Japan Begins to Accept Shareholder Rights

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By David Makman
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Even though the United States is in the middle of a financial crisis, it is worth remembering that our capital markets are supported by a highly sophisticated legal system that has evolved over decades into an enviable source of economic resilience. When functioning smoothly, our laissez-faire system includes checks, balances and incentives that are intended to operate as an "invisible hand," as economist Adam Smith put it, ensuring that, on a macro-economic scale, corporate resources are used efficiently.

The market for corporate control serves as the fundamental building block of our system of checks and balances. Specifically, when management of a publicly listed corporation is not taking enough risks or, for some other reason is generating an unreasonably low return on capital, two things can happen that should rectify the situation: Shareholders can oust management, or else anyone who thinks they can obtain a better return from the assets of a publicly listed company can make a hostile takeover attempt by offering to purchase the company at a premium over the market price of the outstanding shares in the company.

Our legal system recognizes the benefits of such transactions and tries to guarantee their integrity and efficiency. As a result, the United States has perhaps the most active and efficient market for control of publicly listed corporations in the world.

Many aspects of U.S. business culture can be viewed as a direct result of the fact that this market for corporate control exists and is well supported by our courts. For example, officers in publicly listed U.S. companies recognize that shareholders' rights are strong in this country and take steps to protect themselves: They get insurance to protect themselves from liability in shareholder derivative lawsuits and they seek compensation ("golden parachutes") to protect themselves in the event that control of the company is taken away from them.

For another example, companies recognize the advantages of hiring independent outside directors. Though the reasons for hiring such directors may vary from company to company, one is for an advantage in litigation over issues relating to corporate control. For a third example, U.S. companies provide shareholders with far more information than companies do in other countries.

ASIA MARKETS

The value and complexity of our system becomes particularly apparent when one looks at capital markets in Asia, where shareholder rights are so weak that management can entrench itself, and the market for corporate control fails.

In emerging markets like China and India, shareholders don't oust management, corporate balance sheets are opaque, and hostile takeovers are not part of the landscape. Those stock markets have thrived in recent years, but their success has been based on the compelling growth story of the underlying economy. The rapid growth and lack of detailed disclosure obligations in these economies can cover up a lot of inefficiency.

In contrast, Japan has great wealth and great intellectual capital, and has had an active stock market for decades. Yet, Japan's economy has matured, and its capital markets, which were developed during a long period of sustained rapid economic growth, are not adequate for the needs of the current economy. In particular, shareholders do not have strong rights in Japan, and there is no meaningful market for corporate control.

As a result, there is no "invisible-hand" mechanism that will prevent inefficient management from entrenching itself at the expense of shareholders. Japan appeared to have recognized this in 2005, when the corporate law was modified to allow for hostile takeovers. However, the 2005 legal reforms were not sufficient to create a market for corporate control. Since those reforms, management has protected itself by enacting poison pills and increasing cross shareholdings.

Based on economic theory, one would expect to see greater inefficiencies in a country where there is no market for corporate control. In fact, it appears that listed companies in Japan could be getting substantially better returns on capital.

The question of whether or not a corporation is making efficient use of its assets can be measured by looking at return on equity. Although return on equity does not, alone, tell the full story about corporate efficiency, it is a good measure because it captures many different kinds of inefficiencies. For example, companies that are investing in businesses that are not profitable will have low return on equity. In addition, companies that are insufficiently leveraged or otherwise risk-averse, e.g., companies that maintain large amounts of cash without issuing dividends or buying back stock, will have low return on equity.

In Japan, the Pension Fund Agency, a Japanese quasi-government pension fund, has set a sustained 8 percent return on equity as the threshold return that Japanese companies should meet in order to qualify as a good performer.

Recently, Kevin Haag, an analyst at KPH Capital, did a study of the 125 most liquid large-cap listed companies in the Japanese economy. He found that even in March 2006 when the Japanese stock market was near a peak, 32 percent of these companies were poor performers, meaning that they were not able to maintain an average 8 percent return on equity over a sustained period of five years.

Today, due to the global economic slowdown, even fewer Japanese companies can meet this sustained 8 percent return-on-equity threshold. These large-cap companies are the engines of the Japanese economy, and the high number of companies in this category that have low return on equity leads this writer to conclude that the Japanese economy

genuinely has substantial untapped potential — potential that could be unleashed if Japan were to change its corporate governance rules.

CHANGE IS AFOOT

The Japanese appear to have recognized the need for corporate governance reform. In 2005, Japanese corporate law was revised, and hostile takeovers became possible. The new law has had some effect, and we are starting to see changes in Japanese practice and corporate culture.

For example, Japanese publicly listed companies are paying higher dividends. In addition, in May of this year, for the first time, foreign shareholders ousted management in a Japanese company. The company was called Aderans. Steel Partners, an activist fund that is based in the United States, now has a seat on the board at Aderans. In addition, the Tokyo Stock Exchange is soliciting comments on corporate governance issues from foreign investors.

Perhaps most importantly, however, on June 30 — after the 2008 proxy season was closed — the Corporate Value Study Group of the Ministry of Economy, Trade and Industry released a report relating to hostile takeovers. It argues that takeover defense measures should not be adopted or invoked for the purpose of protecting internal management because such use of takeover measures undermines shareholder rights and impedes the efficient allocation of capital.

The report was immediately cited by activist fund Steel Partners and in a letter to takeover target Sapporo Holdings Ltd. If the recommendations in the report are also adopted by the Japanese courts, we could see a market for corporate control develop in Japan — a development that could create sustained pressure on management and increase returns on equity throughout the Japanese economy.

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