The Turnaround of 1997: Changes in Japanese Corporate Law and Governance

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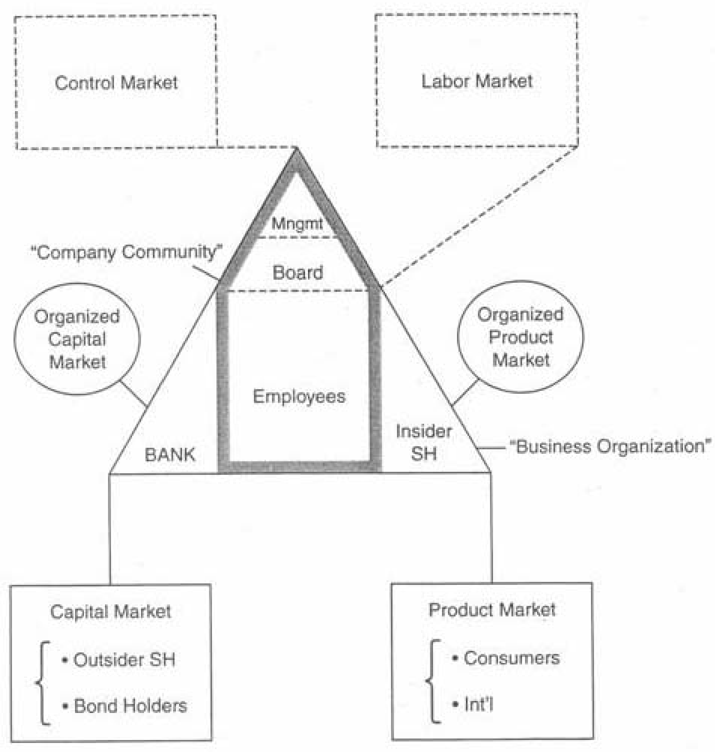
The Traditional J-Model

- "Company Community" centered
- Contingent governance



The Lost Decade and Malfunction of the Traditional J-Model

- The end of economic growth and emergence of free cash flow

  - The traditional J-model had trouble in monitoring the use of free cash flow.

- Retreat of main banks

  - The delegated monitor in the contingent governance lost their ability.

- Change in company community

  - Employment became less secure.

The Turnaround of 1997

- Failure of major financial institutions
  - Hokkaido Takushoku Bank
  - Yamaichi Securities
- Banks began to sell off *mochiai* stocks.
- Change of mind
  – Shareholders cannot be ignored.
- Voluntary reforms of corporate governance practice
  - Sony, Orix, Hoya, etc.
- Drastic reforms of corporate law

History of Japanese Corporate Law Reforms

- Demand-pull reforms: those initiated by the business sectors to enable a new practice.

  - To protect the autonomy of the company community from intervention by outsider investors.

  - To target the interests of shareholders.

  - Most demand pull reforms take the form of deregulation of mandatory laws.

- Policy-push reforms: those initiated by the legislature in a broad sense to change the practice.

  - To improve the monitoring of management.

  - To protect the interests of minority shareholders.

  - Most policy-push reforms take the form of mandatory regulation.

Demand-Pull Reforms since ‘97

- Repurchase of shares
- Stock options
- Simplification of merger procedures
- Holding companies
- Share-for-share exchanges
- Corporate divisions
- Limiting directors’ liability
- *Mandatory nature of Japanese corporate law has been changed by the demand-pull reforms.*

Policy-Push Reforms since ‘97

- Accounting reforms
  - Consolidated accounting
  - Mark-to-market accounting for financial assets
- Outside statutory auditors
- Board with committees as an option
- *The legislature finally intervened in the company community centered corporate governance.*

Convergence of Corporate Governance Debates

- Path dependence theory
  - Bebchuk & Roe (1999)
- Strong convergence theory
  - Ramseyer (1998); Hansmann & Kraakman (2001)
- Functional convergence theory
  - Coffee (1999); Gilson (2001)

Japanese Case as an Opposite Example

- Formal convergence of the legal system
  - You can do as Americans do.
- Functional divergence of internalized governance
  - Incentive patterns are different.

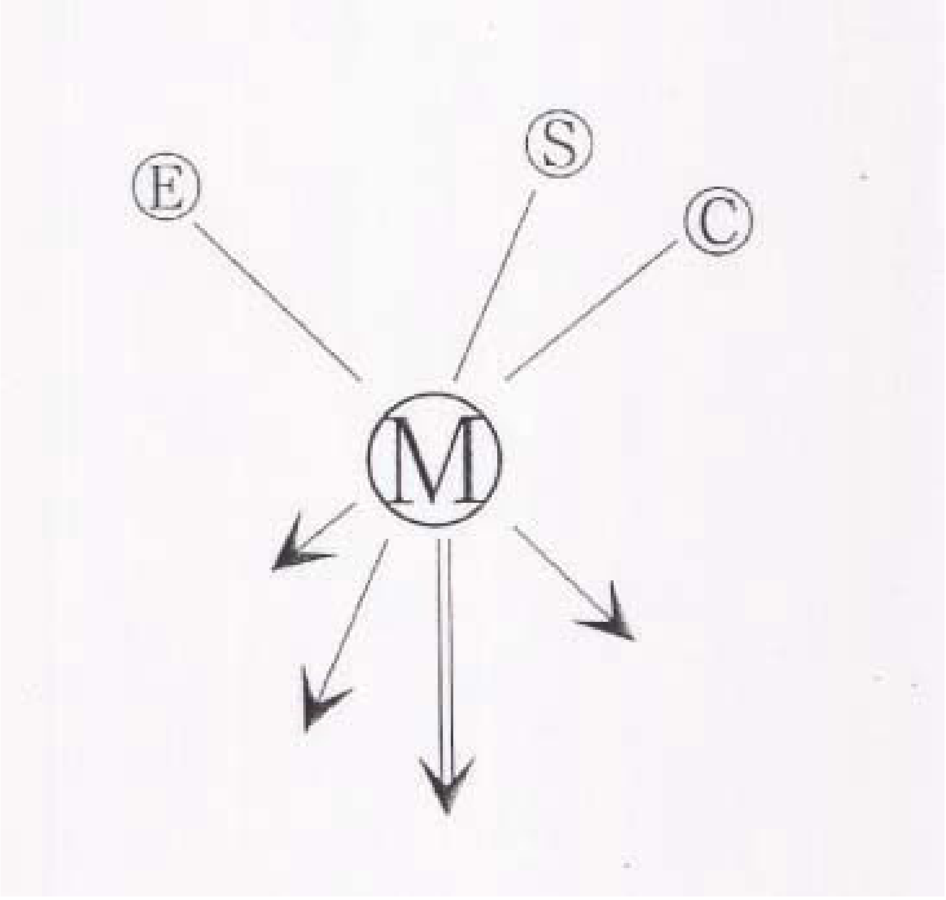
Firm as an Incentive Mechanism

- 4 players:
  - Shareholders, Creditors, Employees, & Management
- 2 different types of capital
  - Monetary capital & Human capital
- Each player must motivate other players to provide their capital in order to maximize their interest.
- Bargaining must always be made via management.

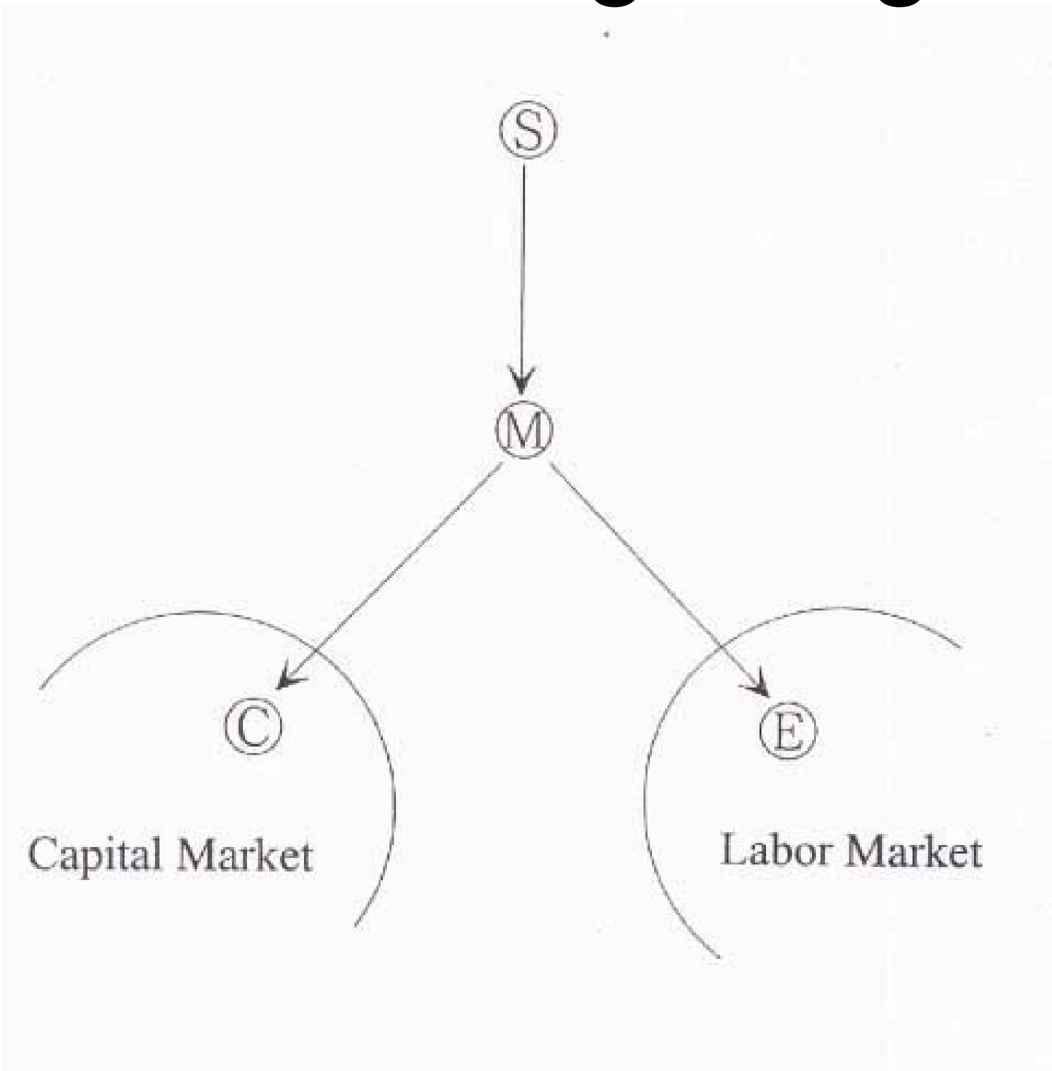
Three Incentive Patterns (Internalized Governance Systems)

- Balancing image
  - Berle & Means “Management control”
- Monitoring image (agency model)
  - A-model
- Bargaining image
  - SV-model, J-model

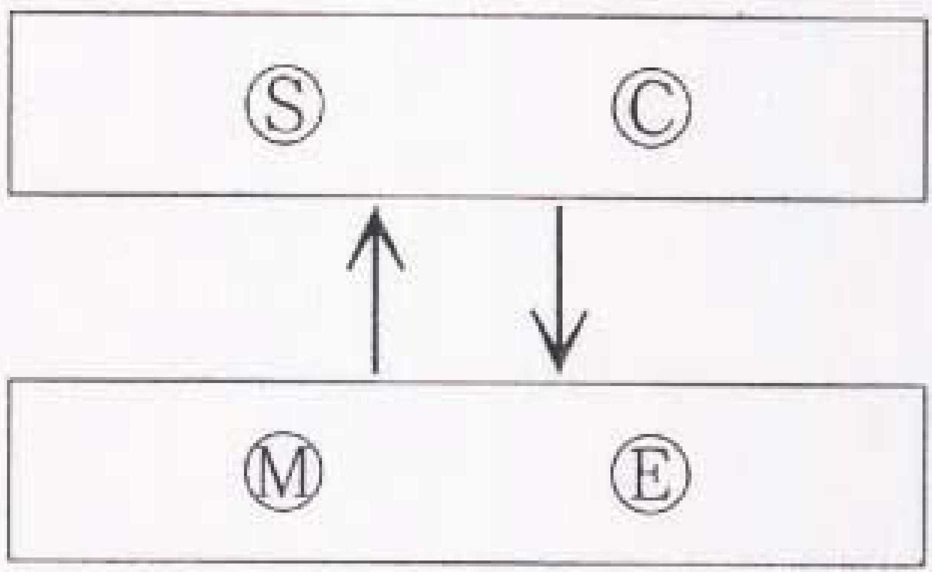
Balancing Image



Monitoring Image



Bargaining Image



Divergence of Internalized Governance

- Optimal internalized governance system (incentive pattern) will diverge depending on exogenous factors:
  – Market (capital and labor)
  – Legal system
  – Social norm
- Possibility of co-existence of plural internalized governance systems in a same country
  – Industry sector (importance of relation specific investment)
  – Growth stage of the company

The New J-Model

- Keep bargaining image
- Abandon contingent governance
- Bargaining board instead of monitoring board
- Insider-outsider parity board
- Infinitely repeated game and Folk Theorem