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Corporate Governance in Japan*

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1 Introduction

Corporate governance is an important discussion point in Company Law, and as such it is a familiar term among commentators. However, the term 'Corporate Governance' has several different meanings.

What is corporate governance?

This report will define the concept of corporate governance in Japan, and show that corporate governance will continue to play an important role in Company Law. In addition to this, this report will seek to broadly outline the balance of power between the directors and auditors.

Many commentators use this term according to their own definitions. Broadly speaking, these definitions can be divided into two categories¹⁾.

Firstly, the question of for whom a company should exist, and

Secondly, the consideration of company management and organisation.

In other words, the former discussed company ownership and control, and the latter

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1) Egashira Kenji, Liberal Democratic Party's Draft of Company Law Reform and auditors / the board of auditors, 1470 Commercial Law Review 17 (1997)

discusses the monitoring system for company managers.

The former focuses on the problem of whether a company exists for the stockholders or for the stakeholders. The concept of “stakeholders” is broader than the concept of “stockholders” because it includes not only the stockholders but also all people who have some connection to the company. This opinion is also related to “corporate social responsibility,” and “participating management,” although these subjects will not be discussed at length.

The latter focuses on the question of company structure and management monitoring. Directors are monitored according to considerations of efficiency and legality²⁾. The efficiency-check determines the standard of the management. Under this check, capable managers are re-elected to the board, and incapable managers are dismissed. This check serves the function of management supervision. The ‘legality-check’ can be separated into a check for legality in relation to statutory rules, and a check for the negligence of the fiduciary duty of good faith. This fiduciary duty-check is similar to the efficiency-check. Of course, managers must not violate any statutes. Some commentators discuss this as a matter of common sense but not as an aspect of the concept of corporate governance. However, this check is a central role of corporate governance. Recently, many company scandals have occurred in Japan, the U.S., and the U.K. These scandals draw attention the importance of the ethical monitoring aspect of corporate governance. From this perspective, the legality-check is one of the most important aspects of corporate governance³⁾.

- The current significance of corporate governance in Japan

Corporate governance currently plays two main roles in Japan. Firstly, it acts to deter company scandals, and secondly it lowers the possibility of corporate bankruptcy during the severe recession. This is particularly important, when we consider the fact that Japanese companies are increasingly compelled to compete with foreign companies.

2) Other measures are conflict of interest and corporate social responsibility. See Morimoto Shigeru, *Corporate Governance and Company Law Reform*, Kawamata Yoshiya 60th Birthday Memorial ‘Some problems of Company Law and Economy Law’ 116

3) When a director violates regulations, the conduct affects profit of the company directly or indirectly. The conduct, at least, affects the long-term span profit of stockholders. The long-term span is one factor of the efficiency-check. Even corporate governance in the narrow sense includes this violation. Thus, the problem of sound governance is the problem of the rule in stock market competition.

Recently, corporate governance in Japan has become increasingly political, forcing the business world to seek reform. Business leaders have suggested regulation amendments to corporate governance. For example, the Liberal Democratic Party announced 'The Framework for Commercial Law Amendment for Corporate Governance' on 8th September 1997, and 'The Framework of Commercial Law Amendment' on 1st June 1998. These reports are well known, and are collectively entitled 'The Liberal Democratic Party's Proposal' together. In addition to this, The Federation of Economic Organisations announced papers entitled 'An Urgent Proposal on Ultimate Corporate Governance' on 16th September 1998, and 'Our Opinions against the Liberal Democratic Party's Proposal' on 18th November 1998. The Corporate Governance Forum of Japan and The Corporate Governance Committee announced 'Corporate Governance Principles –A Japanese View– for the Re-thinking of Regulation for Japanese style Company Control' on 30th October 1997, and the final reports was given on 26th May 1998⁴⁾. These are called 'principle reports.' In addition, there are also many other published articles and theses for corporate governance⁵⁾.

2 Who actually owns the company? – stockholders ownership theory

Company ownership has been discussed for a long time. Debate regarding company ownership has its origins in an American argument of the 1930s over whose trustees are company managers. This argument was held between Berle and

4) 'New situation of Corporate Governance,' separate volume of Commercial Law Review, No. 212, 1998

5) In 1994, Symposium 'Corporate Governance - the role of large company and the management / the governance' was held at Japan Private Law Society's annual meeting. Jurist (one of the leading law journals) published a special issue about corporate governance in the same year.

Recent articles: Morimoto Shigeru, Corporate Governance and Company Law Reform, 1121 Jurist 63; Mori Jyunjiro, Management Governance and legal position of directors in large company, 140-5.6 Housou 109; Hamada Michiyo, Establishment of Corporate ethics and auditors / directive, 1123 Jurist 52; Kitamura Masashi, the problem on Company Law reform about corporate governance, 1477 Commercial Law Review 2; Ichikawa Kanezou, Corporate Governance, 117-4.5 Minshouhou Zasshi 528; Maeda Shigeyuki, the Problem about Corporate Governance in German, 117-4.5 Minshouhou Zasshi 546; Toriyama Kyouchi, Management organ and supervisory organ in stock corporation, 117-4.5 Minshouhou Zasshi 569; Sisido Zenichi, Comparative study of corporate governance between Japan and the U.S. and suggestion to Company Law reform debate, 117-4.5 Minshouhou Zasshi 599; Yanaga Masao, Single system and dual system of corporate governance, 401 Kansayaku 10; Niiyama Yuzou, Corporate governance and problem of Company Law legislation, 70-4 Houritu Jihou 6; Masai Shousaku, Reform in auditors system, 70-4 Houritu Jihou 27; Maeda Masahiro, Corporate Governance and Law, 'Modern Law - corporation and Law 63

Dodd. Berle stated that the power of company ownership should be entrusted by the stockholders. This theory is called “stockholders-ownership theory.” Dodd stated that power of company ownership should be kept under trust by the public. This argument was linked to the conflict between liberalism and managerism. In the U.S., Commercial Law legislation deemed the company to be a city-state of the stockholders. It was, therefore, reasonable that the stockholders should own the company⁶⁾. In 1994, the American Law Institute (ALI) announced its ‘principle of corporate governance.’ In this report, they debated Art.2.01 from the stockholders-ownership-theory⁷⁾.

In Japan, employees-ownership-theory was popular⁸⁾. This theory held that employees should own their company. However, this theory has faded with the onset of recession. In the framework of current commercial law, nothing can support the claim that employees should own the company at which they work. Thus, it is reasonable that only stockholders should have company ownership even in Japan.

The stockholders-ownership-theory in Japan is supported by following arguments;

- 1 The government allows private property.
- 2 Under the commercial law, a company is an aggregate corporation. Stockholders are the members of this corporation, and they contribute their own property to their company under this legislation.
- 3 Stockholders hold the stockholders’ meetings. The stockholders’ meeting is the supreme organ in a company. At stockholders’ meetings, stockholders have the right to decide the essential matters of the company such as the appointment or the dismissal of management members.
- 4 Stockholders have the right of dividend. This right is different from other claims because creditors can always claim their right under their contracts, but stockholders can claim this right only when the company gains profit.
- 5 Stockholders have the right of liquidation. This right is subordinate to other creditors. Stockholders, therefore, exist as final risk takers.

6) See Kariya Hirosato, the Economic thinking for the U.S. Corporate Law, 30 Hitotubashi Univ. Study Annual Law Review 136

7) Contract model can approach the principle for maximum profit of stockholders, as ownership model does.

8) Itami Takayuki, ‘Man capital theory for company,’ 36

Under the traditional commercial law theory, stockholders are recognised as real company owners. The stockholders' ownership can authorise managers to operate the company, and managers' rights are authorised only as stockholders' trustees. Managers are expected to gain the maximum profit for the sake of the stockholders, and stockholders are expected to control the management properly⁹⁾. In the U.S. and the U.K., this theory is realised by agency theory. According to agency theory, stockholders monitor the managers to maximise the company profit for their own sake, because the stockholders are the company's owners and the managers are just their agents¹⁰⁾.

The Liberal Democratic Party's proposal is constructed on the stockholders-ownership-theory. The proposal emphasised that the stockholders are the owners of the company and that the aim of a company is to pursue profit. It is said that the reality under Japanese style management is far from this company law theory, and that the company has sometimes ignored considerations of profit for the stockholders. By emphasising stockholders ownership, The Liberal Democratic Party wanted to show their attitude as legislators that a new system of management should reform this old fashioned system and that a new corporate system should exist on the traditional commercial law theory.

However, large companies cannot always consider the stockholders' profit, they have connections with their own employees, their customers, and also the public. Given this, the company considers the stakeholders' position in light of their own business actions. This is another important aspect of corporate governance. The stock market can control the stakeholders' profit, as can the managers themselves. This system gives the management a large measure of discretion. Another consideration is whether stakeholders can participate in management decision making. This argument has yet to reach conclusion, but in order to resolve, the argument must surely be given due consideration the debate of the corporate social responsibility of a company. Companies should no longer ignore their social responsibility¹¹⁾.

9) Morimoto, *supra* note 5 at 112

10) Shishido, *supra* note 5 at 601

11) Art.2.01 in 'Principle of Corporate Governance' permits charity contribution, although it recognises that basic aim of company is to pursue the profit. See Suenaga Toshikazu, Corporate Social Responsibility, Tatuta Misao 60th Birthday Memorial 'Sound Corporate Governance and Responsibility of directors' 140

3 Monitoring system for management

1 Monitoring system in other countries - single or dual

The Japanese monitoring system is a combination of the two systems of monitoring. Monitoring systems for management can be classified into two categories all over the world: the single system found in the U.S., and the dual system found in Germany¹²⁾.

In the single system, managers are supervised by the board of directors. The managers are the members of the board of directors. This is an internal control system. The role of the internal control system is similar to the role of the efficiency-check. In the dual system, the board of auditors supervises and monitors the managers. The board of auditors is independent of the board of directors. This system is an external control system. This system is legality-check. However, the border between the two systems is not clear. The systems overlap to some extent, and work mutually for the efficiency-check and the legality-check. The sphere of influence of each system is defined according to the emphasis; it is given by the relevant commentator.

The U.S. and the U.K. adopt the single system. In the single system, the management and the supervision come under the same organ¹³⁾. The board of directors appoints the officers who actually carry out business. The most important function of the board of directors is to make basic management policy and to supervise the management. Recently, in order to strengthen the supervision function, outside directors and committee system are adopted and strengthened. The corporate governance principle declared by the ALI advocated the separation of management and the board of directors, by adopting the theory that management of a public company should be exercised by the executive officers or other officers. The executive officers are appointed by the board of directors and the other officers are supervised by the executive officers. The board of directors has several important rights, namely the right to appoint the executive officers, the right to decide their remuneration, the right to decide management policy, and the right to

12) See Toriyama, *supra* note 5 at 569pp

13) Corporate governance in the U.S. and in the U.K. See Kitamura Masashi, *Corporate Governance in the U.K.*, 1050 *Jurist* 76; Morimoto, *Management organ of large company and legal status of director*, 140-5.6 *Hougaku Ronsou* 109; Kawahama Noboru, 'Supervisory system in the board of directors' 3

supervise the management.

The U.K. system is very similar to the American system. Under U.K. Company Law, a company can decide the structure of its management. However, several institutions have published their recommendations in order to promote proper business for large companies. The Cadbury report is a well-known example of these recommendations. The report highly estimated the functions of non-executive directors in order to ensure the power of the board of directors to control the management. The non-executive directors are expected to be independent of the executive directors and to have significant influence in the board of directors.

Germany, by contrast, adopts the dual system¹⁴⁾. According to the dual system, there are two organs in a company; an organ to exercise the business, and an organ to supervise it. Under this system, the board of auditors appoints the directors. Every director has the power to represent the company and to carry out business. In big companies, the board of auditors consists of twenty members. Ten of these auditors represent the stockholders and the remaining ten represent the employees. The board of auditors has assent rights for certain aspect of business.

The two systems are similar in that there are two independent organs; management and supervision. The difference between them is the control system. The single system is an internal control system, and the dual system is an external control system. The difference is whether interlocking directors are approved or not.

What are the merits and demerits of each system¹⁵⁾? In the dual system, management supervision is ensured by the structure. Moreover, the supervision is strongly independent of the management. On the other hand, the single system is suitable for an efficiency-check¹⁶⁾. Moreover, stockholders can control the management properly under the single system, because directors are appointed through a stockholders' meeting. The information is shared more easily under the single system than under the dual system. Objective and independent supervision may be difficult under the single system, but the committee system and the outside directors system can make up this demerit.

14) Corporate Governance in German. See Masai Shousaku, *Corporate Governance in German*, 1050 Jurist 69; Maeda Shigeyuki, *supra* note 5 at 558pp

15) See Yanaga, *supra* note 5 at 12; Maeda, *supra* note 5 at 58pp

16) See Egashira, *supra* note 1 at 22

Another demerit of the single system is the difficulties surrounding the supervisors' decision. Supervisors must take a third party position despite the fact that they are the members of the organisation who really carry out business. In order to make up this demerit, the legality-check should be worked by the dual system. The supervisory organ can work properly only when it is strictly independent of the business organ. Belgium and the Netherlands adopted the restricted dual system. They may recognise that the dual system is sometimes superior to the single system.

The demerit of the dual system is its lack of the above-mentioned function. Under the dual system, the supervising organ is independent of the management. Thus, the supervisors can only check business action the managers after they have been carried out. Under the dual system, it is very difficult to consider business strategies and long span policy in advance.

2 Japan - mixed system

As mentioned above, both systems have positive and negative elements. The Japanese system has introduced both systems over a long period of time. The current system in Japan is a compromise system between the single system and the dual system. Under the Japanese system, the board of directors and the board of auditors supervise and monitor the representative directors. The representative directors are the real managers in Japan. To this extent, it may be said that the Japanese system is similar to the American system¹⁷⁾. Directors and auditors are appointed by the stockholders' meeting. The board of directors consists of the directors appointed. The board appoints the representative directors and supervises the management. The auditors supervise the management of the board of directors and the representative directors. Moreover, it is not the auditor, but the stockholders' meeting that appoints the directors. This shows that the Japanese system is similar to the American system. However, the current Japanese system is unique, because the board of directors and the board of auditors supervise the management and the board of auditors supervises it further. Thus, the current Japanese system has a double check system, under which both systems cross over.

Although the Japanese system is unique, it does not provide absolute management

17) Yanaga, *supra* note 5 at 10

monitoring. The problem of this system is that the double check system does not work at all. The reason for this is cultural. Many public companies are controlled under mutual shareholding. The members of the board of directors are ex-employees, and most auditors are ex-directors.

3 Reform

Ideally, reform of corporate governance should correct the harmful influence of Japanese customs. There are two possibilities for reform. Firstly, the auditors system could be abolished with the executive officers and the outside directors system. This amounts to an introduction of the American system. Alternatively, the independence and the power of auditors could be strengthened by introducing the Germany system.

- Reform in the board of auditors - LPD's Proposal

Reform of the auditors system is crucial in Japan. The Liberal Democratic Party's reform proposal suggested the following:

- (1) The term of auditors should be more than 4 years and the majority of the auditors should be external.
- (2) The board of directors must attain the assent of the board of auditors when nominating any auditors at the stockholders' meeting.
- (3) The board of auditors should be able to nominate accounting auditors under the assent of the board of directors.
- (4) The representative directors must be accountable for the reporting of information to the board of auditors at least quarterly.

When any directors violate the principle of fiduciary duty, the board of auditors must make a report to the board of directors. If the board of directors submits an agenda for re-electing the directors at the stockholders' meeting, the board of directors must have the assent of the board of auditors. In other words, the board of auditors has rejection rights for a violation of fiduciary duty.

This proposal shows that the Liberal Democratic Party intends the board of auditors to strengthen its own power. However, this proposal is fundamentally flawed. The right of the auditors to make a proposal is subjected to the will of the representative directors. If the government really wants to strengthen the auditors' power, they

should authorise an exclusive proposal right to the auditors¹⁸⁾. The right of the auditors to reject directors who have violated their fiduciary duties is an epoch-making right. Even in Germany, the board of auditors only has the right for appointment and dismissal of such directors¹⁹⁾.

- Reform in the board of directors - 'Principle Report'

On 30th October 1997, the Corporate Governance Forum of Japan and The Corporate Governance Committee announced 'Corporate Governance Principles -A Japanese View- for the Re-thinking of Regulation for Japanese Style Company Control'. In this paper, the forum recognises the reforms as follows:

- (1) Separation of governance and management
- (2) The board of directors must supervise the managers.
- (3) The establishment of corporate governance, for example:
 - (a) Board of directors consists of inside directors and outside directors.
 - (b) Inside directors concurrently function externally as executive officers.
 - (c) Outside directors have no connections with the company.
 - (d) The majority of the board of directors are outside directors.
 - (e) In the board of directors, there are several committees enabling proper supervision.
 - (f) The company can abolish the auditors system, especially if a company founds a supervisory committee by the outside directors only.

The Principles are considered from the premise that the auditors-and-directors dual system does not work at all in Japan. Therefore, we must consider the system does not work. Two reasons were pointed out at the forum - firstly, only a few members of the board of auditors are independent of the directors, and secondly the board of auditors does not have the power to appoint and remove the directors. Moreover, the board of directors can actually have the power to appoint members of the board of auditors. There is no auditors committee inside of the board of directors in

18) Okushima Takayasu, *Globalisation of Auditors System and Company Law legislation*, 65-7 *Houritu Jihou* 59; Hamada, *supra* note 5 at 115; Ichikawa, *supra* note 5 at 543; Shishido, *supra* note 5 at 614; Hamada discusses the justification of poll system in number of stockholders, because every stockholder has equally the right to require the legal management. Thinking auditors appointment system over again, the current system in the stockholders meeting has much room to reform. See Hamada, *supra* note 5 at 116. Her suggestion is agreeable.

19) See Maeda Masahiro, 'Corporation and Law' 4, for the LDP's proposal. Egashira, *supra* note 1 at 22; Kitamura, *supra* note 5 at 7; Mori, *supra* note 5 at 54-55 against the LDP's proposal.

Japan. However, this is not the reason why the system does not work²⁰⁾. The problem lies in a personnel issue, namely the fact that it is very difficult for a company to appoint capable outside directors. If a company appoints inter-locking directors of keiretsu as outside directors, the attempt is meaningless.

4 Monitoring by the stockholders

Japanese Commercial Law recognises that stockholders are really the owners of a company. Stockholders are expected as the owner to control corporate management. Stockholders can decide a company's future at the stockholders' meeting. For example, stockholders have the power to appoint and remove the managers. In order to ensure this right, the government has reformed the commercial law. However, it has been said that stockholders' meeting does not serve to allow the exercise of stockholders' rights. It is common knowledge that the stockholders' meeting cannot appoint or remove managers properly, but that the board of directors and the board of auditors can. In the past, the stockholders' meeting had little power, but in 1981, attempts were made to empower the stockholders' meeting through legal reform. The legislators overestimated the effect that this reform would have, however, and the stockholders continued to serve any real function²¹⁾. However, the stockholders' meeting is the most important organ for company control. Since we recognise the importance of the function of the stockholders' meeting, we should ensure the power of the stockholder. Stockholders should have real power to control the stockholders' meeting, and this power should encourage the stockholders to supervise the management. The actual function of the stockholders' meeting is not only to decide the company's future, but also to supervise the management by proper disclosure and directors' accountability. If something is wrong at the stockholders' meeting, stockholders can claim for an injunction of malfeasance or damages by derivative action²²⁾.

In a situation where stockholders of a large company doubt the management, it is more likely that the stockholders would rather sell their shares in the stock market than exercise their right to dismiss the management at the stockholders' meeting.

20) Yanaga, *supra* note 5 at 12

21) Egashira, *supra* note 1 at 21pp; Shishido, *supra* note 5 at 6; Shishido states that the stockholders meeting as a ceremony is natural.

22) See Morimoto, *supra* note 5 at 114pp

This trend is called "The Wall Street Rule." One of the functions of stock price is to control the management. In order to ensure this function, a fair and transparent stock market is required.

As I explained, there are three ways for stockholders to monitor the management.

- 1 Monitoring in the stock market. Stockholders can control by transferring shares.
- 2 Monitoring at stockholders' meetings. Stockholders can exercise their right by submitting an agenda by resolution at the stockholders' meeting.
- 3 Monitoring by direct exercise of shareholder's rights.

In Japan, the stockholders' meeting does not function at all. Thus, monitoring by direct exercise of shareholder's rights is effective. The right of derivative action is the most important. However, in the proposal, the Liberal Democratic Party discourages this power. Moreover, the principle completely ignores this power²³⁾. These attitudes are difficult to justify. The important point of the stockholders' monitoring system is that minority stockholders can influence company control. This also contributes to efficiency for the legality check.

I must now mention institutional investors. Pension funds and insurance companies are called institutional investors, and they have considerable influence in the stock market. Institutional investors also play an important role for company control in the U.S. and the U.K. Institutional investors should participate actively in the monitoring system in Japan.

4 Conclusion

Corporate governance theory has two aspects: company ownership theory, and the monitoring system. As I discussed above, these aspects are not independent from each other. We must consider corporate governance from both aspects. Firstly, we should recognise that stockholders are the real owners of a company. Based upon this, we should build up a proper monitoring system in order to ensure efficient and sound company management. Furthermore, we should consider the balance of interest of the parties concerned. These are the topics of corporate governance.

23) See Suenaga, Current situation and evaluation for derivative action, 70-4 Houritu Jihou 21pp

Recently, the management's high-evaluation of the stockholders is a popular point of discussion in Japan. When we consider that the stockholders are the owners of the company, it is natural that the value of the stockholders is popularly recognised. ROE and net-worth to total capital employed ratio are discussed from this premise. The mutual-shareholding system is collapsing in Japan, no doubt contributes to the tendency to emphasise the value of stockholders to the management. Very few commentators support the mutual-shareholding system. However, those that do support it, recognise that this system ensures independent management and encourages efficient management. Nonetheless, the mutual-shareholding system is criticised because it discourages the monitoring system for management. Another weakness of the mutual-shareholding system is that capital is not fulfilled at all.

The monitoring system in Japan should be built up by combining the American system and the German system²⁴⁾. Firstly, in order to improve the efficiency-check, we should reform the board of directors. Secondly, in order to improve the legality-check we should reform the board of auditors. The board of directors should consist of inside directors and outside directors for supervision of the management. The inside directors should concurrently function externally as executive officers, and the outside directors should be independent of the company. The majority of the board of directors should be outside directors. The power of the board of directors should be restricted to the right of appointment and removal of directors and the right of strategy decision. To facilitate discussion of these issues at directorate level, the number of directors should be limited²⁵⁾. For a legality-check, which would ensure the power of the auditors, the number of outside auditors should be increased. The board of auditors should have an exclusive right to nominate auditors. The board of auditors should have at least a right to state its opinion about the remaining directors, in case that directors break their fiduciary duty²⁶⁾. If the representatives of an employee are to be made outside auditors, the

24) See Hamada, *supra* note 5 at 116; Sharing of corporate function to the board of directors and the board of auditors is too good to be abolished. See also, Sakamaki Toshio, *Function of outside directors and outside auditors*, 1050 *Jurist* 138

25) Egashira, *supra* note 1 at 23; Shishido, *supra* note 5 at 618; I insist that the system of the directors who concurrently function externally as employees must be abolished.

26) Morimoto, *supra* note 5 at 70; Kitamura, *supra* note 5 at 6; Hamada, *supra* note 5 at 120; She suggested the function of the board of auditors when the directors break regulations as follows: 1 the right to submit the agenda of dismissing the directors to the stockholders meeting, 2 the right to bring a claim for dismissing the directors, 3 the right to dismiss the directors by unanimous consent of the board of auditors.

board of auditors must improve not only at the objective aspect, but also at the social aspect²⁷⁾.

27) Chinese Company Law in 1994 has the provision of the system where the employees are involved in the board of auditors (Art. 124). See also Mori, *supra* note 5 at 56; He suggested foundation of the neutral board of auditors whose members are appointed by the employees.