Japanese corporate governance practices in the post-bubble era: Implications of institutional and legal reforms in the 1990s and early 2000s

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ABSTRACT

KEYWORDS: corporate governance, M&As, poison pills, banks, keiretsu, *Japan*

The burst of the financial bubble in 1990 triggered a long recession in Japan. Ensuing massive bad loan problems plagued Japanese banks, many of which faced bankruptcy. Japanese firms also suffered from the massive excess capacity that their banks' bad loans financed. Japanese firms no longer had access to the traditional bank financing from their failing banks and were unable to renew their dated production equipment. They lost global competitiveness in the globalising era. Facing public criticisms blaming Japan's bank-based corporate governance practices for the problems Japan was facing, the Japanese government undertook a major overhaul of almost all aspects of Japan's legal settings for corporate governance. In response to the legal reforms many Japanese firms began changing their corporate governance and other business practices.

Many of the changes that have been proposed or implemented in the 1990s and the 2000s are intended to transform many of Japan's corporate governance practices from insider-oriented keiretsu *and bank-based practices to more transparent market driven practices. These changes are modelled after the US practices. How much of such US practices will be adopted in the end by Japanese firms is still unknown. This paper discusses some of the key changes in Japan's corporate governance laws and their implications for corporate governance practices. Particular attention is paid to the impacts of the recent legal changes on M&A activities and also the changing role of Japanese keiretsu.*

INTRODUCTION

The burst in 1990 of the financial bubble in Japan triggered a long recession in the Japanese economy. It lasted well into the early 2000s and both Japanese firms and households suffered from the lack of economic growth for many years. The Japanese banks' massive bad-loan problem was one of many negative consequences of the recession. Lacking the traditional source of bank financing and facing severe competition from Japan's globalising economic activities, many Japanese firms realised the global competitiveness they enjoyed in the 1980s was all but lost.

In response to this, many Japanese firms began changing their business practices which used to be taken for granted. Many of these changes in business practices have been taking place throughout the 1990s and the 2000s and will likely have fundamental

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implications for the Japanese economy. Japanese firms' corporate governance practices are no exceptions. New Japanese reform laws in corporate governance and other related areas have prompted many industrial firms to undertake new business practices. In addition, failing Japanese banks became the target of the government reform. The new reform laws, some of which specifically addressed Japanese banks, were implemented to monitor banks' behaviour after they were bailed out by the government. It is important to emphasise that Japanese banks traditionally shaped the corporate governance mechanisms of most Japanese industrial firms. As discussed below, Japan's financial deregulation laws and bank reform laws being implemented have had major impacts on Japanese bank behaviour and, in particular, Japan's bank-based corporate governance mechanisms.

Many of the changes in business practices that have been proposed or implemented so far are modelled after the corresponding US (or more broadly the Anglo-American) practices. Establishment of (1) proper market-based mechanisms for corporate governance and (2) mechanisms for monitoring and ensuring smooth and transparent operations of such activities was emphasised by the Japanese government. This is characterised also as a process by which Japanese practices adapt to the Western standard (*de facto* the global standard). Since every aspect of today's Japanese economy is tied to the global economy in some ways, it is likely that significant adaptation of global practices by Japan will take place.

Although it is premature to predict what types of patterns of corporate governance practices will result in equilibrium (or if such an equilibrium exists in the long run), it seems evident by now that the general approach to accomplishing many of market-driven US style practices has been successful, though it has been clearly evolutionary and experimental in many ways.

It remains to be seen, however, how such an adaptation of Western practices will be mixed with the existing Japanese practices, particularly those involving interfirm (*keiretsu*) relationships.

The Japanese government initiated a number of reform measures which they thought would help Japan to regain its global competitiveness. These measures are wide-ranging[1] and include new legal measures and institutional practices in such areas as: corporate governance, financial deregulation and monitoring; bank behaviour, information disclosure and accounting; and market for corporate control (M&As).[2] These measures are briefly discussed below.

A significant number of new regulations and laws in corporate governance have been proposed and implemented throughout the 1990s and the early 2000s. Many of these changes will have a major impact on the corporate governance practices of many Japanese firms. For this reason it is noteworthy that these changes in the legal settings of Japanese corporate governance took place so promptly. It is generally agreed that the reason for this prompt acceptance of the major proposed changes in corporate governance practices is that the problems with the bank-based corporate governance mechanisms prevailing in Japan until the early 1990s were among the major causes of the demise of many Japanese corporations.[3] Even those who defend the benefits of the traditional bank-based corporate governance system concede that the times for such a system are gone. They also argue that a more market-based corporate governance system with proper incentive-based practices and disclosure clauses, particularly those of the Anglo-American system should replace the old post-Second World War Japanese practices. In order to achieve this goal, the Japanese government promptly introduced laws which bring transparency and market based practices into corporate governance mechanisms, capital markets and bank behaviour (eg financial deregulation, monitoring), securities exchange and other areas related to corporate-governance.

Capital market liberalisation

Facing this circumstance and the near collapse of many of the major banks and industrial firms,[4] the Japanese government has implemented several capital market liberalisation measures which would facilitate firms to access public capital markets. For example, firms can in principle issue straight corporate bonds without collaterals. Until the early 1990s firms were free to issue unsecured bonds with equity nature (eg convertible and warrant bonds) and secured bonds with collaterals but not (unsecured) straight corporate bonds. In order to force corporations to disclose relevant information for their investors many aspects of the Commercial Code, the Securities Exchange Law and other laws have been revised. The primary objectives of these changes are to introduce Western standards in accounting transparency and protection of investors.

Accounting transparency

For example, Japanese corporations are now required to file quarterly with the Ministry of Finance consolidated financial statements which report activities for the parent as well as its related firms. (Previous reporting was mostly for stand-alone firms.) Under these new reporting rules many, if not all, of the transactions between the parent and subsidiary firms which used to be hidden from the public, will have to be reflected in the reported accounting numbers.[5]

Under the new rules the value of the financial securities (and also golf club memberships) a firm owns and their unrealised losses must be reported at market value under most circumstances. (Previously no market value had to be reported so long as the securities were kept unsold.) The new requirement implies that banks must disclose the state of their financial assets and loans at market value. This is expected to add previously non-existent transparency. This measure, combined with a new law limiting banks' equity ownership to the level of their own capital, has already had a major impact on Japanese banks.[6]

Another change took place in regard to how R&D expenditures are to be reported. R&D expenditures must now be treated as current expenses. (Previously R&D expenses could be treated as either expenses or an item to be capitalised.[7])

Corporate governance practices

In addition to the above measures to increase information disclosure and transparency, a number of measures have been implemented to improve firm performance and firm value by revising certain corporate governance practices and also market transactions (ie M&As) involving corporations.[8] These include: options to use executive committees for management purposes; optional use of outside directors; legalising holding companies;[9] legalising treasury stocks and warrants to new stocks; and legalising the issuing of various classes of stocks previously not allowed (eg tracking stock[10]). In addition purchasing firms by exchanges of stocks will become legal later in 2006. While takeover bids (TOBs) have been available since 1971, its effective use for M&As began only recently when other relevant tools for M&As (particularly hostile M&As) and legal settings became available. Also, the recent hostile takeover attempt by the Livedoor Corporation to acquire control of the Nippon Broadcasting System prompted many other corporations to be prepared to defend hostile takeover attempts by implementing various anti-takeover measures including poison pills.[11] The Livedoor-NBS incidence is summarised below.

M&A: Livedoor-Nippon Broadcasting-Fuji Television anti-takeover incidence

A historical event involving the hostile takeover attempt by Livedoor Corporation took place in early 2005, giving the public an opportunity for a comprehensive case study of what could happen to Japanese corporations in a modern (Anglo-American?) era. This event was historical in that it made clear in the eyes of the public: (1) what is at stake (the incumbent management versus the shareholders) in a hostile takeover; (2) the Japanese courts accepted the rights of the firm's general shareholders as the owners of the firm (ie the share-value maximisation principle), thus denying to give blind protection to incompetent management, as was often done in the past; (3) the incumbent management's anti-takeover efforts are justifiable only if they provide better expected future profits for the corporation; and (4) a reasonable boundary within which poison pills and other anti-takeover devices are acceptable. The timing of the Livedoor incidence coincided with the ongoing discussions of the revised (new) company law in the Japanese parliament, and the 'lessons' from this incidence were promptly incorporated as parts of the new company law (subsequently enacted in May 2006).

In part prompted by the above incident, the Japanese government (Ministry of Justice and Ministry of Economy, Trade and Industry in particular) has been revising both the Commercial Code and the Securities Exchange Law to delineate the legal extent of various poison pills being proposed by corporations.[12] One underlying issue, which was also highlighted recently by the court case involving Livedoor and the Nippon Broadcasting System, is protection of the existing shareholders without protecting the incompetent management while allowing firm value increasing takeovers to succeed.[13]

Japan has been vigorously implementing various marked-based corporate governance practices and reporting requirements throughout the 1990s and 2000s. These new practices, and the associated laws introduced, are based mostly on the US model. As discussed below, these reform measures have been accompanied by the considerably declined status of Japanese banks as shareholders of Japanese industrial firms. Many of the shares sold by Japanese banks in the market have been purchased by both domestic and foreign individual and institutional investors. This has also resulted in an increased awareness of the importance of non-corporate shareholders such as individual and institutional shareholders by the management of many of Japan's listed corporations.[14]

BANKS' ROLE IN CORPORATE GOVERNANCE

Japanese banks were particularly influential in corporate governance as both the major creditors and the shareholders of many of their client firms until the mid-1990s. This dual role the Japanese banks have enjoyed is still allowed by the Japanese Anti-Monopoly (Anti-Trust) law, by which banks can own up to 5 per cent of the outstanding shares of any industrial firm for control purposes.[15] Their status as Japanese firms' shareholders has been significantly reduced, starting in the late 1990s, at least in the aggregate sense. Table 1 and Figure 1 show the shareholding patterns by stable shareholders of the listed firms in Japan.

Table 1 shows the shares of stable ownership in Japan's listed firms by company shareholders such as banks, insurance companies and industrial firms. This type of stable ownership is intended for long-term control, business transaction benefits and other purposes. In most cases these corporate shareholders are considered friendly in that they do not sell their shares in an opportunistic manner and hence are typically called stable

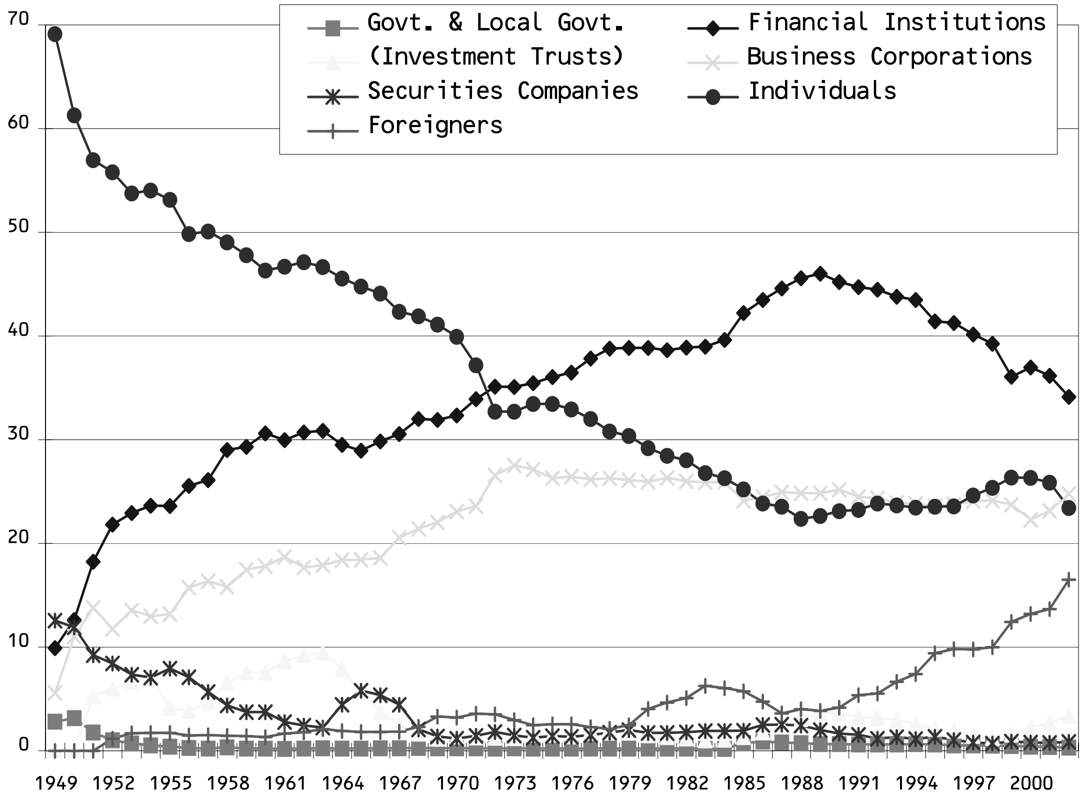
Table 1: Changing patterns of stable shareholding (s.s.): Japanese listed firms, 1987–2003 (in %)

YEAR	*ALL S.S. (1)*	*FINANCIAL INSTITUTIONS (2)*	*Banks (3)*	*Banks: cross-holding (4)*	*Insurance firms (5)*	*Insurance firms: cross-holding (6)*	*BUSINESS FIRMS (7)*	*Business firms: cross-holding (8)*	*Business firms: related firms owned (9)*	*CROSS-HOLDING: SECURITIES FIRMS (10)*	*CROSS-HOLDING: TOTAL (11)*
1987	45.8	31.3	14.9	6.7	16.4	1.0	14.4	10.7	3.1	0.1	18.5
1988	45.7	32.3	15.6	7.1	16.6	0.9	13.3	10.0	2.8	0.1	18.1
1989	44.9	31.3	15.6	7.3	15.7	0.8	13.4	9.1	3.7	0.1	17.4
1990	45.6	31.5	15.7	7.5	15.8	0.9	14.0	9.7	3.7	0.1	18.1
1991	45.6	31.8	15.6	7.6	16.2	0.9	13.7	9.3	3.9	0.1	17.9
1992	45.7	31.8	15.6	7.5	16.2	0.9	13.8	9.4	3.8	0.1	17.8
1993	45.2	31.2	15.4	7.4	15.8	0.8	14.0	9.3	4.1	0.1	17.6
1994	44.9	31.1	15.4	7.4	15.8	0.8	13.7	9.1	4.0	0.1	17.4
1995	43.4	29.8	15.1	7.4	14.8	0.9	13.6	8.8	4.1	0.1	17.1
1996	42.2	29.8	15.1	7.9	14.7	0.9	12.2	7.5	4.5	0.1	16.3
1997	40.5	28.9	14.8	7.5	14.1	0.9	11.6	6.7	4.6	0.0	15.1
1998	39.9	26.7	13.7	6.5	13.0	0.7	13.2	6.0	7.0	0.0	13.3
1999	38.0	22.0	11.3	5.4	10.6	0.7	16.0	4.7	11.1	0.0	10.9
2000	33.1	20.7	9.8	5.4	10.9	0.7	12.4	4.3	7.9	0.0	10.4
2001	30.2	18.8	8.7	4.8	10.1	0.6	11.4	3.7	7.8	0.0	9.0
2002	27.2	17.0	7.7	4.0	9.3	0.6	10.1	3.3	6.9	0.0	7.9
2003	24.3	13.9	5.9	3.0	8.0	0.8	10.3	3.8	6.5	0.1	7.6

Notes: these figures represent the fractions of ownership by the respective owners of the listed firms' outstanding shares (in share value).
1= (2) + (3)+ . . . +(10); (2) = (3) + (5); (3) > (4); (5) > (6); (7) > (8); (7) > (9); (11) = (4) + (6) + (8) + (10).

Source: Nissei Kiso Kenkyusho (NLI Research Institute) (2004) 'Survey of cross-shareholding (mochiai) for 2003' (in Japanese), Tokyo, September. Available online at www.nli-research.co.jp/stp_repo.html.

Figure 1: Long-term trends in ownership structure of Japanese listed firms



Source: Miyajima, H. and Kuroki, F. (2005) 'The unwinding of cross-shareholding: Causes, effects, and implications', RIETI discussion paper #05-E-006, 2005, available at www.rieti.go.jp/jp/publications/dp/05e006.pdf.

shareholders. These stable shareholders include pairs of companies which cross-own each other's shares (cross-shareholding). (Such cross-shareholding is called *mochiai* in Japan.).[16]

We see from Table 1 that the fraction of shares listed on Japanese stock exchanges that were held by stable shareholders declined from 45.8 per cent in 1987 to 24.3 per cent in 2003. In particular the banks held 14.9 per cent (of which 6.7 per cent in *mochiai*) of the total stable shareholders' shares in 1987.[17] These banks' share declined to 5.9 per cent (3.0 per cent in *mochiai*) in 2003. The fraction of shares held by the financial institutions including banks and insurance companies declined from 31.3 per cent in 1987 to 13.9 per cent in 2003.

The substantial decline in shareholding by the banks took place starting in 1998 when Japanese banks' massive non-performing loans prompted the Japanese government to force the banks to improve their financial performance. Two major government policy measures were implemented to achieve this: (1) an injection of public funds into the banks in financial distress; and (2) forcing banks to sell off the shares of other companies they owned. The injection of public funds came with strict government restrictions on bank management. One such restriction is to limit banks' shareholding. This, combined with policy measure (2) forced banks to reduce their holding of shares in other companies. These will be explained in turn.

Injection of public funds

The Japanese government's laws to stabilise the financial sector took the form of a series of cash injections into the troubled banks in 1998 and 1999, with the possibility of nationalising them in case the banks could not recover sound performance within certain specified periods. The first and second injections were budgeted, respectively, at ¥13trn and ¥25trn. All banks except the Tokyo-Mitsubishi Bank chose to apply for these government rescue cash injections. These cash injections took the form of preferred shares without voting rights which are convertible to common shares under certain bank performance conditions. For example, if a rescued bank fails to meet the government's performance criteria in a specified timescale, then the government's shares will become common shares with voting rights and the government takeover of the bank will become possible.

Many of the banks, including major city banks, were facing bankruptcy at that time. Injections of public funds came with many conditions that were imposed on the bank management including prompt disposition of the banks' bad assets (such as highly devalued financial securities in other firms) and non-performing loans which were increasing at a rapid rate. The amounts of non-performing bank loans that were disposed of in 1998 amounted to ¥10.4trn for the 14 largest banks.

In comparison, the total amount of public funds injected into Japan's large banks since 1998 amounted to ¥10.8trn, of which half has been returned by the banks to the Japanese government by early 2006. Upon payback, the government sold off the banks' preferred shares they owned in the market and made profits of at least ¥0.4trn (about US$3.8bn) so far.

Forcing banks to sell off other companies' shares

The continuing poor performance of stock prices during the entire recession periods since 1990 seriously hurt the banks that counted on capital appreciation in the shares they owned over time. For example, massive depreciation of bank-owned shares significantly reduced the ratio of banks' own capital to risky assets including loans, resulting in many Japanese banks' inability to satisfy the own-capital ratio requirement (8 per cent or higher) set by the Basel Accord for conducting international operations.[18] Many Japanese banks, including large banks, had to terminate their international banking operations, thus undermining their financing and investment capacity.[19]

It is at this time that the government (the Financial Supervisory Agency) adopted the policy that the banks must reduce their shareholding in order to lower their exposure to the fluctuations in stock prices.

Additional measures were taken by the Japanese government to reduce the banks' exposure to the stock market. One such measure was to set up the Banks' Shareholdings Purchase Corporation (BCPS) in 2002. BCPS was created in 2002 by the new law to limit Japanese banks' shareholding to the amount of their own capital. This law required the banks to promptly sell off the shares they held in other firms (including their own client firms) in order to meet the required capital target by the above law. In order to avoid the anticipated negative impact on the stock market of such a mass sale of bank-owned shares, BCPS was established for the purpose of purchasing bank-owned shares at market value. The banks were allowed to choose the shares to be sold off in the market. The corporation is capitalised at ¥10bn, which the member banks must provide. The Japanese government guaranteed all required financing, which took the form of bonds issued by the corporation, up to ¥4trn (US$39bn).

As it turned out, the rescue plan by the BSPC was not effective enough to induce the banks to sell the shares they owned. The banks argued that the transaction cost associated with the BSPC plan was in part to blame. Facing the further deteriorating economy, the Bank of Japan, under pressure from the ruling political parties, decided to buy up the bank-held shares directly. (Under normal circumstances such share purchases by the BOJ is prohibited.) In justifying this decision the BOJ argued as follows:

> 'Japanese banks' non-performing loan problem reflects the structural problems of both Japanese industry and Japanese finance industry and hence both must be dealt with by policy; Japanese banks have either written off or set aside reserve for up to 90 trillion yen (about 890 billion dollars) of their bad loans in the previous 10years (i.e. 1992–2001) and yet no improvement is in sight; these 90 trillion yen in bad loans accounts for almost 80% of the loans for Japanese industries' net investment provided by all Japanese banks during the bubble period 1986–1990, suggesting a serious structural problem in Japanese industry; in this circumstance, in order to prevent further deterioration in Japan's financial system and stabilize Japanese banks, it seems a viable alternative for BOJ to buy up bank-held shares and also inject further public funds into Japanese banks.'[20]

The BOJ's plan was not to sell the acquired shares for up to the next 10 years. The BOJ originally set aside ¥3trn for the purchase of banks' shares and actually bought ¥2.18trn (about US$20bn) worth of shares from the Japanese banks during the period November 2002–September 2004. The shares eligible for their purchase were those of firms with BBB quality or above (ie the firms have ability to pay back debt but the ability may deteriorate over time).[21]

This new bank capital law originally required all banks to limit the value of banks' shareholding to the level of their own capital by 2004 but the deadline has now been extended to 2006. This extension was necessary because many of the banks could not make the original 2004 deadline.[22]

Another factor which forced Japanese banks to reduce their shareholding was the new rule we discussed earlier that states that the value of the financial securities (and also golf club memberships) that banks and firms own and their unrealised capital losses and gains must be reported at market value under most circumstances. Since continuing to hold poorly valued stocks in other firms did not help banks' financial reports under such market value based reporting requirements, Japanese banks sold significant parts of their stock holdings.

To sum up, the massive purchases by the BOJ and BSPC of the shares held by Japanese banks and the banks' own sale of their shares for the reasons given above, reduced the amounts of the shares they held rapidly, beginning in 1998, as is seen in Table 1.

KEIRETSU, SHAREHOLDING AMONG FIRMS AND HOLDING COMPANIES

One characteristic of industrial organisation of Japanese firms is their tendency to use relatively small but not negligible amounts of equity ownership as a means of maintaining their interfirm (*keiretsu*) relationships including business relationships.[23] This section discusses the recent developments in *keiretsu* relationships and the possible relationships of recently legalised holding companies to such *keiretsu* relationships.

Bank-based horizontal *keiretsu* groups

Until the mid 1990s the six horizontal *keiretsu* groups based around the six major banks (Mitsui, Mitsubishi, Sumitomo, Daiichi-Kangin, Sanwa and Fuji Banks) were particularly prominent because of their large member firms representing most of the Japanese industries.[24] But the collective decision processes underlying their behaviour as an industrial group were never transparent to the public and the groups themselves never took time to explain their decision processes either. The economic effects, particularly the economic gains to the member firms due to their group memberships have not been empirically demonstrated. These bank-based horizontal *keiretsu* group relationships have been undoubtedly going through significant reorganisations since the early 1990s for the following reasons.

1. The six banks merged into three major bank groups by the early 2000s. These three bank groups are: the merged group of the Bank of Tokyo-Mitsubishi (resulting from the merger of the Mitsubishi Bank and the Bank of Tokyo) and the UFJ Bank (which resulted from the merger of the Sanwa and Tokai Banks); the merged group of the Mitsui and Sumitomo Banks; and the merged group of the Daiichi-Kangyo Bank, the Fuji Bank and the Industrial Bank of Japan. These three newly created bank groups are now represented by their respective (pure) holding companies. At this time the relationships of these bank holding companies to the former six bank-based horizontal *keiretsu* groups is unclear.
2. Following the liberalisation of the access to the corporate bond markets in Japan in the 1990s, together with the existing access to certain global capital markets, many qualified Japanese firms backed by their good firm performance have chosen to depend more on the outside capital markets for financing. As a result better firms significantly reduced their dependence on bank loans. At the same time, as stated above, the banks sold off many of the shares they held in these good-performing firms in order to raise cash and satisfy their capital requirements.[25] The result is the much lessened equity ownership and bank debt based relationships between the banks and their client firms with good performance records.[26] In other words, the traditional main bank relationship (strong equity and bank loan-based relationships between the main bank in the centre and member firms), which used to tightly connect banks to their client firms, whether they are inside or outside the bank's horizontal *keiretsu* group, disintegrated significantly in the 1990s and 2000s.[27] It is also important to emphasise that poorly performing Japanese firms have not had any opportunity to raise outside capital (eg secured or unsecured corporate bands), in part because Japanese bond markets are not yet able to deal with (or rank) high-risk bonds (eg junk bonds). Recent empirical studies[28] suggest that the types of the close relationships Japanese banks used to have with their client firms involving bank loans and equity ownership until the 1980s now tend to be, to a large extent, limited to Japanese firms with poor performance records.
3. At this time (in June 2006) reorganisation of Japanese banks is still continuing and we have not yet seen an equilibrium for the new patterns of financing for Japanese firms. Therefore it is not clear what types of bank-based *keiretsu* groups will emerge once the current transitory circumstances resulting from the banks' non-performing loans, new corporate governance reform measures and other factors have been settled.

Production-based vertical *keiretsu* groups

Another main type of shareholding in Japan is shareholding among non-financial industrial firms. The typical objectives of such shareholding are to control supplier

Table 2: First tier auto suppliers in the Toyota production *keiretsu*

SUPPLIER COMPANY NAME	*TOYOTA'S OWNERSHIP SHARE (%)*	*IS TOYOTA THE LARGEST SHAREHOLDER?*	*MARKET VALUE (IN BILLION JAPANESE YEN)*
Toyota Auto Body	50.0	Yes	242
Kanto Auto Works	50.0	Yes	89
Toyoda Gosei	42.7	Yes	248
Aisan Industry	34.7	Yes	59
Tokai Rica	27.0	Yes	147
Koyo Seiko	24.0	Yes	308
Toyoda Koki	23.6	Yes	140
Toyota Industries	23.5	Yes	955
Denso	23.2	Yes	2184
Aisin Seiki	22.2	Yes	713
Koito Manufacturing	20.0	Yes	188
Shiroki	16.9	No (Toyota is the second largest shareholder)	25
Akebono Brake	13.8	Yes	60
Futaba Industrial Co.	12.2	Yes	145
KYB (Kayaba)	8.8	Yes	81
Ichikoh (Ichimitsu) Industries	6.1	No (Toyota is the second largest shareholder)	26
Owari Precise Products	5.5	No (Toyota is the third largest shareholder)	4
T.Rad (Toyo Radiator)	4.9	Yes	36

Note: The figures in the table are as of May 2005.

firms in vertical production relationships (called vertical or capital *keiretsu*) and also to exert influence on the business decisions of other firms. While it is not unusual for large Japanese manufacturers to own more than 50 per cent of the outstanding shares of their key subsidiaries (often their former production divisions) particularly right after the spin-off of such divisions as new listed subsidiaries, it is also not unusual for large Japanese assembly firms (eg Toyota) to own relatively small amounts of the outstanding shares (eg 20–30 per cent) of many of their suppliers (see Table 2). Such assembly firms are able to exert much influence, for example, on their suppliers' production decisions, on an ongoing basis, in such strategic areas as quality control, just-in-time production systems and new product development.

It is generally thought that production effectiveness of such a vertical *keiretsu* system relies not only on the business relationships, such as customer–seller relationships between the assembler (customer) and their suppliers (sellers), but also the presence of the assembler firm's ownership in the suppliers. It is also not unusual for the assembler firm to send personnel as directors of their supplier firms' boards. In other words, equity ownership in these vertical relationships matters. The role of such equity ownership,

Table 3: Nissan's suppliers who are owned at least 20 per cent by Nissan

SUPPLIER NAME	*NISSAN'S OWNERSHIP, MARCH 2001 (%)*	*NISSAN'S OWNERSHIP, MARCH 2002 (%)*
Tennex	56.7	0. Acquired by Mahle GmbH; became "Mahle Tennex," now fully owned by Marle GmbH.
Nissan Body	42.7	42.6
Aichi Machine Industry	41.4	41.4
Kiriu	36.7	0. MBO by Unison Capital. Now fully owned by Sumitomo Corp.
Calsonic Kansei	32.0	32.0. Now increased to 41.7.
Fuji Univance	31.1	10.32. Shares sold to I.S. Precision Machinery and Daido Steel. Will merge with I.S. Precision in 2005.
Unipres	30.3	14.89. Shares sold to Nippon Steel and Mitsui Bussan.
Ohi Manufacturer Co.	28.8	0. Became Mitsui Kinzoku's fully owned subsidiary; now merged into Mitsui Kinzoku.
Hitachi Unisia Automotive	25.3	0. Now merged into Hitachi, Ltd.
Tsubakimoto Foaming Ind.	24.8	24.8
Nikki	23.8	0. Hitachi owns 7.39.
Exedy	23.4	0. Shares sold to Aisin Seiki Companies.
Jideco (Jidosha Denki Kogyo)	22.7	0. Now owned fully by Mtsuba.
Nissan Diesel	22.5	22.5
Tochigi Fuji Sangyo	20.5	0. Now becoming fully owned by G.K.N. Automotive (Spain).
Kinugawa Rubber	20.3	20.3

however, has not been understood well empirically.

Right after its takeover in 1999 of the Nissan Motor which was facing bankruptcy in Japan, Renault sent in Carlos Ghosn as Nissan's CEO. In his publicly announced plan to revive Nissan, Ghosn argued for the efficient and more profitable use of Nissan's assets and selling off those assets which are not generating enough returns. In particular he declared to sell away most of the shares Nissan then owned in their suppliers (except for the four suppliers' shares), arguing that this type of shareholding is mostly a drag on Nissan's performance and that Nissan can do well with its supplier relationships without resorting to such shareholding. Although he did not exactly get rid of Nissan's shareholding in their suppliers entirely, Nissan nevertheless sold off a large part of the shares they had in their suppliers. Table 3 shows some of the changes in Nissan's ownership in its former suppliers that took place between March 2001 and March 2002.

In the process of reviving Nissan Ghosn reduced the number of suppliers by about 50 per cent and brought competitive bidding into their parts procurement processes. Nevertheless he subsequently conceded that the supplier relations are important. In recent months Nissan did increase equity ownership in certain suppliers with the specific purpose of tightening up their supplier *keiretsu*. The impact of the *keiretsu* assembler firms like

Toyota, Nissan and Honda on their *keiretsu* supplier firms' corporate governance is significant in many ways. But since these *keiretsu* supplier firms are not generally majority owned by their assembly firms, the assembler firms' influence on their suppliers' corporate governance and management decisions is complex, being limited and balanced against such other factors as the suppliers' competitiveness and ability to acquire customers other than their owner assembler firms.

Nevertheless the assembler firm in a well-functioning vertical *keiretsu* can produce their final products at lower cost than a large vertically integrated firm with the corresponding size. The possible reasons for this are as follows. The group suppliers are usually much smaller than the assembler firm and hence pay lower wages than the assembler firm. Furthermore, independently run supplier firms cause less agency cost than the parts divisions of a large integrated assembler firm. On the other hand, the assembler firm operating a poorly coordinated supplier *keiretsu* group cannot be an efficient producer of the final products. In order to run an efficient vertical *keiretsu* group the assembler firm must pour a substantial amount of effort into the management of their suppliers. Such know-how is a valuable managerial asset.

It is possible that, when Ghosn took over as Nissan's CEO, the Nissan *keiretsu* was in serious disarray and many of the Nissan *keiretsu* supplier firms were not contributing to the efficient production of Nissan vehicles. Ghosn may have brought the Nissan *keiretsu* back to where it should be in terms of the overall efficiency.

Another example of interest is the role of the *keiretsu* suppliers for the Mitsubishi Motor Corporation (MMC). Facing severe financial distress MMC was taken over by Daimler-Chrysler in 2000. Daimler-Chrysler dissolved MMC's supplier *keiretsu* group in 2002 (MMC Kashiwakai) which had 344 member firms. After MMC continued to suffer from poor performance and also MMC's many scandals became public, Daimler-Chrysler decided to give up its control of MMC in April 2004 and sold their MMC shares to the Mitsubishi horizontal *keiretsu* group companies such as the Bank of Tokyo-Mitsubishi, the Mitsubishi Corporation and the Mitsubishi Heavy Industries. MMC's new management continued to have problems with their production operations. In early 2005 MMC announced that they would revive their suppliers' *keiretsu* group consisting of over 100 companies in order to solve the current problems of quality control and cost reduction. Although Toyota, Japan's leading auto maker has continued to strengthen its vertical *keiretsu* group throughout the 1990s and 2000s, Nissan and MMC have not done so. But both Nissan and MMC at this time appear to focus on their vertical *keiretsu* production groupings for improving their operational efficiency.

Implications of legalising of holding companies

Holding companies existed in Japan until the end of the Second World War. Typical examples of pre-war holding companies include Mitsui and Mitsubishi holding companies owned by the Mitsui and Mitsubishi *zaibatsu* families (In the Japanese context, *zaibatsu* is used specifically to mean certain pre-World War II family-owned conglomerates of firms or the families themselves, as discussed here. They were highly influential in the historical development of the Japanese economy). Following Japan's defeat in the Second World War, the Allied Forces banned *zaibatsu* and holding companies in the newly instituted Anti-Monopoly (anti-trust) Law. This law banned pure holding companies (such as Mitsui and Mitsubishi holding companies) which exist only to control other firms owned by them. In addition the law restricted large industrial holding firms, which own other firms for control while producing goods and services themselves, from owning excessively large amounts of equity in those industrial firms under their control. The law also prohibited banks from operating as holding companies to operate industrial firms.[29]

Since 1997 various measures to legalise holding companies were introduced. The December 1997 revision of Japan's Anti-Monopoly Law legalised pure holding companies for industrial firms in Japan. In 1998 pure financial holding companies became legal. In 2002 industrial holding companies became legal and equity ownership restrictions for industrial holding companies were removed; and also restrictions on banks' equity ownership were relaxed and banks' owning securities firms as subsidiaries became legal. In addition to these changes in the Anti-Monopoly Law, the Japanese government introduced various revisions in Japan's Commercial Code over time to facilitate firms to be able to take advantage of holding companies. These revisions include: unrestricted exchange and transfer of stocks in 1999; laws allowing firms to split operations into separate firms in 2000; and taxation based on consolidated financial statements in 2001. In addition free reallocation and deployment of all the personnel of former companies under newly created holding companies became legal. This can in many ways override Japan's reasonably protective laws on employment of existing workers,[30] and, in this sense, a major step forward for developing new company forms.

These revisions in Japan's Commercial Code, tax laws and other legal settings have now been incorporated into the new company law. These massive changes in the legal settings for company structures since the late 1990s have brought significant amounts of flexibility into Japan's industrial organisation. In principle, industrial firms are free to merge and split firm operations together with their workers into separate companies, while taking advantage of liberal use of holding companies. While many of these practices are well known in the West, they are new in Japan and adoption of these practices has just begun.[31]

For example, under these new rules, Fuji Bank, Daiichi-Kangin Bank (DKB) and the Industrial Bank of Japan merged under Mizuho Holding Company, a pure holding firm, and the Mizuho Holding Company in turn was able to reorganise the three former banks' operations and create under it new product and service specific companies. Many Japanese firms began going through this type of reorganisation exercise.

Keiretsu and holding companies

Keiretsu, as described above, and industrial holding companies have certain characteristics in common. For example, in a vertical *keiretsu* like the Toyota *keiretsu*, the assembler firm (Toyota) in the centre owns some equity in its suppliers. Sometimes the assembler firm is the majority owner of supplier firms but typically the assembler firm's equity ownership share in its *keiretsu* supplier firms is less than 50 per cent. These supplier firms are usually listed and are not fully controlled by the assembler firm. Nevertheless, these supplier firms' management decisions are usually heavily influenced by their assembler firm's policies. In the US this type of interfirm arrangement would be criticised at least for three reasons: (1) the assembler firm is usually much larger and much more powerful than its supplier firms, and hence whatever they tell their suppliers to do could be considered anti-competitive; (2) the policies the assembler firm tries to impose on supplier firms might infringe the interests of the minority shareholders of the suppliers; and (3) US managers of such supplier firms, on a cultural ground, might not tolerate the types of interference in their management decisions many Japanese assembler firms impose on their *keiretsu* suppliers. In other words Japanese style vertical *keiretsu* would likely be declared illegal in the USA on anti-trust and shareholders' rights grounds. In fact such *keiretsu* structures do not exist in the USA.

This aspect of Japanese vertical *keiretsu* is different from the standard notion of industrial holding companies, which typically own firms under them fully. In this sense application of holding companies in Japan so far has been most prominent for the reorganisation of intrafirm and merged firms' existing operations. Also, most of the newly created pure holding companies are found in the financial sector. As of now there is no case of a vertical *keiretsu* group of firms that has been turned into a holding company structure.

In conclusion, unless two or more firms in a *keiretsu* group decide to merge, they are not likely to put themselves under a holding company's umbrella. Since *keiretsu* groups still exist in various forms in Japan, it is likely that they will continue to exploit production efficiency as their competitive edge and play their role in the Japanese economy. The demand for legalising holding companies came mostly from the business sector, particularly the Nippon Keidanren, whose current thinking is clearly that holding companies can do a lot more than *keiretsu* in general. As has been argued, holding companies add a new degree of freedom to Japanese firms' organisational structures. It remains to be seen what, if any, impacts holding companies will have on the evolution of Japanese *keiretsu*.

NON-CORPORATE SHAREHOLDERS

A massive number of shares was made available to the Japanese stock market by Japanese banks when they sold off many of the shares they owned. Many of these shares were subsequently bought by domestic and foreign institutional shareholders (eg mutual funds, pension funds) as well as individual shareholders. The significant increase in the number of individual shareholders, in particular, has been accompanied by the substantial increase in the level of the shareholders' awareness of their rights as the owners of the corporations whose shares they own. As a result many Japanese managers and executives now feel they need to respond seriously to their shareholders' inquiries. Initially driven largely by foreign fund managers in the mid 1990s this trend of shareholders taking serious interest in various aspects of corporate decision making was unheard of in the past when large fractions of Japanese firms' shares were held by such stable shareholders as banks and other financial institutions and many other corporations. In those days the general shareholders' meeting was never more than a formal ceremony taking little time and ending without any substantive issues being discussed. Any voice raised by dissatisfied shareholders was suppressed by the *Sokaiya* who was hired by the management to keep the meeting short and quiet.

Japan's business press all noted that, in the general shareholders' meetings of many listed firms held in the latter two weeks of June 2005, many shareholders, both individual and institutional, raised issue with the firm's management about many aspects of management problems that affect their share prices. Many CEOs themselves responded to these questions presented by shareholders. This was unthinkable just a few years ago.[32]

Foreign shareholders

It has been noted above that banks and other corporate shareholders sold off many shares which they used to own for the purposes of cross-shareholding (*mochiai*) and other stable shareholding relationships. These shares in turn were purchased by domestic and foreign pension and mutual funds as well as individual investors. Table 4 shows the change in the ownership patterns for Japanese firms' outstanding shares over time. Both domestic and foreign institutional shareholders more than doubled their shareholding in Japanese corporations between 1987 and 2002. Table 5 shows firms with high foreign

Table 4: Ownership patterns: Japanese listed firms

	1987	*1992*	*1997*	*2002*
Institutional investors — domestic (%)	3.35	5.74	5.07	8.01
Institutional investors — foreign (%)	3.62	4.45	6.83	6.66
Stable shareholders (%)	30.54	30.34	27.61	16.67
Employees owners (%)	0.84	0.90	1.16	1.53
Sample size	9.77	10.79	11.64	13.69

Source: Ministry of Economy, Trade and Industry.

Table 5: *Continued*

	Company name	*Foreign ownership (%) December 2004*	*Change from December, 2003*	*Industry*	*Firm size (sales; total assets)*
47	Konica Minolta	36.3	0.0	Precision	(1,067; 955)
48	Advantest	36.2	7.9	Precision	(239; 297)
49	Mitsubishi Estate	36.2	4.2	Real estate, devl.	(775; 3,124)
50	Nittan Valve	36.1	8.2	Machinery	(27; 33)

Notes: Foreign ownership by institutional investors (pension and mutual funds) and individual investors only. Firm size in billion yen.
Sample: Firms listed on the major Japanese Stock Exchanges, excluding those listed on the stock markets for emerging firms (ie Jasdaq, TSE Mothers, OSE Hercules).

ownership.[33] As of December 2004 the number of listed firms with more than 30 per cent of foreign ownership share was 104 (the number for December 2003 was 75). Some of these firms had more than 50 per cent of their outstanding shares held by foreign shareholders. In 2004 the foreign investors bought US$65bn more Japanese shares than they sold of the firms listed on the Tokyo, Osaka and Nagoya Stock Exchanges.

It has also been pointed out that firms with a high level of foreign ownership tend to be the firms with better (industry-adjusted) performance than other firms. It is possible that foreign shareholders were able to identify undervalued firms while being vocal in demanding improvement in the firms' management. In this sense, foreign shareholders have contributed to improve the performance of the firms they owned. It is also possible that they may have invested in already well-known high-performance firms which had high growth prospects. As Japanese domestic shareholders are becoming more sophisticated and more vocal about firm managers' performance, it is possible that the present foreign shareholder effects may erode over time. Nevertheless, it seems clear that the increasing presence of foreign shareholders in the Japanese stock markets, particularly large pension and mutual funds from the USA and elsewhere, has played a significant role in modernising the Japanese corporate governance practices in the 1990s. The questioning of corporate management decisions by fund managers prompted many Japanese firms to pay more attention to share value maximisation and the more full utilisation of their firms' assets.

Table 5: Japanese firms with large foreign ownership, December 2004

	Company name	*Foreign ownership (%) December 2004*	*Change from December, 2003*	*Industry*	*Firm size (sales; total assets)*
1	Orix	57.2	6.5	Fin. services	(917; 6,069)
2	Hoya	55.6	5.1	Optical	(308; 351)
3	Yamada Denki	55.6	5.5	Appliance retail	(1,102; 376)
4	Credit Saison	52.0	9.8	Fin. services	(—; —)
5	Canon	51.7	1.8	Precision	(3,670; 3,587)
6	Don Quijote	50.9	9.9	Retail	(232; 147)
7	Nitto Denko	49.5	4.0	Electrical mach.	(515; 443)
8	Meitech	49.5	9.7	Precision	(79; 69)
9	Fuji Photo Film	48.7	4.5	Chemicals	(2,527; 2,983)
10	Rohm	48.7	1.7	Semi-conductors	(369; 867)
11	Sony	48.1	8.7	Electronics/entmt.	(7,160; 9,499)
12	eAccess	48.1	—	Broadband serv.	(58; 135)
13	Kao	47.1	8.5	Chemicals	(937; 689)
14	SMC	45.2	7.0	Machinery	(280; 539)
15	Astellas	44.5	3.4	Pharmaceutical	(447; 913)
16	Fanuc	43.7	9.1	Numerical mach.	(330; 799)
17	Aderance	41.6	17.7	Wigs mnfg.	(70; 83)
18	Tokyo Electron	41.5	4.6	Semi-con. equip.	(636; 644)
19	Shimachu	41.5	7.3	Furniture retail.	(119; 168)
20	Takeda Pharmaceutical	41.0	2.9	Pharmaceutical	(1,123; 2,545)
21	TDK	41.0	−1.0	Electronics	(668; 790)
22	Secom	40.8	3.6	Security service	(547; 1,097)
23	Mitsui Sumitomo Insur.	38.8	−1.7	Insurance	(1,407; 7,402)
24	Osaka Stock Exchange	38.6	19.2	Stock exchange	(10; 155)
25	Murata mfg	38.1	2.1	Electronics	(424; 851)
26	Santen Pharmaceutical	37.9	2.3	Pharmaceutical	(93; 140)
27	Kurita	37.9	5.4	Build. equip.	(161; 192)
28	Nintendo	37.9	−1.4	Entertainment	(515; 1,132)
29	Nomura Securities	37.9	−2.3	Securities	(1,126; 34,489)
30	Eisai	37.7	2.2	Pharmaceutical	(533; 633)
31	ryohin keikaku	37.7	4.7	Retail.	(128; 61)
32	Shimano	37.6	8.3	Precision	(169; 180)
33	Mitsui Fudosan	37.6	3.2	Real estate dev.	(1,111; 2,928)
34	Hirose Denki	37.4	0.1	Appliance retail.	(89; 222)
35	Nippon Koa	37.3	6.5	Auto insurance	(728; 3,422)
36	Mandom	37.2	11.1	Consumer prod.	(47; 47)
37	Daito Kentaku	37.1	2.1	Real estate, devl.	(492; 409)
38	Daikin	37.0	4.2	Genera mach.	(729; 618)
39	Olympus	37.0	6.9	Precision	(813; 858)
40	Sumitomo Trust Bank	37.0	6.1	Trust banking	(501; 1,5908)
41	Pioneer	36.9	0.2	Electronics	(734; 725)
42	Sompo Japan	36.7	1.8	Insurance	(1,376; 5,875)
43	Keyence	36.6	3.9	Precision	(107; 338)
44	Hitachi, Ltd.	36.5	1.8	Electrical mach.	(9,027; 9,736)
45	Millea Holdings	36.5	4.5	Insurance	(1,925; 11,624)
46	UFJ	36.4	4.9	Banking	(—; —)

For example, foreign shareholders expressed serious objections to many of the items on the agenda to be discussed at their firms' general shareholders' meetings held in June 2005. Foreign shareholders voted negatively on more than 1,800 items at the general shareholders' meetings of Japanese listed firms. In particular the foreign shareholders objected strongly to firm management's proposals to introduce poison pills which would allow the management to expand the firm's share base in response to hostile takeovers.

The firm management's proposal to set up a poison pill for deluding the share base was voted against in more than 200 cases (more than 85 per cent of all the cases) at the listed firms' general shareholders' meetings. It is believed that many foreign shareholders followed the advice given by the Institutional Shareholder Service to accept or reject each of the specific agenda items proposed for approval by the management at each of the 2,000 firms listed on the Japanese stock exchanges. ISS was commissioned by US and European pension and mutual funds to make recommendations on each of the 1,830 agenda items the management of the 2,000 listed firms proposed for approval by their shareholders.

The next section will summarise recent developments in M&A related activities which are of particular interest to Japanese corporations in the new legal environment.

RECENT DEVELOPMENTS IN THE MARKET FOR CORPORATE CONTROL: M&AS IN JAPAN

The Livedoor incident prompted vigorous discussions on possible government policy alternatives which would define the legal environment for M&A activities. The new company law, which implements changes on almost all aspects of Japan's antiquated Commercial Code, stipulates the new rules about M&As in two parts: the parts on poison pills which took effect in 2006; and the parts on the provisions for facilitating M&As which will take effect in 2007. For example, in anticipating hostile takeover attempts, firm management is allowed to give equity warrants to shareholders in advance and to issue new shares to the holders of the warrants when a hostile bidder acquires a predetermined fraction of the firm's outstanding shares. The new law also allows the firm management to change their corporate charters to make stricter the conditions under which the shareholders can approve of mergers at their general meetings.

Another related legal revision made in response to the Livedoor incidence is the more active enforcement of the TOB clause. Japan's parliament passed the revised Securities Exchange Law, and one of the new provisions of the revised law states that the purchaser of more than one-third of a listed firm's outstanding shares from the existing large shareholders outside the stock exchange system must use the TOB mechanism all the time. Livedoor used a loophole of the previous law which required TOB only for such purchases of outstanding shares during the hours of operation of the open market of the Japanese stock exchange system. Once the Tokyo Stock Exchange closes, the open market closes but the TSE system continues to operate out-of-hours, and transactions using the TSE system during these out-of-hours periods are registered as market transactions which did not violate the previous law on TOB. The new provision on TOB of the Securities Exchange Law was enacted in July 2005 and closed the loophole Livedoor used in their hostile takeover attempt of the Nippon Broadcasting System.[34]

In response to the increased possibility of hostile takeovers many firms have expressed interest in implementing poison pills. The Japanese government (the Ministry of Economy, Trade and Industry and the Ministry of Justice) responded to this by setting their guidelines by which poison pills could be justified.

Poison pills

The types of poison pills which caused the shareholders' revolts discussed above are those that are well known in the USA. However, the following anti-takeover devices have special implications for Japanese firms and deserve attention.

First, promoting cross-shareholding and other stable shareholding would reduce the number of outstanding shares the potential hostile takeover bidders could buy up[35] and hence will work as a poison pill. This method has historically been the cornerstone of Japanese firms' anti-takeover mechanisms since the 1960s and its effectiveness has been unquestionable. While this will continue to be potentially effective in Japanese corporate governance, the actual extent of stable shareholding including cross-shareholding, as discussed above (Table 1), has declined significantly during the 1990s. For this reason, despite its popularity among many Japanese firms, prospects for its success are unclear.

Another anti-takeover method, delisting the shares of the subsidiaries which are owned by a parent firm, is a standard method in the USA. This would eliminate the possibility that the parent firm gets greenmails from the firms buying up the outstanding shares of their listed subsidiary firms. We explain here that Japanese firms, unlike US firms, may suffer from certain economic efficiency loss from instituting this poison pill. This is likely to occur in Japan because, unlike in the USA, many Japanese firms list their subsidiary firms' shares in stock exchanges while owning only a block of shares (sometimes more than 50 per cent but not always so) in these subsidiaries. Recall that many production (vertical) *keiretsu* groups have this type of shareholding patterns. For example, Table 2 shows that Toyota Motors owns less than 50 per cent of most of its first-tier Toyota group suppliers.[36] Toyota is known to be seriously concerned about the possible hostile takeover of any one of these suppliers.

Using this poison pill implies reorganising these partially owned subsidiaries as fully owned subsidiaries. This would eliminate the anti-takeover / greenmailing possibilities via these subsidiary firms. However, a potentially serious management problem associated with this method is the loss of production efficiency resulting from the parent firm fully consolidating their supplier divisions. To the extent that the Japanese supplier *keiretsu* is known to have its own economic merit, large assembler firms which rely on such *keiretsu* efficiency might be reluctant to consolidate their subsidiaries. For example, such full consolidation might result in higher wages and the loss of production efficiency (eg due to the agency costs associated with large firms and the lack of plant-level incentives) at the subsidiary's plant operations.[37] But the present vertical *keiretsu* system, as argued above, is inevitably susceptible to hostile takeover attempts and greenmailing.

A well-known example is the case of Bruce Pickens, a corporate raider, who, despite being the largest single stockholder of a Japanese auto supplier, the Koito Manufacturing, in 1990, was denied a seat on its board of directors. Koito is a member of the Toyota *keiretsu* (Table 2), and Toyota, Koito's second largest shareholder, had three seats. The Koito management was able to deny Pickens a director seat because Koito's stable shareholders, including Toyota, other group firms and financial institutions, had more than 70 per cent of Koito's outstanding shares. Pickens complained to the US Justice Department that 'If the Japanese want to operate in this country, they should do so only in complete compliance with all of our laws. If they refuse, then they should face the same civil and criminal penalties as other antitrust violators.' Pickens pulled out of Koito in 1991. It is well known that Toyota has been strengthening their *keiretsu* relationships with their suppliers, including heavily guarded stable shareholding patterns. Such patterns are not easy to maintain for many other Japanese manufacturers who also depend on their traditional *keiretsu* suppliers. For them it may be a matter of time before some of their suppliers will experience successful hostile takeovers.

Implementing poison pills

Recent surveys by Nikkei in December 2005 and by Nomura Securities in May 2006 found that the fraction of Japanese firms which have poison pills and other anti-takeover devices installed is relatively small (6.7 per cent for firms with less than 1,000 employees versus 7.0 per cent for firms with at least 1,000 employees). For large firms with market value greater than ¥100bn, this fraction is 8.5 per cent. Of the anti-takeover devices used, poison pills appear most popular. The triggering point at which the poison pill kicks in tends to be 20 per cent of ownership for many industrial companies (eg Matsushita Electric Industries) but recently Eisai Pharmaceutical chose 15 per cent, a more popular level in the USA and Europe.

A perspective on M&As in Japan

In Japan until the mid 1990s, up to 70 per cent of the outstanding shares of most listed firms were owned by friendly shareholders: banks, other financial corporations and other firms. Hence it was impossible to gain support for a hostile takeover.[38] Consequently virtually all large-scale mergers that took place in Japan until the 1980s were friendly mergers involving domestic companies. They did not involve major changes in the management personnel. In some exceptional cases foreign firms were able to acquire some or the entire ownership of existing Japanese firms in friendly negotiations. In particular, foreign firms were able to take over some of the failing firms which no Japanese firms would want to acquire.

For example, Mazda Motor experienced such takeovers twice (25 per cent by Ford in 1979, which was increased to the controlling ownership level of 33.4 per cent by Ford in 1996). Two previously discussed examples are: Nissan Motor, facing bankruptcy in 1999, was taken over by Renault (ownership 36.8 per cent, which was increased to 44.4 per cent in 2001); and Mitsubishi Motor Corporation whose control was acquired by Daimler-Chrysler in 1999 (ownership 37 per cent) though this relationship was entirely abandoned by Daimler-Chrysler and all of MMC's shares abandoned by Daimler-Chrysler were purchased by Mitsubishi *keiretsu* companies.

As the above MMC example shows, Japan's *keiretsu* groups of various types are heavily involved in M&As. While less than 20 per cent of Japan's M&As involved intra-*keiretsu* group firms until 1992, the proportion of intragroup M&As increased rapidly since then. Since 1996 intragroup M&As accounted for more than half of all of Japan's M&As. These intragroup M&As are between group firms, and, by definition, no group M&As are hostile M&As. It is of interest to compare the implications for economic efficiency between intragroup and non-intragroup M&As.[39]

Despite a number of well-publicised foreign takeovers of failing Japanese firms in recent years, the overwhelming majority (more than 80 per cent) of M&As involving Japanese firms are between Japanese firms. Japanese firms' acquisitions of foreign firms constitute about 15 per cent of all M&As while the remaining 5 per cent involve foreign firms acquiring Japanese firms. About 50 M&As involving Japanese firms used takeover bids (TOBs) in 2005.[40] Using TOBs were rare in Japan until 1997 but began to increase gradually since then. Another trend in the recent M&As is the involvement of investment funds (mostly of US and European origin) as acquirers of Japanese firms. Acquisitions by these investment funds were almost non-existent until 1998 but became very visible in the last few years. They are estimated to be involved in about 300 to 400 M&As annually in Japan.

Globally the size of Japan's M&A market is quite small by comparison. For example, the total amounts involved in the M&As globally in 2004 were $1,500bn, of which Japan's share was only 4.4 per cent ($65bn).[41] Most of these M&As took place in the USA and Europe. In this sense the market for corporate control in Japan is not yet as fully developed as in the USA. But Japan's current attempts to deregulate all areas of M&A activities have had a positive impact in expanding the market, as the above figures suggest.

M&As, particularly those involving foreign firms, can potentially have significant impacts on the real economy in the form of higher productivity. Fukao *et al.*[42] report that M&As where foreign firms purchase domestic firms tend to increase the productivity of the acquired firm (primarily because these M&As are typically accompanied with some reductions (eg layoffs) in employment). On the other hand M&As between two domestic Japanese firms tend to be characterised as stronger firms absorbing weaker and struggling firms, resulting in somewhat lowered levels of increased productivity, if at all, for the acquiring firm.

The amounts of Japan's inward foreign direct investment (FDI) continue to be quite small compared to the amounts of Japan's outward FDI. But foreign firms often bring in new technology and management methods, for example, which contribute to increasing Japanese productivity. For this reason we would expect that deregulation of M&As involving foreign firms will result in visible increases in Japan's productivity.

THE STATE OF CORPORATE GOVERNANCE

The prolonged recession, the massive non-performing loan problems of banks, globalising trends in business operations and other factors have faced Japanese corporations since the burst of the bubble in the 1990s. The financially weakened Japanese banks and industrial firms have sold off many of the shares they held in other firms. In this process Japanese banks seemed, in particular, to have reduced their capacity to influence firms' corporate governance. Strong industrial firms are now able to depend more than ever on debt capital directly raised in public capital markets. Individual and institutional shareholders, many of whom are foreign, have acquired the shares Japanese banks and firms used to hold as stable shareholders. The reduced presence of stable shareholders and the presence of substantially increased and vocal foreign and domestic shareholders are forcing many Japanese corporations to pay more attention to their corporate governance. This became particularly evident in the late 1990s and the 2000s.

In response to the public opinion that the bank-based Japanese corporate governance practices prevailing in the 1980s failed competitiveness of Japanese industrial firms and the Japanese economy in general, the Japanese government promptly introduced a series of new reform measures in the 1990s and the 2000s for revising the laws underlying Japanese corporate governance practices. These new measures emphasise information disclosure and transparency of corporate decisions, among other things, so that Japanese shares become more attractive to more and more individual shareholders in Japan. These measures are, to a large extent, based on the Anglo-American practices of corporate governance. One implication of this is litigation against corporations and their directors by their shareholders. Such litigation has been common in the USA but is only beginning to be more fully appreciated by shareholders for protecting their rights as shareholders.[43]

In part because of a zero-interest policy many individuals have been shifting their savings from bank deposits to stocks in large numbers in the last 10 years. Some of them have brought class-action suits against corporations whose shares they own with some success. The reasons for these legal suits include the lack of information disclosure, misrepresentation of information, illegal business practice and questionable use of corporate funds. For example, Kabunushi (Shareholders) Ombudsman, a Japanese Not-for-Profit-Organization owned by individual shareholders, brought class action suits against the following corporations: Kumagaigumi Construction (for inappropriate political contributions, being appealed, May 2006); and Mitsubishi Heavy Industries and 6 other companies (for so-called *dango*, bid-rigging on public works projects (bridge construction, July 2005)). Another class action suit by shareholders in progress is that against Livedoor Corporation for misrepresentation of information. While the likelihood of such legal actions by shareholders is still limited in Japan, partly because punitive damage is not available for many types of civil disputes in Japan, the recent public awareness in corporate governance and corporate social responsibility means such legal actions will continue to increase.

A noteworthy aspect of Japan's corporate governance reform measures is that, unlike the US practices, Japanese corporations are given a choice in some essential ways of their corporate governance mechanisms between the US and Japanese systems. Another noteworthy aspect is that, while holding companies are now legal, the anti-monopoly law was not changed in other essential areas of corporate governance, ie banks' shareholding in other firms and also shareholding among industrial firms, particularly in vertical *keiretsu* formats. Thus legalisation of holding companies has expanded the set of possible corporate structures for Japanese firms.

At this time it seems premature to predict what types of corporate governance practices will prevail in Japan. Gilson and Milhaupt,[44] for example, found that, as of March 2003 no firm which was a member of a bank-centred horizontal *keiretsu* group, had adopted the executive committee system of governance. On the other hand, the Nomura financial holding company and its 13 privately held subsidiaries, as well as Hitachi Ltd and 21 of its affiliates, had adopted the executive committee system. They also note that many of the adopting firms are in the electronics industry and are largely characterised to be free of *keiretsu* influence and having more than average foreign ownership.

The executive committee system would require at least two outside board members. One-third to two-thirds of the adopting firms' board members are outside members. In contrast, only one-fourth of the firms listed on the Tokyo Stock Exchange have outside board members and outside members constitute less than 20 per cent of all the board members of the listed firms. Interpretation of the outside board member is also questionable since many of these outside members are sent from the firms' affiliated firms (eg parent firms). For example, all outside members of the Hitachi affiliated firms come from Hitachi Ltd. This may reflect the strategic necessity on the part of the parent firm for making sure that production activities of both the parent and affiliated firms are coordinated. The outside members of affiliated firms may be delegated such tasks of production coordination.[45,46]

It must also be pointed out that some of the indeterminateness found with respect to possible future configurations of Japan's corporate governance mechanisms is due to the fact that the new company law gives Japanese corporations little guidance on design of corporate governance practices. This is in part a consequence of the frequent revisions of the Commercial Code by the Japanese government in recent years. (In order to prop up Japanese firms' performance, the Japanese government has revised Japan's Commercial Code 13 times since 1990, sometimes three times within a year.)[47] Many characterise this process as a transition Japan is going through in company laws from the continental civil law (Japanese Commercial Code) based approach to the Anglo-American common law (new Japanese company law) approach. If this turns out to be the case, it will be essential that Japanese stock exchanges and the associated securities exchange laws will play a much stronger role of governance in overseeing securities transactions as is done, for example, by the SEC and stock exchanges in the USA.

CONCLUSION

Few see the revived dominance of the old style bank-based corporate governance system. Japan has already adopted many market-based Anglo-American style corporate governance practices, albeit in somewhat modified ways. What type of role Japanese banks will play in corporate governance once their financial problems have been cleared is of interest.[48, 49] Good Japanese firms have many choices in designing their corporate governance system based on the new laws, new financing realities, more vocal shareholders, the new employment practices and the production *keiretsu* relationships which can improve their efficiency. But firms whose performance is poor continue to face rather limited choice in financing, management and corporate governance practices and will most likely rely on bank financing.

It has been noted that the recent changes in the laws and business practices related to corporate governance are significant in many basic ways once they get fully implemented. These changes have legitimised the presence of institutional speculators in the market for corporate control in the eyes of the public, the government and the business communities. The primary objective of Takahumi Horie and Yoshiaki Murakami, the founders of Livedoor and the Murakami Fund, respectively, appeared to the public to be to buy shares of undervalued firms and sell them for profits in the short run. In this process of profit making both Murakami and Horie get heavily involved in corporate governance issues of the companies whose value they try to increase. In this regard their behaviour seems little different from that of the foreign institutional investors who have been active in corporate governance of many Japanese firms as large shareholders.

Facing the possibility of potential hostile takeovers the management of many listed firms has expressed interest in implementing US-style poison pills and other anti-takeover devices. One additional mechanism many Japanese firms are proposing as an anti-takeover device is strengthening their *keiretsu*, cross-shareholding and other equity-based interfirm relationships.[50]

Ironically this process of *keiretsu* formation as an anti-takeover device resembles very much that found in Japan in the early 1950s. Following the *zaibatsu* dissolution by the Allied Forces right after the Second World War, the shares of all former *zaibatsu* firms were dumped in large quantities in the stock market. Stock prices collapsed, and many of the former *zaibatsu* firms with valuable assets such as land and production and management skill became the ideal targets of post-Second World War Japanese greenmailers. These greenmailers were successful in making huge profits and also taking control of some companies. In response to their experience of being exposed to many hostile takeover attempts which turned out to be highly costly, former *zaibatsu* firms created their bank-based *keiretsu* to lock in their control shares within their group of companies. This took place over a few years following the end of the Allied occupation of Japan in 1952.[51]

Unlike the 1950s, however, Japanese banks may not be able or willing to become an influential player in corporate governance of Japanese firms any longer. Then, it seems questionable that strengthened *keiretsu* groupings in some form, as some Japanese firms clearly want to achieve, will emerge as an anti-takeover device to protect the incumbent management from hostile takeovers.[52] In order for Japan to continue competing in a globalising world, Japan has no choice but to continue apace causing the Japanese corporate governance system to more closely resemble that of the market-based Anglo-American system with greater transparency in accounting, increased disclosure and greater reliance on outside directors.

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REFERENCES

1 Even though some aspects of the reform (ie capital markets liberalisation) began in the 1980s, most of the essential parts of the reform measures were taken up by the Japanese government after the bubble burst.

2 Another important reform being pursued currently by the Koizumi government is privatisation of Japan Post, a government corporation providing postal service, financial service and other services to the public. Japan Post has extraordinarily large amounts of cash reserves held in the savings accounts of client households. (As of 2004, of the total Japanese personal financial assets of US$13trn, US$2trn is in the postal savings accounts, and US$3.3trn of personal savings and insurance business go to various postal accounts annually.) Cash from this source has been invested in numerous public projects with little or negative returns by many government agencies and are often the source of corruptions and political patronage. Japanese banks also want to be able to tap into these accounts currently held by Japan Post, arguing the cash reserve held by Japan Post is a source of economic inefficiency and should be invested by the private sector. Despite the significant opposition from the political and bureaucratic sectors, the lower house of the Japanese Parliament passed the government's Bill for privatisation of Japan Post in early July 2005. After the defeat of the Bill in the upper house, Koizumi had a surprise general election of the lower house of the Parliament seeking approval of the Bill from Japanese voters. After an overwhelming victory of Koizumi's Liberal Democratic Party in the election, Koizumi sent the same Bill back to both houses of Parliament. The Bill easily passed this time and privatisation of Japan Post began in early 2006.

3 See eg Morck, R. and Nakamura, M. (2001) 'Japanese corporate governance and macroeconomic problems', in M. Nakamura (ed.), *The Japanese Business and Economic System: History and Prospects for the 21st Century*, Palgrave, London, 325–349.

4 Throughout the 1990s many banks and industrial firms were suffering, respectively, from massive bad loans and excess capacity. Most of the industrial firms' excess capacity was financed by bank loans.

5 Many business researchers raised concern, however, that consolidation of the financial statements of a parent firm and its related firms under its control masks subsidiary-specific information that used to be available to investors. For example, listed subsidiary firms used to be required to report their financial statements on their own operations. This is no longer available.

6 Japanese banks' shareholding of other firms culminated in the late 1980s. They owned a large number of shares in industrial firms (up to 16 per cent of all listed firms' outstanding shares) for a variety of control and business purposes. In most cases the banks paid little attention to the value of

the shares they owned. Their primary interest was to secure their income from their loans to the firms whose shares they owned. For this purpose, owning large chunks of shares in the firms to which they were creditors worked very well (eg Morck, R. and Nakamura, M. (1999) 'Banks and corporate control in Japan', *Journal of Finance*, **54**, 319–339; Morck, R. and Nakamura, M. (1995) 'Banks and corporate governance in Canada', in R. Daniels and R. Morck (eds.), *Corporate Decision-Making in Canada*, The Industry Canada Research Series, University of Calgary Press, Calgary, 481–501). Following the burst of the bubble, Japanese banks were confronted with a sluggish Japanese economy and the reality of massive non-performing loans in the 1990s. The general consensus was formed that the traditional Japanese corporate governance practices were to blame. The Japanese government reacted promptly and introduced new measures to reform all aspects of the corporate governance behaviours of Japanese firms and banks. These legal measures rewrote many parts of Japan's Commercial Code in the areas of company and bank laws, as well as other related laws which govern corporate behaviour. One such measure introduced, forces Japanese banks to limit their holding of other firms' shares to the level of their own capital. This law was introduced to insulate Japanese banks from getting hit excessively from the stock market fluctuations. (It should be noted, however, that, unlike US banks, Japanese banks are still allowed by Japan's anti-monopoly law to own up to 5 per cent of any firm's outstanding shares for control purposes.) Since all Japanese banks' shareholding exceeded their capital level by a big margin in the early 1990s, they all sold many of the shares they held, destroying many of their stable shareholding practices with their client firms. Such share selling was also done in part to raise cash to cope with their massive and steadily increasing non-performing loans. Now in the early 2000s, Japanese banks own less than 6 per cent of the outstanding shares of Japan's listed firms. This has significantly reduced the role the Japanese banks play in governance of Japanese corporations.

7 Unlike the Securities and Exchange Commission (SEC) in the USA, the Tokyo Stock Exchange (TSE) has no disclosure requirement on the annual compensations its listed firms' top five executives earn. Accordingly, few Japanese firms disclose their executives' compensation amounts. (Nikko Cordial Group, a securities firm, is an exception in this regard and publishes their top executives' total compensation.) Despite the important role executive compensation plays in firms' corporate governance, neither the Japanese government nor the TSE seems to be interested in instituting the disclosure requirement in this area.

8 After these government and private-sector measures were introduced to increase activities in the market for corporate control, the number of M&As in Japan has substantially increased.

9 During the corporate governance reform negotiations in the mid 1990s, the Japanese government promptly accepted industrial firms' argument that reorganising their groups of divisions and firms under a holding company umbrella would allow these firms to improve their financial performance (due to consolidation of money-losing and money-making subsidiaries' financial statements).

10 A multi-division firm may issue a tracking stock which is to reflect only the value of a particular division or a particular subsidiary. Tracking stock shareholders have the same voting rights as the parent firm's common shareholders'. In comparison, shareholders of a listed subsidiary firm have voting rights for the subsidiary but not for its parent firm. Also the parent firm continues to own fully the particular division or subsidiary for which tracking stock shares are issued. On the other hand, the parent firm's ownership shares in its subsidiary firms decline when the subsidiaries are listed. In the USA, General Motors was the first to issue a tracking stock, to be followed by USX's tracking stock on USX Marathon,

AT&T's tracking stock on wireless lines of business, and others. Conglomerate firms which tend to suffer from conglomerate discounts may find merit in such tracking stocks. Nevertheless, only a limited number of firms have used tracking stocks so far. In Japan Sony issued a tracking stock in 2001 on its subsidiary firm, Sony Communication Network. SCN's tracking stock was then listed in the first section of the Tokyo Stock Exchange. However, Sony terminated this tracking stock in December 2005 when SCN went public in the Tokyo Stock Exchange Mothers Section. Sony is the only Japanese company which has issued a tracking stock so far.

11 As discussed below, the recent demise of Livedoor Corporation and its founder Takahumi Horie has not diminished the impacts on Japan's corporate governance practices that Livedoor caused when it tried to take over the Nippon Broadcasting System.

12 In May 2005 the Japanese government (METI and the Ministry of Justice) did announce the guidelines which corporations can follow in their attempts to introduce poison pills. These guidelines delineate the conditions under which poison pills may be introduced either by firms' general stockholders' meetings or by firms' boards of directors. These guidelines will be used together with the revised company law in the Commercial Code which took effect in June 2005.

13 This issue is further discussed in the section 'Recent developments in the market for corporate control: M&As in Japan' below.

14 In order to enhance securities exchange transparency the Securities and Exchange Surveillance Commission (SESC), a government agency, and the Japan Securities Dealers Association (JSDA), a voluntary industry group, both have formal mechanisms for policing exchange activities. Both SESC and JSDA report the number of abnormal activities which have violated the securities exchange guidelines in such areas as securities pricing and insider trading clauses. The effectiveness of SESC's monitoring ability has been seriously questioned. One reason for their lack of effectiveness is that the agency is underfunded and understaffed with only 217 specialists as of 2003. In comparison the US SEC has about 3,100 professional staff. See Securities and Exchange Surveillance Commission, *Shoken torihiki kanshi iinkaino katsudou joukyo* (*Recent Activities of Securities and Exchange Surveillance Commission)*, (in Japanese), Securities and Exchange Surveillance Commission, Tokyo, Japan, 2003.

15 The limit was 10 per cent until 1987, when it was reduced to 5 per cent. Banks' possible conflicts of interest in this dual role are thought to cause economic inefficiency (Morck, R., Nakamura, M. and Shivdasani, A. (2000) 'Banks, ownership structure, and firm value in Japan', *Journal of Business*, **73**, 539–569).

16 The most prominent examples of cross-shareholding are found for companies belonging to the so-called six bank-based horizontal *keiretsu* groups. These *keiretsu* will be discussed in detail in the next section.

17 For the history of corporate governance in Japan, see for example, Fruin, W. M. (1983) *Kikkoman: Company, Clan, and Community*, Harvard University Press, Cambridge, MA; Miyajima, H. (2004) *Economic History on Industrial Policy and Corporate Governance (Sangyo seisaku to kigyotouchi no keizaishi)*, (in Japanese), Yuhikaku, Tokyo; and Morck, R. and Nakamura, M. (2005) 'A frog in a well knows nothing of the ocean: A history of corporate ownership in Japan', in R. Morck (ed.), *A History of Corporate Governance around the World: Family Business Groups to Professional Managers*, NBER/University of Chicago Press, 367–459. Miyajima and Kuroki also analyse the recent trend in cross-shareholding in Japan (see Miyajima, H. and Kuroki, F. (2005) 'The unwinding of cross-shareholding: Causes, effects, and implications', RIETI discussion paper #05-E-006, 2005.

18 In 1988, the Basel Committee on Banking Supervision of the Bank of International Settlements (BIS) developed the Basel

Accord capital ratio requirement for the G10's banks which have significant international banking activities. It has been subsequently accepted by more than 40 countries. The BIS rule allows banks to include 45 per cent of unrealised capital gains from the stocks they own as part of the banks' own capital. Revised BIS rules for calculating the items used for calculating the capital ratio will become operational in 2007. Note also that Japan allows banks with only domestic operations to continue operation so long as the banks' BIS capital ratio is above 4 per cent.

19 The Nikkei Index peaked in January 1990 around 38,922, came down to as low as 7,804 in May 2003 and was around 11,600 on 6th July, 2005). The massive supply of shares dumped in the market by all Japanese banks and other financial institutions in financial distress since the late 1990s dampened the market which had never recovered from the collapse of stock prices immediately after the bubble burst in 1990.

20 Bank of Japan, *Huryo saiken mondai no kihontekina kangaekata (Basic thinking about the Non-performing Loan Problem)*, (in Japanese), Bank of Japan, Tokyo, 11th October, 2002.

21 As of March 2004 the market value of the shares BOJ purchased collectively registered a net gain of about ¥646.4bn. A significant rise in recent years of Japanese stock prices has allowed BOJ to be able to sell the shares they purchased from Japanese banks in the market for a profit. For example, BOJ reports a profit of $4bn from selling these shares in 2005.

22 For example, as of March 1998, the total amount of other firms' shares Japanese banks owned amounted to about ¥50trn ($385bn in 1998 dollars) which was twice as much as the banks' own capital (Fukao, M. (1999) *Corporate governance nyumon (Introduction to corporate governance)*, (in Japanese), Chikuma Shobo, Tokyo).

23 See, for example, Aoki, M. (1988) *Information, Incentives, and Bargaining in the Japanese Economy*, Cambridge University Press, New York; Aoki, M. (1990) 'Toward an economic model of the Japanese firm', *Journal of Economic Literature*, March, 1–27; Gilson, R. J. and Malhaupt, C. (2004) 'Choice as regulatory reform: The case of Japanese corporate governance', Columbia Law and Economics Working Paper No. 251, April; and Gilson, R. J. and Roe, M. (1993) 'Understanding the Japanese keiretsu: Overlaps between corporate governance and industrial organization', *Yale Law Journal,* **102**, 871–906. For example, Japanese supplier-assembler groups of firms in such equity relationships are neither independent nor fully vertically integrated. Rather they are in-between. As discussed below, the legality of equity-based partially vertically integrated relationships like those found in Japan is often questioned in the US anti-trust context.

24 Each of these horizontal groups typically includes one major firm from each of the industries. For example, Honda, a successful auto firm which has always had a significant relationship with the Mitsubishi Bank, does not belong to the Mitsubishi Bank group because the Mitsubishi Motor Corporation is the auto maker in the group. Business history is generally an important factor of the firms' membership with the groups (see eg Fruin, W. M. (1992) *The Japanese Enterprise System: Competitive Strategies and Cooperative Structures*, Oxford University Press, New York). Since the beginning of their operations, Toshiba and Toyota both had major relationships with the Mitsui Bank and hence are significant members of the Mitsui group. It is of interest to note also that, Toyota, a bank-debt free company, continues to be a willing member of the Mitsui group. On the other hand, Hitachi Ltd belongs to multiple bank-based groups.

25 See eg Rajan, R. (1997) 'Insiders and outsiders: The choice between informed and arm's-length debt', *Journal of Finance,* **47**, 1367–1406.

26 It is not clear yet if the banks followed a systematic decision rule in choosing the shares of other firms to sell. While selling off the shares of well-performing firms takes little time and would help the banks' cash positions, the banks may rather sell off the

shares of poorly performing firms from their strategic perspectives.

27 See eg Aoki, M. (1994) 'Monitoring characteristics of the main bank system: An analytical and developmental view', in M. Aoki and H. Patrick (eds.), *The Japanese Main Bank System: Its Relevancy for Developing and Transforming Economies*, Oxford University Press, Cary, NC; Sheard, P. (1994) 'Interlocking shareholdings and corporate governance', in M. Aoki and R. Dore (eds.), *The Japanese Firm: Sources of Competitive Strength*, Clarendon Press, Oxford, 310–349.

28 Eg Miyajima and Kuroki, ref. 17 above.

29 Recall that banks have always been allowed to own, up to certain limits, equity for control purposes in other industrial firms including their client firms. These limits changed over time. Since 1988, banks have been allowed to own up to 5 per cent of equity in other industrial firms.

30 Eg Nakamura, M. (1993) 'Japanese industrial relations in an international business environment', *North American Journal of Economics and Finance,* **4**, 225–251.

31 These changes were enacted very promptly, while the Japanese government accepted most of the recommendations made by Nippon Keidanren (Japan Business Federation) who argued that these changes were required for regaining Japan's global competitiveness. (See also Ginsberg, T. (2002) 'Japanese legal reform in historical perspective', paper presented at the American Society for Legal History Annual Meeting, San Diego, CA, 7th–9th November, 2002.)

32 It should also be pointed out that some firms (eg Mitsubishi Material, Mitsubishi Real State, Mitsubishi Heavy Industries) are not yet willing to adopt the practice of information disclosure that more progressive and better performing Japanese firms have already adopted. The business press argues that this is the reason why these three Mitsubishi companies continue to run closed-door general shareholders' meetings (*Sankei Shinbun*, 30th June, 2005).

33 By foreign shareholders the author means both individual shareholders and institutional investors (eg mutual and pension funds) who reside outside Japan.

34 It has been pointed out that this revision on the TOB clause still contains a loophole because a hostile bidder could purchase less than one-third of a firm's outstanding shares during out-of-hours and buy the remaining shares needed for the control interest of the firm in an open market. The government argues that such a case will still be subject to the new TOB provision.

35 An implication of cross-holding for the Japanese stock market capitalisation is discussed by McDonald, J. (1989) 'The mochiai effect: the Japanese corporate cross-holdings', *Journal of Portfolio Management*, Fall, 90–94.

36 Toyota's ownership shares given in Table 1 affect how these suppliers are dealt with in Toyota's consolidated financial statements. Japanese Commercial Code rules on this are as follows: firms (ie suppliers) in which the parent firm (ie Toyota) owns more than 50 per cent of equity must be consolidated into Toyota's financial statements; for 40–50 per cent ownership, consolidation is required only if Toyota controls the supplier, otherwise Toyota's financial statements must reflect only the supplier's financial figures in proportion to Toyota's ownership (the proportionality principle); for 20–40 per cent ownership, the proportionality principle applies. Another commercial code rule on voting rights states, however, that if Toyota increases its ownership in a supplier to more than 25 per cent, and if the supplier owns some equity in Toyota, then the supplier's voting rights in Toyota disappears. That is, beyond 25 per cent ownership by Toyota, the supplier's voting rights in Toyota associated with its cross-holding arrangements with Toyota perish. This explains the bunching of ownership shares between 20 and 25 per cent in Table 1. We also note that a block holder with more than one-third of the total outstanding shares can reject any proposal in the general stockholder's meeting.

37 It is often said that GM produces 70 per cent of their parts internally while Toyota outsources 70 per cent of their parts. Many

Japanese assembler-based manufacturers rely heavily on their production *keiretsu* structures for maintaining their efficient production. However, the merit of this system was seriously questioned in the 1990s when their critics argued that this kind of *keiretsu* system prevented Japanese manufacturers from using the lowest cost suppliers on a global scale. Nevertheless this system still exists to a large extent in Japanese manufacturing industries.

38 When Japan's Daiichi Bank and Kangyo Bank merged in 1971 to become the Daiichi Kangyo Bank (DKB), one of the adopted rules for the merger was to maintain the original personnel management systems of both Daiichi and Kangyo Banks for the following 10 years. Because of this DKB's performance continued to lag behind its competitors for the next two decades. However, this type of expensive and inefficient personnel management for merged firms is still commonly adopted in Japan. It is forced to be abandoned only when poor firm performance requires the firm to do so.

39 See eg Bradley, M., Desai, A. and Kim, E.H. (1988) 'Synergistic gains from corporate acquisitions and their division between the stockholders of target and acquiring firms', *Journal of Financial Economics,* **21**, 3-40.

40 The estimated numbers of M&As involving Japanese firms are: 1720 (in 2003), 2211 (in 2004) and 2725 (in 2005).

41 In comparison, M&As in Canada amounted to about $160bn.

42 Fukao, K., Ito, K. and Kwong, H.U. (2005) 'Do out-in M&As bring higher TFP to Japan?', *Journal of Japanese & International Economies*, **19**, 272–301.

43 While litigation against corporations and their directors is still new in Japan, several legal cases against brokers selling complex investment without adequate disclosure (eg currency and commodity futures) have occurred. A historical example of litigation against directors of all major securities firms took place in the early 1990s when these firms, under comprehensive investment agreement with large corporations, incurred massive capital losses in these corporations' investment accounts when the securities firm-managed investment went sour as a result of the Japanese bubble burst in 1991. All major securities firms paid back the losses, at least partially, and such loss compensation (called *hoten*) amounted to more than $2bn in total in 1991. Individual shareholders brought legal suits against directors of these securities firms for their inappropriate use of corporate funds. Although the courts partially sided with the shareholders, no securities firm directors received any penalty. Such capital loss compensation practice was made illegal by the revised securities exchange law in 1992.

44 Gilson and Malhaupt, ref. 23 above.

45 The role of the outside directors sent by parent firms to their affiliates is in some ways similar to the role of outside directors Japanese banks often send to their client firms. The bank-appointed outside directors are primarily concerned with their client firms' financial matters.

46 The connection between adoption of the executive committee system and coordination of production activities within a production *keiretsu* group such as the Hitachi group using the directors sent to the parent firm's affiliates is probably irrelevant since such coordinating activities can be done without adopting the executive committee system.

47 Certain inconsistencies and dysfunctionality that inevitably exist in many revisions of Japanese laws on corporate governance may add to the current ambiguity state of Japanese corporate governance.

48 There is some evidence that Japanese banks facilitate their client firms' issuances, for example, of corporate bonds in capital markets (eg Campbell, J. and Hamao, Y. (1994) 'Changing patterns of corporate financing and the main bank system in Japan', in M. Aoki and H. Patrick (eds.), *The Japanese Main Bank System: Its Relevancy for Developing and Transforming Socialist Economies*, Oxford University Press, Cary NC, 325–352; Nakamura, M. (2002) 'Mixed ownership of industrial firms in Japan: Debt financing, banks and vertical keiretsu

groups', *Economic Systems,* **26**, 231–247). It is not clear, however, how this will fit into the newly emerging corporate governance system.

49 The issues associated with possible transfer of Japanese-style corporate governance system to the USA are discussed, for example, in Morck and Nakamura (1995), ref. 6 above, and Romano, R. (1995) 'Commentary on Part V, International aspects of corporate governance', in R. Daniels and R. Morck (eds.), *Corporate Decision-Making in Canada*, The Industry Canada Research Series, University of Calgary Press, Calgary.

50 This device either does not exist or cannot be a practical anti-takeover device in the Anglo-American countries.

51 See, for example, Morck and Nakamura (2005), ref. 17 above.

52 One basic question is the relationship between the alliance capitalism characterised by various types of *keiretsu* (see eg Gerlach, M. L. (1992) *Alliance Capitalism: The Social Organization of Japanese Business*, University of California Press, Berkeley; Lincoln, J., Gerlach, M. and Ahmadjian, C. (1996) 'Keiretsu networks and corporate performance in Japan', *American Sociological Review,* **61**, 67–88; Lincoln, J. R. and Gerlach, M. L. (2004), *Japan's Network Economy: Structure, Persistence, and Change*, Cambridge University Press, New York; Lincoln, J., Gerlach, M. and Takahashi, P. (1992) 'Keiretsu networks in the Japanese economy: A dyad analysis of intercorporate ties', *American Sociological Review,* **57**, 561–585) and economic efficiency in the new economic environment Japan now operates. The supporters of the Anglo-American system of corporate governance thought the Japanese economy was highly underperforming in the 1990s and predicted a potentially substantial efficiency gain in the Japanese economy under the Anglo-American system.