Amendment of the Company Law of Japan: Constraining Managerial Self-interest and Inherent Conflicts

- A Proposal -

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The Problem

- The Democratic Party of Japan is now amending the Company Law
- Neither listing rules nor the Company Law require outside directors, and because the law provides no definition of “independence”, the concept is not well understood even if it is badly needed to deal with many situations
- The legislative quest to “ensure healthy corporate governance” has lost direction and is stalemated. The all-powerful business lobby is opposed to requiring independent non-executive directors, but offers no better alternative
- Economic studies show that even one outside director on a Japanese board results in out-performance and greater reliability of profit forecasts. But the “optimal number” may depend on the company, and recent history from the U.S. example does not make it very popular
- Japan’s Company Law has some very pro-shareholder aspects that could support rapid improvement of corporate governance, given the right “base”
- In this situation, what is the most constructive thing to propose?

Background

- In 2009, the Democratic Party of Japan's (DPJ) election "Manifesto" proposed to create a "Public Company Law to "ensure healthy corporate governance and strengthen audits and disclosure", with the objective of causing companies to "fulfill their responsibilities to all stakeholders"
  - Early draft versions had explicitly proposed that the new law require outside directors on boards. Demands by Labor Union Federation that public companies be required to install one statutory auditor (*kansayaku*) "to represent employees" caused this language to be taken out, presumably because DPJ did not want to attract attention by proposing both concepts
  - The DPJ's "Project Team" proposed an ambitious list of other changes in addition to these, some constructive, others highly complex and hard to implement in Japan's legal system

公開会社法の制定 (From the DPJ's Manifesto)

株式を公開している会社等は、投資家、取引先や労働者、地域など様々なステークホルダー（利害関係者）への責任を果たすことが求められます。公開会社に適用される特別法として、情報開示や会計監査などを強化し、健全なガバナンス（企業統治）を担保する公開会社法の制定を検討します。

Fast Forward

- Per the usual process, the Legal Structure Advisory Council's Company Law Subcommittee was convened in April 2010
  - Composition of the Subcommittee: almost no legal practitioners or representatives of investors. Majority of non-bureaucrat members are academics with limited practical experience. Discussion so only skims the surface
    - <u>Gone from the agenda</u>: all references to "Public Company Law" and the clear presumption that one purpose is to install more than one outside director. <u>Remaining on the agenda</u>: (a) "the appropriate type of corporate governance", and (b) parent-subsidiary dealings and conflicts
  - The Subcommittee and the MOJ are exercising "parental guidance"
  - Perspective of the MOJ: "*This is the third amendment of the law in the last eight years…what more really needs to be done*? *And we are not in charge of protecting investors and market credibility…the FSA is in charge of that politically risky swamp."*
  - The FSA formed a "Corporate Governance Discussion Group" (I was a member). But all bureaucrats want to keep their heads *especially* low in the current political climate. Effectively disbanded earlier this year

Company Law Subcommittee Meeting – 8/25/2010

- One main topic for discussion: “the appropriate form of corporate discussion, including the possibility of requiring outside directors on boards”. The MOJ’s preparatory memo outlined three major possible reasons for requiring appointment of outside directors*: *(* ”Independence” was downplayed.)*

  1. Giving advice to managers

  2. Oversight and monitoring of all management activities, by evaluating managers, deciding upon nominations and terminations, and participating in major business decisions

  3. Monitoring situations and transactions where the interests of managers are conflict with the interests of the company

- The main MOJ memos did not describe much about foreign jurisdictions, their logic, and similar topics that might have been instructive. Debate was long, conceptual, and shallow, with most Subcommittee members referring to (2) and (3) as the most plausible “reasons”. But based on an informal poll, everyone except one member saw no compelling reason to require outside directors

Company Law Subcommittee Meeting – 11/16/2011

- MOJ Briefing Memo: re mandatory appointment of "outside directors" (*note, not "independent outside directors"):*

  A) All companies without transfer restrictions (= public companies) must appoint <u>one</u> outside director

  B) All companies that must submit financial statement to the authorities (= public companies) must appoint <u>one</u> outside director

  C) No change in the present rules

- Re the proposed (*optional*) "Supervisory audit committee-style company":

  - Committee: at least 3 in number. A majority must be "outside" directors (not independent directors). The others can be former employees of the company or a subsidiary, etc. The committee has generally the same authorities as the audit committee of a committee-style company, except that it can "voice its opinion" with regard to the appointment or termination of directors and there are some features that are intended to ensure that the committee is "independent" and has more power, but only indirectly. The committee may be able to release managers from assumed liability in conflict-of-interest situations as would occur per Article 423 (3)

  - The board can streamline decision-making by delegating major asset sales/purchases, or major borrowings, to an individual director

DPJ To the Rescue (??) – DPJ "Working Team" Had its First Meeting at the End of November – Everything Now in Confusion

- Claims that it will examine all areas of the law and regulation, including Company Law, securities law, and audit practices etc.
  - Sort of a tall order….
  - Usually, such breadth confers a lot of "wiggle room" to find **something** "that we can say we did, to fix things others (MOJ) had not fixed enough…"
- Working Team includes some very constructive and sincere members, but also some who view a lot of deregulation as having been forced on Japan by the U.S. for its own interests
- Seems to want to push for requiring one or more outside directors, and giving some limited but greater voice to statutory auditors (can select auditors, maybe decide compensation)
  - But at end of day, do they really mean just "one" outside director? What can one guy do on board of 10+?
  - Historically, "strengthening the role of statutory auditors" is a politically convenient concession to management, which likes its obedient, hand-picked non-voting claim to "neutrality on the board". (The statutory auditor system has some underutilized strengths, but at present, it is all too convenient for everyone.)

Realities

- The concept of having a representative of employees on the board was dead on arrival
- Laws for fiduciary duty are weak, there is no ERISA equivalent, cross-shareholdings keep many institutions quiet, and insurance firms have fiduciary duty with respect to most holdings
- This presents a problem for the Subcommittee. There are no loud-voiced lobby groups that need placating except one or two foreign groups. Many Japanese investing institutions actually want progress, but are only willing to be the 50th person to jump on the bandwagon
- Despite the Manifesto plank, - especially until the Olympus scandal, - many in the distracted DPJ not many members are willing to show that they care about corporate governance reform, as it can be misinterpreted by pro-labor elements. So, the DPJ did not “guide” the Subcommittee”, the risk-averse MOJ does. So far, DPJ did has not delivered its promised “political guidance” (*seiji shudo)*
- The FSA has the legal authority and could have done everything the UK’s FSA has done since 1992. Though they have recently taken some steps to improve governance, progress is very slow
- The Keidanren is vehemently opposed to the idea of requiring outside directors. Politically, this makes it very tough for an outright “requirement” rule to be passed into law. The “ supervisory audit committee company” structure is really being proposed as a third option precisely in order to avoid any form of “requirement”
- Japanese law does not allow the board to form or entrust decisions to legally valid “committees” of the board. The board can only function only as a full board. *(Exception: the three committees required for “committee-style companies; but only for those committees)*

Basis of My Proposal - General

- The most important reason to have independent outside directors is to be able to entrust to them decisions for which disinterestedness and neutrality are vitally important, but managers have an inherent (if latent) conflict of interest, such as:
    1. Nominations and terminations of board members (includes statutory auditors)
    2. Determination of the compensation of board members (in practice:”internal” board members)
    3. Resolutions that could have an impact on “control” of the company, such as the adoption or triggering of takeover defenses, MBOs and certain M&A transactions, special investigations about malfeasance, etc.

- This was the general thinking that drove the evolution of corporate governance in the U.S., the U.K., the European Commission’s rules, and elsewhere. The proposal quotes from the Cadbury Committee Report, a report by the EC, and Professor Gilson’s “The Poison Pill in Japan: The Missing Infrastructure”

- Japan also needs to consider the special problems posed by its weak system for discovery, which makes it difficult for plaintiff shareholders to obtain enough evidence to sue directors, - especially when the vast majority of directors are managers

- The proposal also outlines the results of research by economists Fukao, Abe and Jung, and Saito showing the need for governance improvement, and the economic/market benefits of improving governance and/or having outside directors

Basis of the Proposal – Legal Aspects

- Creating a statutory basis for the flexible creation of board *committees* when needed, for any purpose is complex and runs against legal training in Japan

- However, Article 373 of the current Company Law provides a very convenient base to work from. (This is limited to sales/purchases of large assets, and large borrowings)

(Article 373: Resolution of Board of Directors by Special Directors)

Notwithstanding the provisions of Article 369(1), in cases where a Company with Board of Directors (excluding a Company with Committees) falls under all of the following requirements, the board of directors may provide to the effect that the resolution of the board of directors on the matters listed in item (i) and item (ii) of Article 362(4) may be made, where the majority (in cases where a higher proportion is determined by the board of directors, such proportion or more) of three or more directors appointed in advance (hereinafter in this Chapter referred to as "Special Directors") who are entitled to participate in the vote are present, by the majority (in cases where a higher proportion is determined by the board of directors, such proportion or more) of such directors present:

(i) That there are six or more directors; and

(ii) That one or more of the directors are Outside Directors.

(2) In cases where there is a provision on the vote by Special Directors pursuant to the provisions of the preceding paragraph, directors other than the Special Directors shall not be required to attend the board of directors meeting that decides the matters listed in item (i) and item (ii) of Article 362(4).

(Note: An Article 373 meeting is an *actual meeting of the board of directors*. It is not a committee. Accordingly, all the normal procedural requirements apply: statutory auditors must be present, minutes must be kept, a vote must be taken, etc.)

The Proposal

- **With respect to statutorily defined board decisions with respect to which managers have an inherent conflict or self-interest, all public companies will have a choice**:

  - "Appoint (in advance) 3 independent directors that meet a detailed definition of "independence" subject to "comply or explain" disclosure on an ongoing basis, and use them to compose a "special board" [per a newly drafted Article 373 (2)] that is solely comprised by those directors. In this case, the business judgment rule will operate in the usual fashion: the plaintiff bears the full burden of proof, with the likely result that only rarely is anyone held liable;"

  OR

  - "Don't appoint any independent directors if you don't want to, and/or you are extremely confident about your decision-making. In this case, with respect to the pre-defined types of board decisions, IF there is damage ostensibly caused by such a board decision and a director who voted for it is sued in a shareholder derivative action, there will be a rebuttable presumption that the director has breached his or her duty of due care. That director can rebut the presumption with a showing of facts and an explanation. (At the same time, note that the *plaintiff* shareholder will still bear the burden of proving damages and causation.)

- **The defined types of board decisions are:**
  1. Nominations and terminations of board members (includes statutory auditors)
  2. Determination of the compensation of board members
  3. Resolutions that could have an impact on "control" of the company, such as the adoption or triggering of takeover defenses, MBOs and certain M&A transactions

Logic

- There is widespread opposition to the concept of “requiring” independent outside directors, but conversely, much agreement with notion of “letting companies choose what is best for them”. However, if we provide companies with a choice, we must design the law so that it ensures that in either case, *most boards* will have sufficient incentives to make the correct decision for the company and shareholders, *most of the time*. A rebuttable presumption about due care should be sufficient to for this purpose, with the plaintiff retaining the burden of proving damage and causation. (With regard to the risk of spurious lawsuits, note that if there is no damage or causation is obviously not present, claims will be summarily rejected by the court. Note also that damages are paid to the company, not the shareholder, in shareholder derivative actions.)

- Shifting the burden of proof by way of stipulating a rebuttable presumption is not that rare in Japan. This is a technical solution that provides a effective way to achieve much of what is needed in this case, without imposing (hated) rules requiring independent directors. Because it is a technical solution, it may encounter less stubborn resistance, and the numerous academics on the Subcommittee will understand it. And many in the public may agree that “if directors are confident about their decisions, they have nothing to worry about. That is what accountability is.”

- Presently, especially in situations involving takeover defenses, M&As or MBOs it is often not clear how one should interpret the Company law provisions with regard to duty of loyalty (Article 355), restrictions on competition and conflicts of interest (Article 356), and interested party transactions (Article 369). An internal director acting in good faith could well conclude that he should probably recuse himself from voting in some of these situations on the one hand, but could be liable for “irresponsibly” not voting on the other hand. Present law provides him (and the company) with no clearly safe option for him to not vote

- For the healthy development of corporate governance in Japan and to improve trust in the market, it is vital that the next amendment of the Company Law provide a clear definition of “independence”, so that the concept can take root. If companies have to explain in which respects nominees do not meet the definition and justify their reasons for nominating even so, investors will be able to better differentiate between companies than at present (because the current definition of “outside” means almost nothing other that simply “not a manager”)

- The proposal could be extended to solve the “*nejire mondai*” (twisted incentives problem) and related issues. (This refers to the contradictions caused because the Statutory Auditors Council effectively only has a veto right on the selection of the outside audit firm and its compensation. Said another way, boards controlled by managers are both nominating statutory auditors and (for all practical purposes) selecting the audit firm that audits executives, and negotiating the audit firm’s compensation)

Expected Impact

- Somewhat similar to the U.S. historical example in 1975-1990, lawyers will start advising their clients that the safest thing for both the company and their personal liability would be to simply appoint at least three independent directors. D&O insurance providers will advise the same thing, and may raise their rates if they are not heeded. Over time, more and more companies will take the advice

- Even so, at first many companies will not so appoint. However, their lawyers will advise those companies more carefully than at present with respect to case law about the duty of due care. Different from the U.S. example, Japanese judges sometimes DO enter the realm of “substance” (in deciding whether a particular business judgment actually was reasonable under the circumstances) from time to time, using their wide powers of discretion. There is no prohibition to doing so; and some judges like to exercise that discretion

- As a result, - at the very least – *all* boards will probably be more careful than at present about keeping detailed records, conducting necessary analysis, hiring appropriate advisors, and justifying their decisions with concrete facts, logic, and process

- The proposed amendment offers an alternative by which: a) executives who presently bear not-insignificant risk for participating in the defined board decisions can avoid that risk; and b) Japanese executives who have performed well can also (appropriately) use the special board as an appropriate mechanism for obtaining approval of proposals to increase their performance-linked compensation, something that is necessary to improve managerial incentives. (However, unlike the greed that this dynamic generated in the U.S., things will not get out of control because remuneration bloat is inherently limited by the Japanese Company Law’s requirement that shareholders approve the total amount of director compensation)

- In cases where poor judgment is suspected, plaintiffs will have many more opportunities for discovery than exist at present. Since the burden of proof re due care will be borne by defendant(s) in the second bulleted case above, more information will be forthcoming at the outset of lawsuits. Under Japanese discovery rules, this makes it much easier to get more information. (For instance, in Japan one can only demand that a document be produced if one already knows it exists and can clearly identify it.) In many cases, if the initial rebuttal evidence is weak, counsel will advise the defendant to settle quickly and save reputations

- With more evidence to work with, Japanese judges will make better decisions, and may even be able to develop Delaware-like “standards” over time, if necessary

Appendix - Pertinent Facts and Excerpts

1) About 75% of the “independent board members” appointed pursuant to the new TSE rule are statutory auditors, not directors (and therefore cannot vote on board decisions)

2) Japan Company Law has some very pro-shareholder aspects: a) full access to the proxy, and b) total director compensation (or a cap on it) must be approved by shareholders

3) Excerpts from relevant sections of the Company Law:

(Duty of Loyalty)

Article 355 Directors shall perform their duties for the Stock Company <u>in a loyal manner</u> in compliance with laws and regulations, the articles of incorporation, and resolutions of shareholders meetings.

(Resolution of Board of Directors Meetings)

Article 369 The resolution of a board of directors meeting shall be made by a majority (in cases where a higher proportion is provided for in the articles of incorporation, such proportion or more) of the directors present at the meeting where the majority (in cases where a higher proportion is provided for in the articles of incorporation, such proportion or more) of the directors entitled to participate in the vote are present.

<u>(2) Directors who have a special interest in the resolution under the preceding paragraph may not participate in the vote.</u>

Appendix – - Pertinent Facts and Excerpts

Excerpts from relevant sections of the Company Law (cont'd)

(Restrictions on Competition and Conflicting Interest Transactions)

Article 356 In the following cases, a director shall disclose the material facts on the relevant transactions at a shareholders meeting* and obtain approval of the shareholders meeting [board of directors]*:

(i) If a directors intends to carry out, for himself/herself or for a third party, any transactions in the line of business of the Stock Company;

(ii) If the director intends to carry out any transactions with the Stock Company for himself/herself or for a third party; or

(iii) If a Stock Company intends to guarantee debts of a director or otherwise to carry out any transactions with a person other than the director that results in a conflict of interests between the Stock Company and such director.

(2) The provisions of Article 108 of the Civil Code shall not apply to the transactions under item (ii) of the preceding paragraph that are approved under that paragraph.

* Note: per Article 365, "For the purpose of the application of the provisions of Article 356 to a Company with Board of Directors, "shareholders meeting" in paragraph (1) of that article shall be read as "board of directors." "

Appendix - Pertinent Facts and Excerpts

Excerpts from relevant sections of the Company Law (cont'd)

(Authority of Board of Directors)

Article 362 Board of directors shall be composed of all directors.

(2) Board of directors shall perform the following duties:

(i) Deciding the execution of the operations of the Company with Board of Directors;

(ii) Supervising the execution of the duties by directors; and

(iii) Appointing and removing Representative Directors.

(3) Board of directors shall appoint Representative Directors from among the directors.

(4) Board of directors may not delegate the decision on the execution of important operations such as the following matters to directors:

(i) The disposal of and acceptance of assignment of important assets;

(ii) Borrowing in a significant amount;

(iii) The election and dismissal of a important employee including managers;

(iv) The establishment, changes or abolition of important structures including branch offices;

(v) Matters prescribed by the applicable Ordinance of the Ministry of Justice as important matters regarding the solicitation of persons who subscribe for Bonds such as the matters listed in item (i) of Article 676;

(vi) The development of systems necessary to ensure that the execution of duties by directors complies with laws and regulations and the articles of incorporation, and other systems prescribed by the applicable Ordinance of the Ministry of Justice as systems necessary to ensure the properness of operations of a Stock Company; or

(vii) Exemption from liability under Article 423(1) pursuant to provisions of the articles of incorporation under the provisions of Article 426(1).

(5) A Company with Board of Directors that is a Large Company shall decide the matters listed in item (vi) of the preceding paragraph.

Appendix – - Pertinent Facts and Excerpts

3) Excerpts from papers by Professor Takuji Saito, Faculty of Economics, Kyoto Sangyo University

“The Determinants of Board Composition when Managers Control Director Selection: Evidence from Japan” (2010)

“This paper investigates the determinant of board composition using a sample of large Japanese firms from 1997 to 2008. In Japan, governance regulations do not mandate, but only encourage firms to have more outside directors, most of firms do not have nominating committee and most of boards are dominated by insiders. Because of these features, we argue that managers can heavily influence director selection in most of Japanese public firms.

We find that the determinants of board composition of Japanese firms are different from those of US firms, which have decreased CEO influences in director selection. Firms with low R&D intensity or high free cash flow have a smaller proportion and number of outsiders on boards and a lower likelihood to have at least one outside directors on boards, suggesting that <u>Japanese boards of directors tend to be less independent in firms where outside directors effectively monitor management. In other words, board of directors is structured in ways consistent with the manager’s preferences, which are not aligned with shareholder’s interest, when managers can control director selection</u>. Furthermore, this tendency is stronger after the revision of Japanese Commercial Code, which do not mandate but only encourage firms to have more outside directors on boards.”

Appendix – - Pertinent Facts and Excerpts

(Professor Takuji Saito, Kyoto Sangyo University)

"Presence of Outside Directors, Board Effectiveness and Firm Performance: Evidence from Japan" (2009)

This paper examines whether the presence of outside directors affect the board effectiveness and firm performance by studying the board of directors in Japan, where many firms have recently introduced outside directors into all-insider boards. These introductions allow us to econometrically compare the effects of board with outside directors to those without. <u>We find that introductions of outside directors into all-insider boards significantly improve operating performance and firm value. In addition, we find that when the firm has at least one outside director on the board, president turnover is more sensitive to firm performance and management earnings forecasts are more realistic and accurate. These results suggest that the presence of at least one outside director on the board is effective in monitoring and advising managers</u>…..

The role of outside directors in the board room has been a central issue in the corporate governance literature for several decades. But most of the evidence we have on this topic is drawn from setting where most public firms already have outside directors on their boards, which makes it impossible to econometrically identify the effects of the presence of outside directors, because there is no variation in the explanatory variable. <u>The Japanese setting allow us to compare the effects of board with outside directors to those without, and so provides evidence on how the presence of outside directors affects the board effectiveness and firm performance</u>."

Appendix – - Pertinent Facts and Excerpts

4) Professor Ronald J. Gilson, "The Poison Pill in Japan: The Missing Infrastructure", 2004

The second point is that the pill has "worked" in the United States – that is, it has been largely but not exclusively used to support seeking a better deal for shareholders than simply to block a bid – because independent directors, courts, and active institutional investors have all combined to police the uses to which the pill is actually put.

Appendix – - Pertinent Facts and Excerpts

5) Cadbury Committee, Code of Best Practice, 1992

4.4. … Non-executive directors have two particularly important contributions to make to the governance process as a consequence of their independence from executive responsibility….

4.5 The first is in reviewing the performance of the board and of the executive. Non-executive directors should address this aspect of their responsibilities carefully and should ensure that the chairman is aware of their views….

4.6 The second is in taking the lead where potential conflicts of interest arise. An important aspect of effective corporate governance is the recognition that the specific interests of the executive management and the wider interests of the company may at times diverge, for example over takeovers, boardroom succession, or directors' pay. Independent non-executive directors, whose interests are less directly affected, are well-placed to help to resolve such situations.

Appendix – - Pertinent Facts and Excerpts

6) COMMISSION RECOMMENDATION of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board

- Whereas….In its Resolution of 21 April 2004….the European Parliament called on the Commission to propose <u>rules to eliminate and prevent conflicts of interest….</u>

- Non-executive or supervisory directors are recruited by companies for a variety of purposes. <u>Of particular importance is their role in overseeing executive or managing directors and dealing with situations involving conflicts of interests. It is vital to foster that role in order to restore confidence in financial markets.</u> Member States should therefore be invited to adopt measures which would be applicable to listed companies, defined as companies whose securities are admitted to trading on a regulated market in the Community.

Appendix – - Pertinent Facts and Excerpts

7) One of the most important objectives of the Recommendation is to promote <u>the</u> **<u>presence and role of independent non-executive or supervisory directors in the major fields of potential conflicts of interest</u>** between management and shareholders….

- The main principles of the Recommendation subject to evaluation in this report are the following..

  - **Sufficient number of independent directors on the (supervisory) board:** it is recommended that <u>a sufficient number of independent non-executive or supervisory directors should be elected to the (supervisory) board of companies</u> <u>to ensure that any material conflicts of interest involving directors will be properly dealt with.</u> Independent directors also have a role to play in companies where a controlling shareholder may exert strong control over the management. In such cases, conflicts of interest may arise between the majority and minority shareholders. Independence from the controlling shareholder may be an efficient way of alleviating such conflicts.
  - <u>Creation of board committees for dealing with issues raising conflict of interest:</u> the Recommendation encourages the creation of nomination, remuneration and audit committees within the (supervisory) boards where these tasks are not the direct responsibility of shareholders.
  - <u>Strong presence of independent directors in board committees</u> and clear delineation of the role of such bodies: the Recommendation emphasises the need for a strong presence of independent non-executive directors in board committees.