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Changes in corporate governance are having an effect in Japan

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These days, there is a major push to reform Japanese capital markets. The Japanese recognize that their capital markets are not working as well as they could, and that a system giving shareholders stronger rights could provide meaningful long-term benefits to the economy, which is mature and no longer can grow the way that it did during the second half of the 20th century. As a result, the government is hard at work trying to figure out a way to strengthen shareholder rights and better align the interests of management and shareholders.

As often happens in Japan, a clear way forward has been articulated by foreigners who are exerting "gaiatsu," or external pressure. In May, the Asian Corporate Governance Association published the ACGA *White Paper on Corporate Governance in Japan.* This white paper, which was endorsed by major financial institutions such as the California Public Employees' Retirement System and the British Columbia Investment Management Corp., clearly sets forth changes that could bring Japan's financial markets into step with capital markets in other First World countries. Moreover, it contains several anonymous quotes from Japanese financial professionals, thereby suggesting that the changes the white paper proposes enjoy domestic Japanese support.

At first glance, one might think that the white paper cannot succeed because the proposed changes are too radical and dramatic. In particular, the white paper is premised on increased shareholder rights — a development that would either require management to voluntarily cede power that it now holds to shareholders, or require government intervention on shareholders' behalf. Management is unlikely to cede power to shareholders because legally it doesn't have to, and, culturally, managers are not accustomed to doing so. As to intervention, the courts are in no position to intervene on shareholders' behalf because the laws in place do not allow them to do so in an effective manner. Therefore, new legislation or new administrative lawmaking that will align management rights with shareholder rights would be required.

In the West, when a publicly listed company is not earning adequate returns on capital, shareholders can and will oust management. Shareholders have leverage to negotiate with management because their votes are important. Using this leverage, they can pressure management to get better returns. Moreover, in extreme cases — i.e., when the company's assets could be much more efficiently managed by someone else — companies can be bought out in hostile takeovers. Management knows that, if the hostile takeover price is high enough, it will lose control of the company, and that the courts are not likely to stop the takeover from happening unless the purchase price is too low. The fear of a takeover creates additional pressure on management to look after shareholder interests and keep the share price high.

In Japan, traditionally, shareholders do not oust management (although they have the power to do so), boards are not necessarily independent and hostile takeovers have not occurred. As a result, Japanese management has not needed to negotiate publicly with shareholders and is not in the habit of doing so. Furthermore, executive compensation, which is low by global standards, is not linked to stock market performance. For at least these reasons, shareholder interests and management interests are poorly aligned in Japan. And, in general, shareholder returns and liquidity are low in the Japanese markets when compared to other First World countries. The top quintile of the Japanese market performs well, but the bottom four quintiles are earning poor return on equity and are thinly traded. There is room for improvement.

Thwarted takeovers

In 2005, a small company called Live Door Co. Ltd. made the surprising announcement that in off-hours trading, it had purchased more than 30% of the shares of the Nippon Broadcasting Co. The broadcasting company responded by issuing shares to Fuji Television in order to dilute Live Door's holdings and prevent a takeover. However, the Tokyo District Court intervened and issued an injunction preventing the issuance of the shares. *Live Door v. Nippon Broadcasting Co.*, 1899 Hanrei Jihou 56 (Tokyo D. Ct. March 23, 2005). The case settled and did not result in an actual takeover.

The Live Door incident was significant. This would have been a domestic takeover — the purchaser, the target and the third party all were Japanese companies. In addition, the purchaser was willing to go to court, even though the Japanese generally are not litigious. Furthermore, the court was willing to enforce the purchaser's rights. Therefore, it appeared in 2005 that hostile takeovers were becoming a reality in Japan. Since then, although there have been a number of high-profile takeover disputes in Japan, there were only a few takeovers that might be characterized as "hostile." In other words, there is still a failure in the market for corporate control. As a result, the revised Corporate Law has not operated as the kind of engine of change that it was intended to be.

METI takes steps

Recently, the Ministry of Economic Trade and Industry (METI) has recognized this market failure and taken steps toward making hostile takeovers a genuine possibility in Japan. On June 30, the Corporate Value Study Group issued a report titled, "Takeover Defense Measures in Light of Recent Environmental Changes." The report, which was well received and has been commended by the American Chamber of Commerce in Japan, takes on many of the practices that have been adopted by Japanese management in order to avoid hostile takeovers. It proposes a legal and policy framework that, if followed, would help ensure that hostile takeovers will occur unless management of the target company can demonstrate that the proposed price is too low.

In addition, it argues that management should be held responsible for appointing an independent board. The report was prepared by a multidisciplinary group of lawyers, academics and representatives of manufacturing and financial companies. It demonstrates the growing breadth of Japanese society that supports hostile takeovers as a way to better align management's interest with shareholders and to protect shareholder interests generally.

METI is not alone in pursuing corporate governance reform. The Tokyo Stock Exchange (TSE) also is taking positive steps. In June 2008, the TSE circulated an English-language survey to foreign investors, asking for opinions as to how the exchange should prioritize its reform efforts. The survey addressed the causes of the failure of the market for corporate control, and identified the key issues that would have to be resolved in order to create such a market. In the survey, the TSE asked foreign investors to identify which issues were highest priority to them. Since foreign investors provide more than one-third of the turnover in the Japanese market, foreign opinion is important to the TSE.

Bulldog Sauce's poison pill

One reason that hostile takeovers do not take place in Japan is that there are inadequate protections against arbitrary or discriminatory dilution. The lack of adequate protections was demonstrated to dramatic effect in the famous dispute between Steel Partners LLC and the Bulldog Sauce Co. Ltd. In the Bulldog Sauce case, a takeover defense, or "poison pill," was exercised and Steel Partners' share of ownership in the company was diminished to one-quarter of its original share. Steel Partners went to court to enjoin execution of the poison pill, but the shareholders had voted in favor of exercising the pill even though exercising the pill would cost the company more than $18 million. Bulldog Sauce Case, Vol. 61 No. 5 Saibansho Minji 2215 (Japan Sup. Ct. 2007). See also "Japanese sauce maker launches takeover defense against U.S. fund," Int'l Herald Tribune, July 11, 2007.

This procedure was acceptable under guidelines jointly published by METI and the Ministry of Justice. The official (nonbinding) translation of those guidelines says:

"It does not run counter to the principle of shareholder equality to allot new shares or stock acquisition rights only to shareholders other than the acquiring person." Ministry of Economic Trade and Industry and Ministry of Justice, "Guidelines Regarding Takeover Defenses for the Purposes of Protection and Enhancement of Corporate Value and Shareholder's Common Interests," Id. at 7 May 27, 2005.

Given this rule, it is not surprising that the Japan Supreme Court, after determining that the shareholder vote had been properly taken, upheld the vote and did not enjoin the takeover defense measures. Id. The TSE, which could solve this problem by creating a rule to prevent arbitrary and discriminatory dilution, has raised this issue in its survey of foreign investors.

Another reason that hostile takeovers are virtually impossible in Japan today is that listed companies can issue new shares through private placement to third parties without providing transparent disclosure about those third parties. As the white paper puts it:

"It has become increasingly evident in recent years that some Japanese companies are using third-party share placements, not as a legitimate means of raising necessary capital, but rather as a way of manipulating their shareholder registers in order to ward off unwelcome corporate bidders." White paper at 24. The solution is to introduce pre-emption rights so that shareholders have adequate prevention against such dilution. The United Kingdom has a system that prevents this sort of dilution, and the TSE could adopt a similar rule. Again, the TSE is aware of this issue and has solicited foreign opinion on this issue in its survey.

A web of alliances

One reason that shareholders do not oust management in Japan is that Japanese management makes extensive use of cross-shareholdings. Japanese management argues that such cross-holdings result in business alliances and are beneficial to the companies. However, foreign investors are skeptical of such cross-holdings.

This issue is well explained in the white paper, which identifies a concern that such cross-shareholding may be used to form voting pacts. Id. at 33. Although such cross-shareholdings decreased in the 1990s, they are increasing again these days. Id. Such cross-holdings are difficult to justify. When a company purchases shares in another company, it is maintaining an asset that is not related to its core business. Moreover, if that company votes in favor of management instead of in its own interests as shareholders, then it runs the risk of perpetuating inefficiencies and thereby causing harm to the common interests of shareholders.

The experience with cross-holdings in other countries has been quite negative. For example, the use of cross holdings was extremely harmful in South Korea. See E. Han Kim & Woochan Kim, "Changes in Korean Governance: A Response to Crisis," J. Applied Corp. Fin., Vol. 20, Winter 2008, 42-53.

One way to try and limit the negative effects of cross-holding would be to require listed companies to publicly disclose the full results of their shareholder votes promptly after the votes are taken. There is no reason to keep such votes confidential, and if they were public, investors might be able to see whether cross-holding companies were voting responsibly or not. However, an anonymous "Japanese analyst," quoted in the white paper, proposed an even more radical solution: Japan should enact legislation along the lines of the Employee Retirement Income Security Act (ERISA) that would obligate institutional investors to vote their shares in accordance with the interests of account holders.

That analyst said: "Without ERISA-type legislation, it's hard to hold trust banks (who manage the lion's share of pension assets in Japan) and other asset managers accountable for their voting behavior. Some have confessed to me that while they were inclined to vote in favor of some of the activist's proposals for higher dividends in 2007, there were occasions when the parent bank or insurance firm 'interfered' with the final vote." White paper at 34.

The white paper itself does not go so far as to propose ERISA-type legislation, but instead proposes a law that would require institutional investors to disclose their voting records so as to minimize potential conflicts of interest. Id.

While many things would need to change before shareholder rights and management's rights in Japan become more evenly aligned, the reforms already have had meaningful effects. This past year, many Japanese companies raised their dividends in response to pressure from shareholders. Furthermore, in the first half of 2008, listed Japanese companies conducted a record 2 trillion yen in share repurchases. "Share Buybacks Top ¥ 2 Trillion for First-Half Record," Nikkei Weekly, Aug. 4, 2000. Foreign shareholders were able to oust management in the high-profile Aderans Holding Co.

Ltd. proxy vote.

These developments would have been almost unthinkable five years ago. And foreign investors are have taken notice. For example, on Aug. 6, *Investor's Business Daily* ran an article claiming that because of a number of developments including Japan's "embrace of shareholder rights," we could see a bull market in Japan in 2009. Joanne von Alroth, "Bear Market in Japan May Be Nearing End," IBD, Aug. 6, 2008.

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