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Mitigating uncertainties when replacing board members

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Although listed companies routinely deal with the rules governing the replacement of board members, the matter came into the spotlight recently when Jean Paul Prates left Petrobras, where he had been both CEO and a member of the board. His departure sparked debate over whether Petrobras was required to call an immediate shareholders' meeting to elect a new board.

Brazil's Corporations Law gives shareholders considerable flexibility when it comes to establishing rules on the replacement of members of the board of directors. A company's bylaws can provide, for example, that members of the board will be replaced by their respective alternates, or, if the alternates are not linked to an effective member, the board itself can choose which alternate will step into the vacancy, as long as the minority shareholders' representation on the board is respected. A substitute may also be chosen by the remaining board members, to serve until the end of the replaced member's term. Thus, and as long as the rules are set out in the company's bylaws, he mechanism for replacing board members can be adapted to the company's governance structure and the interests (and creativity) of its shareholders.

If the bylaws are silent, the Corporations Law provides that the substitute member will be appointed by majority vote of the board of directors (which, in Portuguese law, is called co-option), and will hold the position until the first general shareholders' meeting following the departure of the former member. In such cases, the replacement takes place in two steps: in the first, the board itself chooses the temporary substitute, and in the second, the shareholders may either ratify the board's choice or elect another candidate.

In some cases, the Corporations Law does not permit co-option. The first is when a majority of the seats on the board of directors becomes vacant, and in that case the Law requires a general shareholders' meeting to be called so that an election can be held, either to appoint a whole new board, or to fill the vacancies. The second is when the members of the board are elected by cumulative voting, and it was around this issue that the debate over the replacement of Petrobras's former CEO turned.

In Brazil, cumulative voting is only adopted when requested by shareholders representing a minimum number of voting shares. In the cumulative system, each share receives a number of votes equal to the number of positions to be filled, and shareholders can opt to distribute their votes equally, or concentrate them on one or more candidates, thus increasing their chances of electing the candidate of their choice.

When a board is elected by cumulative voting, the departure of any one of its members means that all the other members chosen in that election can lose their seats. Nonetheless, the timing of their replacement may differ, depending on the reason for the vacancy.

If the departing member was removed by the shareholders, the other members' seats immediately become vacant and a new board must be elected. However, if there is another reason for the member's departure, such as resignation or death, the remaining members continue to hold their seats until the first shareholders' meeting after the member's departure, when a new board will be elected.

In the latter case, although the Corporations Law requires the entire board to be replaced at the next shareholders' meeting, it does not say how the vacancy will be filled in the meantime. As a result, even if the board was elected by cumulative voting, the rules under the company's bylaws have to be consulted to determine how the departing member should be temporarily replaced. If the bylaws are silent, then the temporary substitute may be appointed by the remaining board members.

Even where the board has been elected by cumulative voting, however, a vacancy does not necessarily mean that an entire new board must be elected. If the departing member has an alternate, the alternate can step in as the member's replacement, and there is no need to apply the Corporations Law and its requirement for a new election of the board. On this point, Brazil's securities and exchange commission, the CVM, has taken the position that the bylaws must specifically authorize replacement of the effective member by the alternate, and that the alternate must have been elected by the same group of shareholders that elected the departing member.

This nest of rules, exceptions and situations show how important it is for shareholders to ensure that the company's bylaws contain clear and precise provisions on the mechanism for replacing board members.

At the same time, the policies on nomination of board members required by special listing segments like the *Mercado Novo* (New Market) are designed to ensure that even where the board of directors has the power to choose replacement members, the board must follow certain procedures and its choice must be based on criteria that ensure that the composition of the board will be aligned with the best corporate governance practices.

Thus, although cumulative voting can foster greater representativity in boards of directors, it does represent a degree of instability in the company's governance, since it subjects the board to a general, abrupt replacement on the departure of one of its members. Well-drafted bylaws are the best way to mitigate the potential risks associated with such situations.

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