Corporate Governance and the Capital Market (Especially Takeovers)

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I am very happy to have the opportunity to address this symposium today. Currently, I am serving as the director of Waseda University's Global Center of Excellence, Institute for Corporation Law and Society, which is a co-organizer of this very meaningful symposium. Although I am serving as a leader of the aforementioned research program, I myself am not a globalized individual at all, and have opted for the very parochial approach of distributing my paper in English and presenting in Japanese. Given the cost of translation, I am quite sure that my presentation is the most expensive one today.

You may ask how someone like me can pursue a research career in the field of comparative law. The answer is that we in Japan have been studying foreign laws for the past 150 years and have developed a complete range of fully nuanced Japanese terms that correspond to the European terminologies of jurisprudence and social sciences. Moreover, we have formulated our own laws as the product of a veritable melting pot of foreign laws, and we continue to take our study of foreign laws very earnestly. The fact of the matter is that comparative law research has become an essential and core element of our Japanese culture. I stand before you as one of the prime beneficiaries of this historical process.

One of the salient features of the study of jurisprudence in Japan is that we are able to investigate the legal systems of various foreign countries in the Japanese language. It is estimated that 70% of all the terminologies of jurisprudence and social sciences currently in use in the Chinese and Korean languages were invented and first used by

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* The lecture format has been maintained.

Japanese scholars. This is a testimony to the contribution of Japanese jurisprudence and law studies to the Asian region.

However, what Japan itself absorbed and conveyed to others originated in Germany, the 'father' of modern jurisprudence. Therefore, my presentation today is filled with a sense of gratitude to the Max Planck Institute and to Germany itself.

I. INTRODUCTION

For the following reason, I have chosen Corporate Governance and the Capital Market as the subject of my presentation today. While the joint-stock company system contains the necessary mechanisms for utilizing the capital market, the Japanese still lack a deep understanding of the attendant benefits and risks. We also lack operating know-how on managing the joint-stock company system as an integral element of the capital market. To cope with this shortcoming, the Japanese found it necessary to commit themselves to countering the European advantage of experiential knowledge with a healthy dose of theoretical knowledge.

In reality, it is difficult to fully utilize a joint-stock company system that bears the weight of the securities market on its back without having experienced the failures that result from speculative bubbles and the runaway securities market. If left without the benefit of such bitter experiences, the general tendency is to become overly dependent on an optimistic view of the self-correcting mechanisms of the market and to become heedless of the legal foundations and management know-how that allow the market to function in the first place.

Europe has made use of past failures in this area to design a relatively stable legal system that opts for a restrictive framework of company law and avoids excessive dependence on market mechanisms. The United States, on the other hand, has taken a different approach. Although the United States did formulate an elaborate scheme of securities regulations immediately after its grand failure at the end of the 1920s, it later returned to emphasizing freedom in the markets, which eventually led to another failure. This cycle has been repeated time and again, giving the impression that the United States is caught in an endless drama of trial and error in which it swings between the two poles of market regulation and deregulation in a process that is predictably punctuated by repeated failures.

Japan and China do not have the luxury of time needed to gain the experiential knowledge that Europe and the United States have accumulated through repeated failures. And in fact, if Japan and China were to traverse these cycles, the impact on the rest of the world could be extremely severe.

This brings me to the question: What logic has Japan employed in generating the theoretical knowledge that it needs? As a starting point, I would like to outline my personal views on this matter.

II. THE SECURITIES AND EXCHANGE ACT AS MARKET LAW

First of all, Japan's capital market legislation (the Securities and Exchange Act enacted in 1948, which was revised and renamed the Financial Instruments and Exchange Act in 2007) can be characterized as legislation that concerns itself with the capital market. In other words, it functions as a market law.

Post-war Japan went through a period when indirect finance played a dominant role in corporate finance while direct finance was assigned a very subsidiary role. During this early post-war period, the Securities and Exchange Act functioned essentially as a law for regulating the securities companies. The provisions of this law concerning disclosure, accounting and other matters were seen to complement the inadequacies of the Companies Act. Consequently, the Securities and Exchange Act was deemed to be similar in nature to the Companies Act. Because almost all of the provisions of the Securities and Exchange Act during this period pertained to equities, it was quite natural to interpret the Securities and Exchange Act to constitute an aspect of company law. In other words, just as exchange law came under the Civil Code and commercial transaction law came under the Commercial Code, the general tendency was to view the Securities and Exchange Act as a body of rules under private law that pertained to the exchange of securities. Because the Securities and Exchange Act itself constituted private law, there was no notable theoretical tension during this period between the Companies Act and the Securities and Exchange Act as private law.

However, as the Japanese economy completed its recovery and rose to new heights, the period of dependence on the leadership of the bureaucracy, banks and corporate executives eventually came to an end. With the rapid diversification of values, the principal role steadily shifted in the direction of market-oriented thinking. As a result, the Securities and Exchange Act came to be viewed increasingly as a securities 'market law' instead of just a securities 'exchange law'. Consequently, all of the various systems that existed under the Securities and Exchange Act (systems that traditionally had been presented as means for the protection of investors) were now explained as systems devised for achieving the purpose of maintaining the functions of the capital market.

Thus, Article 1 of the Financial Instruments and Exchange Act of 2007 defines the purpose of this law to include ensuring the 'full utilization of functions of the capital market' and 'fair price formation'. It is possible that Japan was the first country in the world to adopt such a direct and straightforward definition of the purpose of its capital market legislation. In this process, capital market legislation came to be viewed not as private law but as economic law.

To illustrate this point, let us examine the disclosure system. In the current environment, it is no longer satisfactory to explain the purpose of disclosure to be the protection of investors who are at a disadvantage due to limited access to information. Instead, it is explained that by revealing the true value of the objects of transaction, the disclosure system facilitates investment decisions based on accurate information, and that the

cumulative force of these investment decisions leads to fair price formation. (Time does not allow me to consider other systems.)

I find, in the stated purpose of the Financial Instruments and Exchange Act, Japan's commitment to avoiding the experiences of Europe and the United States in this area, and its firm intention to jump straight into an understanding of the purpose of capital market regulations and of various related systems in the hope of avoiding or minimizing potential failures.

Thus, the 'market-law structure' of the capital market, and particularly the securities market, reflects the intent to grasp and incorporate beforehand the various elements necessary for proper management of a highly developed capital market. As such, an effort is made to understand capital market legislation as a form of *Idealtypus*. Looking at the problem from this perspective, we see that the joint-stock company system contains mechanisms that allow it to bear the pressures of the capital market at its largest scale, and that it is also adaptable to the capital market at its largest scale. Here I would like to present certain segments of the logical conclusion that can be derived from this understanding.

III. Basic Concept of Publicly Traded Company Laws

The first problem here is to consider what constitutes the inherent characteristics of a joint-stock company that has positioned itself in the securities market. By this I mean publicly traded companies and companies that are subject to the provisions of capital market legislation. (In Japan and the United States, there is a slight difference between companies that are required to disclose annual reports and other information and companies that are publicly traded.) In other words, we need to consider companies that are subject to the demands and provisions of capital market legislation on a day-to-day basis. Specifically, such demands and provisions include disclosure (including the timely disclosure of information as required by stock exchanges), accounting, audit, and internal control systems and compliance systems for preventing securities fraud.

As compliance with these demands and provisions of capital market legislation relates to corporate governance (executives and business management systems), compliance with capital market legislation constitutes one of the basic responsibilities of the executives of such companies. In my view, joint-stock company law delineates a system that seeks to achieve harmony between the market and democracy. While problems specific to company law that are centred on the requirements of democracy are certainly important, it is also obviously important to develop a clear awareness of the relation with the capital market.

Capital market legislation assumes its principal agents to be investors, which include investors as both buyers and sellers. Consequently, to be in compliance with capital market legislation, corporate executives are responsible for disclosing information to unspecified buyers. This responsibility is by no means limited to shareholders, which is a

title given to individuals after they have purchased shares in the company. Under the laws governing publicly traded companies, shareholders are also perceived as investors who are sellers. In fact, shareholders' greatest concern is whether the company has disclosed accurate information and implemented proper accounting and audit procedures, rather than whether they are able to exercise the right to vote.

In joint-stock companies that are integrated into the capital market and constitute public companies in the true sense, the first layer of governance is 'governance for investors' who consist of a large body of unspecified individuals. Built upon this is a second and overlapping layer of 'governance for shareholders'. Here, the investor as buyer can be replaced with a notion of a large number of unspecified citizens. As such, publicly traded company laws can be said to pertain to companies that are open to the citizens. (In the United Kingdom, while 'company' can also denote a non-profit corporation, a 'public company' that is open to the public means a for-profit corporation which takes on the responsibility of paying dividends to the people and preserving the value of its shares. It is notable that in the Financial Services and Markets Act of the United Kingdom, the concept of 'investor' has been dropped in favour of 'consumer'.)

In a publicly traded company, an investor decides on becoming a shareholder after examining the company's mission statement and information concerning its business performance. As such, the discussion does not always begin with the shareholder. Rather, the discussion is predicated on the disclosure of the company's purpose, its mission, and business results, and goes back to the point where investors or members of the public, acting through the capital market, assess the information that has been disclosed by the company.

In a capitalist market economy, the consumer goods, capital goods, jobs, services, R&D activities, and other elements that are required in supporting the livelihood of the people are basically supplied by private enterprises through a process of market competition. In this framework, companies endeavour to maximize the realization of their own business objectives and missions, while the market is charged with the task of evaluating the results of these efforts. Investment is rewarded through dividends and share prices if it has made a contribution to maximizing the realization of the company's mission, but is not rewarded if such a contribution has not been made. For investment by capital or shareholders, it is this contribution that provides the most important *Merkmal* for judging the results of an investment. Within these bounds, the maximization of shareholder profit is by no means the objective of corporate management.

Nonetheless, this does not imply that shareholders and their interests can be ignored. From the perspective of the company, shareholders that have evaluated the company's performance and decided to invest their capital in the company are to be thanked and efforts naturally must be made to respond to the expectations of shareholders. As a result, progress made toward maximizing the realization of the company's mission can be consistent with maximizing the profit of shareholders. However, this does not mean that the purpose of corporate management is to maximize the profit of shareholders.

IV. What Does Maximizing Shareholder Value Mean?

In Japan, there is a relatively widespread view that the purpose of corporate management is the maximization of shareholder value. Suppose this objective is clearly prioritized over the purposes explicitly mentioned in the articles of incorporation. It is my contention that such a course of action can in certain instances constitute a violation of the articles of incorporation.

Be that as it may, the crux of the issue here is how the shareholder is specifically envisioned in various countries. In Europe and the United States, thanks to their long historical experiences, shareholders are generally envisioned to comprise individuals and citizens or institutional investors who are deemed to be equivalent to individuals on account of the rigorous fiduciary duties that they have to individuals. Where this vision is widespread, at least on a conceptual level, the shareholder is an individual who is a sovereign member of society. Hence, I believe it is acceptable to say that shareholder sovereignty or a shareholder-centric model exists in such countries. As the prime actor in society, the individual becomes a consumer when he or she purchases something, a worker when he or she takes a job, and a shareholder when he or she purchases stocks. It is as simple as that. If we take this to be a social norm that exists in the background, there is very little reason to be obsessed with the term ‘maximizing shareholder value’. (However, as one who has learned from Europe, the rampaging behaviour of shareholders in private placement funds and anonymous funds created for small groups of the rich tempts me to ask my ‘teacher’ whether this is consistent with the European values and social norms that we have been studying all along, and whether this is symbolic of European progress or decadence.)

On the other hand, in the case of Japan, large segments of Japan’s shareholders are actually nonfinancial companies (reflecting the prevalence of cross-shareholding). As for China, the state remains the principal shareholder. Advocating shareholder sovereignty in an underdeveloped capitalist environment of this type can be risky and dangerous because those who rule the company would be tempted to emphasize the concept of shareholder sovereignty in a manner completely unrelated to any conception of respect for individuals or citizens as sovereign members of society. In this context, of the two elements of the joint-stock company system, which consist of the market and democracy, undue emphasis would be placed on the logic of the market. What I mean to say is that in such an environment, instead of focusing on the sovereign members of society as shareholders, logical affirmation would be given to those who are able to buy on the market (those in possession of large sums of money or those capable of gathering large sums of money) as sovereign members of corporate society.

V. WHAT IS CORPORATE GOVERNANCE?

What happens when the power and authority of 'being able to buy on the market' is overestimated? The outcome is that democracy, the second element of the joint-stock company system, is minimized. While the joint-stock company system provides a framework facilitating the utilization of the capital market, joint-stock companies must comply with certain democratic controls as the suppliers of goods and services needed in maintaining the lives of the people.

While the Dutch East India Company was formed in 1602 as a corporation with no shareholders' general meeting, it is said that the inclusion of a shareholders' general meeting in the British East India Company reflects the influence of Cromwell's democratic reforms. In societies such as Japan and China where there is very little attachment to the concept of shareholders as individuals, it is necessary to emphasize the democratic aspect of the joint-stock company system. (The significance of 'socialist' in China's formulation of its socialist market economy was supposed to be that the market economy was going to be by the people and for the people.)

Let me move on to the question: What is corporate governance? My answer is that corporate governance revolves around the discussion of the sources of the legitimacy of the right of management or rule of the company. Very few Japanese corporate executives can satisfactorily reply to the question, 'What is your right of management derived from?' One possible response would entail a search for pedigree, a position that states, 'I was appointed by the board of directors, and the board of directors was elected by the shareholders, who are the owners of the company.' A sense of security is found by going back to the distant past and the authority of shareholders as owners of the company. Such a response has in its background a very simplistic conception that claims that the righteous are in the majority in the securities market, and the securities market is designed to allow the righteous to emerge victorious. It is with this conception in mind that so much emphasis is placed on the authority of the shareholders' general meeting.

However, there must be a reason that, as seen in the case of the United States, the number of resolutions adopted in the shareholders' general meetings tends to be small in countries with highly developed capital markets. Highly developed capital markets cease to be a forum for communicating intentions and evolve into a mechanism functioning simply for the purpose of exchanging capital as a form of commodity. In extreme cases, as seen in the operation of the Berle-Means model in the United States, ownership and management are separated, and the shareholders who exercise the right to vote in the shareholders' general meeting are merely those investors who happen to hold the shares at a certain point in time in an uninterrupted series of transactions occurring in the secondary market.

While the existence of this type of shareholder certainly does not detract from the significance of the shareholder's identity as an individual or a citizen, equating the shareholders' general meeting to a 'freeze frame picture' of the secondary market does effec-

tively reduce its significance as a management organ charged with the function of supervising management. However, it is this erosion of importance that highlights the importance of corporate governance systems. In this environment, the right of management finds its justification in the relatively strict governance systems (systems that provide for the removal of executives) that come together to affirm in unison that 'current executives have been given a vote of confidence'. Thus, the basis for the right of management and the justification for rule reside within rationally designed governance systems.

The capital market is ruled by the logic of the material. Hence, by identifying it as the world of the material, the capital market allows us to see humanity in its true and pure form. I believe the role of the corporate governance system is to discover and regain humanity in its true form within the framework of a joint-stock company that carries the weight of this kind of capital market on its shoulder; and as such, the corporate governance system provides justification for the delegation of the right of management.

VI. Long Continuing Debate in Japan on the Essential Characteristics of Joint-Stock Companies

You may find it surprising that in Japan, discussions of the essential characteristics of joint-stock companies go back to the pre-war era. Originally, under the influence of German jurisprudence, the commonly accepted view in Japan was that shares did not represent claims or property rights but symbolized membership in an incorporated association. In other words, shares constituted membership rights (*Mitgliedschaftsrechte*).

However, as the securities market developed and expanded in later years, Japan came under the strong influence of US notions of separation of ownership and management. In this environment, discussions of corporate governance gained momentum and gave rise to myriad theories. For example, under the doctrine of the denial of membership rights, shares were seen to combine two dissimilar rights: the right to claim the distribution of profits; and the right to vote, which one is obligated to exercise in good faith for the benefit of the company. Then there was the view that a stock certificate is no more than a claim, while the right to vote constitutes a non-transferable right that attaches to an individual regardless of the number of shares held. In yet another interpretation, the joint-stock company was viewed to be a fund management organization and an incorporated foundation committed to realizing profits (wherein the acquisition of shares constitutes an investment contract entered into with the company, and as a mechanism for protecting investors, the shareholders' general meeting is not different from the bondholders' meeting).

Reviewing these theories today, one is struck by the fact that almost all types of governance theories can be found here. However, it should be noted that these discussions were being carried out during the early post-war period when Japan's securities market remained in the ashes. This meant that these remained theoretical discussions

captured in the literature of the time, and did not reflect the realities of the market. This allowed the traditional doctrine of *Mitgliedschaftsrechte* to resurface in later years and to become the generally accepted view in Japan. Although the highly varied theories on the essential characteristics of joint-stock companies mentioned above reflected the ongoing development of the securities market and the emergence of the public stockholder, these theories were limited by the fact that they were not conducted with adequate knowledge of the Securities and Exchange Act and the securities market.

The situation in Japan today calls for the proper management of the joint-stock company system as predicated on the securities market. By adding the logic of the securities market to Japan's very advanced discussions of the past, I hope to develop new theories of publicly traded company laws.

VII. CORPORATE MERGERS AND ACQUISITIONS

My presentation today mentions 'especially takeovers' in its subtitle. But I am afraid that I have used up most of my time in general discussions. An old Japanese proverb (which we have borrowed from China) explains what I have done: 'offering mutton but selling dog's meat'. So, in the time left to me, I would like to share some of my thoughts on what can be deduced concerning corporate takeovers from the preceding discussions.

First of all, it should be noted that Japan does not have a comprehensive body of rules governing corporate takeovers that can be compared to the City Code on Takeovers and Mergers of the United Kingdom. Nor does Japan have the blatant anti-takeover laws of some US states that are designed to guard local companies from takeover. However, Japan has moved significantly in the direction of excessive deregulation and liberalization as found in the Delaware General Corporation Law. As a result, hostile takeovers have become relatively commonplace. For this reason, Japanese law firms have gone into the business of devising 'takeover defences' in the form of shareholder rights plans. These defence packages are being sold to companies at very high prices. So we see that companies that pay large amounts to the government in taxes are purchasing packaged rules and procedures for defence from law firms. It is very strange that Japanese society views this phenomenon with so little unease.

Such defence packages typically take the following approach. When the acquiring company has purchased about 20% of the outstanding shares of its target company, an independent committee is formed in the target company to judge whether to support the takeover. If the independent committee chooses to oppose the takeover, the company puts a shareholder rights plan into operation that is designed to repulse the takeover by adopting discriminatory measures against the acquiring company. I believe this approach would be subject to serious criticism in other countries. However, given that there are no other viable countermeasures to protect against hostile takeovers, the Japanese courts have to a certain degree shown a willingness to recognize the validity of this approach.

In the United States, there are other options available in fending off unwelcome acquisitions. One is to lobby Congress for the passage of a specific bill, and another is to invoke the anti-takeover provisions contained in state corporation laws. Thus, the United States effectively protects its own companies from takeover even while it goes on the offensive in other countries under the banner of deregulation and liberalization. Japan does not have a presidential system (under a parliamentary cabinet system, most Japanese laws are drafted and sponsored by the government). This means that the Japanese government cannot resort to the excuse that 'the legislature is to blame', nor does it have the option of claiming that company laws come under the jurisdiction of states. Seen from the Japanese perspective, the United States speaks with a forked tongue on two separate levels, a situation that leaves much to be envied. The Japanese structure is well designed for constantly making excuses.

There has been considerable debate in Japan regarding the effectiveness of anti-takeover defensive measures under company law. In my opinion, this question ultimately depends on who the acquiring party is. If the acquirer has a very bad reputation and is poorly behaved, even the most slipshod countermeasures would be judged effective. On the other hand, if the acquirer is a distinguished company with an excellent reputation, even the most carefully devised defences would be judged ineffective. When so much depends on the identity and features of the counterparty, it is risky to debate the problems of company law with no reference to the character of the specific counterparty. That is to say, such an approach runs the risk of leading to countermeasures capable of warding off all comers on the premise that shareholders are essentially evil. This would represent a serious deterioration of company law theory.

Personally, I believe that the first subject to be discussed must be the character of the acquiring party. In this context, the acquiring party must be able to successfully argue that, if acquiring control of the company, it is capable of more fully realizing the objectives and mission of the target company than the current management. In a mature civil society, it is normally not possible to consummate a hostile takeover of a company that is universally supported by society, which I think is perfectly acceptable. Moreover, I believe that a company has the right to rebuff a takeover when the acquiring party is unable to satisfactorily show that it is capable of making a better contribution to the maximum realization of the company's mission. Based on the perception that corporate acquisitions are generally good, there is a strong feeling in Japan that a company should be able to reject a takeover bid only when the bidder is an abusive acquirer (greenmailers and others). However, I do not share this view.

Finally, I would like to say a few words about an 'incredible defensive measure'. I do so half in jest and half seriously. Japan stands out in the entire world as home to many old and established companies. (Japan has nearly 20,000 companies with histories exceeding 100 years; more than 900 companies with histories exceeding 200 years; about 430 companies that are more than 300 years old; and about 10 companies that are more than 1,000 years old. The oldest existing Japanese company is a 1,400-year-old firm

specializing in temple carpentry and construction.) On the other hand, we have the United States, which is a country with a history of less than 300 years, and a corporate valuation method that uses the same method (such as the discounted cash flow method) to assess the value of centuries-old businesses as the value of companies established just a month ago. I firmly believe that we cannot permit our centuries-old businesses to be bought up according to this standard. Therefore, I am recommending that Japan grow a second tongue and use this to designate all Japanese companies with histories of more than 300 years as 'important cultural treasures', thereby in principle rendering them impervious to all takeover bids. It is with this modest proposal that I wish to close this presentation of a patriot and lover of his home country.

Thank you.