

## What a new law should not accomplish

**Abstract** – Any change in positive law should consider the effects it might generate when confronted with the past experience, the former path. Especially the problems arising out of piggybacking foreign models although from the same legal family. The examples extracted from the new Brazilian Civil Code are emblematic of the importance of institutions and the law. The choice of a business organization form and of an article included in contracts general provisions aim to demonstrate that good intentions are not enough to design good laws.

**Introduction:** No one doubts that laws might be outdated in which case, they should be reviewed to reflect social changes. What is not always perceived by Congressman, especially when facing the urge to update or, in Italian *aggiornare*, legal rules, is that outdated projects are even worse than outdated rules. This paper discusses some articles of the new Brazilian Civil Code, approved in January 2002, that reflect views and ideas were long surpassed by doctrinal discussions and Courts decisions.

Following the Italian path of 1942 that combined all private ordering in one code, the *codice civile*, but disregarding the fact that, at the time, the regime in Italy was a dictatorship and State intervention in economic activity public policy, even though only part of the new Brazilian Civil Code may be seen as piggyback, the flaws it contains create transaction costs that may hinder private relations.

It is easy to understand what lack of discussions when a legal change is approved causes and I take two aspects of the new Code to demonstrate it. As far as contractual general rules the Code introduces the concept of a social function that might limit the ability to contract. As far as types of business organizations, the Code deeply changed a 1919 Decree regarding the organization of the **limitada**, a type of closed company, common in Europe and Latin-American countries.

In both cases the new rules create transaction costs where there was none and, since the Code is in force for less than 4 years, more problems might arise in the future than the ones presented.

**The new Brazilian Civil Code:** Changes in Brazilian positive law were introduced by legislators in 2002, whose effects started to be noticed in 2004. Brazil is a Civil Law country, and its former Civil Code approved in 1916, and in force in 1917, in the eyes of some, was outdated. Maybe so as from 1917 on social and economic changes took place that might not properly reflected in the legal rules.

It must be pointed out that in the 1960s, the military regime took over the government, and the concept of the Big Brazil became public policy. During the period of military government emerged the idea of updating Brazil's Civil Code, following discussions dating back to the first half of the century in Italy.

A project was presented by the mid of the 1970s, but, as it frequently happens, it was not a project demanded by Brazilian society so it remained in some drawer in Congress until 2001 when, due to personal efforts and vanity it surfaced. Not discussed, or at least not enough discussed, it was voted and enacted in January 2002, and was enforceable one year after, that is January 2003.

Considered by some as a legal advancement, the new Code has several flaws that make it a piece of bad ingenuity. Two points are sufficient to corroborate, as is the intent of the paper, that social institutions do matter as far as writing laws, and good intentions are not enough to overcome conceptions that have bad starting points.

A challenge legislators face when drafting and/or proposing new laws (or changes in existing laws, for that matter) is how people affected by the changes will understand and accept them. Laws that depart from, or are against social institutions, or those aiming to change long standing social institutions, incur in the possibility of being ignored, or not complied with by the community. The process of law making, based on proposals discussed by Congressman not always captures social anxieties, needs, and practices. That is why persons sometimes abide by the rules while other times they simply ignore the law.

That challenge is observable as far as some articles of the new Brazilian Civil Code, enacted in January 2002, and effective as of January 2003, are taken into consideration,. The new Code introduced important changes as compared to the prior Code, not only in regard to the reception of part of the commercial rules into this Civil Code.

Brazilian private legislation, based on the continental European tradition, was divided, according to the subject matter, between two Codes: a Commercial Code, dated 1850 (defining who could be considered a merchant, traditional commercial contracts, business organizations – partnerships and other forms except corporations – were the most important ones). The former Civil Code was dedicated to all other matters including property, obligations and contracts, liability, family and inheritance law.

Due to the fact that there was, in the Commercial Code, an article, that remitted to the Civil Code contracts provisions if and when no legal commercial rule or usage existed, doctrine considered that”, in spite of the dualism in private law, a material unification could be seen in contracts and obligations.

So, in those areas of law, some claimed, as dualism was only formal, why not to combine both set of rules in just one private law code? No surprise that, as discussions started, in the early 70<sup>s</sup>, regarding the *aggiornamento* of the Brazilian Civil Code, the Italian experience, the *codice civile* dated of 1942, should be considered as the paradigm.

Brazilian legislator did not, however, take into consideration that, in 2002, globalization was a fact, that the economic development of the country, and social arrangement, plus a new Constitution, and several statutes, had already changed the interpretation of the Civil Code.

The Italian Civil Code was designed and approved during the 2<sup>nd</sup> World War based on the Führer Principle; continental European countries that belong to the same family and have the same roots, Roman-German-Canonic tradition, with the exception of Italy, maintained the dualism in their private laws. This should have been an alert to Brazilian legislator but the signal was completely ignored. Worse than that, a code drawn in the late 70<sup>s</sup> was voted by Congress in 2002 with little or no discussions with or amongst professionals, let alone the people.

This new Civil Code does not replicate entirely the Italian model, but took a different approach: based on previous discussions the Code unified only the discipline of obligations and contracts. As a result of such policy, contracts are subjected to the same legal provisions whether business or individual ones, despite the fact that there are various special statutes applicable to business transactions based on different assumptions. One must be aware that the Code was designed during the years of the military regime, a time in which government aimed to control all economic activities, public or private ones; since the Code was designed in the 70<sup>s</sup>, some of its articles reflect the “state of the art” at that time in social relations.. The result of such a political decision and we assume that legislators’ intent was for the better, was an increase in transaction costs, allowing space for opportunistic behavior, all unintended results of the policy.

Maybe, due to the fact that there were not enough discussions of the various projects since most of the scholars did not believe that such a change in legislation would ever be voted, society will bear the effects of a law that did not respect social institutions.

I will concentrate in what I consider some of the consequences that could have been avoided had the project been properly discussed; and what could be the consequences as social institutions or common practices were modified without paying any attention to what people did or wanted to change. One of the problems deals with a business organization form, a society prior designated as *sociedade por cotas de responsabilidade limitada*<sup>1</sup>, known in Brazil since 1919. This business form was designed following the German GmbH (Gesellschaft mit beschränkter Haftung), with some peculiarities such as: no minimum capital requirement, married couples could organize a *limitada*, thus shielding common assets from business creditors; majority requested a vote of 50%+1 quotas; the appointment of managers that were not partners by delegation of powers of the manager quota holder.

**The Limitada:** Because the law allowed partners to elect corporate law to supply any and all non foreseen cases in the *limitada*’s “charter”, if and when compatible with the form, the 19 articles of the 1919 Decree, granted such a flexible structure that could resemble a partnership in which partners had limited liability, as well as a more organized structure, close to the corporate one. In fact the plasticity of that law allowed in designing the “charter” transformed *limitada* into the most used form in the country.

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<sup>1</sup> - limited liability quota company (tentative translation)

Some restrictions such as the impossibility to go public, to issue debt to finance operations, legal provisions on managers personal responsibility for abusive use of the business form existed and it seems that it were enough to inhibit misconducts in most cases. The *limitada*, in Brazil was one of the most successful business forms that did not result from business practices, instead it was one created by the legislator.

The *limitada*, as it was usually referred to, when first introduced in Brazilian's legal system, legal scholars were concerned of the effects it might cause in debtor-creditor relations. The new form, as corporations do, permitted partners to isolate their personal assets from any constraints attempted by social creditors, permitting the shielding of personal assets from business creditors. The only request was that the whole *limitada*'s capital had been paid for. It did no matter if the *limitada* was organized for a small or gigantic business and, later, by and between spouses.

Some compared the *limitada* to a small corporation, which it was not; sure partners did not have to publish financial statements at the end of the fiscal year, or even minutes of board meetings, and as the *limitada* was a legal entity, the novelty was successful. After years of discussions, judicial decisions, it seemed to all that this business form, the *limitada* was an issue that would not be object of any further disputes; except for the fact that in Brazil it was impossible to create a one man *limitada*, (a reality in most European countries, that led to a change in the definition of what an economic society is in order to include the one man *limitada*), there were no special concerns justifying any substantial changes in the Brazilian *limitada* law.

In fact should any changes be made, they would concern the one man *limitada* rather than any other. Nevertheless, the 2002 legislators, for unknown reasons, took into account the prior discussions, that had been settled by Courts or doctrinal studies, and took a different path. Most of the former critics and concerns presented at the laws enactment were brought to light again and thus in 2002, the *limitada* was reshaped in a way that makes it a business form much similar to the corporation, without the benefits that the corporate form offers as will be shown below, those problems.

Contrary to the former Decree that remitted to corporate law as a secondary source of rules in the lack of a specific legal provision, if the contract contained such a clause, this one (art. 1.053), in order to supplement any lacks in legal rules or contract clauses, remits to the discipline of a new organization form, copied from the Italians, that is not a business organization model. Worse, the Code states that the model – *sociedade simples* - is not a business organization form and forbids its use in case the activity to be developed is commercial. So instead of linking the *limitada* to the corporate form it links it first to a non business partnership. Worse than that, the wording adopted makes it almost impossible to understand that the sole paragraph, allowing partners to maintain corporate law, as before, as the applicable rule, is feasible.

A paragraph should not change the meaning of the head of any article. So, if the article determines that the type is, were and when no special rule exists in the Code for the *limitada*, that this lack is supplemented by the provisions existing for the *sociedade*

simples, it is easy to fool readers and induce them to believe that those orderings come first and, therefore, what the sole paragraph allows, is the “supplement of the supplement”. Some interpreters say that corporate law, even when mentioned as a source in the contract to complete it comes second. Such an interpretation would prevent almost any recourse to corporate law, in a change that would contribute nothing to enhance the use of the *limitada* as a small business organization.

Truth is that the paragraph was added when someone, paying attention to article 1053, recalled that corporate law use to be the secondary source of rules for the *limitada*. The other complication arises from the change in the majority rule that instead of 50%+1 now requires a 2/3 vote in order to destitute the manager designated in the charter; and ¾ in order to approve any change in the charter or the merger, consolidation, the winding up. Some lawyers say that those changes are equivalent to a control expropriation.

Worse is the prohibition that couples, married under one of the two assets regime – total communion or absolute non-communion - organize, between them or even among the couple and a third non related party, any *limitada* (art. 977)

The problem is that, before the enactment of this Code, many *limitadas* were organized by couples married under one of the assets regime, *limitadas* that, according to the new law should have to be wound up. The protests in reaction to the change in law lead to an awkward decision by the Board of Commerce – that is the official registrar of business organizations -: two different *limitadas* coexist in Brazil. The ones organized before January 2002 by and between married couples, whatever the asset regime, did not have to change the arrangement and, after that, no such organization by and between couples, whose asset regime falls under the prohibition were allowed.

Result is there are *limitadas* bC and aC<sup>2</sup>, as far as married couples are involved. This is a typical Brazilian solution: former *limitadas* do not have to comply with the new law as they existed before; married couples are allowed to modify the asset regime, therefore if they decide to create a *limitada* that is what they should do. Could it be any better?

There are other effects linked to the changes in the *limitadas*' rules, one of which was predictable. In 2002 there has been an increase in majority rules from 50%+1 of capital quotas to 2/3 or even ¾ of capital quotas in order to amend the contract, for example. To some it appeared as an expropriation without indemnity. The violence it represents produced as a consequence the fact that most (more than 85%) of existing *limitadas* did not, during the legal time frame (one year after January 2003) to amend the contracts. By the end of 2004, a law was enacted to extend the period for another year. To make it brief, the date is now January 2007 and, my guess it will be postponed for as many years as necessary until the rules change again.

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<sup>2</sup> -before the code and after the code.

As mentioned before, the limitada was one of the most successful business organizations forms in Brazil until 2002. After that, or after the Code, lawyers are suggesting to their clients it is better to organize corporations instead, as the legal discipline is far more favorable if one has 50%+1 of voting shares.

Finally it must be noted that, in 2002, that in Europe, Germany, France, Italy, Spain and Portugal, had already amended their laws to allow for the organization of one man limitadas, most probably because it would not generate problems others than the one man corporation as far as creditors should be protected. Not only in 2002 did Brazilian legislators ignore it but in 2006 this organization as a means of dividing risk it is still forbidden in Brazil. new law and old spirit or lack of knowledge of institutions and economic requirements?

**II – Contracts General Clause:** Another concern refers to article 421<sup>3</sup> of this new Civil Code.. Said article, which initiates the disciple of contracts, a general provision as we say, introduces the idea that freedom of contract should be limited by a so called contract' social function. The problem is defining the meaning of a social function in the law of contracts.

Analyzing the expression professor Villela says that, amongst the innovations brought by this new Code, most probably none caused such excitement as this one.<sup>4</sup> As he sees it, the expression means the contract itself, as no valid and binding contract exists out of a social function context. In other words, what would be the reason for anyone to celebrate a contract should it not have a social function?

Therefore, concludes professor Villela, the expression – contracts' social function – would have no other meaning except to reproduce the idea that contracts have no other but a social function. As for the limits, (or social limits) to the right to contract, no question they must be established and guaranteed by the State (legislators).

Professor Villela's interpretation of the wording, appealing as it is, is not the one judges adopt. Ideology might be the basis for different interpretations. Considering that the new Code has been formulated to part from the individualistic basis over which the 19<sup>th</sup> Century Codes were based, and that social is an important element in interpreting the new rules, one should not be surprised that judicial decisions taking into consideration the expression "reason and limits of the social function", would lead to the understanding that interpreting contracts should abide to a distributive paradigm.

Nothing to do with risks and advantages decided by and between the parties, *ex ante*, not with setting the rules for *ex post* distribution; the social function should be considered as

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<sup>3</sup> - Title V- Of Contracts in General – Chapter I – General Rules – Section I – Introduction – “Art. 421 – A liberdade de contratar será exercida em razão e nos limites da função social do contrato.” The freedom of contract shall be exercised for and in the limits of the contract's social function” (free translation)

<sup>4</sup> - Villela, João Batista –presented in a Law and Economics group meeting in May 2006 in São Paulo.

a means of dividing gains and, sometimes, transferring to one party the burdens or losses that would encumber the other.

Since the rule is applicable to all contracts, business, non-business and even consumer ones, it is not difficult to imagine the damage it might cause. Because the question is not the meaning of the expression “social function”, the concern regards business contracting in a world where changes occur at a very high speed rate. Can one foresee any and all future events and provide remedies in case that it materializes? If not, and if contracts are, generally incomplete, mainly in a commercial environment, how can any one take precautions that generate confidence?

It seems clear that contracts exist in any organized even if little developed society, or, in other words, contract is a social institution. As such, the more people are assured that promises will be kept; the more the social function contracts may be present. Without credible contracts how would wealth circulate legitimately? How would risks and bonuses be distributed among persons? How would a vulnerable party (or the one that, in the eyes of judges, appears as vulnerable) be protected when entering into an agreement?

It was said, to explain art. 421, that since property (some say productive good) have a social function when that function is not fulfilled property may be confiscated or expropriated; since enterprises should also comply with a social function (not polluting, providing adequate environment for employees and respective families, not harming the community where they are located) it is clear that focus is moving from individual to collective, or social. Why not contracts? What could be wrong with applying the concept of social function if one is interested in fostering collective interests over individual ones?

Why not to require that at any time one enters into an agreement, one should take into account not only one's personal interests but also social ones? Social here meaning communal interests, or interests that do not harm communities is the problem. A social institution – contract – should be dealt with in order to reduce transaction costs and opportunism both far apart of article 421 wording. Well, it is not hard to imagine transaction costs increase when one is writing a contract in order to avoid judges' interference and biased interpretation (as it usually happens) as an external event affecting promises made.

One would imagine that law, as a system of prizes and punishments would be designed to enhance confidence, reduce opportunism and transaction costs and, whenever possible, create incentives to internalize negative externalities.

Should the prevailing interpretation of the expression “social function” be: refrain from damaging third parties, and it would not be necessary since liability rules would take care of the events.

Attention must be paid to several recent Court decisions that voided contracts on the bases that clauses were detrimental to one of the parties, the vulnerable or less informed

one. The result in the productive chain was immediate: transaction costs increased as confidence vanishes. Developing a safe business environment under this new Code is a difficult task.

A Code with rules that emphasize social over individual applicable to business transactions might create problems that will not be easily solved as the consequences do not appear immediately. Worse, a Code enacted without extensive and profound discussions, that does not reflect social institutions and aims, is a source of transaction costs that hinder economic growth.

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