RIETI Discussion Paper Series 10-E-063

The Structure of Enterprise Law: Interrelationships among contracts, markets, and laws in the bargaining structure of the firm

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http://www.rieti.go.jp/en/

RIETI Discussion Paper Series 10-E-063
October 2010

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Abstract

The firm is an ongoing joint project requiring both financial and human capital. Like other joint projects, the firm cannot maximize added value without achieving an efficient incentive bargain among the indispensable capital providers, i.e., shareholders and creditors as the monetary capital providers, and management and employees as the human capital providers. To stimulate efficient incentive bargaining at the firm level and, consequently, to enhance the efficiency of the whole economy, I will propose a new concept, the "enterprise law," and define it as any law which will affect the incentive bargaining of the firm. We will draw the whole picture of incentive bargaining at the firm by focusing on the interrelationships and complementarities among contracts, markets, and laws; thereafter we will present some legislative policy implications.

Keywords: Contracts, Markets, Incentive, Corporate governance, Labor law, Bankruptcy law, Tax law

I. Introduction

The firm is a consecutive joint project among providers of indispensable capital, which includes both monetary capital and human capital, for the project. Like other joint projects, the firm cannot maximize the added value without achieving an efficient "incentive bargain"[1] among those indispensable capital providers, i.e., shareholders and creditors as monetary capital providers, and management and employees as human capital providers.[2]

Markets and laws are two basic infrastructures of the incentive bargain of the firm. Therefore, law matters for successful incentive bargaining among the four different capital providers. The important point is that law does not by itself affect the incentive bargain among those four players, but rather affects it interrelationally with markets. We can observe interrelationships among different markets, and interrelationships between law and contracts, too.

Also a specific law, in many cases, would not affect the incentive bargain independently, but affects it complementarily with other laws. Law has traditionally been studied by dividing a legal system into its many substantive parts. Now, however, we must adopt a new perspective in order to study law as an infrastructural element of the firm's incentive bargain. I will propose a new concept, the "enterprise law" and define it as any law which will affect the incentive bargain of the firm. To show the structure of the enterprise law, we need to not only gather different areas of law, such as corporate law, securities regulation, bankruptcy law, labor law, and tax law, but also analyze complementarities among different laws and interactions between law and markets. In other words, we cannot show you the structure of the enterprise law without drawing the whole picture of the incentive bargain of the firm, including interrelationships among different institutions.

The object of this paper and the object of the proposal to reconstruct legal systems, which affect the incentive bargain of the firm, as the enterprise law, is to stimulate efficient incentive bargaining at the firm level, and consequently, to enhance

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[1] The incentive bargain is defined as the bargain among the indispensable capital providers of the firm, for motivating each other to provide the capital they own to the joint project, including the bargain for sharing control and the bargain for sharing cash-flow.
[2] Zenichi Shishido, *Dokizuke no Shikumi toshiteno Kigyo: Insenthibu Shisutemu no Hoseido Ron* [*The Firm as an Incentive Mechanism: The Role of Legal Institution*] 1 (2006).

the efficiency of the whole economy.

It would be a big project to draw the complete picture of the enterprise law. In this stage, as a game plan, this paper will address four examples of different types of complementarities and interrelationships to provide the image of the whole structure of the incentive bargain of the firm and the enterprise law. In this paper, the model of the firm is a typical Japanese publicly held corporation in late 2000s, which has no controlling shareholder but stabilizes stock ownership by cross-shareholding.

In Chapter II, I will introduce a framework to see the firm as an incentive mechanism among the four players by providing three basic "incentive patterns." I also propose a concept of "enterprise law" as an important infrastructural element of the incentive bargain among the four players of the firm, and introduce five different types of interrelationships among different institutions. Chapter III will analyze the incentive of management and show you how different markets and laws interrelationally affect management's incentive. Chapter IV will examine the risk taking of management and illustrate how contracts and laws interrelationally affect it. Chapter V will focus on the trend of shareholder activism and show you how different laws complementary stimulate shareholder activism while other laws complementary discourage shareholder activism. In Chapter VI, I will characterize the reaction of Japanese management against the shareholder activism movement since 2005 as the "alliance against genuine shareholders" by dividing it into the coalition between cross-holding shareholders and management, and the coalition between employees and management. I will illustrate the interrelationship between the two coalitions. Finally, Chapter VII will provide a conclusion and some legislative policy proposals for enhancing the efficiency of the firm's incentive bargain.

II. The Firm as an Incentive Mechanism

A. The Incentive Bargain of the Firm

The firm can be understood as an incentive mechanism between those who provide human capital (management and employees) and those who provide monetary capital (shareholders and creditors). The human capital providers use the funds provided by the monetary capital providers and create value[3]. According to the

[3] Therefore, the human capital providers seek more autonomy and the monetary capital

contracts negotiated at the outset, the four groups of participants then share the returns that accrue to the firm. Each of the four groups provides capital that is crucial to their collective enterprise. Should one group hesitate to provide that capital, the enterprise will suffer. Therefore, the groups use the firm structure to give each other incentives to invest in a way that maximizes the firm's value added and maximizes each party's payoff [See Figure 1].

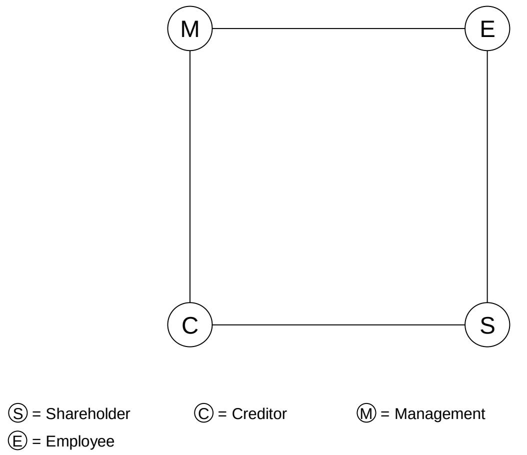

Figure 1

Those four players try to give incentives to each other through the bargaining over sharing cash-flow rights and sharing control. Such bargaining is always conducted via management, which functions as the sole bargaining window, although some coalition could be made among the 4 players. Therefore, there are three bargaining relationships in the firm: the bargaining relationship between shareholders and management; that between creditors and management; and that between employees and management [See Figure2]. As I will mention later, [4] we can observe interrelationships among those bargaining relationships.

providers want more monitoring power on how to use money. See id., at 38.
[4] *See infra* note 15.

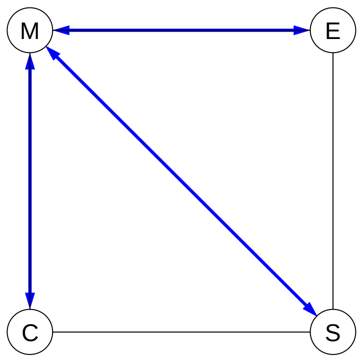

Figure 2

B. Three Incentive Patterns and Divergence of Internalized Governance

The differences between the "functional corporate governance" practices of different countries[5] will be revealed as the differences in "incentive bargaining"

[5] Interesting debates on convergence of corporate governance in the world have been made for the last decade (*See* Lucian Bebchuck & Mark Roe, *A Theory of Path Dependence in Corporate Governance and Ownership*, 52 STAN. L. REV. 127 (1999); J. Mark Ramseyer, *Are Corporate Governance Systems Converging?* (Working Paper, 1998); Ronald Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001); John Coffee, Jr., *The Future as History: The Prospects for Global Convergence and Its Implications*, 93 NW. U. L. REV. 641 (1999); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439 (2001)). Nowadays the participants in the debates realize that they should distinguish between the formal convergence of legal systems and the functional convergence of practices, and the prevailing view is that if formal convergence cannot be achieved, functional convergence will still occur (*See* Gilson, *supra* note 5, at 329; Coffee, *supra* note 5, at 641.). Two main topics of the functional convergence debate are the concentration of share ownership and the labor influence (*See* Bebchuck & Roe, *supra* note 5, at 127.).

The "strong convergence" theses argue that world corporate governance will converge or already have converged to the A-model(*See* Hansmann & Kraakman, *supra* note 5, at 439.). Contrary to the prediction and the recognition by those strong convergence theorists, however, "there is little sign that Japanese corporate governance practices are being fundamentally transformed or rapidly 'converging' with those of the United States" (*See* Curtis Milhaupt, *The Lost Decade for Japanese Corporate Governance Reform?: What's Changed, What Hasn't , and Why* (Working Paper 2003).).

In the convergence of corporate governance debate, diversity of stock ownership is practices among the four players in these countries, particular the way in which coalitions are constructed among the four players. We will call them "incentive patterns." There are three different incentive patterns for publicly held companies.[6]

Optimal internalized governance system, i.e., incentive patterns, will diverge depending upon exogenous factors: viz., markets (capital, labor, and product); social norms; and legal systems.[7] There is also the possibility of the coexistence of multiple internalized governance systems in a single country, depending upon the industry sector and the growth stage of the company. Different degrees of significance of relation-specific investment in each industry sector will be particularly influential on the choice of optimal internalized governance system.

1. Balancing Image

The basic incentive pattern is the "balancing image," in which, while there is no coalition among players, each player tries to pressure the management; as a consequence, the management will run the firm toward the direction of the sum of the vectors of pressure [See Figure 3]. That is the Berle & Means model.[8]

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mostly argued as the criteria of functional convergence. However, the most fundamental aspect of functional corporate governance system, which can be chosen by the players under certain exogenous conditions, is how to motivate monetary capital providers and human capital providers to invest their own capital to the company. I will call the aspect "incentive pattern." Diversity of stock ownership (and liquidity of stock market) is rather one of the exogenous factors, which restrict the choice of incentive pattern (*See* Zenichi Shishido, *The Turnaround of 1997: Changes in Japanese Corporate Law and Governance*, *in* CORPORATE GOVERNANCE IN JAPAN: INSTITUTIONAL CHANGE AND ORGANIZATIONAL DIVERSITY 310, 323 (Masahiko Aoki, et al. eds., 2007)).

[6] *See* Shishido, *supra* note 2, at 169.

[7] Legal systems, here, do not indicate jurisdictional bodies of law, but indicate bodies of substantive laws.

[8] *See* ADOLF A. BERLE GERDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

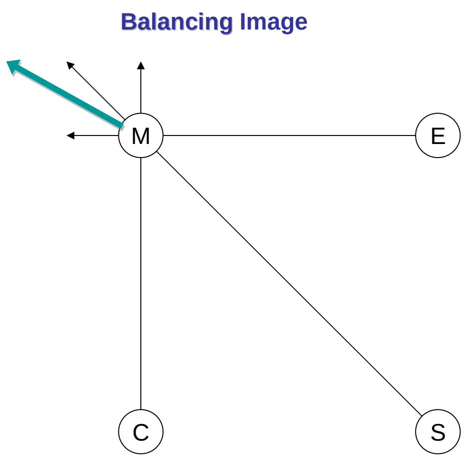

Figure 3

2. Monitoring Image

The second incentive pattern is the "monitoring image," in which shareholders, as the owners, monitor their agent, the management, to run the firm only in their best interests, while the other players, creditors and employees, should be motivated through markets and should not be involved in corporate governance [See Figure 4]. That is the A-model.[9]

[9] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Frank H. Easterbrook & Daniel R. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 69 (1991); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991); Manuel A. Utset, *Towards a Bargaining Theory of the Firm*, 80 CORNELL L. REV. 540, 550 (1995).

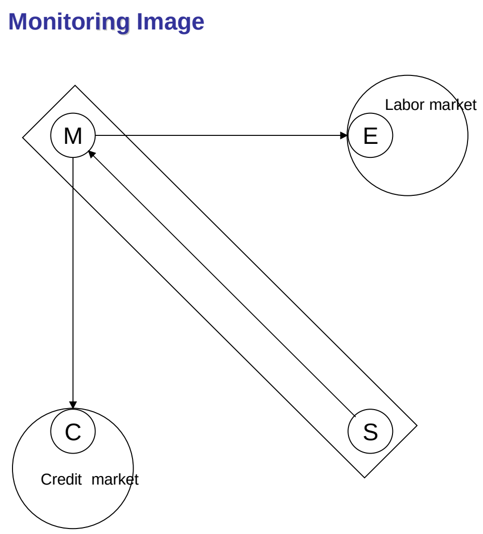

Figure 4

3. Bargaining Image

The third incentive pattern is the "bargaining image," in which monetary capital providers and human capital providers organize their teams, and these two teams bargain with each other to motivate each other to invest their respective monetary and human capital [See Figure 5]. That is the J-model.[10]

[10] *See* Tetsuji Okazaki, *Nihon niokeru Kohporehto Gabanansu no Hatten* [*The Development of Corporate Governance in Japan*], *in* SHISUTEMU TOSHITENO NIHON KIGYO [JAPANESE ENTERPRISES AS A SYSTEM] 456 (Masahiko Aoki & Ronald Dore eds.,1995); Zenichi Shishido, *Reform in Japanese Corporate Law and Corporate Governance: Current Changes in Historical Perspective*, 49 AM. J. COMP. L. 653, 663 (2001).

Bargaining Image

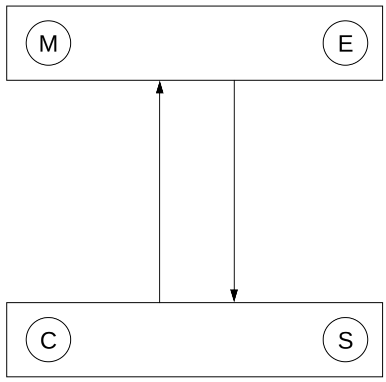

Figure 5

C. Enterprise Law

The legal system is an important infrastructural element of the firm's incentive bargain. That part of the legal system that affects the bargaining among the participants in the firm we call "enterprise law." This enterprise law specifically includes corporate law, securities regulation, bankruptcy law, labor law, tax law, and others (intellectual property law, antitrust law, etc.).

The enterprise law affects bargaining among the four players in three ways. First, it may directly affect the incentive of a specific player. Second, it may affect the relative bargaining power of some two players and consequently increase or decrease the risk borne by each player. And third, it may affect the coalition between some two players [See Figure 6].[11]

[11] On coalition, *see, e.g.*, John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multiple-Player Game*, 78 GEO. L. J. 1495 (1990).

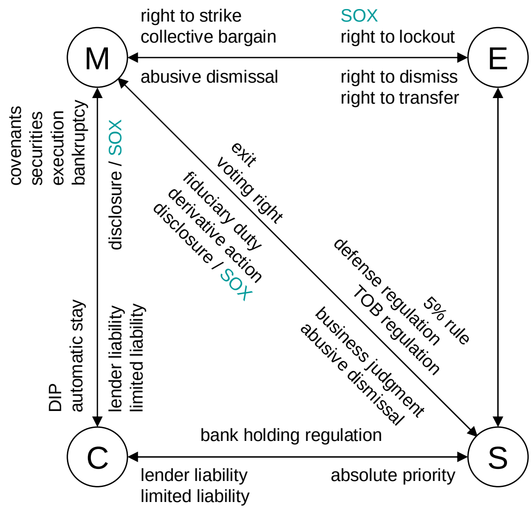

Figure 6

A part of the enterprise law works, in most cases, interrelationally with other parts of the enterprise law, including enforcement systems.

D. The Role of the Government

In addition the four players, the government also provides crucial infrastructural services (like the legal system and the courts), and through the tax regime acquires an interest in the returns to the firm's activities. Therefore, we could also consider including government as the fifth participant in the firm's bargaining structure. In this analysis, however, we will not take the government as the fifth player of this game, but we treat taxation and regulations, which are provided by the government, as a given infrastructural component of the incentive bargain among the four players.

Usually, the government exercises its influence over the incentive bargain among the four players through the corporate personality of the firm, either through taxation or industrial regulation. Sometimes, however, governmental regulations directly address a specific player. The latter mode of regulation strongly impacts the incentive bargaining among the four players, although even the former mode of regulation cannot be neutral to it [See Figure 7].

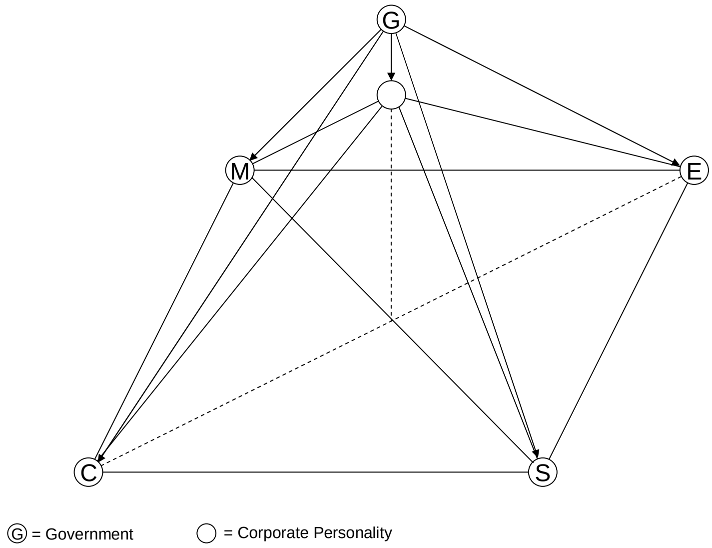

Figure 7

E. Categories of Each Player and Relevant Markets

Although we already categorized indispensable capital providers of the firm into four players, i.e., management, employees, shareholders, and creditors, we need to further divide each player into two sub-categories, at least for analyzing the effects of the enterprise law and markets on each player [See Figure 8].

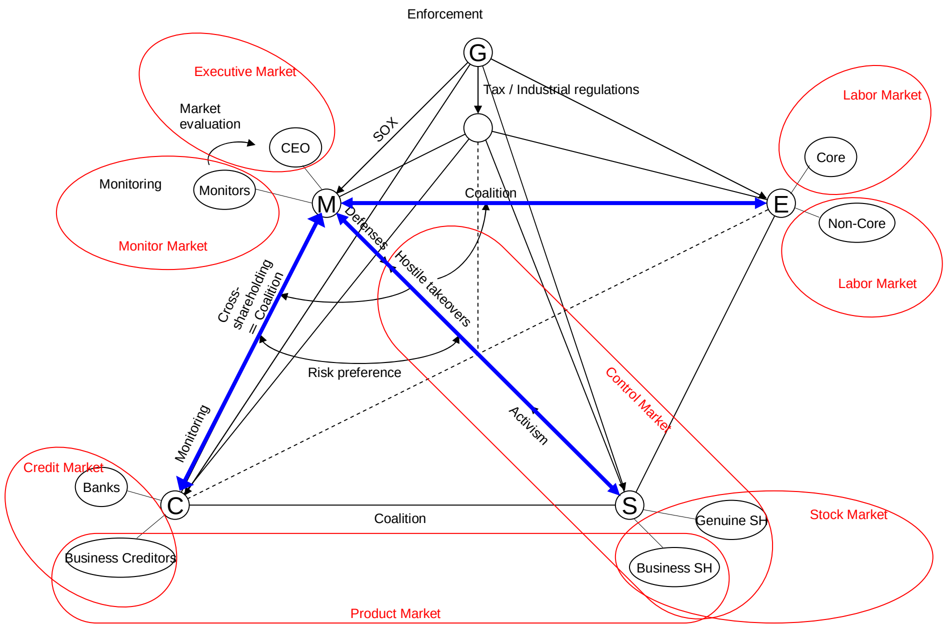

Figure 8

Specifically, management can be divided into executives, particularly CEO, and monitors, such as independent directors and independent auditors. The incentive of the executive will be influenced by the executive market and the incentive of the monitor will be influenced by the monitor market.

Employees can be divided into core employees and non-core employees. The labor market, which influences the incentives of employees, can also be divided into the labor market for core employees and that for non-core employees.

Creditors can be separated into banks and business creditors, typically suppliers. The credit market will influence the incentive of both banks and business creditors. The incentive of the business creditor will also be influenced by the product market.

Shareholders can be separated into genuine shareholders and business shareholders. The stock market will influence the incentive of both genuine shareholders and business shareholders. The incentive of the business shareholder will also be influenced by the product market. Both types of shareholders create the control market, which influences the incentives of both types of shareholders.

F. Five Different Types of Interrelationships

In this paper, interrelationships exist when the coexistence or conjunction of two or more specific institutions, either gives the incentive of the players stronger effects, or counteracts their effects on the incentive of the players.

We can observe five different types of interrelationships, which are important to understand the structure of the incentive bargain among the four players of the firm.

1. Interrelationships among Different Markets[12]

2. Interrelationships between Law and Markets[13]

3. Interrelationships between Law and Contracts[14]

4. Interrelationships among Different Laws[15]

5. Interrelationships among different bargaining relationships[16]

Among the notion of interrelationship, we will try to identify the notion of complementarity. As definition, complementarity exists between the two variables when the marginal returns to one variable are increasing in the level of the other variables. In other words, we can identify "two policies or inputs or activities as complementary precisely when doing (more of) one raises the return to doing (more of) the other." [17]

[12] *See e.g.,* plural markets influence management's reputation and her incentive (*See* Chapter III).

[13] *See e.g.,* antitrust regulations and product market & disclosure regulations and stock market (*See* Chapter III, Sub-chapter B).

[14] *See e.g.*, covenants and management responsibility rules on the risk taking of management (*See* Chapter IV, Sub-chapter B).

[15] *See e.g.,* minority information rights and the shareholder derivative action on shareholder activism (*See* Chapter V).

[16] *See e.g.,* risk taking of management and the interaction between the shareholder-management bargaining relationships and the creditor-management bargaining relationship (*See* Chapter IV); alliance against genuine shareholders and the interaction among the three bargaining relationships (*See* Chapter VI).

[17] Paul Milgrom & John Roberts, *Complementarities and Fit: Strategy, Structure, and Organizational Change in Manufacturing*, 19 J. ACC. ECON. 179, 181, 199 (1995). Professor Deeg divides complementarities to two forms: complementarity in the form of

III. The Incentive of Management and Evaluation by Markets: Interrelationships among Different Markets & Interrelationships between Law and Market

When we see the firm as an incentive mechanism, the most important question is what is the incentive of management, particularly, the CEO, who has the authority to run the firm.

We could hypothesize that a CEO will manage the firm for maximizing her own reputation as an executive because it will lead to maximizing both her long-term payoff and her psychological satisfaction.

An executive's reputation is evaluated by the executive market. How the executive market will evaluate a CEO is a complicated question. First, the executive market can be divided between the external market and the internal market. The latter is more important than the former in Japan and such a characteristic of the executive market inevitably influences the incentive of Japanese CEOs and consequently affects the incentive bargain of the firm. Second, the evaluation by the executive market is a mixture of the social evaluation, the evaluation by the product market, and the evaluation by the stock market. Here, we can observe interrelationships among different markets.

A. Interrelationships among Executive Market, Product Market, and Stock Market

Most CEOs care a lot about their social evaluation, which is not necessarily related to their evaluations by the product market and the stock market. The incentive to increase their social evaluation may lead to a good result for other players, for example, the CEO may try to keep good compliance because she does not like to lose opportunities to obtain chairperson's positions of business associations due to possible scandals. On the other hand, it may lead to bad results for other players, for example, a CEO who frequently appears in the media ("super star CEO") may use her time and energy not for her own firm but for social events.[18]

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supplementarity in which one institution makes up for the deficiencies of the other (decreasing negative effect); and complementarity in the form of synergy (increasing positive effect). *See* Richard Deeg, *Complementarity and Institutional Change: How Useful a Concept?* 3 (Working Paper 2005).

[18] *See* Urlike Malmendier & Geoffrey A. Tate, *Superstar CEOs* (Working Paper 2008).

Although such a social evaluation is an important part of the evaluation by the executive market, the evaluation by the product market and that by the stock market constitute major parts of the evaluation by the executive market. If a CEO pays more attention to the evaluation by the product market and that by the stock market, her actions will likely produce better results for other players. Law can influence executive incentives to lead towards the optimal direction.

B. Interrelationships between Laws and Markets

Generally speaking, CEOs have an incentive to avoid competition in product markets, which is hard for them. Therefore, antitrust law, particularly, the cartel regulation, is necessary to maintain efficient product markets. Because of antitrust regulations, CEOs cannot avoid severe competition in product markets, and therefore they will have an incentive to motivate employees to win the competition.

Disclosure regulations could increase the sensitivity of stock markets. More efficient stock markets may affect the CEO's priorities among competing incentives. The evaluation by the stock market may become more important than the social evaluation because of the improvement of the stock market. It may also influence the practice of stock options and that of hostile takeovers [See Figure 9].

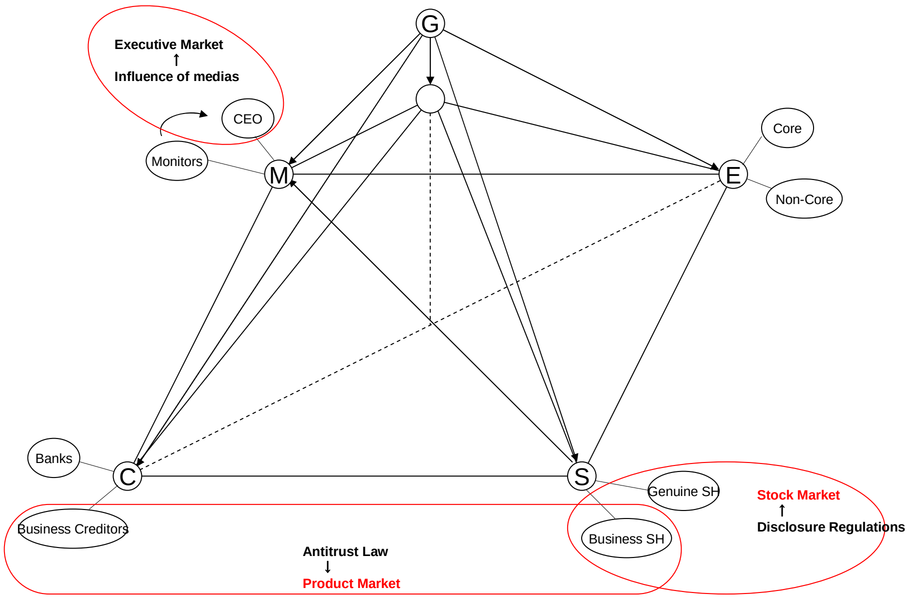

Figure 9

IV. Risk Taking of Management: Interrelationships among Contracts and Laws

A. The Interrelationship between the Shareholder-Management Bargaining Relationship and the Creditor-Management Bargaining Relationship

The risk taking of management is very relevant to the incentives of the other three players in the incentive bargain, particularly, shareholders and creditors. There are conflicting interests between shareholders and creditors, although they share the same interest as monetary capital providers. Shareholders have an incentive to gamble on the risk of creditors because shareholders can obtain all the upside-gain while they are protected against downside loss by limited liability. Therefore, creditors have an incentive to push CEOs to adopt a risk averse management policy, while shareholders have an incentive to push CEOs to adopt a risk neutral management policy in an ordinary time, and even risk loving management policy when the firm is almost insolvent. Management, particularly the CEO, is in a position of balancing such a conflict of interests. Here, we can observe an interrelationship between the two bargaining relationships.

B. Interrelationships among Contracts and Laws

Several contracts and laws interrelationally affect the risk taking of management.

Creditors, particularly banks and bond holders, who feel the risk of opportunistic behavior by shareholders and management, often try to insert covenants to lending contracts for preventing management from taking too much risk, such as, restrictions on providing collaterals, requirements for maintaining a certain level of profitability, requirements for retaining certain amounts of equity or certain equity ratios, restrictions on dividends, etc.[19]

Besides such contracts, several different laws lead management to take less risk.

Comparatively, Japanese corporate law has stricter dividend restriction than most jurisdictions in the United States. Japanese corporate law also has a unique statute providing for director responsibility to third parties, who are mostly creditors.[20] Japanese management risks personal liability to creditors in cases of corporate bankruptcy. Japanese bankruptcy law has procedural statutes to enforce management liability.[21] The structure of shareholder derivative actions will also affect the risk preference of management. Japanese corporate law has no system of letting courts respect a board decision against a shareholder derivative action,[22] and restricts capping damage amounts.[23] Those Japanese laws will lead management to take less risk, relative to American laws.

On the other hand, in Japan, shareholders can propose for the firm to pay more

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[19] *See* KENJIRO EGASHIRA, KABUSHIKIGAISHA HO (LAWS OF STOCK CORPORATIONS) 652 (2d ed., 2008).

[20] Corporate Law Section 429.

[21] Bankruptcy Law Sections 177; 178.

[22] In the United States, *see* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, Sections 7.08; 7.09; 7.10 (1992).

[23] Ex ante limitation, up to two times one's annual remuneration, could be put only on outside directors. Limitation of liability of inside directors, up to six times of one's annual remuneration in case of representative directors and up to four times of one's annual remuneration in case of non-representative directors, could be allowed ex post either by resolution of the board of directors if more than three percent of shareholders did not object or by special resolution of shareholder meeting (Corporate Law Sections 425; 426; 427).

dividends and to repurchase shares at shareholder meetings,[24] while this practice is impossible in the United States. This legal system gives shareholders stronger bargaining power to push management to take more risk.

Both in Japan and in the United States, tax law, which let companies deduct interest payment from their profit, lead management to take more risk. Bankruptcy laws, which favor the debtor in possession[25] and private reorganizations,[26] also lead management to take more risk [See Figure 10].

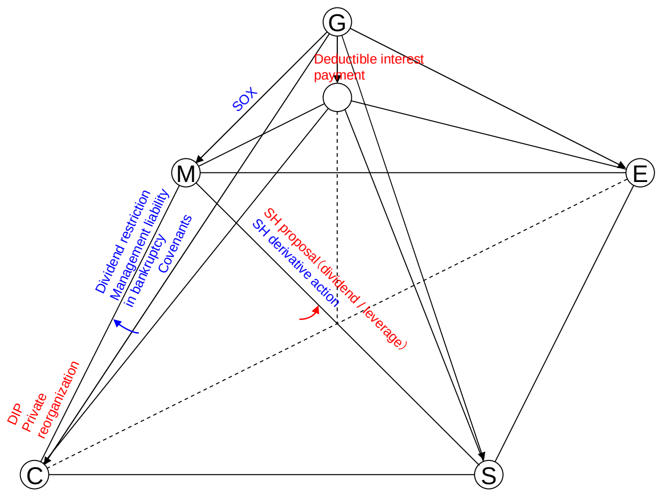

Figure 10

I will argue, in the next subsection, that SOX and J-SOX, contrary to the original plan of the lawmakers,[27] may lead management to take less risk.

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[24] Corporate Law Sections 454; 156. The company can, however, let its board of directors decide dividend and repurchase of shares by changing its article of incorporations (Corporate Law Section 459 Subsection 1). The company needs another change of its article of incorporation for precluding those matters from shareholder proposal (Corporate Law Section 460).

[25] Private Rehabilitation Law Section 38 Subsection 1.

[26] There are two competing schemes of private reorganizations in Japan, one is the Guideline of Private Reorganization (2001), and another is the Business Rehabilitation ADR, which is based on the Industries Vitality Stimulating Law Reformation of 2007. They contribute to increase the transparency of private reorganization procedure and, as a result, encourage the practice.

[27] The Sarbanes-Oxley Act of 2002 (SOX), enacted in response to major corporate and accounting scandals including those involving Enron and WorldCom, is said to be the most

C. Spillover Effects of SOX and Interrelationships Enforcement Laws and Substantial Laws

SOX and J-SOX play an interesting role, which lawmakers probably never expected, in interactions among different bargaining relationships.

1. Impacts on Management and Shareholders Relationship

The major beneficiary of SOX and J-SOX, as an original intent of the legislatures, must be shareholders and potential shareholders, i.e., investors. They can demand that management provide better disclosure and better governance because of SOX and J-SOX. In this meaning, SOX and J-SOX give shareholders additional bargaining power against management and decrease shareholders' risk in investment.

Shareholders will, however, bear costs of implementation and maintenance of the internal control system required by SOX and J-SOX, even though they may benefit from the system. The problems are what methods can be used to balance the costs and benefits of internal control, and in this regard, how shareholders, particularly institutional shareholders, as the cost-bearers perceive this problem and how implementation guidelines would work.

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important regulatory reform in the 70 plus-year history of U.S. federal regulation of securities transactions, and has already been widely evaluated from a legal perspective. Japan learned from the U.S. and, effective the fiscal year commencing April 1, 2008, implemented the Financial Instruments and Exchange Act, known as J-SOX for its similarity to SOX, requiring public companies to report on internal control. The United States, after six years of regulatory experience since implementing SOX, is currently discussing possible amendments to the law, while Japan has just entered its first year under J-SOX.

In the U.S., the most controversial provision of SOX, Section 302, requires that the chief executive officer (CEO) and chief financial officer (CFO) of each public company attest to the effectiveness of internal control and the adequacy of financial statements. Furthermore, Section 404 provides that the company's management assess the effectiveness of internal controls over financial reporting and that the external auditor attest to and report on that assessment. Any "significant deficiencies" must be reported by the company's management and an independent auditor. The inclusion of this requirement in the law points to congressional concern that under the then-existing rules there was a reasonable possibility for a material misstatement in financial statements to not be prevented on a timely basis. Responding to criticism over substantial increases in compliance costs associated with the reporting requirements, the regulatory authorities have adopted new standards calling for a "top down, risk-based approach" for testing the effectiveness of internal controls.

Serious questions were raised not only concerning their cost problem, but also about their benefit to shareholders. Many believe that increasingly abundant and precise information disclosure and its resulting greater transparency are always desirable. According to Professors Hermalin and Weisbach, however, this is not necessarily the case from the perspective of good governance. With respect to ex post evaluation, CEOs inevitably become taking less risk, both from the viewpoint of retaining their current positions and in view of their desire to improve their reputation amid today's job-hopping market. Disclosure of more precise information increases the likelihood for the ex ante evaluation of a CEO to be changed to ex post. Therefore, higher-quality information increases the expected payoff to shareholders but decreases the payoff to the CEO. The CEO in turn demands higher compensation. That, however, is not the only outcome of requiring the CEO to provide more precise information. The demand for greater disclosure provides the CEO with the incentive to manipulate information. External efforts to enhance information disclosure can be harmful and reduce social welfare. Companies disclose information to differing extents, which means they are selecting their optimal level of disclosure in accordance with the conditions they face.[28]

2. Impacts on Management and Creditors Relationship

Actually, the real beneficiaries of SOX and J-SOX seem to be creditors. Of course, from the beginning, shareholder protection was not the sole purpose of SOX. The legislation has multiple aspects and was devised to enhance the transparency and accountability of listed companies as public entities.[29] Therefore, it was expected that, beside shareholders, creditors will also benefit from better disclosure and better governance system.

SOX provides an unexpected benefit, a kind of windfall for creditors, which raise the fundamental corporate governance point of the conflicting interests between shareholders and creditors on risk taking. Because of SOX, management is more likely to be pushed towards the less risky business judgment[30].

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28 Benjamin Hermalin & Michael Weisbach, Information Disclosure and Corporate Governance (Working Paper 2008).
29 *See* Donald Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817 (2007).
30 See Kate Litvak, Defensive Management: Does the Sarbanes-Oxley Act Discourage

When disagreements arise over the adequacy of internal control, the company's management and independent auditor then negotiate, which places excessive costs on management because the auditors' bargaining power is substantially strengthened by, among other things, the presence of the Public Company Accounting Oversight Board (PCAOB), a new regulatory organ. This prospect causes corporate managers to adopt more less risky behavior.[31] As a result, creditors will benefit at the expense of shareholders.

We will call such an unexpected effect of a legal system the "spill-over effect."[32]

3. Characteristics of Its Enforcement

From the legislation history point of view, both SOX and J-SOX were not demand pull reforms, but typical policy push reforms. In other words, they were not initiated by the business sectors, but initiated by the legislature in a broad sense to change business practices.[33] Although, generally speaking, policy push reforms which influenced practice are relatively rare,[34] SOX and J-SOX are obviously having a serious influence on practice, owing to the special characteristics of their enforcement mechanisms.

First, unlike many corporate governance regulations which are based on private enforcement, the enforcement of SOX and J-SOX is based on public enforcement. Management is monitored by governmental agencies and management will be prosecuted if she breaches her duty. Therefore, the enforcement mechanism is very strong and management is not allowed to balance the costs and benefits of the internal

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Corporate Risk-Taking? (Working Paper 2008); Qiang Kang & Quiao Liu, The Sarbanes-Oxley Act and Managerial Risk Taking: A Structural Assessment (Working Paper 2007); Leonce Bergeron, Kenneth Lehn & Chad Zutter, Sarbanes-Oxley and Corporate Risk-Taking (Working Paper 2007).

[31] *See* Langevoort, *supra* note 29, at 1824.

[32] We can observe another spill-over effect on the employees-management bargaining relationship, too. Management is actually another unexpected beneficiary of SOX. With SOX or not, management always has an incentive to collect information from employees and make sure her orders are followed by all employees. Employees have, however, an incentive not to disclose their information to their boss because they would like to keep their autonomy. Now, management gains special bargaining power over employees because of SOX. Management can order employees to report precisely, because it is the law.

[33] *See* Shishido, *supra* note 10, at 656.

[34] *See id.* at 673.

control system.[35]

Second, while many governmental regulations, such as tax and industry regulations, usually address the corporation itself, SOX and J-SOX directly address management and external auditors. While most governmental regulations indirectly influence management's incentive, SOX and J-SOX directly influence the incentive of management and external auditors [See Figure 11].[36]

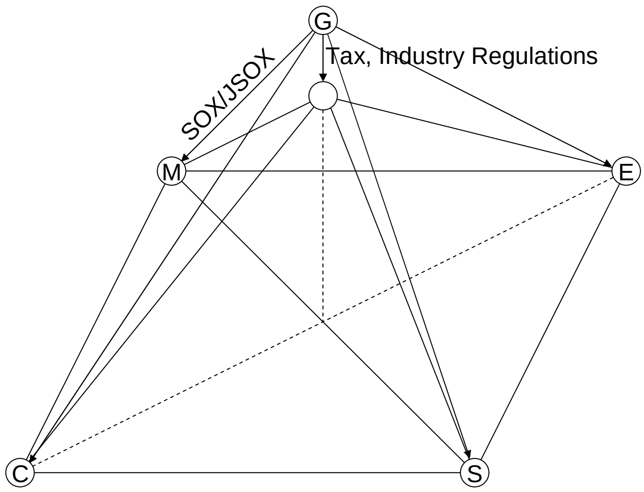

Figure 11

V. Shareholder Activism: Complementarities among Different Laws

Shareholder activism is a new trend in Japanese corporate governance since 2005. We can find that here, the legal system plays an important role. Some laws stimulate shareholder activism and other laws discourage it. We can observe

35 The cost bearers of such a mechanism are shareholders. Although the corporation is a private business organization, whose purpose is maximizing shareholder value, shareholders cannot demand management to balance costs and benefits to maximizing shareholder interests.
36 Even though tax and most governmental regulations address the corporation, instead of directly addressing management, these regulations cannot be neutral to the incentive bargain among the four players. The structure of SOX and J-SOX risks changing the status quo of the bargaining relationship among the four players too much.

complementarities among different laws for both directions.

A. Complementarities among Laws which Stimulate Shareholder Activism

Japanese corporate law gives the shareholder meeting wider decision making power than state corporate laws in the United States do.[37] The wider decision making power of the shareholder meeting by itself will not stimulate shareholder activism so much, but with the minority shareholder right of proposal[38] and the proxy voting system,[39] it will be substantially influential.

In order to be fully effective, the minority shareholder right of proposal and the proxy voting system must be supported by minority information rights, such as the right to see accounting documents[40] and the right to elect inspectors.[41]

Such minority information rights are also complementary to the shareholder derivative action. Japanese minority information rights are, however, generally recognized as not sufficient for supporting shareholder activism either with shareholders derivative actions or with the right of proposal and the proxy voting. Japanese courts have restrictively interpreted the right to see accounting documents,[42] requiring that shareholders specify the documents, although shareholders are generally unaware of the existence of specific documents.[43] The right to elect inspectors is organized in too neutral a manner to incentivize shareholders' exercise of the right.

However, a small reformation of the shareholder derivative action in 2005, which requires the company to notify the plaintiff shareholders the reason why it will not sue the defendant directors,[44] is expected to stimulate shareholder activism.

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[37] In Japan, shareholder meeting decides more than what American shareholder meeting does, such as dividend, repurchase of shares, and directors' salary.

[38] Corporate Law Sections 303; 304; 305. In Japan, shareholders can propose amendments of article of incorporation without proposal by the board of directors, while it is impossible in the United States.

[39] In Japan, shareholders of listed companies must be offered the opportunity to vote either by proxy or by letter. Corporate Law Section 298 Subsection 2.

[40] Corporate Law Section 433 Subsection 1.

[41] Corporate Law Section 358 Subsection 1.

[42] *See In re* Koito Manufacturing, 1315 HANREI JIHO 3 (Tokyo Dist. Ct., June 22, 1989); 1397 HANREI JIHO 114 (Yokohama Dist. Ct., Apr. 19, 1991).

[43] *See* 27-1 KOMINSHU 34 (Sendai High Ct., Feb. 18, 1974); 1221 HANREI JIHO 126 (Takamatsu high Ct., September 29, 1986).

[44] Corporate Law Section 847 Subsection 4.

B. Complementarities among Laws which Discourage Shareholder Activism

The United States and Japan share the same type of so-called five percent rule,[45] which requires that a purchaser of shares in a publicly held corporation identify itself and disclose certain information within certain period after it acquires five percent or more of the corporation's shares, even if it plans no further purchases. This five percent rule was implemented as an early warning system, in order to prevent the so-called "Saturday night special" and to promote auctions and increase takeover premiums.[46]

The five percent rule, however, has the practical effect of discouraging shareholder activism.[47] The reporting obligations for joint ownership[48] will weaken the incentive of institutional investors to solicit other institutional investors against voting. The disclosure obligation of the object to hold shares[49] will discourage institutional investors from making informal proposals to management.[50]

Incomplete information rights also discourage shareholder activism. The lack of discovery in Japan will discourage the use of injunctions against management activities[51] [See Figure 12].

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[45] Financial Instruments and Exchange Law Sections 27-23 ~ 27-30.
[46] *See* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 193 (10th ed, 2007).
[47] Until 1992, in the United States, the proxy solicitation rule and the five percent rule (Rule 13D) had complementarily discouraged shareholder activism. American law makers, however, reformed the proxy solicitation rule in 1992 and in 1999, and the five percent rule in 1998 for getting rid of such negative effect to shareholder activism. *See* Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical analysis*, Summer 2007 J. CORP. L. 681, 686-694.
[48] Financial Instruments and Exchange Law Section 27-3 Subsection 5.
[49] Financial Instruments and Exchange Law Section 27-3 Subsection 1.
[50] *See* Sadakazu Osaki, *Tairyo Hoyu Houkoku-seido no Haseikoka to Kinofuzen* (*Spillover Effects and Malfunction of the Large Stockholding Report Regulation*) (Discussion Paper for RIETI Panel Discussion, Feb. 5, 2009).
[51] Corporate Law Sections 360; 422.

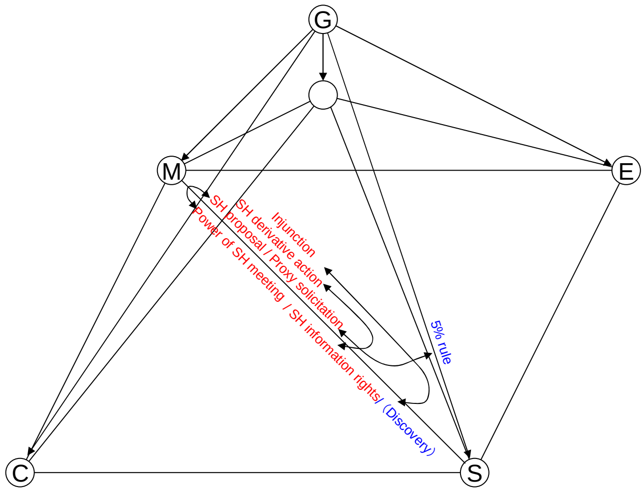

Figure 12

VI. Alliance against Genuine Shareholders: Multi-Relational Interrelationships

After the control market was created and the trend of shareholder activism has emerged since 2005, Japanese management started to recreate cross-shareholding, which had been decreasing during the 1990s. At the same time, the coalition between management and core-employees, which had appeared to loosen during the 1990s, began to tighten again. We can observe the "cross-holding" shareholders alliance against genuine shareholders as the fourth incentive pattern, in other words, the interrelationship between the creditor-management bargaining relationship and the employee-management bargaining relationship. Several legal systems, including case laws, may affect the creation of such coalitions [See Figure 13].

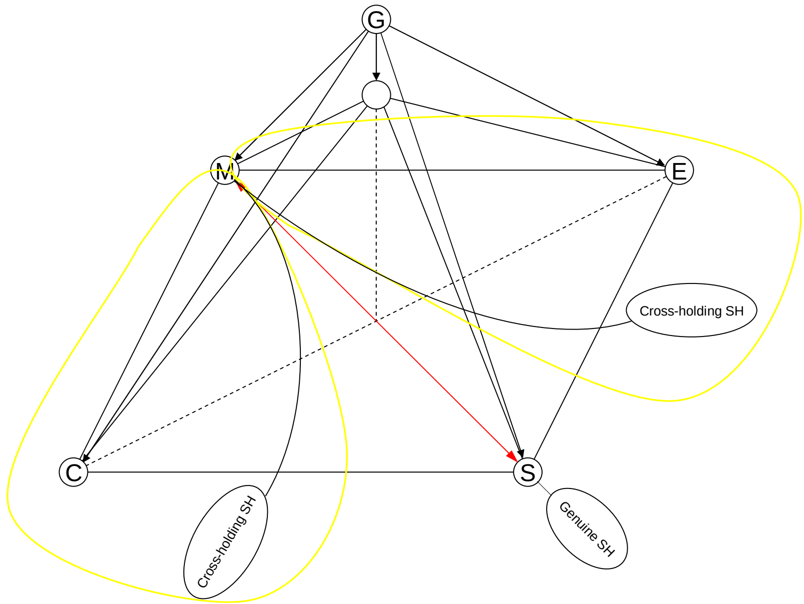

Figure 13

A. Coalition between Cross-holding Shareholders and Management

Cross-holding shareholders can be divided to three categories: banks, business creditors, and business shareholders. Trading partners of the firm in the Japanese business system have multi-dimensional characteristics. They are usually either creditors or debtors. Trading partners provide important human capital to each other. In many cases, trading partners cross-hold each other's shares as a symbol of long-term trading relationships.

Such a practice can be economically supported from two points of view. First is the hostage theory. Trading partners exchange "hostages," i.e., a certain block of shares, with each other, which is intended to prevent each partner from engaging in opportunistic behavior to the detriment of the other.[52] Second is the monitoring theory. A trading partner, as a factor provider, has an incentive to monitor the management of its partner for survival in the product market, and it also has good information to

[52] *See* Motoshige Itoh, *Kigyokan Kankei to Keizokuteki Torihiki* [*Inter-Firm Relationships and Relational Transactions*], *in* JAPANESE ENTERPRISES 109 (KENICHI IMAI & RYUTARO KOMIYA EDS., 1989); David Flath, *Shareholding in the Keiretsu: Japan's Financial Groups*, 75 REV. ECON. & STAT. 249 (1993)

monitor. Therefore, it is advisable to let trading partners hold a block of shares and exercise their voice, backed up by voting rights.[53]

The recent trend of cross-shareholding since 2005 is, however, designed to organize defense alliance among nominal trading partners. The unwinding of cross-shareholding from 1998 to 2004 was mainly caused by banks' investment behavior, but the revival of cross-shareholding in recent years is among non-bank business corporations.[54]

Because cross-shareholding among trading partners could be supported for several reasons, as previously discussed, it is hard to prove that organizing a cross-shareholding is a violation of management's fiduciary duty, if management insists that it was motivated by a good business reason. In other words, the business judgment rule strongly protects management's discretionary authority to organize defense cross-shareholdings.

The Supreme Court decision in the Bulldog Sauce case in 2007 also encouraged management to organize defensive cross-shareholdings. The Supreme Court held that the exercise of the poison pill by Bulldog Sauce was legal because it had been supported by majority shareholders.[55]

The Bulldog Sauce case and the business judgment rule complementarily give management the incentive to recreate cross-shareholdings for defensive purposes, even providing incentives to create inefficient business alliances.

The ambiguity of Japanese case law on defensive measures against hostile takeovers, so-called poison pills, also encourages management to create defensive cross-shareholdings. A statistical study shows that firms with poison pill defenses also tend to organize more cross-shareholdings.[56] This suggests that cross-shareholdings

[53] *See* Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps between Corporate Governance and Industrial Organization*, 102 YALE L. J. 871 (1993). See also Hideaki Miyajima & Fumiaki Kuroki, The Unwinding of Cross-shareholding in Japan: Causes, Effects, and Implications (Working Paper 2006), which statistically shows that block shareholding by corporations have positive effects on firm performance.
[54] *See* Keisuke Nitta, *Corporate Ownership Structure in Japan: Recent Trends and Their Impact* (NLI Research, 2008).
[55] *Steel Partners v. Bulldog Sauce*, 61-5 MINSHU 221 (Sup. Ct., Aug. 7,2007).
[56] *See* Miho Takizawa, Kotaro Tsuru & Kaoru Hosono, *Baishu Boeisaku Donyu no Doki: Keiei Hoshin Kasetsu no Kensho* [*Takeover Defense Measures: Testing of Entrenchment*

and poison pills are not substitutive but complementary, which indicates the entrenchment of management.

Such a recent revival of cross-shareholding does not look favorable because it distorts the incentive of genuine shareholders to invest. The question is which legal systems can be effective for discouraging the creation of defensive cross-shareholding.

The first possibility is to change the accounting rule on cross-holding stocks. Actually, the accounting rule was already changed. Cross-holding stocks used to be booked on their purchased value. Therefore, management did not need to worry about the performance of cross-holding stocks. Since the fiscal year of April 2001, cross-holding stocks must be booked at market price.[57] Management will be criticized by genuine shareholders if they suffer capital losses. It would be hard for management to keep holding bad performance cross-holding stocks. The effect of the change is, however, unknown. Although ownership of corporate shares by financial institutions dropped significantly after the banking crisis of 1997, cross-shareholding between corporations decreased only slightly[58]. Cross-shareholding has even re-increased among some companies since 2005, the year of opening Japanese control market. The benefit of cross-shareholding to management of the companies with high risk of take over must be larger than the risk of bad reputation by the stock market.

The second possibility is to implement the *Revlon* rule, which require the board of directors to be an auctioneer in case of a change of control.[59] The significance of the Revlon rule is to guarantee shareholders the right to exit at the highest price in the battle for control. It would be possible to argue that the *Revlon* rule cannot be waived by majority vote because it is the right of individual shareholders.[60] Currently, Japanese management can get rid of raiders as long as she obtains support from the majority of

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Hypothesis for Corporate Managers] (RIETI Discussion Paper, 2007).

[57] *See* Enterprise Accounting Committee, Financial Instruments Accounting Guideline of 1999.

[58] The selection of shares, which banks sold after the banking crisis, not only undermined corporate governance but also led the degrading of their own portfolio because they sold shares with higher liquidity and higher expected rates of return, while holding shares of firms with which they had long-term relationships. See Miyajima & Kuroki, *supra* note 53.

[59] *Revlon Inc. v. MacAndrews & Forbes holdings, Inc.*, 506 A.2d 173 (Del. Supr. 1085). *See* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 204 (10th ed, 2007).

[60] If we can understand the intent of the *Revlon* rule as guaranteeing minority shareholders the right of exit at the highest possible price, such a right should not be changed by the majority rule.

shareholders. This takeover defense would not be guaranteed under the non-waivable Revlon rule.

The third possibility is the reinterpretation of the statute which prohibits giving benefit for the exercise of shareholder rights.[61] Although the statute was originally made to prohibit management from giving bribes to professional shareholders, Professor Takahito Kato proposes to utilize it for aligning the incentive structure of shareholders.[62]

As we discussed, a variety of legal systems, including case laws, such as *Bulldog Sauce* case, as well as the lack of laws, such as the absence of the *Revlon* rule, interrelationally encourage the creation of defensive cross-shareholdings in Japan [See Figure 14].

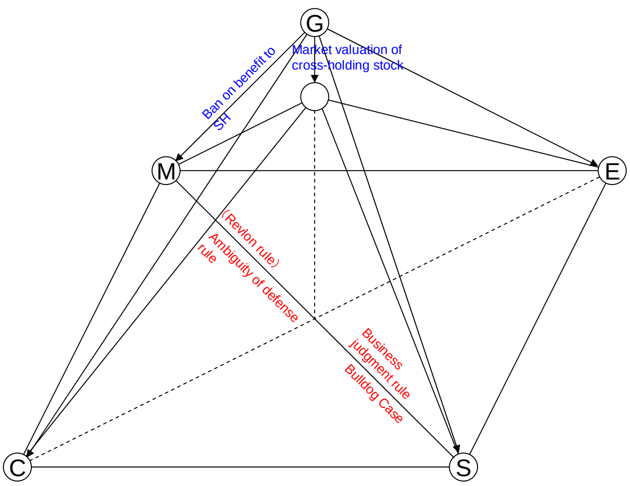

Figure 14

B. Coalition between Employees and Management

61 Corporate Law Section 120.
62 *See* Takahito Kato, Riekikyoyo Kinshi Kitei to Kabushiki Mochiai: Kabunushi no Insenthibu Kozo no Kantenkara [The Statute of Prohibiting Giving Benefit for the Exercise of Shareholder Rights: From the Perspective of Shareholder Incentive Mechanism] (Discussion Paper for RIETI Panel Discussion, Feb. 5, 2009).

While the coalition between employees and management is famously known as the "company community" in the Japanese business system,[63] here we will argue it functions as a part of the alliance against genuine shareholders. In a sense, it is natural for management and employees to create a coalition against genuine shareholders because they share the same interest in their role as human capital providers, i.e., to keep autonomy against monetary capital providers, particularly genuine shareholders. Additionally, unique Japanese practices, markets, and laws interrelationally support these defensive coalitions against genuine shareholders [See Figure 15].

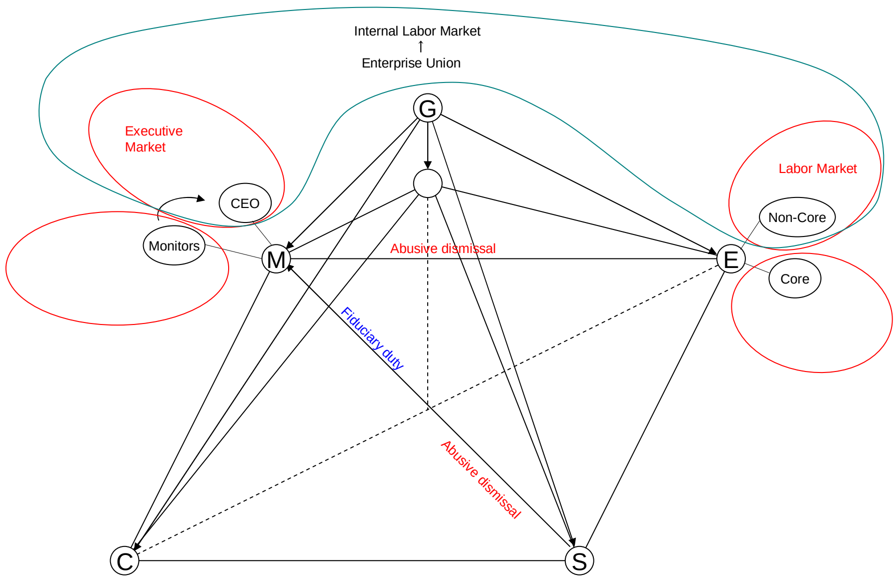

Figure 15

1. Enterprise Unions

Union practice is unique in Japan, in comparison with both the United States and Europe. While, in United States and in EU countries, labor unions are industry unions, Japanese labor unions are basically enterprise unions.[64] It is much easier to create a coalition between employees and management with enterprise unions than with industry unions. Particularly in cases of hostile takeovers, Japanese enterprise

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63 *See* Zenichi Shishido, *Japanese Corporate Governance: The Hidden Problems of Corporate Law and Their Solutions*, 25 DEL. J. CORP. L. 189, 201 (2000).

64 *See* Nobuhiro Hiwatari, *Employment Practice and Enterprise Unionism in Japan*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 275 (Margaret M. Blair & Mark J. Roe eds., 1999).

unions always declare their support for incumbent management and against the raider.[65]

2. Labor Markets

Japanese labor markets are unique in two ways. First is the lack, or incompleteness, of external labor markets for core employees and for management. Second is the combination of internal labor markets for core employees and for management. In other words, the turnover rate of core employees is small and management is mostly chosen among core employees as in-house promotion. As a result, incumbent management and core employees share the same identity and both of them invest their energies in maintaining good reputations within the firm. It is also understandable for them to try to prevent the raider's intervention in order to save their sunk costs.

3. Labor Laws

Finally, unique Japanese labor law affects the incentive of the players of the incentive bargain of the firm,[66] and plays the role of shark repellent.

The rule of dismissal is very different in the United States and in Japan. In the United States, management basically can discharge employees without cause (the employment at will rule).[67] In Japan, management cannot discharge employees without good cause, which has been strictly interpreted by courts (the abusive dismissal doctrine).[68]

Such a case law was originally created to protect employees and as a result ratified the practice of so called lifetime employment.[69] In fact, the case law doctrine of abusive dismissal does not only strengthen employees' bargaining power against

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[65] *See e.g.,* NIKKEI, Aug. 3, 2006, at 3 (Hokuetsu Paper Case).

[66] *See* Takashi Toichi & Yuki Tanaka, Kaikoken Ranyo Hori no Insenthibu Koka to Hasei Koka [Incentive Effects and Spillover Effects of the Abusive Dismissal Doctrine] (Discussion Paper for RIETI Panel Discussion, Feb. 5, 2009).

[67] *See* J. H. Verkerke, The Law and Economics of Employment Protection (Discussion Paper for RIETI Panel Discussion, July 15, 2008).

[68] *See* Ryuichi Yamakawa, *Changing Aspects of Japanese Dismissal Law*, *in* LAW IN JAPAN: A TURNING POINT 483 (Daniel H. Foote, ed., 2007).

[69] The case law doctrine became statutory law in 2004. *See* Labor Contract Law Section 16.

management, but also strengthens management's bargaining power against shareholders.[70]

Management owes a fiduciary duty to shareholders both in the United States and Japan.[71] Shareholders can demand management to run the firm for maximizing their interest. When decreasing the labor force will increase the firm's profitability, shareholders will likely insist upon layoffs and management will be forced to lay off employees because of her fiduciary duty to shareholders. Japanese management has greater bargaining power against shareholders, because she can respond to shareholders' demands that even though she owes the fiduciary duty to shareholders, she has to comply with the labor law rule against abusive dismissal. However, American management cannot make such statements to shareholders, and therefore has weaker bargaining power against shareholders' demands. Japanese management is legally allowed to balance the interest of shareholders and the interest of employees, at least in the case of dismissal. The labor law rule of abusive dismissal and the corporate law rule of fiduciary duty interrelationally affect the interaction between different bargaining relationships.

The abusive dismissal doctrine does not only strengthen the management's bargaining power against shareholders, but also makes the existence of full-time employees[72] a shark repellent because even a new management could not discharge surplus labor easily.[73]

Besides the abusive dismissal doctrine, other Japanese labor law rules have similar shark repellent effects. It will be very hard for management to change the salary system unfavorably for employees,[74] and make employees work overtime,[75] if labor

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70 *See* Toru Kitagawa, *Torishimariyaku no Chujitsugimu nikansuru Ichi-kosatsu: Kaikoken Ranyo Hori to Sutehkuhorudah Riron* [*A View of Directors' Fiduciary Duty: The Abusive Dismissal Doctrine and the Stakeholder Doctrine*], 30 SEIKEI DAIGAKU HOGAKU SEIJIGAKU KENKYU 1 (2004).

71 Although Japanese corporate law only refers directors' fiduciary duty to the company (Corporate Law Section 355), the overwhelming view considers the interest of the company is the economic interest of shareholders. *See* Egashira, *supra* note 19, at 395.

72 Strong protection of employment and wage by Japanese labor law gives Japanese management incentive to distinguish full-time employees and part-time employees who are not protected by the abusive dismissal doctrine for adjusting work force to business cycle.

73 *See* Marco Pagano & Paolo Volpin, *Managers, Workers, and Corporate Governance*, 60 J. FIN. 841 (2005).

74 *See* Labor Union Law Section 16; *In re* Asahi Fire Marine Insurance, 713 ROHAN 27 (Sup. Ct., Mar. 27, 1997); *In re* Daiyon Bank, 51-2 MINSHU 705 (Sup. Ct., Feb. 28, 1997).

unions do not agree. As a result, labor unions obtain bargaining power against the raider.

VII. Conclusion

To write the structure of the enterprise law is to write the structure of the enterprise, particularly, the structure of the incentive bargain among the four different types of capital providers to the enterprise. The enterprise law does not have significance by itself, but has significance when it works as an infrastructural element for the incentive bargain of the firm. Each part of the enterprise law will seldom affect the incentive bargain independently, but it will, in many cases, affect the incentive bargain interrelationally with other parts of the enterprise law, contracts, and markets.

While the law is relevant to business practice, it is not the same as business practice. Laws often affect business practice by influencing the incentive of players within the incentive bargain. Lawmakers, however, often seek to draft "good" textual law, without ever considering the incentives of the players or the interrelationships that law shares with other infrastructural elements of the firm's incentive bargain. Some laws may have no effect on the practice at all because they do not affect any player's incentive. Other laws, however, may cause unexpected changes in business practice because of their spillover effects.

Law makers should take the following five points into consideration when they attempt to change the current enterprise law: first, how the new law will affect the incentives of the four capital providers of the firm, particularly, the possibility of giving some players perverse incentive; second, how the new law will work interrelationally with contracts and markets; third, how the new law will work interrelationally with existing laws, including enforcement systems; fourth, whether there are any spillover effects or malfunctions in the current enterprise law; and finally, how to keep a good balance between autonomy and monitoring of management. Then law makers can contribute to achieve an efficient incentive bargain of the firm and to stimulate the whole national economy.

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[75] *See* Labor Standard Law Section 36.