These best practice codes contain rules: a) that deal with the political shielding of the members of the board of directors and of the executive board, in order to not be co-opted by the controlling State or by illegal incentives that could lead them to commit crimes against the government (example: solicitation of a bribe by a public officer); and b) in which the public mission of these companies is recognized, but that this goal of social interest should be previously known by the other shareholders so that the future behavior of the companies is predictable, allowing the monitoring of the actions of the controlling State and of the directors by the other shareholders and stakeholders.

These proposals for solutions, presented in the form of written rules, can be useful in mitigating the abuses of the State as a controlling shareholder, because they focus specifically on the typical and specific problems of State-Owned Companies. As a result, provided they are adopted and implemented, these proposals will in fact promote the improvement of the corporate governance of State-Owned Enterprises. In addition, it is important to note that the rules of political shielding of the board members challenge the potential political allotment of offices in State-Owned Enterprises, minimizing the effects of the political norm, the Coalition Presidential System.

7.2. Strengthening of regulatory agencies

Lazzarini, Musacchio and Pargendler (2013, p. 88) suggest the strengthening of the regulatory agencies of each sector of operation of the State-Owned Enterprise. According to them, independent regulatory agencies can be "a fundamental mechanism to limit discretionary interventions of the State". In another paper, Lazzarini, Musacchio and Pargendler (2013) highlight that ANP, Brazil's National Oil Agency, is still technically weak and its acts are still heavily influenced politically by the Brazilian Executive Branch. In 2011, the executive officers of ANP were also accused of

[21] State-Owned Enterprises Governance Programme – BM&FBOVESPA: http://www.bmfbovespa.com.br/pt-br/noticias/2015/BMFBOVESPA-apresenta-Programa-Destaque-em-Governanca-de-Estatais-2015-09-30.aspx?tipoNoticia=1&idioma=pt-br.

[22] Handbook of Best Practices of Corporate Governance for Government Controlled Private Companies – IBGC: http://www.ibgc.org.br/userfiles/2014/files/Arquivos_Site/Caderno14.PDF.

receiving bribes from private companies. As a result, the professors' report shows that the President of Brazil and the Minister of Mines and Energy are actually the regulators of Petrobras, and not ANP. How to solve that? Strengthening the technical staff of the agency and giving them political independence. Is there an example? Lazzarini, Musacchio and Pargendler (2013) show that the Norwegian Petroleum Directorate (NPD), a regulatory agency of the oil industry in Norway, has regulatory force and a voice in the decisions of Statoil, the Norwegian oil company. And why? They clarify that the reason is based on its high technical knowledge that help to prevent potential abuses that could be committed by the controlling State. "Strong agencies allow a system of "weights and counterweights" to actions of the State that could cause inefficiency not only in state-owned enterprises, but in the entire sector" (Lazzarini, Musacchio and Pargendler 2013, p. 88).

Also with regard to regulatory agencies, the importance of the financial self-sufficiency of the Brazilian Securities and Exchange Commission – CVM should also be highlighted. Many of the complaints that fall upon the CVM regarding its reluctant performance when it comes to investigating and punishing the controlling State can be linked to the fact that the financial resources necessary for its administrative survival are controlled and retained by the National Treasury. Santana (2015, p. 161) clarifies that the main problems affecting its performance are linked to the lack of financial and human resources that, in addition to being insufficient, are also of unpredictable supply. In light of this reality, it is possible to see that the Brazilian agency responsible for regulating and punishing abuses of controlling shareholders, is also subject to political pressure from that which it should also regulate and supervise, i.e. the State. Reporting to the ministry of finance, the National Treasury, which controls the flow of financial resources owed to the CVM, naturally suffers political influence, which consequently ends up impairing the independence and freedom of action of that regulatory agency. After all, depending on the decisions made before the controlling shareholder State, if it goes into conflict with the interests of the latter, it could be depleted of resources for its own maintenance.

The independence and the strengthening of regulatory agencies eventually confront the damaging effects that the Coalition Presidential System and the social norm

concerning the *certainty of impunity* or *Social Norm 2*[23] cause on the effectiveness of the applications of rules and corporate governance laws. The strengthening of ANP will also help to mitigate the political influence of the executive branch, "closing an entry door" for the allocation of offices that consequently occurs when seeking an alliance aimed at the political sustenance of the federal government. On the other hand, when ANP is made more independent and when the financial independence of the CVM is ensured, both agencies' ability to enforce will become stronger, and the punitive reluctance against corporate abuses of the shareholder State may consequently decrease. Hence, the perception of *lack of impunity* or the strength of *Social Norm 2* can be mitigated by decreasing the predatory urge of the government with regards to the State-Owned Enterprise.

In short, the improvement of government agencies will certainly involve the strengthening of the financial capacity, consolidation of technical independence and improvement of the ability of accountability of these agencies. Thus, the public sector will benefit when we enhance the governance of regulatory and supervisory agencies of the oil sector and of the capital market.

7.3. Corruption and the problem of enforcement

Corruption affects all countries in the world. However, some are more successful in controlling this problem. Brazil, for example, is listed among the most corrupt countries in the world, according to the world corruption perception index of International Transparency. In 2015, Brazil ranked 76th in the ranking among 168 countries. The *Pasadena case* suggests that there is currently an example of systemic corruption in Petrobras.

Therefore, faced with ethical problems involving one of the major oil and energy companies in the world, how can shareholders and stakeholders in general rely on protections for their investments or believe that the business practices adopted by Petrobras are focused on the public interest? In this case, there must be a profound restructuring of the judiciary and of the regulatory and supervisory agencies, aiming at the improvement of enforcement. This is an urgent problem that affects not just

[23] Social Norm 2: "the greater the likelihood of someone being punished for having a certain conduct, the greater the incidence of respondents stating that they acted in accordance with the law".

minority shareholders, but rather Brazilian society and the economy as a whole. Studies have been carried out and proposals have been presented aiming to improve the judiciary and governmental agencies[24], which would require a paper to address this subject alone.

On the other hand, convictions of former executives of Petrobras, linked to political parties, and major contractors in Brazil, under the *Car Wash* investigation[25], and the enactment of a specific law to confront corruption in Brazil (Law 12.846/13) suggests that the enforcement of laws may be improving. But how does this relate to the *Pasadena case* and with *Social Norm 2* that sustains the perception of impunity? We do understand that, in the event of success of these lawsuits, the perception of impunity tends to decrease and thus compel politicians and directors of State-Owned Companies to adopt ethical attitudes in dealing with public affairs and with the interests of shareholders and stakeholders.

With regards to public administration, Carvalhosa (2015, p. 93) explains that it is in the criminal relationship between legal entities and public officials at all levels of power that is the origin and explanation of bad public management in Brazil, where governmental investments are not completed and, in the rare cases in which they are carried out fully, it is always with great delay. Therefore, an improvement in the perception of impunity will also certainly bring one more element to encourage the best practices of governance in the administration of public interests.

8. Final Comments

The evaluated cases show that, regardless of the economic and political period experienced by the country, the rights of minority shareholders were expropriated by the State as the controlling shareholder of the State-Owned Companies. However, as it

[24] Among several studies and discussions concerning the problem of enforcement of the rules and laws of Brazil's capital market and the inefficiency of the Judicial Branch, for a further study, please look into the following: a) (OECD 2013), *Brazil – Supervision and Enforcement in Corporate Governance, Corporate Governance and the Enforcement of Corporate Governance Rules - Supervision and Enforcement in Corporate Governance*. OECD Publishing. Available at: http://dx.doi.org/10.1787/9789264203334-en. Access in January/2016; and b) Getulio Vargas Foundation – São Paulo Law School – Report with the research data on Justice Confidence Index (ICJBrasil) for the Year 5 (2nd quarter of 2013 to the 1st quarter of 2014). Available at: http://bibliotecadigital.fgv.br/dspace/handle/10438/12024. Access in January/2016.

[25] Cf. Brazilian Federal Public Prosecutor. Available at: http://lavajato.mpf.mp.br/. Access in March/2016.

turned out, this predatory behavior was supported by informal institutions which, in interacting with the rules and laws concerning corporate governance (formal institutions), were responsible, even if only in part, for the ineffectiveness of these institutions. As studied, assessments made on the basis of the model of Helmke and Levitzky (2003), show that social and political norms were not complementary to the economic rules aimed at the protection of the minority shareholders of State-Owned Companies. On the contrary, these informal institutions supported the State, always in opposition to the objectives sought by formal institutions.

So, in light of this, and in compliance with the social, economic and political characteristics of Brazil, the possible solutions should seek to mitigate the harmful effects of such informal institutions, expressed as social and political norms.

In this paper, the outcomes of interactions between formal and informal institutions have been theoretically evaluated through four leading Brazilian corporate governance cases in accordance with the last three major macroeconomic periods of Brazil. Such evaluation has revealed that interactions between formal and informal institutions really matter when looking to understand the subtle reasons that may induce the poor performance of Brazilian corporate law. Political and social norms are capable of producing negative impacts on the effectiveness of Brazilian corporate governance rules, as well as undermining the quality of public administration.

In fact, reinforced by political and social norms, and acting as the controlling shareholder in companies such as Petrobras, the State has been a major player in the expropriation of minority shareholders' rights in Brazil. Additionally, through corruption, formal institutions have been ignored and the stakeholders of Petrobras (suppliers and workers, for example) were also affected due to the loss of jobs and breach of contracts. As a political institution, Coalitional Presidentialism has endorsed abuses of the Executive Branch in public administration, employing officers and board members politically linked to the government. Indeed, officers of Petrobras and ANP seem to have no independence and low technical expertise to manage, regulate and supervise Petrobras and the Brazilian petroleum sector. As a result of this described arrangement, the cases of *Pasadena* and the *Capitalization of Petrobras* flourished in the Brazilian economic scenario, undermining its formal institutions.

Finally, another conclusion we may infer is that, although we are aware that economic, legal and social difficulties shall be challenged by a multidisciplinary

approach, it is not obvious how to deal with it. Yet, through the institutional lens, it is more conceivable to face a multilayered problem, such as the corporate and public governance issues, just like the cases evaluated in this paper.

Thus, from this perspective, the main contribution of this paper lies in the potential of this study for future theoretical and empirical research in the corporate governance and public administration disciplines. After all, the cases evaluated here have revealed to us that social and political norms (informal institutions), although not evident in a first analysis, play a major and subtle role in the study of corporate and public governance.

Therefore, in order to promote Brazilian social and economic development, this interaction between institutions must be studied in a more profound approach and, consequently, its negative effects be minimized through better institutional design.

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