# VORTRÄGE

## Recent Developments of Corporate Governance in Japan

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### I. INTRODUCTION

Corporate governance has increasingly gained attention in Japan in the past decade. Various recommendations and proposals have been published on this topic including the much publicised report of the Corporate Governance Forum.[1] There was also a report of an informal research group under the auspices of the Ministry of International Trade and Industry.[2] Most recently, the Japan Corporate Auditors' Association published an interim report on the future of corporate legislation.[3]

In discussions on corporate governance in Japan, there are basically two different focuses, which should be distinguished. One is the quest for sound and fair management of the company and increased accountability of the senior management. The other is the pursuit of efficient and speedy corporate management, i.e. timely decision-making and efficient implementation of decisions. The first goal has been pursued for some years, while the second goal emerged more recently at the time of economic recession.

In the following, after review of the overall system of corporate governance in Japan, changes in both directions will be examined and their limits will be discussed, followed by a brief discussion on prospective changes to the Company Law.

### II. AN OUTLINE OF THE JAPANESE SYSTEM OF CORPORATE GOVERNANCE

Company Law in Japan is incorporated in the Commercial Code which was enacted in late 19th century modelled on German and Austrian Law. Unlike German Law, there is no separate joint stock company law. There was a significant influence of US Law after the Second World War. Therefore, the current system of corporate governance is closer to the US system than the Civil Law system.

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1 An English translation can be found in New Facets of Corporate Governance, *Bessatsu Shôji Hômu*, 1998 No.212.

2 Report of the Research Group on Corporate Governance in the 21st Century, *www.miti.go.jp/topic-j/ekopr1j.html.*

3 *Shôji Hômu*, 2000, April 25, pp.16-20.

Basically, there are two types of system of corporate governance in the industrialised world. In one system, the power of decision-making and the monitoring of it both belong to the same body – the board of directors (single-tiered system). This is the system employed in Anglo-American jurisdiction. In contrast, in the company law of some European countries, there is a system of a supervisory board, which is designed to supervise the conduct of the business by the board of directors. For instance, in Germany, supervisory boards are mandatory for joint stock companies; they are composed of representatives of shareholders and employees. Thus, under this system, the function of making decisions and monitoring it are separated (two-tiered system). In Japan, there is no supervisory board, and in this sense, Japan belongs to the Anglo-American system.

However, if one takes a closer look at the Japanese system, there are some differences with the Anglo-American model. In the United States, the board of directors comprises internal and external directors, in many companies the latter being in the majority. Independent outside directors are on the increase and are placed on key committees. They are playing more effective roles in determining corporate policies and in monitoring the performance of principal executives.[4] Thus, there is an element of external control, although it is not performed by a separate body. In the United Kingdom, non-managing directors perform a similar function. While the board makes strategic decisions, actual business decisions are taken by executive officers, who are not necessarily board members in the United States. However, the board of directors in Japan is different from either type of systems. It is very rare to have an external member of the board. Most board members are those who have been promoted from among senior employees. A majority of board members are at the same time, head of the business department and combine the position of a director and an employee. The existence of directors combining the position of employee symbolises the ambiguous character of Japanese board of directors – an amalgamation of decision-making, implementation and monitoring.

The board, and ultimately, directors have a duty to supervise the exercise of power by representative directors and other directors, and if necessary, convene a board meeting and ensure that directors perform their duties (Commercial Code, Art. 260, para. 1). However, it is difficult for the board to check the activities of senior directors because of the structure of the board.

Some of the directors are more senior than the others; they are given the title of managing director, senior managing director, vice president, president, vice chairman, or chairman. The Commercial Code, however, does not provide for such titles. Technically, they are all directors with the same power. On the other hand, the Code provides for 'representative directors' who are empowered to represent the company in

4 J.D. COX et al. eds., Corporations, New York 1997, p.150.

external relations. In most companies, it is the chairman, president, and vice presidents who are granted this power.

The real decision-making power does not rest with the board of directors. The number of directors is in general very large in Japan. In large companies, there are around 40-50 board members. With this size of board, it is inevitable that a system of an ‘inner cabinet’ was developed within the board. Incidentally, a similar development can seen in the US ‘executive committees’ within the board. Many companies in Japan have a „managing directors meeting“ or „management committee“ which comprises directors above managing director or senior managing director level. The real decision is made by these bodies, and the board often becomes a mere rubber stamping body. According to a survey of the top management of listed companies and companies whose shares are traded over the counter conducted in 1996, in 78.5% of the companies, the board approves more than 90% of the proposals, while bodies such as the meeting of managing directors approves more than 90% of the proposals in merely 43.8% of the companies. This indicates that there is more substantial discussion in the ‘inner cabinet’.[5] The board exercising supervisory or monitoring function over representative directors is rare in practice.

Directors of large companies are mostly promoted from among the employees; companies with external directors are exceptions. Directors owe their promotion to the board and to senior directorship. According to the above-quoted survey, in 65.2% of companies, the performance of directors is appraised by either the chairman or the president of the company.[6] There is no independent nomination committee for directors or auditors. Therefore, they are not in a position to oppose the proposals of senior members of the board.

There have been some cases where the duty of directors to supervise the activities of other directors came to an issue. In one case, two directors were found liable for the failure by serious negligence to control mismanagement on the part of the representative director. These directors had left the management of the company entirely to the representative director, who ran the company without holding a board meeting. Eventually, the company went bankrupt. The Supreme Court ruled that directors should monitor the carrying out of business by the representative director and if necessary, convene the board meeting and ensure that the company’s business is carried out in a proper way.[7]

In large companies, i.e. companies with a capital of five hundred million yen, or with a debt of 20 billion yen or more, establishment of an audit committee of at least three corporate auditors is mandatory. One of the auditors has to come from outside the

5 KEIZAI DÔYÛ-KAI ed., *Kigyô hakusho* (White Paper on Corporations), Tôkyô 1996, pp.150-151.
6 Ibid., pp.156-157.
7 Judgement of the Supreme Court, May 22, 1973 (*Minshû* 27-5-655).

company, i.e. this person must not have been an employee or a director of the given company or its subsidiary in the past five years.

Shareholders do not have much influence over the management. The annual general meeting of shareholders of Japanese companies often turns out to be a mere formality. In 1999, of the 2,439 listed companies, in around 67% of them, the meeting took less than 30 minutes. In 72,8% of the companies, no question was asked by shareholders.[8] In fact, in 46,9% of the companies, less than 10% of the issued shares was represented by shareholders who were present at the meeting.[9] On the other hand, consensus of major shareholders is obtained before the shareholders' meeting.

In reality, individual shareholders are not always interested in taking part in the general meeting, nor are they interested in finding agents. It is often pointed out that because of the extremely low dividends, small investors are not particularly interested in participating in the management of the company. A practice had developed in which the company sent individual shareholders a blank proxy to be signed by the shareholder, together with the announcement of the meeting. Shareholders were invited to sign this proxy which empowered the general manager of the company's general affairs department, or the chief of the securities section to vote on their behalf. The rationale of this practice was to ensure that the meeting reached a quorum. Moreover, in this way, it was easier for the management of the company to obtain support of a majority of shareholders. In almost 60% of the listed companies, a majority of shareholders vote either by proxy or by vote in writing. In around 90% of listed companies, a proxy with a „no" vote is less than 1% of the proxies returned.[10]

One may think that major shareholders must have much influence over the management. However, this is not necessarily the case in Japan. In the United States, a majority of companies have an institutional shareholder as the top shareholder, while in Japan, a large block of shares are held by stable shareholders – banks and companies which have constant dealing with the company. These shareholders, in principle, do not dispose of shares even when the performance of the company is poor, since the primary purpose of holding the shares is to consolidate the relationship with the company.[11] This stable shareholding is arranged in both directions; thus, there is a network of mutual shareholding. The effect of mutual shareholding is that it reduces control by shareholders. If companies mutually hold shares, they are virtually in a stalemate and cannot exercise control over one another.

In the United States, and increasingly in Europe, the securities market provides a mechanism for 'external corporate governance'. The idea is that if a company is

8 SHÔJI HÔMU KENKYÛ-KAI ed., *Kabunushi sôkai hakusho* (White Paper on General Shareholders' Meeting) 1999, Tôkyô 1999, pp.97,115.
9 Ibid., p.106.
10 Ibid., pp.74-75.
11 H. ODA, Japanese Law, second edition, Oxford 1999, pp. 216-240.

performing badly under the incumbent management, it will be reflected on the share prices, and eventually, the company may be taken over and the management replaced. In Japan, this mechanism does not work, since hostile take-over is uncommon. There are more than 2,000 mergers and acquisitions a year. However, mergers and acquisitions involving listed companies are very rare – in 1998, 72. Only in 11 of them were both parties listed companies.[12] They were all friendly mergers. Although the TOB (take-over bid) system was introduced in Japan in the 1970s and went through a reform to galvanise it in the 1990s, TOB is still very rare. It became news in 1999 even when a German pharmaceutical company resorted to TOB against a medium sized Japanese pharmaceutical company in which it already held a significant stake for some years.[13]

There are two primary reasons for the rarity of hostile take-overs. Firstly, it is difficult to purchase substantial number of shares of large companies, primarily due to the system of stable shareholding, even if there is such an intention. In large companies, even the largest shareholder has got less than 10% of shares. Secondly, and most importantly, there is a cultural barrier against hostile take-over. Presumably, there is a general belief that companies are not just for shareholders, and other stakeholders, particularly the employees are equally important.

Another possible means of external corporate governance is the 'main bank system' which was said to be unique to Japan. This system emerged in the 1930s when, in preparation for war, the government allocated companies/borrowers to banks in order to ensure efficient use of financial resources. Thus, each bank was allocated several companies which the bank was expected to finance. It survived the post-war reform and continued until the 1980s.[14] Under this system, a company has a main bank which serves as a primary financier of the company. Japanese companies heavily depended on bank borrowing as a source of finance, particularly under the low interest policy of the government. This made the role of the main bank much more prominent.

The bank, as a major lender, had some influence on the company. However, since the bank and the company invariably mutually held shares, the influence of the bank was rather limited. It was not uncommon for the bank to send in a director to the company, but whether this director had much influence or not was questionable. The real benefit of the main bank system comes to light when the company gets into financial difficulties. Then, the bank will step in, make arrangements for debt re-scheduling with other lenders, and even replace the management in extreme cases. Thus, the bank will interfere at the last moment, rather than monitoring the performance of the company on a constant basis.

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12 DAIWA SECURITIES SP CAPITAL MARKET ed., *Zôshi hakusho* (White Paper on Capital Increase) 1999, Tôkyô 1999, pp.117-122.

13 *Nikkei*, February 17, 2000.

14 Y. NOGUCHI, *1940 nendai taisei* (The 1940s System), Tôkyô 1995, pp.32-36..

The role of the banks in monitoring the borrowers was further reduced at the time of the 'bubble economy'. In the 1980s, various means of finance through the securities market became available to large companies. Companies rushed to the market with the assistance of securities companies which were aiming at profiting from commissions in issuing shares and floating bonds. With the diversification of finance, banks had to compete with securities companies as well as with other banks. As a result of fierce competition, banks lost what little power they had as a lender over the companies, and competed to lend money to the companies. Naturally, reviewing of the creditworthiness of the borrower became lax and the appraisal of security was eased. Risks were ignored. This eventually led to the accumulation of bad debts by the banks. Thus, banks were not in a position to monitor or control the borrowers already in the 1980s.

The 'bubble economy' in the 1980s led to the demise of the main bank system. It is true that after the fall in the securities market, in the early 1990s, companies returned to banks for finance. While companies needed finance for the redemption of bonds which they issued in the 1980s, finance was not available in the securities market. Companies had to turn to the banks again. However, this time, companies learned to diversify. Most companies now do not have a single bank which plays a dominant role in financing the company. Instead, companies use four-five banks on a case by case basis in order to make them compete. On the other hand, the role of the main bank at the time of crisis should not be underestimated. Recently, a major construction company was rescued by the main bank arranging debt-forgiveness of 400 billion yen by major creditors.[15]

Thus, management of Japanese companies is, in general, free from any external or internal control. There was a significant lack of transparency in the system. However, with the growing awareness of the necessity of introducing transparency and accountability into corporate management, changes began to take place.

## III. QUEST FOR SOUND AND TRANSPARENT CORPORATE MANAGEMENT

Improved soundness and transparency in corporate governance has been pursued through a series of amendments to the Commercial Code and changes in the accounting standards. In fact, until recently, this has been the primary goal of the amendments to the Code. The underlying idea was to place the management under control mainly by strengthening shareholders' rights and the power of auditors. The changes covered three main areas: the audit system, shareholders' action (derivative action), and accounting standards.

The reform of the audit system began with the 1974 amendments to the Commercial Code. As a result of the successive amendments, major listed companies now have a minimum three corporate auditors, of which at least one has to be an external. Auditors

15 *Nikkei*, September 1. 2000.

are not only empowered to check the accounts, but to oversee the sound and fair management of the company. These auditors are to form an audit committee. In addition to corporate auditors, a company's account must be audited by a chartered accountant who is selected at the general shareholders'meeting. The latest amendment in this respect involves changes resulting from the introduction of holding companies. The power of the auditor of the holding company has been extended so that subsidiaries are appropriately audited.[16]

The second area of reform was the system of shareholder's action. This system was introduced in 1950, but had not been widely utilised until the early 1990s. This was primarily because the cost of suing was too much for individual shareholders to bear while even if the plaintiff wins, damages will be paid to the company and not to the shareholder. In total, there were around 30 cases of shareholder's action before the 1993 amendment to the Commercial Code which made shareholder's action much easier.

The first and the only case for the period between 1950 and 1992 where a shareholder was successful was the *Mitsui Mining* case. In this case, the company arranged to buy back the shares through subsidiaries from a shareholder who was opposed to a proposed merger. This was against the law, which, as a rule, prohibited purchase of own shares by the company at that time. The Supreme Court ruled that directors caused damage to the company by purchasing shares at a higher price and held them liable for the difference between the market price and the purchase price.[17] It should be noted that in this case, the plaintiff acquired shares of *Mitsui Mining* after the transaction in question by the company.

One of the primary reasons why shareholder's action had not been widely used was the cost of litigation. The stamp duty which the plaintiff is required to pay at the time of litigation is calculated on the basis of the contested amount. Since the contested amount in shareholder's action is usually substantial, the stamp duty can also be high. In addition, the litigation lasts long – in the *Mitsui Mining* case, it took 17 years – and the attorney's fee can be high as well. The disincentive is that even if the plaintiff wins, the damages are paid to the company, and not the plaintiff.

Some lower courts took an initiative to make shareholder's action easier for shareholders. In 1993, in the *Nikko Securities* case involving payment of compensation to favoured customers, the first instance court ruled that the amount of stamp duty should be calculated on the basis of the claimed (contested) amount, which was 47 billion yen. The appellate court, however, ruled that the contested amount in cases of shareholder's action was incalculable since the claim should be regarded as non-proprietary, and therefore, the stamp duty should be 8,200 yen.[18] The Supreme Court upheld this

16 Amendments of 1999, Law No.125, 1999.
17 Judgement of the Supreme Court, September 9, 1993 (*Minshû* 47-7-4814).
18 Judgement of the Tôkyô Appellate Court, March 30, 1993, *Hanrei Jihô* 1460-138.

decision. This is a good example of flexible interpretation of law in favour of an equitable solution by Japanese courts.[19]

In the same year, the Commercial Code was amended and the above arrangement was incorporated in the Code. Thus, the Code provides that the contested amount in a shareholder's action should be deemed to be non-proprietary. Furthermore, the Code introduced a system in which the successful defendant may have the attorneys' fee reimbursed at reasonable scope from the company.

The third area of changes is the accounting system. The accounting standard in Japan has long been lagging behind the international standard in that e.g. there was no full consolidated accounting system and the assets were entered in the balance sheet at the acquisition price rather than the current value. It was known that the balance sheet of Japanese companies did not necessarily reflect the true state of finance of those companies. After the collapse of some financial institutions which had kept the losses off the balance sheet, the government has finally decided to approximate the accounting standard with the International Accounting Standard in 1998. The approximation is still under way, but there were some significant changes such as the introduction of a fully-consolidated account and valuation based upon market value instead of acquisition value.[20]

All in all, there have been developments, particularly in the 1990s, towards improved soundness and transparency in corporate management.

To be sure, these changes were not an outcome of 'shareholder's power'. Rather, they were more of a reaction of the government to various incidents which triggered public outcry for ensuring sound and fair corporate governance. Thus, the 1974 amendments to the Commercial Code were a result of the exposure of window-dressing at a sizeable non-ferrous steel company which was forced to apply for corporate reorganisation procedure. The 1993 amendments, which introduced significant changes in terms of corporate governance, came after the collapse of the 1980s 'bubble economy', during which time, business companies have gone into frantic activities in the real estate and securities markets. Assisted by excess liquidity, companies invested in questionable project without much prudence. Companies were left with the consequences of this period. There were also various incidents of wrong-doing involving major securities companies and banks in the early 1990s.

With the 'burst of the bubble', many companies were left with enormous debts, which dismayed shareholders. Shareholders were not treated well during the bubble economy. Companies issued new shares and offered them to the public at market price. Equity bonds were issued in Japan as well as overseas. As a result, existing shareholders' interest was significantly diluted. Compared with foreign companies, ROE of

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19 See ODA (note 11), pp. 216-240.

20 F. TOKUMASU/N. KATO, *Kigyô kaikei Big Bang* (Big Bang of the Corporate Accounting System), Tôkyô 1997.

Japanese companies was rather low, normally less than 5.[21] Excess liquidity during the bubble economy was invested in various projects whose commercial viability was questionable. The management of the companies was blamed, in many cases justifiably, for reckless investment; it was generally accepted that the system should undergo a major change towards soundness and fairness, but there was not much shareholders could do.

Finally, since 1997, there has been a renewed public pressure for better corporate governance. With the deepening crisis in the financial sector in the aftermath of the 'burst of the bubble', in 1997, a major securities company was forced to terminate business after it was revealed that there had been 260 billion yen of debt off-balance sheet, concealed in overseas paper companies. This was followed by the collapse and subsequent nationalisation of two long term credit banks in 1998, which were later sold with further burden on the budget. These banks had failed to disclose accumulating losses from bad loans, but nevertheless, kept paying dividends. The problem was not limited to those failed financial institutions; the banking sector as a whole was in trouble.

The immediate cause of the crisis was the delay on the part of the government in dealing with the problem of bad debts held by the banks, but the ultimate cause was the imprudent lending by them in the 1980s and early 1990s. In 1999, a total of 7.5 trillion yen of tax payers' money had to be injected into 15 major banks. Naturally, the general public was unhappy, particularly in that the successive management of these banks failed to take responsibility. Although the Financial Restoration Law which was enacted in 1998 at the time of crisis mandated that the liability of those directors who were responsible be pursued, this did not happen with at least one of the long term credit banks.[22] It became clear that the existing system of accounting failed to ensure full disclosure of relevant information. All in all, under these circumstances, there was no surprise that corporate governance became a much discussed topic in the 1990s.

Reform of corporate governance in the direction of sound and transparent system has been more or less led by academics through the Legislative Advisory Council, which is an advisory body to the Minister of Justice. A majority of the members are leading academics in the respective fields. For example, the facilitation of shareholder's action was proposed by some renowned academics, supported by lawyers, and was introduced against the resistance of the industry. Business people had feared that it might result in a flood of litigation against directors and have a chilling effect on business decision-making. The reform was not a shareholder-led process. Shareholders are not really represented in any organisation. Institutional shareholders are not powerful in Japan as in the United States, although their presence has come to be felt more in the last 2-3 years.

21 *Nikkei*, July 15, 1998.
22 *Nikkei*, August 31, 2000.

However, this process of academic/lawyer-led reforms may be changing. Since the late 1990s, politicians, backed by the industry, have become more vociferous. The Legislative Advisory Council has been bypassed on some occasions such as the introduction of the system of stock options, allegedly because the Council was unable to act quickly enough in a rapidly changing economic environment.[23] Recently, the Minister of Justice suggested that the composition of the Council should be changed in order to reflect the views of the industry more than before.[24]

It should also be noted that there was also some 'foreign pressure' for changes. There has been a steady increase in the number of foreign shareholders. According to the latest report, 18,6% of the shares in terms of market price are held by foreign shareholders. In terms of the number of shares, the figure is 12,4%. This is almost equal to the shares owned by individual shareholders in Japan.[25] This has worked as a stimulus to improve the system of corporate governance. With shares held by foreign investors on increase, it was no surprise that there was 'foreign pressure' to change the system in Japan. The issue was already taken up in the US-Japan Structural Impediments Initiatives Talks which took place in the late 1980s. Strengthening of the rights of shareholders came to be one of the issues there. The US side thought that Japanese company law failed to give adequate protection to shareholders and asked for better protection of their rights. On the same occasion, it should be added that the system of *keiretsu* (business affiliation) and business groups were criticised for exclusivity and the lack of transparency.[26] These circumstances resulted in the 1993 amendments.

## IV. THE EFFECT OF THE REFORMS

Whether the above reforms have resulted in a significant improvement towards sound and transparent corporate governance is not without doubts.

The reform of the audit system seems to have failed to bring in meaningful changes in reality. Corporate auditors are not really powerful enough to exercise control over the board of directors. Auditors are appointed by shareholders, but the actual nomination is made by the board. Auditors owe their position to the board, namely senior members of the board, who actually make the decision.[27] The Law mandates that at least one of the three auditors be an external. 'External' in this context means a person, who, in the past five years, was not a director or an employee of the company or its subsidiary. In many

23 *Nikkei*, September 17, 2000.
24 *Nikkei*, September 16, 2000.
25 *Nikkei*, June 27, 2000.
26 *Nichibei kôzô kyôgi saishû hôkoku-sho* (The Final Report of the US-Japan Structural Impediments Initiatives Talks), Tôkyô 1990, p.117. See also K. MIYASHITA/D. RUSSALL, *Keiretsu*: Inside the Hidden Japanese Conglomerates, Tôkyô 1994.
27 KEIZAI DÔYÛ-KAI, *Kigyô hakusho* (White Paper on Corporations), Tôkyô 1998.

cases, the 'external' comes from one of the group companies. Sometimes, a person who was a director of an affiliated company is appointed as an auditor.

Although the effectiveness of the system should not be judged solely by celebrated corporate failures, auditors have not really exercised much power over the management. Recently, amidst a series of wrongdoings by major companies, a leading article entitled 'where were the auditors?' was published in a major newspaper.[28]

Chartered accountants have not fared too well. In cases such as the collapse of the two long term credit banks and a major securities company, accountants failed to detect financial irregularities which had been continuing for some years.

In contrast, recent changes in the accounting system are expected to have a significant impact on corporate governance. Although it is too early to make any judgements, the effect has already been felt. Companies are no longer able to conceal losses in affiliated companies which were beyond the reach of consolidated accounts. As a result of a stricter accounting system, some companies were forced to file for corporate reorganisation. The shift to a current value accounting system is also having a significant impact on the mutual shareholding system, which reduces the control by major shareholders.

There had been a steady decline of mutual shareholding in the last decade. Already in 1998, *Keidanren* (an equivalent of the German Confederation of Industries) floated an idea of reducing mutual shareholding, primarily in order to raise the low share prices. At that time, the level of share prices was around 15,000 as compared to the 39,000 level of 1990.

According to the research of *Nissei Research Institute*, while in 1990, 21,42% of shares in the market were mutually held, the figure has been in constant decline, and in 1998, it reached the level of 16,02%. In addition, the stability rate, i.e. the percentage of mutually held shares, shares held by financial institutions, and shares of financial institutions held by business companies against the total number of shares, was 47,52% in 1990, but fell to 41,26% in 1998.[29] Proportion of shares held mutually between banks and business companies among all shares significantly fell from 18% in 1887 to 10,53% in 1999 in terms of value.[30]

The immediate cause of the decline was the low share price since 1991. Financial institutions, which had been in a difficult situation, were forced to sell the shares of business companies which they had been holding. It is reported that the erosion of mutual shareholding started from financial institutions releasing their shares. Banks have become 'selective' in their relationship with business companies. 16 major banks disposed of shares worth 2 trillion 300 billion yen in March 2000.[31] This has been

28 *Asahi Shinbun*, August 2000.
29 www.nli-research.co.jp/mochi
30 *Nikkei*, September 22, 2000.
31 *Nikkei*, May 23, 2000.

further enhanced by the changes in the accounting system. Companies could not afford to hold shares whose price was performing badly, if current value of the shares, not the acquisition price, is to be entered in the balance sheet.[32]

However, it may be premature to declare the demise of mutual shareholding or stable shareholding. Although in decline, the rate is nevertheless at a high level, and besides, in major company groups such as *Mitsui, Mitsubishi, Sumitomo, Fuji, DKB*, and *Sanwa*, both rates are still high. The pace of decline is slow in business companies – 31,48% to 28,31% stability rate decline from 1990 to 1998.

## V. SHAREHOLDER'S ACTION

Whether the facilitation of shareholder's action contributed to a better corporate governance in terms of ensuring sound and transparent corporate governance requires a closer examination.

Provisions of the law on the duties and liability of directors in Japan do not substantially differ from those in other jurisdictions. Nevertheless, there have not been so many instances where directors were held liable.

Directors owe a fiduciary duty to the company. They are under obligation to exercise a standard of care as good manager (Commercial Code, Art.254-3).

The Commercial Code sets forth various grounds of liability for directors against the company (Art. 266, para. 1). These are:

i) proposing to the general meeting the payment of illegal dividends
ii) payment of dividends not proportionate to the number of shares held by shareholders
iii) offering of benefits to shareholders in relation to the exercise of their rights
iv) extending of loans to other directors
v) effecting a transaction which involves conflict of interest with their company
vi) acting against law, ordinances, or articles of incorporation

The liability of directors for the acts against the law, ordinances, or articles of incorporation is based upon fault whereas acts provided in the remaining items are non-fault liability.

Directors who have committed these acts as well as those who supported them at the board meeting are liable. Unless their objection has been entered in the minutes of the board meeting, directors are presumed to have given consent to such acts (Art. 266, paras. 2 and 3).

As a rule, directors are discharged of their liability only with the consent of all shareholders. In cases where transactions involving conflict of interest between the company

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32 Ibid.

and the director are at issue, a director may be relieved of liability with the consent of shareholders who hold more than two thirds of the issued shares.

The Commercial Code also provides for criminal penalties up to seven years' imprisonment for directors and others who acted against the interest of the company in various ways (Arts. 486-491, 494-2, 493-498). Directors and others are penalised if they purport to benefit themselves or a third party or to harm the company and, against their duty, cause pecuniary loss to the company.

In cases where litigation pursuing the liability of a director is at issue, the company may be reluctant to sue. In such cases, shareholders are given a right to sue the directors on behalf of the company, provided that the company fails to pursue the liability of a director (shareholder's action).[33] The system of shareholder's action was introduced in Japan by the 1950 amendment to the Commercial Code.

This right belongs to the individual shareholder who has been a shareholder for more than six months regardless of the number of shares he or she holds. The company, as well as other shareholders may take part in the proceedings.

In order to exercise this right, the shareholder must first ask the company in writing to sue the director. Only when the company failed to start proceedings within 30 days, may the shareholder sue the director on behalf of the company (Art. 267, paras. 1 and 2). However, if it is likely that an irrecoverable loss will occur by following the above mentioned procedure, a shareholder may sue the director immediately (Art. 267, para. 3).

In the early 1990s, in the aftermath of the 'bubble economy', many companies incurred loss from their reckless investment in securities and real estate in Japan as well as overseas. Directors were much criticised, but means to pursue their liability was limited.

In 1993, the Commercial Code was amended in order to make shareholder's action easier. As a result, the number of shareholder's action as well as the claimed amount have increased.[34] In 1994 alone, 11 shareholder's actions were initiated. In an extreme case, the claimed amount exceeded one trillion yen. Until 1993, companies involved in shareholder's action were mostly small or medium sized companies. In contrast, after 1993, directors of major companies have come to be sued.

The grounds for the action range from failed joint venture abroad, investment in a golf course, assumption of debt of an affiliated company, unlawful donation to a local governor, excessive price for acquisition of a company, excessive investment in hotel business, reckless investment to violation of export control regulations [see the table below]. The grounds can be divided into three groups. The first group involves cases of alleged errors in management or lack of prudence, such as a failed joint venture, failed

33 COX et al. (note 4), pp.396-400.

34 BUREAU OF INDUSTRIAL POLICY, MITI ed., *Kabunushi daihyô soshô no genjô to kadai* (Current Situation and Problems concerning Shareholders' Action), Tôkyô 1995, p.5.

investment in securities, failed project for building golf courses etc. The appropriateness of the judgement on the part of directors is being questioned in these cases. The second group comprises unlawful acts by directors and the failure by other directors to prevent it. This also includes failure on the part of directors to prevent unlawful acts by employees. These include cases of bribery, violation of export control, bid-rigging, and unlawful payment of benefits to a special shareholder. When a violation of law by a company or directors is reported in the press, the company's directors are invariably sued by a shareholder in a shareholder's action nowadays. The third group cases are mainly cases arising from citizen's movement such as an action against directors of a power company for the expenditure in nuclear power plants or against building a golf course.

Concerning the second group, the Commercial Code provides that directors are liable to the company for violation of the law and of the articles of incorporation. However, it was not clear from the Code whether any unlawful act by directors serves as a ground for shareholder's action, or was limited to acts in violation of commercial legislation. For example, it was discussed whether bribery, which is a breach of the Criminal Code, would serve as a ground for shareholder's action. In the *Hazama Construction* case, where a director bribed a local governor for a public work, the first instance court found the director to be liable. However, the director did not appeal, and therefore the case did not reach the higher court. In a recent case involving unlawful compensation of loss by *Nomura Securities*, the Supreme Court ruled for the first time on this matter. In this case, the issue was whether a violation of the Anti-Monopoly Law (Competition Law) constitutes a violation of law in the context of the Commercial Code provision on the liability of directors (Art.266). The second instance court denied this, but the Supreme Court ruled that Article 266 covers violation of the Anti-Monopoly Law and that it was a duty of the director to ensure that the company does not violate the law, even if the law is addressed to the company, and not to the director.[35]

In most of the second group cases, the criminal procedure precedes the shareholder's action. It seems now to be a more or less established pattern that once the defendant director(s) is found guilty, a settlement is reached between the parties in the shareholder's action.[36] In such cases, the company itself is often a party to the settlement. The settled amount is much less than the claimed amount which is often enormous. For example, in the *Obayashi Construction* case, an out of court settlement of 20 million yen was reached against a 230 million yen claim.[37] There is often a statement of repentance by the director and the declaration by the company that it would make all efforts to comply with the law in the future. However, there is no guarantee that the

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35 Judgement of the Supreme Court, July 7, 2000 (*Shôji Hômu* 1567-37).

36 SHÔJI HÔMU KENKYÛ-KAI ed., *Kabunushi sôkai hakusho* (White Paper on General Shareholders' Meeting), 1998, p.21.

37 Ibid., 1999, p.22.

outcome of the settlement is fair. Parties are not required to publicise the content of the settlement. Reportedly, in some cases, this resulted in an obscure deal. It should also be added that in the light of the provision of the Commercial Code which requires the unanimous support of shareholders to discharge the liability of directors, the legal basis for such settlement is not without doubt. A legislative measure is needed here.

In the most recent case, the Ôsaka District Court ordered directors of *Daiwa Bank* to pay 84 billion yen to the Bank for the failure to prevent a rogue dealer in the United States from covering dealing losses and failure to report the incident to the US regulatory authority. There has been a case where directors were ordered to pay 200 million yen, but the parties reached a settlement at a much lower amount at the second instance. The amount of damages in the *Daiwa Bank* case is unheard of, and has immediately triggered criticisms of the system.[38]

There have always been concerns in the business circle that shareholder's action may be abused. In contrast to the United States, in Japan, a shareholder who has only a single unit of share can initiate the action. The shareholder does not even have to have been a shareholder at the time the wrongful action took place. There is no guarantee that the shareholder who initiated the action is an adequate representative of the entire body of shareholders because there is no way of screening the action by the shareholder. The shareholder may simply proceed to initiate shareholder's action in court if 30 days lapse after the shareholder asks the company to initiate an action. This is in contrast to the United States where the 'contemporaneous ownership rule' prevails and where independent bodies such as special litigation committees determine whether the shareholder fairly and adequately represent the shareholders.[39]

A possible means of defence against ungrounded shareholder's action is the deposit placement order by the court. The Commercial Code provides that upon request of the defendant-directors, the court may order the plaintiff to place a deposit (Art.267 para.5). The defendant has to present a prima facie case that the plaintiff has acted in bad faith (Art.106 para.1). The deposit can be very high; in the *Tokyo-Mitsubishi Bank* case, the court ordered the plaintiff to place 30 million yen. In the end, the first instance court dismissed the case, since the deposit was not paid. Similarly in the *Mitsubishi Corporation* case, placement of deposit of 30 million yen was ordered, and later, the court dismissed the case for the same reason.

There are different views on the concept of „bad faith". Lower court decisions vary. One group of decisions suggests that there are two different instances where bad faith can be found. First, there are instances where the plaintiff is pursuing an unjustifiable goal such as the inappropriate personal interest in or personal revenge against the director. Secondly, there are cases where, because the claim of the plaintiff does not have sufficient factual and legal basis, the possibility of the court acknowledging the liability

38 *Asahi Shinbun*, September 21, 2000.
39 COX et al. (note 4) pp.415-428.

of the director is thin but nevertheless, the plaintiff had knowingly, or by negligence, initiated shareholder's action. In both cases, the existence of bad faith should be acknowledged (*Tokai Bank* case).[40] 'Unjustifiable purpose' in this context means 'using shareholder's actions as a means to obtain unjustifiable benefit and other purposes incompatible with the legitimate exercise of shareholders' rights'.[41] This approach has been supported by some lower courts. In one case, an activist opposing the construction of a golf course acquired a share in the company and initiated shareholder's action. The court ruled that such action based upon political or social purposes to be alien to the system of shareholder's action when considered in conjunction with the existence of legal and factual basis of the claim.[42]

On the other hand, there is another line of decisions starting from the *Midori-Jûji Pharmaceutical* case which limits bad faith to cases where the plaintiff had acted with intention and excludes negligence. In this case, the court ruled that bad faith means instances where the plaintiff, being aware that the claim has no factual and legal basis, nevertheless brings the case to court, or brings the case to court for socially unacceptable purpose such as harming the director and the company and thus pursue personal interest.[43] Ôsaka Appellate Court has subsequently quashed the decision of lower courts ordering the placement of deposit. On the other hand, there were several cases where the court ordered the placement of deposit in the same year.[44]

If 'bad faith' is interpreted too narrowly, then shareholder's action may come to be abused by problem shareholders. If it is interpreted broadly, shareholders may be deprived of their opportunity to contest the case in court. Since the same court decides on the issue of deposit order and the substance of the case, if the plaintiff is ordered to pay the deposit, it is likely that the case would be lost. In the above-cited case involving the construction of a golf course, the court eventually concluded that the plaintiff's claim was inappropriate and groundless while the company had conducted necessary research and had reviewed the project from various angles internally; the court ordered deposit placement.[45]

In general, the court has been cautious in ordering deposit placement. In most, if not all, of the cases where deposit was placed, the plaintiff lost or withdrew the case.

The 1993 amendment to the Commercial Code was primarily influenced by US Law. The general understanding was that shareholder's action was widely utilised in the

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40 Decision of Nagoya Appellate Court, March 8, 1995 (*Hanrei Jihô* 1531-134).

41 Decision of Tôkyô District Court, July 22, 1994 (*Shiryô-ban Shôji Hômu* 125-184; *Janome* case).

42 Decision of Gifu District Court, November 9, 1997 (*Bessatsu Shôji Hômu*, 196-300; *Dainihon Doboku case*).

43 Decision of Ôsaka Appellate Court, August 26, 1997 (*Shiryô-ban Shôji Hômu* 165-291).

44 SHÔJI HÔMU KENKYÛ-KAI (note 36) p.27.

45 Decision of Gifu District Court, November 9, 1997 (*Bessatsu Shôji Hômu*, 196-300; *Dainihon Doboku* case).

United States. However, there are not so many cases where a director has been found liable for mismanagement in the United States. There was a study in Japan which pointed out that there have been only 40 cases since the beginning of the century where a director was found liable for the breach of the duty of care.[46] One of the reasons for this is the existence of business judgement rule in the United States. According to this rule, directors are not held liable for judgements on business in which they did not have any personal interest, and were made with the knowledge which they reasonably believed to be sufficient under given circumstances, with the rational belief that the decision was compatible with the best interest of the company.

There have been a couple of cases where non-listed company directors were found liable, despite the fact that the defendant tried to justify his action by claiming that it was within the scope of business judgement. One was a case involving a director who continued extending loans to a failing affiliated company, knowing that the loans would eventually be irrecoverable.[47] In the other case, directors of a small company had borrowed money and got involved in a speculative investment in the financial market.[48]

In fact, so far, there have been cases where directors were found liable in shareholder's action for unlawful acts such as bid-rigging, breach of export control, etc. (second category cases), but there has not been any case where directors of a listed company was found liable for error in judgement or imprudence (first category cases).

In a case where directors of *Nomura Securities* were sued for paying illegal compensation to preferred customers, the district court found the directors not liable under the business judgement rule.[49]

Directors thought that even by paying out 360 million yen as compensation for the loss [incurred by the client], if the business relationship with the client would be maintained and expanded by paying compensation, in the long term, the company would earn a profit equivalent to this expenditure, and therefore, paid compensation. In fact, after the payment of compensation, the business relationship with the client continued and the company has profited reasonably; this is likely to continue in the future. Considering all these circumstances, even though compensation of loss was against the Anti-Monopoly Law, in relation to the company, it cannot be acknowledged that the company had suffered damage as the plaintiff asserts.

The court found the act of directors to be 'within the discretion of business judgement'. It cast some doubt on the reasonableness of the decision, but concluded that the decision was not 'extremely unreasonable'. The appellate court upheld the conclusion, denied liability of directors, but on different grounds.

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46 M. KONDÔ, *Keiei handan to torishimari-yaku no sekinin* (Business Judgement and the Liability of Directors), Tôkyô 1994, pp.17-22.

47 Judgement of Tôkyô District Court, October 26, 1995 (*Bessatsu Shôji Hômu*, 196-88: *Tôkyô Metropolitan Kankô Kisen* case).

48 Judgement of Tôkyô District Court, September 21, 1993 (*Hanrei Times*, 827-47).

49 Judgement of Tôkyô District Court, September 16, 1993 (*Hanji* 1469-25).

It was questionable whether the business judgement rule should be applied to this case, since the rule is applicable only when directors acted in good faith, without breaching the law. In the Nomura Securities case, directors had acted against the Anti-Monopoly Law (Anti-Trust Law). In the United States, the rule would not have been applicable to such cases.

The reason why there has seldom been a case where directors were found liable for mismanagement is because lower courts have applied a consideration similar to business judgement rule. In a case decided in 1992 (*Cemedine* case), directors were sued for a failed joint venture with a US company. The company formed a joint venture with a US company, but in the end, had to buy back the shares of this joint venture company from its US partner in order to make it a full subsidiary. Furthermore, the company had to make their US partner additional payments for the dissolution of the joint venture and also assumed debt by the joint venture owed to this US company.

The court ruled as follows:

> Such decisions on corporate action are made upon forecast of volatile and uncertain market movement and judgement of the future of the business involving complicated factors, and the overall and specialised judgement capability of the management is to be exercised at its best, and therefore, a broad discretion should be acknowledged. … In a business judgement, if there was no material and careless error in the acknowledgement of facts which serve as a basis for the decision and the decision-making process was not particularly unreasonable or inappropriate, the director should not be found in breach of duty as a good manager or fiduciary duty.[50]

The second case involved a bank whose directors were sued by a shareholder for extending loans without taking appropriate security. The loans were extended to a company called *GCS* which invested the money for acquisition of a US hotel and other real estate overseas. The court ruled as follows:

> Whether directors should be held liable for the breach of duty as a good manager or fiduciary duty should be determined by whether in relation to the judgement made by the director, there was an impermissible error or defect as a normal entrepreneur in the acknowledgement of facts which serve as a basis of the judgement or in the process of the decision-making which results in excess of discretion given to the director.[51]

In this case, the court found the insufficiency of security procured at the time of the loan by the bank not to be a ground for liability of directors, since the granting of the loan was decided by the senior management by taking into account various factors, and 'based upon policy decision', extended the loans. The bankruptcy of the borrower was a result of the stagnation of the US economy after the Gulf War and other factors which were unforeseeable by the directors.

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50 Judgement of Tôkyô District Court, February 8, 1996 (*Bessatsu Shôji Hômu*, 196-36; *Cemedine* case).

51 Judgement of Nagoya District Court, January 20, 1997 (*Bessatsu Shôji Hômu*, 196-108: *Chûkyô Bank* case).

It should be noted that the scope of discretion given to the management in this judgement is broader than in the *Cemedine* case. There have been some more cases involving mismanagement in the late 1990s. These include a bank assuming debts of an affiliated financial institution (*Tôkai Bank* case), unprofitable assignment of business (*Hokkaidô Takushoku Bank* case), debt-forgiveness by the bank (*Tôkyô-Mitsubishi bank case*), and failed development of a resort by a subsidiary (*Japan Airlines* case). In some cases including the *Japan Airlines* case, the plaintiff failed to comply with the deposit payment order and the case was dismissed.

Thus, in the first category cases, i.e. cases involving errors in judgement and imprudence, with the current tendency of the court to acknowledge broad discretion to directors in corporate management, it is questionable whether shareholder's action would have any immediate impact in recovering the losses on behalf of the company. The system is not necessarily used in the way it has been envisaged by the legislature, since it is used more as a system of social censure rather than a rational economic device for recovering the losses the company has incurred. It is inconceivable that directors in Japan could afford such a huge amount of compensation in the first place. Obviously, the system is in need of rationalisation. However, the system does play an important role in ensuring soundness of management. The very existence of this system has made the management behave in a more prudent way lest they should be sued by shareholders.

All in all, despite some well-publicised failures, there has been a definite shift of emphasis towards sound and transparent corporate governance and some improvements can be seen, but still there is a long way to go.

## VI. REFORM IN PURSUIT OF EFFICIENT CORPORATE GOVERNANCE – INTRODUCTION OF THE SYSTEM OF EXECUTIVE OFFICERS

In the second half of the 1990s, a growing awareness emerged among the companies that not everything was well with corporate governance in Japan. The stress was more on efficient and speedy decision-making and effective implementation rather than the ensuring of fairness and transparency in corporate management. This was the time when 'deregulation' became a keyword. The government launched a major programme of deregulation in 1994. Companies had to face fierce competition now that various regulations which used to protect their position within the market were gradually dismantled. They were forced to change their own system in order to gain competitive edge against other companies, including foreign ones.

One of the responses was to the introduction of the system of executive officers (*shikkô yakuin*), ostensibly following the US system. Although in the United States, there are traditional corporate officers such as the CEO, president, vice president, treasurer and secretary, the US system varies from state to state and company to company. However, in most Japanese companies, the system of executive officers seems to be rather different from the original US system.

In the 1990s, there were some companies which introduced the position of CEOs, but it was *Sony* which was the first major company to introduce the system of executive officers. In 1997, *Sony* reduced the number of board members (directors) from 38 to 10. These ex-directors were appointed executive officers together with 9 newly appointed executive officers. At *Sony*, the introduction of the new system was combined with the reform of the board. Not only was the number of directors reduced; the board was transformed into a body which determines basic business strategy and other significant matters, and at the same time, supervises the performance of business by the company and its subsidiaries. What is important is that of the 10 directors, now 3 are external directors. It should be added that the remaining 7 directors are simultaneously executive officers. Thus, there are 7 directors cum executive officers and 27 executive officers.[52]

Since then, the system of executive officers has been adopted by around 250 listed companies, including major companies such as *Toshiba* and the *Industrial Bank of Japan* (and subsequently, *Mizuho Financial Group*).

It should be noted that there is no legal basis for executive officers in the Commercial Code. There is no provision concerning duties or liability of executive officers. While the relationship between the company and directors is that of mandate as provided in the Civil Code, executive officers are, under the current system, employees, and senior ones at that. The relationship is regulated by employment law.

According to a survey of 2500 listed companies conducted by the *Tokyo Bar Association*, of 951 respondents, 122 companies have introduced this system, and 57 were planning to introduce it. Primary reasons of these companies for introducing this system were:[53]

i) speeding-up of decision-making (79,5%)
ii) separation of decision-making and implementation (70,5%)
iii) galvanisation of the board of directors (61,5%)
iv) strengthening of the implementation of decisions (55,7%)
v) reduction of the number of board members (44,3%)

The reason for the introduction of this new institution is a result of dissatisfaction by the companies on the present system of the board. Thus, companies planning to introduce the system, when asked about their perception of the present system of the board of directors, responded as follows:[54]

52 H. YOSHIDA, *Shikkô yakuin* (Executive Officers), Tôkyô 2000, pp.11-12.
53 *Shikkô yakuin, shagai torishimari-yaku no jittai chôsa (1)* (Fact-finding Inquiry on Executive Officers ad External Directors), *Torishimari-yaku no Hômu*, 2000 June, pp.26-27.
54 Ibid., p.20.

i) insufficient supervisory function of the board (46,2%)
ii) existence of too many directors (44,2%)
iii) slow decision-making (30,8%)
iv) existence of directors combining the position of an employee (23,1%)

Insufficient supervision may mean two things: insufficiency in supervising the implementation of decisions of the board or insufficiency in supervising and monitoring representative directors. Introduction of the system of executive officers will most probably rectify the first, but would not improve the second. The view that there are too many directors means that the board meeting tends to be a formality or the board has ceased to become an efficient decision-making body and needs reform.

On the other hand, according to this survey, of those companies which have no intention of introducing executive officers or have not yet introduced the system, 40,8% of them did not contemplate a reform of the board, while 35,4% of the companies responded that a reduction of the number of directors was considered.[55]

Thus, there are various reasons for introducing the system, but most of them are not directly related to the reform of the board in the direction of strengthening of control over the senior management.

In many companies, the system of executive officers was introduced as part of downsizing the personnel. Companies had to reduce the size of employment due to poor business performance in the present economic climate, but such measures had to be accompanied by the slimming down of the top management in order to be convincing to the employees (sharing of the pain!). If the size of the board is to be reduced, there has to be an alternative position available to those who cease to be a board member. In a guideline on the introduction of the system of executive officers published by a private research institution, it was pointed out that the creation of a position of executive officer also helps maintain the morale of those directors who lost their position by the reduction of the number of directors.[56]

In some companies, it was a result of the introduction of the 'companies within the company' system. Business departments of those companies were given virtual autonomy, sometimes with hypothetical capital and separate balance sheet, and encouraged to compete against one another. These 'companies' were to be headed by executive officers who did not necessarily have to be directors.[57]

However, if one takes a close look, the introduction of the system of executive officer in many companies did not accompany the reform of the board, except for the reduction of the number of directors. This is demonstrated by the small number of companies which have external directors. In a survey of 187 companies which intro-

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55 Ibid., p.24.
56 M. SAWAGUCHI, *Shikkô yakuin no jitsumu* (Practical Issues concerning Executive Officers), Tôkyô 1999,pp.8-9.
57 *Nikkei*, June 25, 1999.

duced this system by the time of the general shareholders' meeting of June 1999, there were only a few companies which did not reduce the number of directors at the same time. On the other hand, there were only 8 companies which have or intend to have external directors on the board.[58] The function of the board and the frequency of the meetings have not changed.

According to the above-cited survey, of the 122 companies which introduced this system, 76 companies have less than 10 directors, and 34 companies have less than 20 directors.[59] In a majority of companies, there seems to have been a reduction of the number of directors accompanied by the introduction of executive officers. In general, while the number of directors were around 20 in these companies before the introduction of the system, after the introduction, it was reduced to around 10. 13 companies reduced the number by 20.[60]

The number of executive officers varies. In 51,2% of the surveyed companies, the number was 11 or under. Then, who become executive officers? The response was as follows:[61]

former directors 75%
employees 89,2%
externals 33,3%

The fact that in a majority of companies, former directors, among other people, became executive officers suggests that in these companies, directors, presumably some of those who used to combine the position with that of an employee (head of the business department) became an executive officer without a position on the board. It was also natural that employees were made executive officers in most of the companies, while there were not many externals, since these officers were most likely to be the head of business departments, who, under the previous system, would have been made a director. Thus, the position of executive officers seemed to be something in-between that of a director and a senior employee.

According to this survey, despite the fact that one of the purposes of introducing the system of executive officers was to separate decision-making and implementation, in almost half of the companies, there still are members of the board who combine this function with the position of an executive officer. In more than 41 companies out of 121, over half of the board members are at the same time, executive officers.[62] In the United States, it is not uncommon for a CEO to be simultaneously the chairman of the board. However, in Japan, the size of overlap indicates that in these companies, it is not

58 SAWAGUCHI (note 56) pp.15-25.
59 '*Shikkô yakuin* (1)' (note 53) pp.26-27.
60 Ibid., (2), July issue, 27.
61 Ibid., p.30.
62 '*Shikkô yakuin* (2)' (note 53) pp.29-30.

only the CEO who combines both positions, but some directors who formerly combined the position with that of an employee have now become director and executive officer.

In order for the introduction of the system of executive officers to contribute to a better control over the management, it has to be combined with the reform of the board. However, from the result of the survey and also various newspaper reports, except for a handful of companies such as *Sony*, the introduction of the system of executive officers did not really accompany a major reform of the board other than the reduction of the number of directors. In another survey of companies which introduced the system, in response to the question of whether the actual decision-making power has shifted to another body, 63,5% responded that there was no change. The frequency of the board meeting has not changed much either, which means that the board is still not the real decision-making body.[63]

For a fair and transparent corporate governance, it is important to introduce external control, e.g. external directors as suggested in various proposals including the American Law Institute Statement of Principles of Corporate Governance and Structure. However, this is yet to be realised in Japan. Of the 121 companies which introduced the system of executive officers, only 9 have an intention to introduce an external director or increase their numbers.[64] Of the companies which have not introduced executive officers, only 4,7% have considered or introduced external directors.[65] In fact, Japanese companies are fairly reluctant to have external directors. In an annual survey of the head of 100 selected companies conducted by *Nikkei*, only 5% replied that increase/introduction of external directors was contemplated,[66] although another survey with 1200 samples (90% are senior management of listed companies) showed that 25,5% responded that it was necessary, and 47,9% replied that it was more or less necessary.[67]

Other reform proposals whose model can be found abroad, such as a committee within the board to determine the remuneration of board members and a committee to nominate candidates for board members, have not found much support either. According to the *Keizai Dôyû-kai* survey cited above, around 65% of respondents replied in the negative for the establishment of both committees.[68] Needless to say, even if there are external directors, if the nomination process is not fair and transparent, there may be not much advantage in terms of better corporate governance.

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63 *Nikkei*, June 13, 1999.
64 *'Shikkô yakuin…* (3)' (note 53) p.69.
65 '*Shikkô yakuin* … (1)' (note 53) p.24.
66 *Nikkei*, May 26, 2000.
67 KEIZAI DÔYÛ-KAI (note 5) pp.116-120.
68 Ibid., pp.121-127.

## VII. PROPOSED TOTAL REVIEW OF COMPANY LAW

Earlier this year, the Sub-committee on Company Law of the Legislative Advisory Council announced that a thorough review of the Commercial Code, namely the company law, would begin. At the first meeting held on April the 12th, representatives of the industry as well as the officials of the Ministry of International Trade and Industry strongly urged that fundamental changes be made to the existing law in order to 'revamp the economy'.[69] The Ministry of Justice intends to introduce changes within two years.[70]

Joint-Stock Company Law, which is part of the Commercial Code, has undergone a series of amendments, particularly in the 1990s. The latest changes involve the facilitation of setting up holding companies by share transfer and exchange and facilitation of the procedure for splitting of companies. However, the proposed changes this time exceed the scale of such piecemeal reforms; this is intended to be the first major amendment to company law since 1950. An outline of the proposed reform was published in September 2000.[71]

By the proposed amendment, first of all, the language of the Code, which is in classical written-Japanese, will be modernised, just like the Criminal Code which was modernised in 1995.

The focus of the total review is the company law. The Legislative Advisory Council published the basic directions of the review in September. These are 1) ensuring the effectiveness of corporate governance, 2) adaptation to the era of information technology, 3) changes for the diversification of the measures of financing, and 4) adaptation to the internationalisation of corporate activities.

Issues to be addressed include:

i) separation of regulations on closed companies from those on public corporations and application of simplified rules for closed companies
ii) system of corporate bodies (shareholders' meeting, directors, auditors)
iii) mandatory disclosure of information in line with the international accounting standards
iv) deregulation of transactions between the parent company and 100% subsidiaries
v) changes to the stock option system
vi) reform of the settlement system of corporate bonds
vii) abolition of par value shares
viii) redemption of shares from capital reserves
ix) introduction of 'paperless' commercial papers
x) electronisation of the announcement of shareholders' meeting and voting

69 *Nikkei*, April 13, 2000.
70 *Nikkei*, April 12, 2000.
71 *Nikkei*, September 7, 2000.

The industry has been making various proposals concerning the reform of the company law. Some of them are reflected in the above outline.

The division of power between the board of directors and the general shareholders meeting will be reviewed. The industry strongly supports the idea of broadening the power of the board. It is proposed that matters such as the remuneration of directors will be decided not by the shareholders' meeting, but by the board of directors.

There is an apparent move towards efficiency. In order to facilitate mergers and the implementation of other significant corporate strategy, the quorum of the shareholders' meeting on such matters may be reduced.

It is also proposed that the liability of directors which is currently on a non-fault basis in some matters such as unlawful paying out of dividends will be made liability based upon fault. The present system has been criticised by the industry for discouraging externals to become directors.

There are proposals for changes to the shareholder's action too. 'Contemporaneous ownership' may be required. It is proposed that it should be made possible to pursue liability of chartered accountants together with directors and auditors. In the light of the recent *Daiwa Bank* judgement, proposals to limit the liability of directors, e.g. setting a ceiling at two years' income, have been made.[72]

These proposed changes largely reflect the long-standing demand of the industry. Some people characterise it as a 'deregulation of corporate law'. The basic idea of the entire reform is said to enable efficient and mobile corporate management.[73]

The total reform is expected to be completed by the year 2000. However, the part concerning corporate finance will be submitted to the Parliament in 2001.[74] Furthermore, in the light of the recent judgement of Ôsaka District Court which held directors liable for 83 billion yen, there is a move among the ruling coalition parties to introduce changes to the system of shareholder's action by 2001.[75]

## VIII. CONCLUDING REMARKS

Since the early 1990s, there have been some significant reforms in corporate governance in Japan. The reforms were intended to reinforce the control of corporate management by shareholders. The 1993 amendments to the Commercial Code have strengthened the rights of shareholders including the right to shareholder's action. The management of companies has also become increasingly aware of the necessity of improving shareholders' value, and efforts were made in that direction.

In the second half of the 1990s, there were some attempts at reform on the initiative of the companies, namely the introduction of the system of executive officers. However,

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72 *Asahi Shinbun*, September 23, 2000.
73 *Nikkei*, September 7, 2000.
74 *Nikkei*, September 7, 2000. www.moj.go.jp
75 *Asahi Shinbun*, September 23, 2000.

this seems to be more orientated towards speedy and timely decision-making and efficient implementation within the company rather than towards better supervision of the senior management for fairness and transparency.

All in all, despite various attempts and resulting changes, senior management of Japanese companies is still basically free from external and internal control, with the result of a lack of accountability.

Theoretically, the ultimate goal of corporate governance is the maximisation of shareholders' value. In Japan, there is some hesitation in pursuing this goal. This is because of the traditional 'communitarian' perception of companies generally accepted in Japan.[76] Generally, in Japan, companies are not regarded as an entity which should solely be governed by shareholders; interest of other stakeholders should also be taken into account. Although the proposal by the ruling Liberal Democratic Party stressed that shareholders are 'sovereign' in the company and maximisation of their benefit should be pursued, there is a strong apprehension of this concept. The 1998 proposals of the Corporate Governance Forum does refer to maximisation of shareholders' value, but at the same time, carefully pays attention to the interest of other stakeholders and rejects 'short-termism' by shareholders.

In reality, there is still a significant benefit in Japan for stressing this idea of maximisation of shareholders' value, provided that it does not lead to 'short-termism'. Shareholders have not been treated very well in the past, and the reform is slow to take effect. The system of corporate governance is still very much an insider system and there is not so much prospect of changes. The proposed changes to corporate law do not seem to help the shift in this direction.

Those changes backed by the industry are more or less aiming at 'deregulation' of corporate law, which, in the view of the industry, often becomes a 'yoke' against free market development. Deregulation will naturally lead to a broader discretion for the management. However, under the current system of insider dominance, there is no guarantee that the management will always act in the interest of shareholders or stakeholders other than themselves. If there is to be a 'deregulation' as proposed by the industry, it has to be counterbalanced by other measures in pursuit of sound and fair corporate governance. After all, this may be the only way to ensure maximisation of shareholders' value.

Despite constant efforts to strengthen the rights of shareholders on the part of the legislature, and also by the management of many companies, overall, shareholders have failed to exercise much control over the management.

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76 S. OCHIAI, *Kigyô-hô no mokuteki* (Goals of Corporate Law), M. IWAMURA et al eds., *Kigyô-hô kôza* (Corporate Law), Tôkyô 1998, pp.23-26. For a view of an economist, see K. IWAI, Persons, Things and Corporations: The Corporate Personality Controversy and Comparative Corporate Governance, American Journal of Comparative Law, 1999 vol.47, p.582ff.

**Table**

**Selected Derivative Actions Pending in 1998/1999**
**(1 USD = 105 yen)**

| *Company Involved* | *Ground of Action* | *Claimed Amount* |
|---|---|---|
| Nomura Securities | Unlawful sale of foreign bonds in the United States | 23.5 billion yen |
| Chûbu Electric Power | Expenditure for a nuclear power plant | 6.2 billion yen |
| Obayashi Construction | Bid-rigging | 200 million yen |
| Nomura Securities | Unlawful compensation of losses | 16.1 billion yen |
| Kajima Construction | Unlawful political donation | 500 million yen |
| Japan Airlines | Failure of resort development | 2.2 billion yen |
| Sumitomo Corp. | Loss in copper trade by a senior employee | 200 billion yen |
| DKB | Unlawful loan to a shareholder | 2.2 billion yen |
| Yakurt | Loss from derivatives transaction | 65 billion yen |
| Keihin Express | Closure of a hotel (subsidiary) | 20 billion yen |
| Tôkai Bank | Excessive lending/forgiving of debts | 8.5 billion yen |
| Yamaichi Securities | Window dressing | 6 billion yen |

(Compiled from SHÔJI HÔMU KENKYÛ-KAI ed., *Kabunushi sôkai hakusho* (White Paper on Shareholders' Meeting), 1998, 1999, Tokyo)