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THE ROLE OF LAW IN
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IN BRAZIL



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Clifford Chance is supporting a research project which examines the role of law and legal institutions in economic development, growth and innovation in Brazil, India, Russia and China. The project is being led by the Centre for Business Research at Cambridge University which brings together economists, lawyers and social scientists. At an event at Clifford Chance in London, John Armour, Professor of Law and Finance at the University of Oxford, discussed the empowering of financial institutions in Brazil. In this extract he discusses the legacy of Brazil's hyper inflation and the steps that are being taken to reform its laws.

Access to finance

Our research involved interviewing lawyers, judges, bankers, regulators and people working in industry in Brazil. We asked them about the relationship between the substantive law and enforcement institutions and about how businesses raise finance.

Over the last 20 years there has been a great deal of literature about the problem of 'arms-length finance' in emerging and developing markets. Financiers putting money into a business are often concerned, rightly, that the controllers of the business will expropriate their investment and so, unless there are mechanisms to control that, there will be a heavy premium put on external financing. In jurisdictions where legal mechanisms don't work effectively or are non-existent, people have to establish a reputation before they can credibly raise finance at an acceptable rate. However, that impedes market entry because you don't get a reputation just by opening up shop – you have to work hard to establish it. Our research looked at how changes in the law and legal institutions (the courts in

particular), could help to facilitate arms-length finance and make it cheaper for firms to get access to finance. There's plenty of academic research showing that without effective enforcement, 'good quality' rules by themselves don't make a great deal of difference and Brazil has taken some positive steps in that regard.

The story I'm going to tell about Brazil has a lot to do with the legacy of sustained, high inflation. This is something that it took me a little while to understand, because it's a very counter-intuitive financing environment for somebody who comes from the UK, the US or Europe. The shadow of inflation is cast over pretty much everything that's going on in corporate finance and has been very difficult to dislodge.



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Brazil in context

The story of inflation in Brazil begins in 1964 with a military coup. The military rule that followed lasted for 20 years. At first, the economy functioned quite well and there was quite a lot of growth during the late 1960s. The country pursued a strategy that was common in many developing countries at the time: restrictions on capital flows, tariffs on imports; engaging in 'import substitution' that is, manufacturing products for sale into the domestic market and financing domestic firms through the state. A by-product of the way that the economy was run was that inflation set in and it was persistent. That got worse during the 1970s with the oil shocks and by the early 1980s was really quite bad. Then in 1985 the country returned to democracy and, unfortunately, the economy went from bad to worse, inflation became exorbitant, peaking in the early 1990's at 3000% per year. My colleague, Caroline Schmidt, a Brazilian lawyer who worked with me on this research, told me that when she was growing up in Brazil she wondered why her parents kept a room in which they'd put a month's worth of food. It was only when she was an adult that she realised why: if you didn't buy the food at the beginning of the month, you wouldn't be able to buy it later in the month because prices would have gone up by so much. From the mid 1980s to the mid 1990s, successive governments changed the currency no less than six times to try to stamp out inflation. – However, all but the last attempt were unsuccessful.

The government had a real challenge raising finance because nobody wanted to lend money on any kind of long-term basis when inflation was so high. The government's response was to issue

index-linked bonds that were sold to Brazilian banks and the banks then offered index-linked deposit accounts to Brazilian citizens. It was a way for the government to pacify the population – because people's bank accounts were index-linked they didn't feel the pain in terms of the destruction of their savings. The problem was that as people were getting index-linked returns on deposit accounts they didn't want to put money into equities or bonds, and banks did not want to lend to businesses, as opposed to buying government bonds. Consequently, credit to the private sector increasingly came from the state. The Brazilian National Development Bank ('BNDES'), originally set up in 1952, became an important source of finance for industry. By the mid-1980s it was really the only source of long-term finance for Brazilian domestic firms and, as it was offering below-market rates, it was good for those businesses that could get access to credit.

Private parties also responded to inflation. There was a great deal of indexation of private contracts. The Fundação Getúlio Vargas, (FGV), a Brazilian academic institute, maintained a number of indices of different sectors which were used in various contracts. It was very important which index you chose because each had different properties. Using these indices created new risks because the index that you chose to update your contractual obligations didn't necessarily follow the path that inflation followed. There was also a risk that indices could be manipulated. Our interviewees told us that during this period Brazilian banks and financial institutions made money by engaging in arbitrage between different indices, which practice did not put any money into the real economy.

Economic reform

The economy settled down under the tenure of Fernando Henrique Cardoso who was President from 1995 to 2003. He finally tamed inflation, relaxed capital controls and engaged in large-scale privatisation. This programme of reforms was similar to that in other emerging markets and in line with the Washington Consensus. From that period onwards, Brazil began reforming the law to try to stimulate investment. Bovespa (the São Paulo stock exchange) launched a new listing sector in 2000 – the Novo Mercado (new market) that brought in higher corporate governance standards, more independence requirements, more board committee requirements and various other corporate governance features. It was an opt-in framework, so that firms that chose to do an IPO on the Novo Mercado could opt for these new higher corporate governance rules. The Brazilian stock market went through a strong period with 113 IPOs between 2004 and 2008 and five-fold growth in trading volume.

The legacy of inflation

While the Novo Mercado was considered very successful in Brazil, the stock markets in India and China actually experienced much more accelerated growth, so we might question how effective the changes were. Inflation has a continuing legacy that holds back the development of external finance for equity and debt. When we talked to interviewees about equity investment their answers seemed at first counter-intuitive. They said IPOs had fared well around the turn of the century when inflation was low but ‘if inflation grows again investors won’t want to invest in the equity market’. That was

surprising because in the UK and US we all learnt in the 1970s to invest in equity when inflation is high. The reason for the difference in Brazil is index-linked bank accounts offering a risk-free rate of return, which make it hard to stimulate investment in equities. So the legacy of inflation continues to cast its shadow.

The government introduced legal reforms to stimulate debt finance – reforms to facilitate enforcement of secured credit and new bankruptcy laws in 2005. These reforms were a move in the right direction, but if you compare Brazil with China, the latter has been far more successful in stimulating domestic credit. Brazil’s credit mobilisation is relatively weak – it’s on a par with India and India has notoriously ineffective bankruptcy laws that hinder the raising of credit finance.

There was a view amongst our interviewees that public supply of credit crowds out private credit. This is a controversial view in Brazil, but the balance of evidence shows some support for it, and it is consistent with a wider academic literature, which says that financial institutions enjoying state subsidies are able to offer the most attractive interest rates. They go into the market and cherry pick the best investment opportunities and that dampens private parties’ willingness to invest because they’re left with the second best. BNDES, the Brazilian Development

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Bank, currently has a larger balance sheet than the World Bank. It's the largest development bank in South America and it's very proud of what it does; it's very proud of the investment that it channels into Brazilian companies; and it doesn't wish to shrink its balance sheet or to reduce its activity – between 20% to 25% of the credit going into Brazilian firms still comes through BNDES. It doesn't try to subsidise firms that couldn't otherwise get credit, rather it lends to the best opportunities. One has to suspect that this has some crowding-out effect. The institutions that were important during the era of high inflation haven't gone away and now they're perhaps part of the problem rather than the solution.

Another issue that was highlighted in our interviews is the 'addiction' to indexation in contracts. Indexation provisions are still present in many Brazilian contracts and there is inertia about change so they continue to be used even though today's inflation rates don't justify it.

Enforcement problems

To make arms-length finance more attractive, Brazil needs to build capacity for high quality enforcement. The challenge is that the Brazilian courts have an enormous backlog of cases and are overworked, with eight times more cases pending than in the EU for example. Brazilian citizens are no more litigious than Europeans and there isn't a shortage of judges – there are about half as many judges per head of population as in the EU and the same as in the US. Judges are extremely well paid in Brazil and the quality of people attracted into the judiciary is very high, while levels of corruption compared with other emerging markets is low. So what's the problem?

There are two particular challenges in Brazil – the first is the uncertainty of the outcomes in court. The Brazilian Constitution and the Brazilian Civil Code both say that private law rights have to be interpreted in accordance with their 'social function.' The Constitution talks about the social function of property and the Civil Code talks about the social function of contract. We asked our Brazilian interviewees, 'what does the social function mean?' The answer was that it seems to mean whatever the judge decides it means. Judges are faced with an open-ended obligation to interpret contractual rights and property rights in accordance with their social function, and there is relatively little guidance about what that means. This creates uncertainty in private law litigation and in the presence of uncertainty, parties told us that they're less likely to settle because they can't predict what the outcome will be. So the backlog of cases remains high.

The other challenge is once again, inflation. During the 1980s and early 1990s there were, as I said, six changes of currency. The rates at which the new currency was exchanged for the old currency were contentious. This triggered an enormous amount of litigation, much of which still hasn't been decided. It's politically very sensitive and judges are unwilling to grapple with the issues so there's a backlog of around about 100,000 cases.

Strategies for enforcement

We talked to a number of professional parties in Rio de Janeiro, Brasilia and São Paulo about the strategies that have been used to build enforcement capacity on top of this rather difficult litigation environment. We identified four distinct mechanisms. The first is arbitration. Before 1996, arbitration was not permitted in Brazil, but the 1996 Arbitration Act now permits arbitration to be selected via an arbitration clause in the contract. The Act gives an arbitral tribunal the ability to decide on the scope of its own competence. This reduces the opportunities for judicial challenge of the competence of the arbitral body. Arbitration sits on top of the existing judicial system, because a case has to be initiated in the courts, but it takes the workload off the regular judges, because the substantive dispute resolution happens with the arbitrator.

In securities law there's a particular arbitration innovation regarding the Novo Mercado, which comes with a built in enforcement capacity – a special chamber of arbitration. The stock exchange selects the arbitrators and if you want to list on the Novo Mercado then you have to put a clause into your articles or charter that binds shareholders to arbitration in this chamber. This introduces business expertise into the dispute resolution process and includes an expedited procedure providing quicker decision making. However, this technique has some clear limitations. The most obvious being that you still need to initiate your lawsuit in the regular courts in order then to be moved to the arbitral track. Another problem is that the decisions in all these arbitral proceedings are, as is the case generally, confidential and so they don't produce precedents, they don't help with the certainty problem in

litigation generally and they're not providing guidance for future parties to help them settle their disputes.

Another channel that has been pursued is specialisation within the existing court structure, particularly in São Paulo. In 2005 the São Paulo State Courts introduced a specialist bankruptcy chamber that sat in the city, and then in 2010 this was merged with a general business law chamber, in each case with judges selected for their expertise in business law. The other trend is the production of 'sumulas' – summaries of multiple decisions that are somewhere between a precedent and a re-statement giving a direction about the court's position. Both the court specialisation and the sumulas help parties to get more expert, and more predictable, resolution of their dispute. The limitation of this mechanism is that the judges are still bound by the constitutional principles of interpretation so, although they are experts in business law, they still have to interpret contracts by reference to the 'social function.'

Another channel is the so-called 'Processo Administrativo' – administrative proceedings brought by the Brazilian securities regulator, the CVM, which has the power to enforce general corporate and securities law. The CVM engages in administrative enforcement, which involves an investigation of public companies and participants, initiated following a demand by investors. For example, if an investor has lost money, he or she can contact the CVM and ask for an investigation. The CVM has the power to impose administrative penalties through a decision-making body known as the CVM Board which operates independently of civil and

criminal proceedings. The decision-makers have expertise in securities and corporate law and their rulings, although not binding, are influential in the civil courts. The CVM dispute process happens quickly and their decisions do influence the ordinary courts. However, the limitation of this channel is that while the securities regulator can enforce a penalty, it can't make a compensation award to investors – they need to pursue private law suits to get compensation.

The final channel is the Brazilian takeover panel, the Comitê de Aquisições e Fusões (CAF) which was launched in 2014 and is modelled on the UK's Takeover Panel. It is an expert panel that will publish decisions, but it has no authority to impose its jurisdiction – adherence is entirely voluntary. We asked why would people submit themselves voluntarily to a public decision by a body that doesn't have any authority? The hope is that the expert decision-making by the CAF Panel will be influential in the same way as the

CVM Board's decisions are influential, and that compliance with the CAF process would send a strong signal that parties' actions had been in accordance with the law. As yet there has been very limited uptake and it's unclear whether this is really going to take hold. However, it is an example of the variety of different enforcement mechanisms which parties in Brazil are developing.

All of these enforcement mechanisms build on the existing court structure and are trying to take some of the burden off judges and provide additional expertise and, in some of the cases, guidance for private parties. In Brazil there has been a lot of law reform activity and a great deal of energy invested in enforcement capacity. However, the legacy of inflation continues to weigh heavily, dragging back reform efforts. Regrettably, inflation is once again on the rise which may have an impact on future developments.

Project Research methodology

The research methodology is both qualitative and quantitative, as objective data-based analysis can be effectively complemented by more finely grained interview-based information gathering. More specifically, the quantitative methods involve ascribing values to types of legislation in the relevant jurisdictions, as it evolves over time, according to whether it appears to be more or less supportive to shareholder and creditor rights, and comparing this with economic data over the same period. This kind of objective data on its own may fail to capture significant features of the legal environment, such as attitudes to law, the level of compliance, the quality and reliability of the courts and regulators and the role of the state, all of which will be explored in interviews. Interviews are being conducted with a range of business people, lawyers and where available, regulators, lawmakers and policy makers. Clifford Chance is providing access to our lawyers and to our contacts in each jurisdiction who will be interviewed by the researchers.

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