

CORPORATE GOVERNANCE IN THE CONTEXT OF THE RECOVERY OF DISTRESSED FIRMS: A CASE STUDY IN BRAZILIAN AIR TRANSPORTATION SECTOR

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Abstract

Corporate governance is a set of practices and processes of board and executives coordination and control that aims at protecting the interests of shareholders and others affected by the value of the company. The discussions and disputes involving shareholders in Brazil and a new corporate law aimed at improving governance practices in the country, reducing the cost of capital of the company and contributing to national economic growth. In this study, we compared the theoretical evidence on the governance structure of airlines with the reality of a large company in the sector in Brazil. The results indicate that a wrong architecture of ownership and control combined with the non-corporate governance system may result in financial distress for an organization.

Keywords: Agency Theory, Corporate Governance, Organizational Structure

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1. INTRODUCTION

In today's economy, companies that use the capital markets have a key role: creation of technology, increased productivity and wealth generation. Funding for the viability of projects is essential for business growth and consequently for the economic development of countries where they operate. The availability of capital for financing depends on the efficient collection of resources of the sparing agents for productive investments. This collection depends primarily on investor confidence and not only in relation to the economic viability of the enterprises, but also in relation to obtaining for themselves the fruits resulting from the investment, since there is a risk whether the investment will be profitable.

However, it is not enough just to raise funds, if it is not observed allocation criteria that take into account the interests of shareholders, summarized by the expected increase in value. From the perspective of the creditor, corporate governance can be explained as a set of mechanisms that aim to increase the likelihood of resource providers to ensure their return on investment. The risk of investors' resources not being well spent or diverted stems primarily to the existence of a situation of separation between ownership and control, where the party who provide capital does not directly participate in corporate decisions. This situation occurs in most large corporations, where managers, executives,

professionals in companies with ownership structures sprayed or controlling shareholders in companies with concentrated ownership structures, do not carry the entire financial burden of their decisions.

The minimization of the damage caused by the conflicts of interest among decision makers and suppliers of resources depends on the presence of a set of internal and external mechanisms that align the interests of managers to those of all shareholders. To this set of incentive mechanisms and control is given the name of corporate governance practices.

In this context, the airline industry has faced challenges in adapting to the increasing demands of its market in several ways. Nelson & Quick (2003) comment on these changes with emphasis on the changes in regulation, mergers and acquisitions, new security parameters, changes in the cost structure (highly linked to the dollar), changes in the treatment of customers and employees and bankruptcies.

In Brazil, one of the largest airlines operating in national and international territory has gone through serious economic and financial difficulties and requested in June 2005 under the Act 11.101/2005 a sort of judicial recovery similar to Chapter 11 in USA.

This study seeks to contribute to improving the process of defining organizational structure and management of relationships between controllers and managers of companies in the airline industry, bringing thoughts on corporate governance and the

suitability of application of international standards of governance to Brazilian companies. The methodology presented in this study was the case study, which noted, first, the determining factors for the success of the governance framework in airlines.

2. AGENCY THEORY AND CORPORATE GOVERNANCE

The agency theory has roots in economic thought and is widely accepted in academia. It aims to understand the vision of the control of agents, observing predominantly conflicts between the owner (principal) and executives or managers (agent). Jensen and Meckling (1976) analyzed these relationships and, based on the assumption that parties maximize utility, they found that the independent agent does not act in the interests of shareholders in full, because attitudes that produce welfare for the latter not always do generate to the first. In order to limit differences in the behavior of the manager, the owners could use various forms of monitoring (e.g., audits, reports, budget constraints) and incentives (e.g. rewards tied to performance). Such activities, however, generate costs and still would be insufficient to ensure perfect adhesion of agents' attitudes. The sum of all costs incurred by the owner, including those related to losses due to selfish decisions of the administrator, are defined as "agency costs".

In the relationship between shareholders and managers, the agency costs of the "residual loss" are manifested by decisions taken by managers that are not maximizing shareholder wealth. Among the theoretical works of the duo, the analysis of ownership structure and financing of the firm in search of the optimum balance of contract stands out as one of the central points. The results concluded that, given the size of the firm, it would be economically advantageous for a certain level of ownership to be maintained by the administrator, i.e., that the agent possesses a number of company shares. This proposal would generate, then, a reasonable disincentive to the agent acting against the shareholders, because if he did, he would be acting partly against itself.

Although firm in his propositions, Jensen and Meckling (1976) cited important caveats to their own analysis. Among these, the fact that they conducted the study considering the so-called "single administrator's decision", that means that they do not address aspects of intertemporal decisions that influence the reputation of it and therefore tend to naturally stimulate action in line with the welfare of the owners. They stressed, however, that given the finite life of the administrators, the individual time horizons have limits and therefore the effects of agency costs would never be reduced to zero.

Some subsequent empirical studies have sought to confront the proposals of Jensen and Meckling (1976) with real data. Allen (1981) provided evidence

that the level of total remuneration of the administrator is a decreasing function of the number of shares held by it. Lambert, Larcker and Weigelt (1993) obtained similar conclusions. In their research, they showed that the CEO's compensation was lower when its ownership upon the firm was bigger. Core, Holthausen and Larcker (1999) presented evidence in exactly in the same line. These results are consistent with the theory. However, in related research, Morck, Shleifer and Vishny (1988) showed mixed results. They exposed through empirical data that the market value of the company followed an increasing function in relation to the level of agent's property - to some extent, from which the incentive effects were dominated by negative effects of concentration of voting capital. Holderness and Sheehan (1988) diverged completely from the theory. They found that managers with majority ownership - those with at least 50% of the shares - in publicly traded American companies, received marginally higher salaries.

Another issue widely discussed concerning the Agency Theory is the structure of boards of directors in order to ensure its effectiveness as a tool for maximizing of the value to the shareholder and to the monitoring of the attitudes of the administrator. In this context, there are discussed eminently characteristics such as size and composition of this body and the convenience of separation from the administrator and the chairman of the board.

Regarding the size of the board, Lipton and Lorsch (1992) recommended limiting the number of members to a maximum of ten people. They argued that although the power of surveillance was increased with the number of members, the benefits would be far outweighed by the costs of delays in decisions. Jensen (1993) reaffirmed the loss of productivity pointing coordination problems arising from increases in the group of advisers. Moreover, he suggested that boards with more than seven or eight individuals are more susceptible to manipulation by the administrator.

These theories were supported by empirical evidence. Yermack (1996) prepared a study to analyze the relationship between board size and measures of business efficiency, mainly using financial indicators such as profitability and market value of firms. Considering the trial of Mintzberg (1983), Vance (1983) e Jensen (1993), that the boards are ultimately responsible for corporate performance, the construction of Yermack (1996) is even more appropriate. The econometric regression model found an inverse relationship between the variables, consistent in both stationary analysis between companies and in time series analysis of individual firms. In addition, the author found that in companies with smaller boards, remuneration of directors tended to be lower and that they were fired more easily after periods of poor performance.

With respect to the literature about the composition of the board, we find a line

predominantly favorable to the majority formation of the council by individuals outside the company. Kesner and Dalton (1986), Baysinger and Hoskisson (1990) and Jensen (1993) argued that board members internal to the company would fall in a situation of conflict and precarious independence to try to balance their loyalty between manager and shareholders. Your participation would therefore deficient in honesty and diligence. In addition to these authors, Hambrick and D'Aveni (1992) and Stearns and Mizruchi (1993) also defended the use of outside counsel, but on the grounds that they would add new features in terms of experience, and additionally represent additional sources for attracting and winning of new business.

A wide stream of empirical research points to the benefit of keeping only external members (or a large majority of them) on the board, except for the unavoidable presence of the administrator. Rosenstein and Wyatt (1990) observed a positive impact on stock prices of companies when hiring announcements of outside directors. Core, Holthausen and Larcker (1999) presented evidence that firms with boards made up of internal members offered more rewarding payment to the principal' agent. They also found that firms that paid more to their agents had worse performance in the stock market. Lambert, Larcker and Weigelt (1993) and Boyd (1994) also studied the implications in the administrator compensation and found results in the same direction. Baysinger and Butler (1985) studied effects on market value and pointed out the advantage of having external members on the board. Daily (1995), studying the processes of reorganization under the protection of the regulations outlined in Chapter 11 of the Bankruptcy Reform Act of 1978 of the United States, noted that a higher proportion of outside directors was positively associated with reorganization processes successful.

The discussion about the need to improve corporate governance in companies emerged in response to various records of expropriation of shareholder wealth by managers in firms with ownership structures sprayed and minority shareholders by controlling shareholders in companies with concentrated ownership structure. These records

result from the agency conflict that occurs when managers make decisions in order to maximize their personal utility, not the wealth of all shareholders, why they are hired. Thus, the explanation of corporate governance requires an understanding of how the agency conflict occurs in business and what mechanisms could be employed for their extermination.

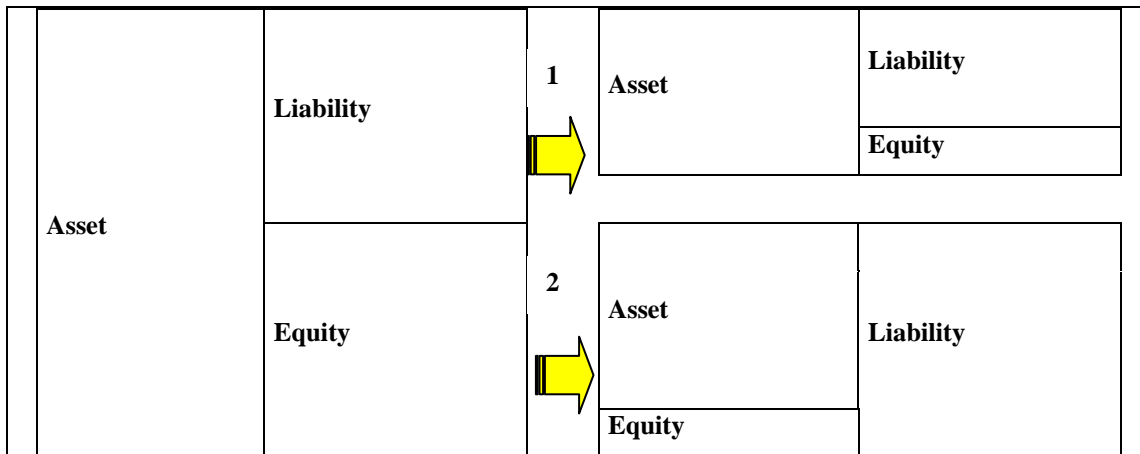
In recovery, the company already faces a number of difficulties, will now need the support of creditors in the making and approval of the plan and also in maintaining minimum subsidy for the company to survive during the discussion of the strategy to uplift and to the approval of the plan of recovery.

As companies in recovery often find themselves in difficulties due to inefficiency of management, sometimes associated with the adoption of bad corporate governance practices regarding the control structure and the configuration of committees and boards, any change at this point will require a management shock. It should also be observed in this case that although the incidence of poor administrative diligence, it cannot expropriate the business in crisis of the shareholders. It is thus necessary to convince the controllers for adherence to the new management principles that would lead the company to overcome the crisis.

For companies in crisis, we have some specifics, which we discuss in light of the balance sheet. The Figure 1 shows in the left side, the most common equity position of a company economically healthy, showing a reasonable balance between the amounts invested by the partners (equity) and the amounts invested by suppliers, financial creditors, employees and government (liability).

When companies enter into economic-financial crisis, its equity structure is mutated in order to consume the reserves of its members to pay onerous obligations at the expense of financing the expansion or maintenance of the company. Thus, the assets of the company become, at first, funded by costly third-party resources, as characterized in Figure 1, after the transition "1".

Figure 1. Evolution of the balance sheet in companies in crisis



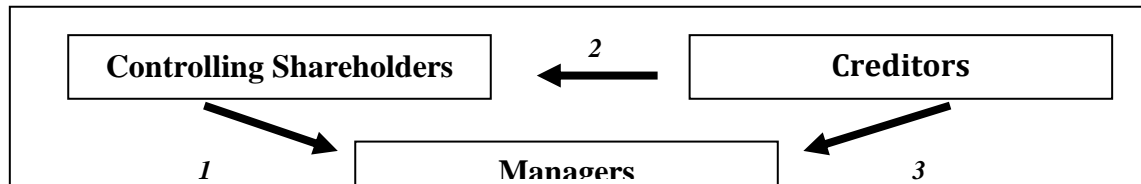
Source: authors.

If the crisis worsens, the company's equity (primarily composed of resources of its members) may even become negative, at which time your creditors, be they operational or financial, are to be the effective funders of the project.

In understanding that those who have power over the company, and therefore the power to delegate its management functions to third parties are the

stakeholders of the operations, would be admitted, in a crisis situation, that the power of decision migrate from the hands of the shareholders to creditors. This situation is partly seen in cases of judicial recovery where the creditors determine the company's fate, with votes in amounts proportional to the value of their claims.

Figure 2. Duty to agency in companies in crisis



Source: authors.

Thus, the duty of the agency that was once expressed by the relationship between Controlling Shareholders - Managers (relationship "1" in Figure 2), in the situation of economic-financial crisis, needs a new component that represents the role of lenders as active participants in defining the direction of the company (relationship "2" or relationship "3" in Figure 2). Then it can consider two options for establishing a bond of responsibility and sharing of information that support decision-making during the crisis period:

- a) Creditors - Controlling shareholders: where Creditors assume the role of principal and Controlling Shareholders assumes the role of agent, being responsible for guiding Managers to take actions in accordance with the provisions of Creditors;
- b) Creditors - Managers: where Creditors replace the Controlling Shareholders in the position of defining strategic orientations, thus, the Managers

become responsible to act to meet the interests of Creditors.

In the crisis, one of the first uncertainty with which the creditors have to deal with concerns the reorganization of the company or its complete closure. This decision involves an evaluation of the more profitable alternative, or in the situation more prone to failure that will minimize the losses of creditors. This trial may distort the real needs of the company in crisis, accelerating its degradation process. It is therefore necessary that the creditors when taking decision-making posts in the situation described, be subject to mechanisms that encourage the maintenance of company's operations, if it proves economically viable.

Gitman & Madura (2003) argue that managers act as agents of shareholders, making decisions in favor of maximizing the value of the company, therefore, seeking to maximize the value of the company's stock price. In this sense, investors rely on executives attitudes to generate attractive returns. The

company's strategic decisions in terms of investment and financing affect the company's performance and, consequently, determine levels of dividends and capital gains made by the shareholders to sell shares of the company.

3. METHODOLOGY

The present study has the general characteristics of a whole, which was investigated an engineering corporate governance on the structure and control of existing agency. First, we developed a literature review, in particular on the experiences outside of the Brazilian context, considering international experience in the sector under review in both instances of successes and failures.

This case refers to a company in the airline industry. The survey was developed from a study of literature with the aim of obtaining information and concepts that can be used as plumb lines for the study, followed by an exploratory field survey and suggestions for a base model of organizational environment that effectively will contribute to the improvement of corporate governance of the company in focus.

The case was designed by estimations of the study plan, field procedures, and major research questions, which were cast:

- a) What ownership structures and control are more appropriate for companies in the airline industry?
- b) What is the influence of inadequate infrastructure for the survival of companies in the airline industry?

The case study involved the following steps: design of the case, conduction (preparation and data collection), evidence collection, data analysis, evidence and report composition. In the preparation and collection of data and evidence were used to subsidize the study:

- a) documents (letters, evaluations, petitions, proposals, presentations, news clipping - <http://www.aeronautas.org.br> - reports, ...);
- b) records (financial statements and its annexes, charts, sectional time series, ...);

In order to explain the theory in the Brazilian reality, we take a case of a company who suffered due the inefficiency of its management system and its control structure, entering into a severe economic-financial crisis.

4. ANALYSIS

The case study in question comprises the oldest airline operating in Brazil to its time, and one of the oldest in the world. It had one of the largest holdings in domestic and international flights, but in recent years has experienced losses and presents no alternative to changing the situation.

For over fifteen years, the company had negative financial balances, and changed the command more

than five times in a period of six years. With debts estimated at more than seven billion reais, the difficulties faced by the company were, supposed, the reflection of the freezing of fares in the 1980 and 1990, complemented by a very inefficient administration.

As a last and only alternative to uplift the company, its administration filed a judicial recovery solicitation under the Act 11.101/2005, seeking immediate legal protection against the seizure of aircraft and then negotiating a recovery plan with all its creditors that would allow their uplift.

The airline in question is controlled by an organization of employees of the company itself and goes hand in hand with other companies over the control of the same organization. All companies are somehow related to the business of air transport. The described diversification is not exactly the problem identified in the documents analyzed, but the lack of transparency in business management and the interrelationships of all subsidiaries.

One can note also that the command positions in the company exchange often, which may be generated by the very inconsistency of the control structure. To implement strategies and long-term commitments, the company's structure seems inappropriate, being used in order to satisfy the interests of any controlling blocks within the parent organization.

The organization that runs the company makes strategic decisions of collegial manner, attended by about 220 employees. Decisions that do not affect greatly the future of the organization are made by a small committee composed of seven employees, chosen among those who participate in strategic decisions. Decision-making processes in the company are characterized by a high degree of centralization and little horizontal communication between the various sectors that might have interest. It happens that this wide control is not effective in broad day-to-day business, with strong tendency in the company to its fragmentation into smaller units, which ultimately inhibit the construction of a system of long-term goals for the entire company.

Note that the decisions, even when not directly issued by the collegiate structure, must be compatible with the objectives of the parent organization, which we can derive in part from its mission statement: "To promote the welfare of its beneficiaries with actions aimed at improving the quality of life, which makes it an element of motivation and commitment to the Entity and the company where they work." The parent organization's objectives system is based on social goals, not compatible with the economic and financial needs of the subsidiary.

It is noteworthy that in the research material, experts report to the mismanagement as the cause for the economic-financial problems the company. This statement can probably generate the false impression that the inefficiency was of the figure of manager. It should be noted, as this work presents, that even if the

manager is well qualified and even if he acts according to the interests of the controller, an inadequate management structure and decision-making can cripple the operations of a company.

Another problem noted is the lack of clearly defined relationship between the company and other subsidiaries of the parent organization. There is little transparency as to the limits of operation and management between several companies that compose the group, having crossing of employees, managers, resources, programs and policies. In some cases, companies have business relationship, with the company that is the focus of this study operating both as a customer and as supplier of them. There is in these situations a lack of commercial rigor, characterized by induced monopolies and service prices inconsistent with market practices.

In short, the lack of business vision in the company led to an obscure strategy or a lack of long-term corporate strategy. A major cause for this lack of strategy is the uncertainty about the future of the company in terms of definition of structure and control positions. The reduction of this uncertainty, with the construction and establishment of a control architecture aimed at economic targets, taking into account the interests not only of all employees as shareholders, certainly will provide an environment of greater professionalism in the conduct of operations.

It is suggested that a more appropriate structure will elapse from the development of a corporate strategy, which will undergo periodic review, based on new market situations, considering all the variables that substantially affect customers, competitors, technology and employees.

5. CONCLUSIONS

In the case studied there are conflicts between the manager and owner as declared by the Agency Theory. Company officials, organized in the parent, exhibited a behavior exclusively dedicated to the satisfaction of their interests to the detriment of other shareholders. Through a governance structure opaque and centralized, they established directions for the company that benefited their positions when the most coherent attitude would be to set appropriate answers to the variations observed in the external environment.

International terrorism, changes in safety regulations, freezing of fares in the 1980 and 1990, an increase in fuel prices, all these factors encouraged a crisis in the airline industry. The Company's management should therefore have been prepared to respond to such difficulties in a manner consistent with a market economy. First, should have sought an organizational structure that facilitates efficiency in taking and implementing decisions and generate value for the *stakeholders* in a balanced way. On the contrary, what happened was a policy of favoring employees. This has led to a terrible economic-

financial situation, which made the company inevitably enter with the process of judicial recovery of enterprises set up by the Act 11.101/2005.

It can be affirmed that the judicial restructuring finds higher probability to succeed than the continuation of an administration centralized in the employees. The appointment of a judge to follow the process, coupled with the participation of creditors and other shareholders in the negotiations, provide greater transparency of company operations. Under such circumstances, employees will have less flexibility to act in their own interests. It is recommended for future development, the design and the construction of an information system that can be implemented in an optimal governance infrastructure. Thus, it may be presented as result a system of governance suitable and with directions for improvement adjusted to the peculiarities of the airline industry.

This system of governance can be built from the assembly of an architecture of the existing decision-making flow and subsequent identification of potential broken synapses and relationship channels and incentives inconsistent with good corporate governance practices, with regard to ownership structure and control.

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