The Duties of Directors of Japan's Publicly Held Corporations, with an Emphasis on Supervisory Issues

Kenjiro Egashira *

I. Conventional Monitoring System

1. The Structure of the Board of Directors

Looking back at the history of Japan's publicly held corporations, it would be fair to say that at no time has the efficiency of supervision of executives by directors and/or their board been so seriously discussed as at present. The latest revision of the Commercial Law (promulgated in 2002, put into force in April 2003) introduced a new organizational form for stock corporations called a "company with committees" (*i'in kai tô setchi kaisha,* hereinafter "new company" or "new company regime"), which clearly segregates the management of corporate business and its supervision.

Despite the limited number of companies that have adopted the new company regime so far (some forty companies out of approximately 3500 public held corporations in Japan), the impact of the new company regime is considerable because among those who have adopted it are many of Japan's foremost companies, with world-renowned names that include the four big electronic companies (*Sony*, *Toshiba*, *Hitachi*, and *Mitsubishi Electric Corp.*) and *Nomura Holdings,* the holding company of Japan's largest securities firm.

Today I would like to focus on the issue of supervision by directors and their board rather than the duty of management in general. The following historical overview may

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help readers to understand why the segregation of management and supervision is so critical to Japanese corporations.

A company needs leading personnel (executives) who conduct managerial jobs on a full-time basis, including but not limited to decisions of business strategy, quantitative goal-setting, planning to achieve such goals, provision and distribution of managerial resources, sales of products, and control of employees. In the conventional company regime (which preceded the new company regime, though both currently exist together), such executives are appointed through the nomination of representative directors by the board of directors.[1] It should be noted that according to the common practice of conventional companies, even directors without representative powers are vested with more or less managerial powers and fulfill their duties on a full-time basis. Considering such a practice, it would be fair to classify them as executives. In other words, a typical conventional company's board consists entirely of directors serving as executives, but it has no outside director.

2. *Historical Overview*

a) *The Epoch of the Emergence of Large Publicly Held Companies*

In Japan, this manager-oriented regime has lasted for over a century. Let me present some anecdotal stories from earlier days to offer a background view of this conventional regime.

As you might know, Japan's rapid modernization started out of the political revolution in 1868 known as "*Meiji Ishin,*" but it was only sometime between 1885 and 1890 that large companies first emerged. Many young talents who had studied in Western countries later served as executives in this period. *Takeo Yamabe* of the *Osaka Spinning Company*, founded in 1882 (now *Toyobo Co. Ltd.*), is a representative case. *Yamabe* was successful in the cotton spinning industry, which was the first successful example of a modern industry in Japan. *Yamabe* got a chance to study abroad as an attendant to a young prince of the *Tsuwano* clan who was also studying in London. *Yamabe* completed his study of mechanical engineering and economics at London University. In addition to his academic training, his experiences at British factories led him to the development of practical skills such as installations of machines and their maintenance.

A modern manager such as *Yamabe* was too talented to be governed by traditional Japanese directors at that time. Though many outside directors and corporate auditors acting as representatives of the shareholders were involved in large companies, they were not taken overly seriously. The image of outside directors and their evaluation is well depicted in an 1884 essay by *Ukichi Taguchi*:[2] "A director is like a retired old

1 Commercial Code [*Shôhô,* Law No. 48/1899 as amended by Law No. 139/2003] Art. 261.
2 A well-known economist and politician at the time (1855-1905).

man. He has no connection with the real world. Nor has he any connection with the internal affairs of the company. His job is nothing but coming to the office daily, reading newspapers, and passing his time gossiping."[3] Thus it comes as no surprise that *Yamabe*, after being successfully promoted at *Osaka Spinning* and being offered the post of chairman in 1898, gradually exchanged these outside directors, who demanded more dividends than reinvestment in corporate businesses, for his own men. The same was true with many other large companies.

Based upon the circumstances at that time, such a purge could have been justified. At any rate, outside, part-time, and unpaid directors representing the interests of shareholders disappeared from large Japanese companies in this manner. From 1910 until today, directorial posts have been occupied by executives.

b) The Revisions of the Commercial Law in 1974 and in 1981

The first legislative attempt to strengthen supervision over management was made in the wake of the revision in 1974 of the Commercial Law, which was triggered by the successive bankruptcies of public companies during the recession period after the Tokyo Olympics in 1964 that made excessive capital investments upon the judgment of dictatorial managers.

The revision of 1974 entitled corporate auditors (*kansa-yaku*)[4] elected at shareholders' meetings not only to do accounting auditing, which they had already conducted before, but also to do auditing of management. It should be noted that it is the board of directors, not the corporate auditors, which has the power to appoint and dismiss executives. The auditing of management by corporate auditors is also called "illegality auditing" because corporate auditors can become involved in management only if laws have been breached; corporate auditors then can demand the court to correct illegal acts by managers (specifically by asking for an injunctive order and/or the compensation for damages incurred by a company due to such an illegality).

Though corporate auditors can participate in the meeting of the board of directors and present their opinions, the board is exclusively made up of executives. Additionally, in many cases, corporate auditors are former directors of the same company and/or former employees of the same company who nearly missed being elected as directors.[5]

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3 See T. YUI, *Nihon ni okeru jûyaku soshiki no hensen,* in: Kei'ei Ronshû Vol. 24, Nos. 3-4, (1979) 30.

4 The "corporate auditor" does not need a qualification as certified accountant. The law provides that a large company as defined in the law has to appoint a certified accountant as its "accounting auditor".

5 In order to strengthen auditing by corporate auditors, the revision of 1981 introduced a rule providing that at least one corporate auditor should work on a full-time basis. Special Exception Law [*Shôhô tokurei-hô*], Law No. 22/1976, Art. 18 (2). Almost all full-time corporate auditors are former directors or employees of the same company.

Another revision of the Commercial Law in 1981 stipulated that managerial activities should be specifically determined by the board, and that broad managerial power may not be delegated to individual directors.[6] Practically speaking, this means enhanced mutual monitoring among executives.

The bottom line of the revisions in 1974 and 1981 was that they supposed that the enhancement of supervision would be achieved by executives of the same company; the understanding that the supervision should be done by someone other than executives was still uncommon.

Such an atmosphere on the legislative stage could be well explained by Japan's strong economic growth at that time, which arguably was pushed by the famous three institutional features of Japanese companies: lifetime employment, the seniority system, and the company-based union. In those days, the Japanese management style (hallmarks of which were long-term-oriented and thoroughly informed management and supervision) was regarded as superior to its U.S. counterpart, which involves supervision of executives based on the short-term performance evaluation by the capital markets. By the same token, it was believed that all Japanese publicly held corporations needed for their supervision were measures against abusive or illegal activities[7] by exceptionally ineligible executives.

The scope of the power of corporate auditors has not been changed since then, despite repeated revisions after 1981 which introduced some enhancements of corporate auditorship, including the extension of terms and the compulsory nomination of outside corporate auditors.[8]

I would like to emphasize the incorrectness of the common understanding widely held abroad that attributes the monitoring function of executives to banks and/or executives of other companies on mutually holding terms. Rather, banks have not demonstrated a high monitoring ability over executives, let alone other companies mutually holding their stocks, except in emergencies such as pending bankruptcy where the bank most closely related becomes involved in the management and exchange of executives.

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6 Commercial Code Art. 260(2).

7 Even during stronger economic growth periods, illegal acts by executives – such as breach of the antitrust law, bribery, and pecuniary support to corporate extortionists – were often exposed.

8 As for the transitory rules, the 1993 revision required companies over a certain level to have at least one full-time independent corporate auditor; the 2001 revision required further that the majority of corporate auditors be independent auditors. The date of enforcement for the 2001 revision was fixed as May 1, 2005. Prior to the 2001 revision, directors and/or employees of the company or of its subsidiaries were qualified as an independent corporate auditor provided that they quit the office more than five years prior to their assumption of the corporate auditor's position. The 2001 revision, however, negated such an exemption. The enforcement date of this is again May 1, 2005.

II. THE REVISION OF THE COMMERCIAL LAW IN 2002 – DIRECTORS OF THE NEW COMPANY

1. Characteristics of the New Company

a) The System of the New Company

After the crash of the bubble economy in 1990, Japanese companies in general showed a disappointing performance. Executives started to consider the aforementioned rule introduced in the revision of 1981, which broadly requires a decision at the board level and thus hinders quick decision-making, as one of the causes of this. Additionally, the crash of the bubble economy exposed many scandals that uncovered the insufficiency of the internal control system which was supposed to warrant risk management and compliance with rules and regulations.

Consequently, the new company framework was legislated as part of the revision of the Commercial Law in 2002. It simultaneously responds to several requirements, *i.e.,* smooth decision-making and the enhancement of supervision over executions: the new company allows the delegation of powers to individual executive officers (*shikkô-yaku*) (the decision of the board is not required for decisions related to the management); on the other hand, the new company has outside directors[9] (*gaibu torishimari-yaku*) with strong powers who monitor management by executive officers.

Any large company that fulfills the conditions of the law can adopt the new company regime by writing such a decision into its bylaws.

Under the framework of the conventional company, it is the shareholders' meeting which elects directors who also serve as executives. This practically means that the shareholders' meeting elects the executives directly. In contrast to this, under the framework of the new company, it is the board of directors – consisting of directors elected by a shareholders' meeting – which would elect executive officers.

Because a director of the new company could also be an executive officer of the same company,[10] the system is closer to the U.S. public corporation practice than to the German stock corporation system. Another example of the similarity with the U.S. practice is that the new system requires committees to be set up within the board of directors (the nominating committee, the audit committee, and the compensation committee).

These committees have strong powers and apparently there are no similar institutions provided for elsewhere in company law. Decisions by the nominating committee or the compensation committee may not be upset and are to be regarded as decisions of

9 Those who served as an executive-director, an executive officer, or an employee of a company or of its subsidiaries are disqualified as outside directors of the same company. Commercial Code Art. 188(2)7-2.

10 However, an outside director cannot simultaneously take the office of executive officer. Special Exception Law Art. 21-8(4) (proviso). Similarly, directors serving as members of an audit committee cannot do so either. *Id.* Art. 21-8(7).

the board itself.[11] The reason for their power resides in the fact that legally those committees (which are comprised of at least three directors) must have a majority of outside directors,[12] while the board of directors itself is not obliged to satisfy a similar condition. Such a gap was based upon the understanding that it is not very hard to find two candidates for outside directors (who could serve in three committees with three directors respectively), while it is very hard to maintain outside directors as the majority on the board of directors, which normally has many more than three directors, as is stated below.

b) *Facts on Directors of the New Company*

There was a concern that very few companies might actually adopt the new company regime. However, the reality is that quite a number of renowned companies have adopted it. Those companies enumerate the necessity of smooth decision-making and the segregation of management and supervision as a first reason for the adoption. The rapid increase in foreign investors in Japanese companies seems to be an important but indirect cause; many of those companies list their stocks at the New York Stock Exchange, and it is therefore hoped that they would have a system comprehensible to foreigners, especially to Americans.

The typical structure of the board of the new company is characterized by some ten directors in total, of whom about four are outside directors, which means that they make up slightly less than the half the number.

Deciding who will serve as chairperson of the board is a sensitive question. Usually, the chief executive officer would not do so because of the segregation concern. On the other hand, cases where an outside director serves as a chairman are few. Therefore, in most cases it is the former CEO who occupies the position.

The role of chairpersons of committees depends on each company's policy. One possibility is to have an outside director as a chairperson of the nominating committee and of the compensation committee. But it is often observed that the chairperson of the board (as stated above, usually a former CEO) also serves as a chair of such committees.

It is noteworthy that almost all new companies have directors who are neither executive officers nor outside directors as defined by law. They have a full-time position and do jobs comparable to those of full-time corporate auditors of conventional companies.[13] Typical candidates for such a position are full-time corporate auditors or their

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11 The board of directors shall submit to a shareholders' meeting the bill for the appointment of directors decided by the nomination committee without making amendments. Special Exception Law Art. 21-7(3)10. The compensation committee has the power to decide the compensation for directors and executive officers on an individual basis and without consulting the board of directors. *Id.* Art. 21-8(3).

12 Special Exception Law Art. 21-8(4) (proviso).

13 Such directors do not always serve as members (including the chair) of the audit committee.

candidates when the company took the conventional form. Perhaps such directors could hardly be found elsewhere in the world. It is interesting to see that even Japanese companies adopting the new company regime necessitate directors such as these.

2. The Duty of Outside Directors of the New Company

It is a duty of outside directors of new companies to supervise the management conducted by the executive officers. The supervision consists of monitoring the appropriateness of management by the executive officers; of giving counsel to them when the execution is inappropriate; and, finally, of dismissing them when inappropriateness in substantial parts of management remains unchanged. It is true that the board of directors has the power of appointment and dismissal of executive officers, and that as a rule outside directors comprise the minority of the board. However, the nominating committee, whose majority normally consists of outside directors, has the power to appoint and dismiss directors (this decision will in turn be submitted to a shareholders' meeting). Therefore, it is safe to say that outside directors have the ultimate power regarding the appointment and dismissal of executive officers.

Still, some people have concerns about the ability of outside directors. For instance, they believe that the CEO could have outside directors under his/her thumb without difficulty because they are unfamiliar with internal affairs. For the CEO, it is much easier to tackle outside directors than to deal with managerial directors under the conventional company regime. It is to be noted that one company[14] clearly related that they had a larger number of executive officers who also serve as directors (*shikkô-yakuken torishimari-yaku*) in comparison with the typical U.S. practice (where the board of directors consists largely of outside directors, and only one or two members, including the CEO, would also serve as executives) lest the CEO winds others around his/her little finger.

I have just mentioned a certain type of director (*i.e.,* directors who are neither executive officers nor outside directors as defined by law) which almost all new companies have, though perhaps it is a very rare case from the view of comparative law. This might be similarly understood as astuteness on the part of Japanese companies, for these directors can furnish internal information to outside directors.

Anyway, we will have to wait and see whether the specificities of Japanese practice based upon the concern with outside directors will be judged superior to its counterpart in the United States.

The reason why they do not is presumably that their participation could hinder the satisfaction of the majority requirement for outside directors.

14 A. MAZAKI, *Sony no kôporêto gabanansu to i'inkai tô setchi kaisha,* in: Torishimari-yaku No Hômu, 109, (2003) 24. As is stated elsewhere, other new companies that are not so forthcoming also have outside directors that make up less than the majority of the board.

There seem to be fewer questions about the goal of the duty of outside directors. The issue is rather an expected level of effort to be made, which of course depends on the circumstances. Assuming ordinary circumstances, how many hours should an outside director spare each year? There is a view that an outside director is expected to spare about 200 hours a year – namely, four hours of work per week – which is a considerable burden for those with substantial principal businesses. Unfortunately, I do not have at hand related data concerning criteria or practices of other countries pertaining to this problem.

III. BUILDING AN INTERNAL CONTROL SYSTEM

1. Background

Internal control (IC) is indispensable for efficient management and good compliance. Consequently, the supervision of executives by directors or their board includes supervision of the IC system to warrant that it works adequately. Unfortunately, the IC of our publicly held corporations has been far from perfect so far.

One major problem is that from an international perspective, Japanese CEOs are far less interested in building the IC system.[15] Possible explanations for such an attitude might be the belief that the faithfulness of Japanese employees allows a lower investment in IC, or that control from above might spoil capable and willing workers (this is based on the Japanese paradox: "The lower the position, the higher the ability"). However, in the latter half of the 1990s, the successive big scandals – including bribery to corporate extortionists (*sôkaiya*), big hidden losses from dealing at the New York branch of the *Daiwa Bank*, and faulty guarantees of meat quality by *Snow Brand Foods Co.* – made it impossible to neglect this issue any longer.

Another problem is the functional overlap of IC activities under the CEO and auditing activities by corporate auditors of conventional companies. Though these two have many things in common as their goals, their relationship is clarified neither in law nor in practice. Let me present a hypothetical case: The law provides that power to the corporate auditors of conventional companies to examine the corporate business and the financial status.[16] Could he or she, then, directly issue an order regarding the IC system under the control of the CEO? At least one academic asserts that such a direct order would be illegal because this would mean that the corporate auditor is involved in managerial activities.[17] Very few cases have been reported where the corporate auditor of a conventional company gives orders on the IC system under the CEO; presumably, it

15 S. BEPPU, *Kansa-yaku kara mita naibu tôsei kei'ei toppu wo makikonde giron shiyô,* in: Kigyô Kaikei Vol. 55 No. 4 (2003) 86.

16 Commercial Code Art. 274(2).

17 H. KATAGI, *Kansa-yaku to kansa i'inkai,* Minshôhô Zasshi, in: Vol. 126 Nos. 4-5 (2002) 561. But see M. MAEDA, *Kei'ei kanri kikô no kaikaku,* in: Shôji Hômu 1671 (2003) 31.

was a common practice for corporate auditors[18] to conduct the examination of books and records by themselves.

2. *Internal Control System of the New Company*

The revisions of 2002 provided that the board of directors of new companies should specify matters designated by ministerial order (by the Ministry of Justice) as necessary to pursue the duty of the audit committee.[19] With such a broad mandate, it is hard to grasp the gist of the revision here. Fortunately, the legislators annotated this part as follows:[20]

The goal of this statute is to have new companies enable their board of directors to specify matters necessary to build the IC system, and enable the audit committee to audit by utilizing such an IC system.

The enforcement rules[21] provide that the board of directors shall specify matters concerning:

(1) employees supporting the duty of the audit committee;
(2) their independence from executive officers;
(3) the report to the audit committee, including that by executive officers and employees;
(4) the storage of the data concerning the official execution by executive officers;
(5) systems including rules regarding the loss control; and
(6) all other issues concerning the system that warrant the execution of the duty of executive officers to comply with the law and the bylaws and to be efficiently conducted.

In such a manner, it was clearly regulated in the law and the related order that under the new company regime, it is a duty of the board of directors to build the IC system.

How would the board of directors of a new company specify the relationship between the IC system under the control of the CEO and the IC system open to the audit committee? Possible options are as follows:

(a) build a comprehensive IC system under the control of the CEO and have it available to the audit committee when necessary;
(b) build two systems quite independently; and
(c) build the IC system under the control of the audit committee and place no IC system under the control of the CEO.

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18 Corporate auditors of conventional companies are normally poorly equipped; there are statistics indicating that the average size of staff is one and a half. This is despite the statute providing that a corporate auditor can request the budget to include payment for any necessary assistance and that the board of directors cannot reject such a request unless the board can prove them to be unnecessary expenses (Commercial Code Art. 279-2).

19 Special Exception Law Art. 21-7(1)2.

20 M. SHISEKI, *Heisei 14 nen kaisei shôhô no kaisetsu* (V), in: Shôji Hômu 1641 (2002) 22.

21 Enforcement Rules for the Commercial Code [*Shôhô shikô kisoku*] Art. 193.

Most of the recent practice seems to prefer choice (a). Specifically, they hold a couple of employees[22] exclusively under the control of the audit committee on one hand, and let the audit committee govern the IC system under the control of the CEO on the other, and thus enable the audit committee to audit the execution of the duty of executive officers and others.[23]

What are the substantial differences between the IC system of new companies and that of conventional companies? First, corporate auditors of conventional companies can take measures only after the inefficiency of the IC system has reached an illegal level, while the audit committee of new companies can do so when a decision of the board on the IC system is inappropriate.[24] The power of the audit committee is clearly enhanced in this regard.

Second, though the law provides that the audit committee can control the IC system under the CEO, does this really change the relationship between the corporate auditors and the IC system under the CEO in the conventional company regime? Among the companies I interviewed that had adopted the new company regime, most answered that there was a change because corporate auditors under the conventional company regime did not control the IC system under the CEO. However, some responded that there was no substantial change because corporate auditors did control the IC system under the CEO even in the conventional regime. The latter suggests the existence of conventional companies with similar practices.

Last, even after such a revision where the audit committee is enabled to govern the IC system under the control of the CEO as mentioned earlier in this lecture (II. 1 (2)), the practice (perhaps idiosyncratic with Japan) needs full-time non-outside directors engaging in auditing but not in management.

IV. CONCLUDING REMARKS

During the last century, management at publicly held companies in Japan was conducted without the supervision of executives by outside directors. The revision in 2002 added the new company system based on the powerful supervision by outside directors (more specifically, committees whose majority should consist of outside directors). The goal of this new system is to motivate the development of both systems through the competition between conventional companies and new companies. The adoption of the new company regime by famous companies, including those listed at the NYSE, seems to be a first step toward this goal.

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22 Such employees are similar to staffs of corporate auditors of the conventional company.

23 Another possible case is to oblige the IC system under the CEO to submit the same reports to the audit committee as the ones submitted to the CEO.

24 Special Exception Law Art. 21-29(2)2.

It should be noted that even under the new company regime, the supervision of executives has already demonstrated features specific to Japan (*e.g.*, placing a larger number of directors also working as executive officers to solve the weakness of the U.S. outside director system, or holding full-time non-outside directors not serving as executive officers but engaging exclusively in auditing).

Also, technical problems such as standard working hours for outside directors should be examined as a practical application of their duty.

As for the IC system, the new company regime declared by law that it is a duty of the board of directors to build the IC system. Meanwhile, the conventional regime leaves unresolved problems, including the ambiguous relationship between the IC system under the CEO and corporate auditors.

ZUSAMMENFASSUNG

Zu keiner Zeit wurde in Japan die Überwachung des Managements so intensiv diskutiert wie gegenwärtig. Der Verbesserung der Aufsicht dient auch die Reform des Handelsgesetzes von 2002, die im April 2003 in Kraft getreten ist und die so genannte „Aktiengesellschaft mit Ausschüssen" eingeführt hat, bei der Management und Überwachung klar getrennt sind.

In historischer Perspektive lassen sich die Anfänge der großen Publikumsgesellschaften bis zum Anfang des 20. Jahrhunderts zurückverfolgen. Erstmals hat der Gesetzgeber durch Reformen in den Jahren 1974 und 1981 versucht, die Überwachung des Managements zu verbessern. Er ging dabei noch davon aus, dass sie durch Organmitglieder derselben Gesellschaft erfolgen sollte. Demgegenüber setzt die Reform des Jahres 2002 auf eine Überwachung durch externe Mitglieder des Verwaltungsrates (outside directors).

Die neue Organisationsstruktur der Aktiengesellschaft ist nicht verbindlich. Es haben sich aber bereits eine Reihe von großen Unternehmen dafür entschieden.

Eine japanische Besonderheit ist, dass diese Gesellschaften oftmals Verwaltungsratsmitglieder haben, die weder outside directors *im Sinne des Gesetzes sind noch mit Managementaufgaben betraut sind, sondern eine ähnliche Aufgabe erfüllen wie die gesellschaftsinternen Prüfer bei Aktiengesellschaften mit der herkömmlichen Organisationsstruktur. Die Reform des Jahres 2002 hat ferner eine Reihe von Vorgaben für die Organisation der unternehmensinternen Kontrolle bei Aktiengesellschaften des neuen Typs aufgestellt.*

(Die Redaktion)