Revision of the Commercial Code and Reform of the Japanese Corporate Governance

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1. Revision of the Commercial Code and the "Counterattack" of the Stock Market

Commercial Code revised in the 2000s

In 2002, the Commercial Code was substantially revised. The revision enabled Japanese firms to choose freely one type of corporate governance from among various options. One option is the traditional governing structure, with a traditional board of directors, together with traditional auditors. Another important option is what is called the "committee system," whereby three committees (nomination committee, compensation committee, and audit committee) consisting mainly of outside directors are placed above the board of directors, the committees being in charge of designating directors, drawing up proposals for their compensation, and auditing them, respectively.

The revision makes it legally possible for Japanese firms to allow outside directors to gain control of the board of directors through committees, a system adopted in the U.S.A only as a restriction imposed by the stock exchange on listed companies, not by the corporate law. In so far as the revised code in Japan now allows what U.S. corporate law does not require legally, it is understandable that the latest revision of the commercial code in Japan should be called more "U.S.-style" than the U.S. corporate law itself. However, adoption of the committee system is no more than one option, and is not compulsory.

The revised commercial code has not only opened the door to the revision of corporate governance practices but has also made it legally possible to do corporate acquisition through share exchanges, and will allow, from 2005 on, exchanges of shares between Japanese firms and a Japanese subsidiary of foreign corporations. In other words, foreign companies will in practice be able to buy out Japanese firms via this share exchange method.

These revisions of the commercial code undeniably show a tendency to bring into Japan the shareholder-oriented corporate governance which is practiced in the U.S. In this sense, the 1990s were the decade when American standards were seen as global standards, and Japanese corporate managers felt a psychological pressure not to lag behind the “global standard” in any aspect of management, not only in the field of corporate governance practices. Possibly, when the bubble boom collapsed, Japanese managers might have lost the confidence they had in the 80s when they boasted of “Japan as No.1.” And this psychological change seemed to bring about revision of the commercial code in a somewhat hasty and fairly drastic manner.

This article is aimed at providing the author’s logical inferences concerning the possible impact of the revised commercial code on the corporate governance of Japanese firms. My conclusion is that the revision itself does not have any substantial direct impact, and that the newly provided option on the governing structure will not trigger any considerable change in the corporate governance practices of Japanese firms; rather, it is the risk of hostile takeovers by foreign firms that will have a certain influence on corporate governance. In the following pages, I will explain the logic which has led me to this conclusion.

Counterattack of Stock Market

Japanese firms in the 1990s seem to have sought corporate governance with clear emphasis on the interest of shareholders, as a means of avoiding the criticism of inattention to the shareholders. Behind this behavior lie not only the simple loss of confidence caused by the overall sluggish economy after the collapse of the bubble boom and the subsequent compulsive compliance with the standard global emphasis on the interests of shareholders, but also the occurrence of a phenomenon in the 1990s which might be called the “counterattack of the stock market.” While Japanese firms up until the 1980s had been allowed not to pay enough attention to the interests of shareholders, the Japanese stock market situation in the 1990s seem to have forced the Japanese firms to heed the shareholder’s voice.

Pressure came from two quarters – a sharp fall in stock prices due to the burst of the bubble boom, and the subsequent prolonged depression in stock prices. These created seeds of great discontent among investors. First, the burst of the bubble boom brought about a sizable plunge of the Nikkei Average below one-third of the highest score marked in late 1989. It seems quite natural that investors, who had suffered from huge capital losses, should press firms for a larger dividends. But firms on their side might feel that the investors barked up the wrong tree, in that firms did not necessarily receive new funding from investors when the stock prices were high during the bubble boom. And it was the investors, definitely not the firms themselves, that benefited from selling at the highest price during the bubble years. Of course, some firms did equity financing at a high stock price and acquired enormous funds, but those were not a majority.

Nevertheless, a fair recovery of stock prices would have eased the situation, but the stock prices hovered at a low level for a long period. This meant that new investors coming to the stock market in the 1990s were unable to earn capital gains as large as they had expected in the 80's and before.

The double hardships of investors in the Japanese stock market in the 1990s were utterly unthinkable given that the market until the 1980s had been the most profit-making market in the world on a time-scale of decades. The high investment performance was backed up by large capital gains thanks to a long-term rise in stock prices. As is generally known, the dividend payout ratio of Japanese firms is low, and so is the dividend yield. But investors had enjoyed a rise in stock prices large enough to make up for the low dividend payout and yield, a rise made possible by Japan's economic growth. Because capital gains were huge, investors did not have enough justification to take a firm stance in complaining to firms. Put differently, corporate managers were not under close scrutiny from investors.

In other words, capital gains which had satisfied investors until the 1980s were no longer available in the 1990s. Instead, huge capital losses were created, which generated protests by investors against corporations. Japanese firms, in short, encountered a "counterattack" by the stock market.

What is more, two additional factors which tended to heighten criticisms by investors arose in the 1990s. One is that banking institutions suffering from non-performing loans unloaded cross-shareholdings of affiliated companies. The unwinding of cross-shareholdings was a consequence of banks' efforts to secure profits by materializing paper gain from stocks they had held. The main purchasers of such unloaded stocks were foreign investors, in particular foreign institutional investors. They followed practices prevailing in their own countries or in the U.S.A., and loudly demanded satisfactory distribution of profit from Japanese firms. The shift in the composition of shareholders from quiet long-term ones, that is, Japanese banks, to loquacious foreign institutional investors had an impact in enhancing shareholders' influence on firms.

The second factor emerging in the 1990s was the adoption of the market-price valuation method for corporate accounting. Quite a few companies suffered appraisal losses when their stockholdings were evaluated at market value. The generation of losses lowers corporate profit, and serves as a cause of further stagnation of stock prices. It is also likely to discourage firms from holding stocks which have a substantial impact on accounting profit. One reason for banks to unwind their stocks, apart from realizing appraised gain in stockholdings, was to adjust their asset portfolio so as to avoid volatility of profits. Once firms have started to avoid holding shares, this in itself serves as selling pressure in the stock market, and leads to a continued downturn of stock prices. Consequently, investors find it more difficult to make capital gains, and bring stronger pressure on firms.

In this way, Japanese firms in the 1990s were put in a situation to face counterattack from the stock market and strong protests from investors.

The situation might be, I suspect, somewhat "confusing" for a majority of Japanese firms. Certainly as a legal entity incorporated under stock corporation system and as publicly traded company which are listed on the stock exchange, it seems so natural to listen to the voices of the shareholders as the most important stakeholder. However, the actual corporate aims of many Japanese firms consistently throughout the postwar period have been, though implicitly, employment stability for their employees and the development of the firms themselves. Satisfaction of shareholders has been only a reluctantly accepted constraint. It seems that many corporate managers believed that all they needed was to secure a state of affairs satisfactory to their shareholders, and did not see it the aim of the business management to expand the proportion of profits allotted to shareholders and to increase the aggregate market value of the firms by heightening stock prices. The belief that companies belong to the employees who are committed to them, rather than to the shareholders has been tacitly agreed upon as a self-evident truth among Japanese corporations. I express this concept as "employee-sovereign," and have claimed for many years that the concept, in a long term, is conducive to the benefit of shareholders, and is thus highly rational from the economic viewpoints (See, for example, Itami [1987] or Itami [2000b]).

It was in the 1990s that this tacit agreement among Japanese firms came under counterattack from shareholders in the wake of a sluggish stock market.

With the economy remaining stagnant in the 1990s, Japanese firms looked as though they, after all, kept adhering to the concept of employee-sovereignty. While the value added of companies continued to hover low, they gave priority to the distribution of value added to labor (i.e., frequent pay hikes), so that the labor's share in the value added increased, whereas the corporate profit after payment to labor shrank or remained low. This resulted in a reduction in sources for distribution to shareholders. To maintain the level of dividends in this situation, internal reserve funds were liquidated (or stocks were sold to secure profits). The distribution of value added to labor and to stockholder in the 1990s literally illustrates the principle of employee-sovereignty. (See Itami [2000a])

However, this practice was overdone and should be called as overrun of the employee-sovereignty principle. Since value added remained low, distribution to labor should have been determined accordingly. But in the decade of the 90's, wage hikes beyond the productivity increase were a rather regular practice among Japanese firms. And these pay hikes occurred at the time when the counterattack from the stock market was becoming real. The late 1990s was a period when Japanese firms were exposed to still harsher voice from the "counterattack."

2. Essence of Corporate Governance and Dangers of the Committee System

The True Focus of Reforms of Corporate Governance

Given that an economy would be brought to a standstill unless a return on capital were secured and capital continued to circulate within the economy with fair return, the protests of investors were quite rational in some ways. However, what does not make sense is that, though they should call for an increase, even if not substantial, in their share of corporate profits, people often hastily rushed to the conclusions that the basis of corporate governance must be returned to the shareholders' sovereignty, and that the governing system must be reformed to allow shareholders to check on every aspect of corporate behavior.

In other words, even though Japanese firms are now exposed to a counterattack from the stock market, this does not necessarily mean that the principle of corporate governance in Japan requires fundamental alterations. But in the 1990s, when corporate governance was much debated in Japan, it was also the time that the financial system across the country was unstable, and U.S.-style corporate governance focusing on the interests of shareholders was prevalent throughout the world due to the demise of the Soviet Union and the advent of a mono-polar U.S. hegemony. I have the impression that this series of unfortunate developments encouraged what was a rational protest from the stock market to develop into the full-scale revision of the commercial code aiming at a sweeping reform of Japanese corporate governance practices.

Should the counterattack from the stock market, in fact, go as far as demanding a fundamental change in the principle of corporate governance, that is, the abandonment of Japan's tacit agreement, employee-sovereignty? This is very doubtful. And the doubt grows when we begin to think about the essence of corporate governance.

I believe that the crucial point in practice in reform of corporate governance is to establish a vigilant watch on corporate management.

It may help understand the issue more easily if we make an analogy with governance of a nation: the establishment of a check mechanism on policy makers is vital in maintaining the health of the governance structure. In a democratic country, elections play such a role. Similarly, in the case of corporate managers, keeping a watch on top managers or executives– whether their behavior is ideally conducive to the long term development of the economic organization – forms the bedrock of corporate governance, and further, how to restrain top management when its business conduct gets out of hand; if so, how to dismiss the managers responsible; and in the very first place, how to select managers who are most likely to conduct sound business management.

In sum, the most crucial point of corporate governance is to explore an suitable checking function and ways of appointment and dismissal of top management. This question is universally relevant across the countries; and the essence of corporate governance lies neither in the question of countermeasures against misconduct nor in securing satisfactory margins of profit for shareholders, as is often contended.

In Japan, however, where managers have paid too little attention to the interests of shareholders, these are now highlighted as a central issue in corporate governance. But in the light of the fundamental question of what governance is required for sound corporate development, top priority should still be given to the monitoring of top management.

And it seems that virtually no checking mechanism for top management existed in Japanese firms in the 1990s. One might say that this was a by-product of an unspoken consensus of employee sovereignty among Japanese firms.

In order to practice employee sovereignty principle under the legal system of joint stock corporation, many Japanese firms have made efforts to minimize the influence of shareholders. In other words, that they have made efforts to keep shareholders as silent as possible. For example, firms sought other companies who would cross-hold shares and keep silent, while the board of directors was filled from within the company. On top of that, an odd common sense prevailed that the best general shareholders meeting was a short one.

Thus it is not surprising that there is a criticism that this behavior on the part of Japanese firms has vitiated the mechanism of “checking of corporate managers by shareholders” provided by the commercial code. The disempowerment may not be a particularly serious problem so long as other checking mechanisms, apart from that laid down by the code, function properly. These include, for example, monitoring by main banks.

However, with Japanese firms accumulating internal funds and becoming less dependent on bank loans for financing, the main bank system is becoming less effective in monitoring firms. As a result, one major checking mechanisms has disappeared. To keep shareholders silent was not absolutely wrong by itself, but the real trouble begins when the absence of any effective checking mechanisms is allowed to go unattended.

How can the vacuum in the mechanism for checking top management be filled in? This is the primary issue that we should focus in the debate on Japanese corporate governance.

Seen with this focus, how much impact do the revisions of the commercial code made throughout the 2000s have?

Doubtful Aspects of the Committee System

At present, not many firms have actually chosen the committee system under the revised commercial code. In 2003 when this option became available, 60-odd firms including quite a few well-known companies shifted their governing structure to the new scheme, but it seems that far fewer firms did so in the following year. In sum, currently less than a mere 5 percent of all firms listed on the Tokyo Stock Exchange have adopted the system.

The true feeling of firms hesitating to go for the system seems to be a suspicion that an appropriate top management team may not be able to be formed if the nomination committee – which is in some ways the most important committee in that it holds the power of designating directors – is organized with an absolute majority of outside directors. A ground for the suspicion comes from doubt about the impossibility of outside directors having sufficient information to evaluate every inside director. Firms are wondering if it is in practice possible to entrust them with such an important aspect of personnel assignment.

Even if they organize things so as to provide information from relevant offices within the firms or from incumbent top managers, another problem remains unsolved, concerning whether qualified persons can be secured as outside directors. This problem concerning the supply of outside directors may be even more crucial, in that, although they might be in good supply if, say, 100 or so firms needed them under their committee system, if a thousand firms adopted the system, it would be doubtful if suitable and effective outside directors could be mobilized.

Even so, the supply problem may possibly arise only at the initial stage after implementation of the system; outside directors, perhaps, will be supplied from various sources in the long run. Some claim that adoption of the system itself serves as pressure creating a supply of such personnel. This may be true. However, even if the problem of appropriate supply of outside directors can be solved in the long run, when one thinks about the question of whether or not the nomination committee authorized to retain or dismiss board members employs the proper mechanism to execute the envisaged tasks, a potential danger is seen to be embodied in the committee system.

The potential risk becomes real when the system is abused through the nomination committee's being taken advantage of to consolidate the power base of the very top people who are actually in power now. Although the committee is set up to monitor top management, it is highly likely to be exploited as a device to maintain the power of that management.

Since the nomination committee holds the power in practice to appoint members of the board of directors, the person who bestrides the committee will be in paramount authority in the firm. The nomination committee consists of both internal and outside directors, though the latter make up a majority of the members. Thus, so long as outside directors in the nomination committee have been persuaded, the power to retain or dismiss any directors will be readily available to the person who can do this persuasion. Who, then, is responsible for actually searching out and contacting candidates for outside directors of the committee?

This is, inevitably, the actual power holder in the current top management team, that is, either the chairperson or the president. The pattern remains exactly identical to the controversial traditional system of boards of directors in which internal directors are dominant, and the person currently in paramount authority holds the actual power to nominate them. It is identical in the sense that the person currently in the highest position of the company has the power to nominate members of the "nomination committee" which is supposed to have the final authority in determining membership of the legal governing structure of the company.

Under the committee system, therefore, the nomination committee alone is able to impose checks on (in particular, to dismiss) the person currently in the highest position. This means that the only possible means to dismiss the person is a rebellion of outside directors.

A majority of firms which have adopted the committee system have three to five outside directors. And in many cases, these outside directors in the nomination committee are personal friends of the authority in the highest position. Is it in fact possible for them to have any substantial incentive, or information, such as to make them bother to rebel against the person in power in order to exercise their duty as members of the nomination committee?

It is natural to assume that, unlike somebody whose future prospects rely utterly on the fate of the company, friends or acquaintances outside the company will usually have neither incentive nor the information to make them rebel. There is still, of course, a possibility that certain insiders will find the current top manager incompetent, seek to persuade nomination committee members to take action, and give them any necessary information. But, even in this case, such a move by insiders is highly likely to be detected by the person in power. This is even more obvious if some committee members are acquaintances of that person. How many employees dare to take the risk of passing on information which only inside workers can obtain to outside directors? The scenario of sound functioning of the committee system, in short, is over-optimistic.

It is not sufficient to point out the potential risk hidden in the mechanism of the nomination committee; any system encompasses risks. Rather, the focus of the question lies in whether the adoption of the committee system is an improvement over the old system. It is necessary to compare the new system with the old option, that is, a traditional board of directors consisting mainly of internal directors, in the light of its effectiveness as a checking function and the “possibility of a successful rebellion” against the person who is in effect in paramount authority (who can dominate the nomination committee itself.)

One should consider that even under the conventional system, the power to nominate internal directors is in the hands of the person in the highest position in the company. Thus, since members of both the nomination committee in the new system and the board of directors in the traditional one are designated by the top management of the company, the checking function may not work properly either way. The question here is which is more likely to rebel against the top manager when necessary (that is, when the idea of stripping him of the position is becoming dominant) – the nomination committee, or a board of directors consisting mainly of internal directors.

In my opinion, in terms of the information and incentives necessary to defy the top management, a board of directors consisting mainly of internal directors is more likely to take action, in that their fate has been, and will be affected by the fate of the company throughout their business lives, and that such internal directors have empathy with the large number of employees working together with them. The circumstances of those directors may be far more likely to persuade them – rather than outside directors who have no strong ties with the company – to take defiant action against the person in the power. As for the information required for defiant action, inside directors are in an advantageous position compared to outsiders, since they are physically close to the authority and able to see what he does within the company.

What is more, quite a few firms are now carrying out reforms such as adopting a system of operating officers under the conventional board of directors, and in fact the number of directors has been declining. This seems to facilitate rebellion within the board of directors. For example, if a board consists of 25 directors, 13 members must secretly unite to rebel against the person in power, whereas if a board comprises 11 directors, only six members are needed to do so. There is a great difference between 13 and six in secretly preparing for a rebellion.

In other words, under the conventional system of board of directors comprising mainly internal directors, the president or chairperson, namely the person in power, are ultimately in a situation as if they were subject to a final check for their retaining their position by directors who have gone through the ranks within the company. This in fact conforms to the tacit understanding in Japanese firms that I described as “employee-sovereignty” in the previous section. All the more reason, then, that defiant action by internal directors, if such a thing happens, is likely to attract support within the company.

Of course, I do not believe that such defiant action can take place easily. Nevertheless, I know of some such cases in the past. Judging from these cases, and looking into the actual membership of nomination committees under the newly adopted committee system in certain companies, I have a feeling that outside directors under the committee system are much less likely to undertake defiant action against the top management.

Certainly, the shift to the committee system obliges the top management the accountability to outside directors, which will serve as a source of new checking function. Thus, the real question is which is more effective as a checking mechanism, accountability to outside directors or the threat of the traditional board's rebellion. This question is difficult to judge, but at least it does not seem that the committee system is clearly superior with respect to the efficiency in checking the top management.

Judging from the paucity of practical effects, and the question of inadequate supply of outside directors, it cannot be logically inferred that the corporate governance of Japanese firms will change substantially thanks to the availability of the committee system, nor does it seem that the system will be adopted widely with substantial function, beyond "window-dressing " or cosmetic propaganda for the capital market.

Discipline by Threat of Hostile Takeover Bids

A possibly more effective device than the committee system as a mechanism to check top management is the threat of the takeover of Japanese firms by their foreign counterparts via the stock-swap system which is to become available in 2005.

It seems that an increasing number of business managers feel threatened by such hostile takeovers. In particular, under current circumstances with low average levels of stock prices of Japanese firms, foreign companies need only provide a small number of their own stocks in order to effect hostile takeovers. Currently, in other words, many foreign firms are able to buy out Japanese firms without ignoring to any considerable extent the interests of their own shareholders.

The threat to the top management through hostile takeover bids is a classic mechanism in Western countries to check the top management via the stock market. This mechanism works in two different ways: first, by facilitating the self-discipline by the top management whereby the threat of buyout places discipline on corporate managers, and the managers naturally pay careful attention to their business; and secondly, via the replacement of the top managers as a result of an actual buyout. Replacement does not have to take place frequently and a small number of occasional replacements would be enough to strengthen the function of the first mechanism. In other words, the potential threat of hostile takeover bids should really exist to make two types of the mechanism work properly. And now it may be going to be applicable for the first time in Japan also.

However, even if the potential threat of buyouts facilitates appropriate corporate management, its effect would tend to be biased toward the corporate managers to pay more attention to increase the aggregate market value of the company in order to reduce the risk of being bought out. That is, one of the greatest concerns of top management is likely to do management reform which will contribute for higher stock price higher in the market. Of course, it is a good thing to conduct business management to improve strategies for corporate growth and to heighten the possibility of growth in future, which will have a beneficial effect in turn on both employees and shareholders, but the threat may carry a risk of tempting corporate managers to steer the company in order to pursue a short-term interest, i.e., to increase the size of profits distributed to shareholders. And this is not necessarily compatible with favorable long-term prospects for the company.

What is more, another thing requiring attention is a possible expansion of cross-shareholdings to act against the threat of buyout. In view of the fact that the expansion of cross-shareholdings among Japanese firms in the 1960s was occasioned by the threat of buyout by foreign companies due to capital liberalization at that time, one cannot ignore the possibility that history will repeat itself. This risk may not be so great since the introduction of current value accounting system has made the volatility of corporate profit due to cross-shareholdings much greater and thus made cross-shareholdings less attractive than before.

In sum, the threat of hostile takeover bids would move Japanese companies to take various counter measures to avoid takeover. Being a straightforward menace to the corporate power structure, takeover threat would have much greater impact on corporate governance in Japan than the committee system.

3. One Proposal for Top Management Checking Mechanism

Checking from Inside and Outside

As is obvious from the discussion so far, I do not believe that the creation of the new option for the governing structure of Japanese firms can be expected to fundamentally improve their corporate governance.

A firm has two characters at the same time intrinsically: on the one hand, as a financial entity or community of money, it can be considered to belong to its shareholders; on the other, as a entity of persons or community of people, it can be considered to belong to its employees. If one accepts frankly this bilateral character, I think that corporate governance reform aimed at shareholder-only top management checking mechanism as in the revised commercial code is, in principle, inadequate from the beginning. A checking mechanism which does not reflect the internal voices of employee is particularly inadequate for Japanese firms which have always relied tacitly on the principle of employee-sovereignty.

Even more, as explained in the previous section, the committee system seems extremely inadequate as an option in filling the void in the checking mechanism created by the silencing of shareholders.

In any reform of the mechanism for checking top management, it is crucial, I feel, to create a device to check it from both within and without.

My suggestion is to take advantage of core employees for the internal checking mechanism. Employees, above all, are the core members within the business organization, and if they play the part of sovereign with the corporate citizenship, they should have the right to check the top managers in accordance with the weight of their shared sovereignty. This would be quite understandable if one considers that citizens of a nation play a major part in a mechanism for checking the rulers of the nation with their right to vote in election. In this light, what I shall now advocate in detail below is a “referential confidence vote system” by the core employees of the firm, especially middle managers.

On the other hand, since corporations are in some ways public institutions, it is also necessary to reflect widely the voice of public in the mechanism for checking top management. For this, it will be useful to establish a “management auditing committee,” made up mainly by the people outside the firm. As for the ideal participants in this committee from outside the company, it will be appropriate to select outsiders who have both the capacity and information to judge the quality of top management. Examples include highly reputed top managers of companies with little stake in the company in question, and academic experts or others who seem qualified to evaluate top managers.

In addition, former top managers of the company may well be counted among such “outsiders.” Retired top managers, rather like the Senators of ancient Rome, are familiar with the circumstances of the firm, and are, in many cases, have intimate knowledge of the personal integrity and intellectual capacity of candidates for new top managers. Naturally, if they dominate the checking mechanism, the system will invite the criticism that it is a “gerontocracy,” but their participation in the auditing committee together with a larger number of top managers from unrelated companies, academic experts and other outsiders will not do much harm; rather, it can be expected to make a great contribution.

The “management auditing committee” is in no way identical to a nomination committee. It is not in charge of the nomination of directors nor auditing the entire body of the board of directors. Rather, it is responsible for auditing only the very top people in the top management rank, usually one or two highest ranking executives.

Shareholder representatives should, of course, participate in the management auditing committee, but the manner of their involvement is somewhat difficult, the reason being that they are insiders in one sense and outsiders in another. If we think core employees as the most typical insiders of the firm, shareholders should be counted as a combination of insider and outsider in the following sense.

They are insiders in that they are an indispensable component of the firm as providers of capital which has promised not to flee from the firm no matter what. A firm as an economic entity inevitably has the nature of a community of capital, and since shareholders are the source of the core capital, they are insiders. And if we are to divide shareholders into core and non-core shareholders, the former can absolutely be counted as insiders.

On the other hand, shareholders, in particular non-core shareholders, can be regarded as outsiders for a firm as an economic entity in that they can easily walk away from the company at any time by selling the stocks they hold. They are sometimes no more than simple providers of capital, requiring no more than an appropriate return on capital. When they call for the distribution of profit, their voice comes from outside, that is, the market.

Under the current legal framework, such double-faceted shareholders have full powers in checking corporate managers. Although they are insiders and outsiders simultaneously, the law defines them as insiders and assigns them the final authority to appoint and dismiss top management. This is, taken at face value, a fairly problematic situation. However, this is the commercial code, whether before or after the 2000 revisions.

Whatever the case may be, it seems to be a general rule that both insiders and outsiders should undertake the checking of the top managers. In this light, many deficiencies can be immediately apparent in the checking mechanism the current corporation law provides. That is why additional reform is required.

Three-Layer Structure of Nomination, Confidence, and Approval

Institutional reform to include both insiders and outsiders in top management checking mechanism as described in the previous section means, in my opinion, establishing a system with a three-layer mechanism for the nomination, approval, and dismissal of the top management.

The first layer involves nominating candidates in the management auditing committee consisting mainly of outsiders. The second involves conducting a vote of confidence by core employees. And the third involves, in the conventional manner, selecting directors to be in the board at the general shareholders meeting. (Here, as elsewhere, top managers mean chairperson and president, who are literally in the highest rank in the company.)

Under the traditional commercial code, the board of directors nominates candidates for new top managers, while members of the board are approved at the general shareholders meeting. This two-step process is now divided into three steps of nomination, confidence vote, and approval. The management auditing committee is responsible for the nomination of the candidate for top managers within the board of directors, while core employees undertake a vote of confidence on the candidates. Including the candidates, the entire board needs the final approval by the general shareholders meeting as the last step. This completes the three-layer structure of the system. This is three-layer not only in terms of process, but also in terms of the number of parties involved. In other words, shareholders, employees, and outsiders all take part in each process.

In more detail, the nature of the three steps is as follows.

The first step is the "nomination" of candidate managers.

The management auditing committee comprising mainly outsiders nominates one single candidate each, and no more, for chairperson and president, respectively.

Main tasks of the committee are, as the name implies, to audit the job performance of the present top managers and nominate candidates as their successors in the next term, for the final approval by the general shareholders meeting. Since it is assumed that the top managers double as representative directors, the nomination is to take place as the term as their directorship ends. In cases where the committee finds the incumbent top managers incompetent from their audit, the committee is also responsible for suggesting dismissal.

The committee comprises of outside corporate managers, academic experts, shareholder representatives, retired top managers of the company in question, and other suitable outsiders. The incumbent top managers are not eligible for the membership of the committee, although they should be given an opportunity to give their opinion to the committee concerning the candidates to be nominated. This is because they are most likely to be in a position to know of the quality of the potential contenders. Representatives of the employees are not eligible for the auditing committee membership, either. This is because the essential point of the committee is to provide outside check and insiders' duty is to provide outsiders with enough information, not to decide on the candidates.

The most important aim of establishing this management auditing committee which nominates the candidate top managers is to obviate the risk of the current top manager becoming the absolute power, and to secure the healthy selection process of top managers with enough outside checks. At the same time, in order to avoid the complete dominance of outsiders alone, shareholders who play double roles as insiders and outsiders are incorporated into the nomination process, together with retired top managers who are expected to provide internal information with objective eyes.

What is more, the incumbents are given the opportunity to express their opinion concerning potential successors at the management auditing committee, so as to ensure the meaningful impact of internal information. Their role is largely limited to offer information; it would not be healthy if they became too engaged in the nomination itself.

Nevertheless, it is still important to devise means of securing the influences of the former and incumbent top managers on the realistic selection of the new top managers. Selection may become overly unrealistic if nobody provides meaningful information to the committee about the quality and characteristics of potential contenders and the needs of the firm. It is of course not appropriate if the influence of the current managers is overwhelmingly or exclusively dominant, as is often the case in many Japanese firms today. That would lead to negative genetic selection, so to speak. The presence of considerable influences of the current managers, however, is a good thing in itself.

The second step of the three-layer process of top management selection is the "confidence vote" on the candidate managers by representatives of core employees.

The method of choosing these "representatives" can take various forms, but the discussion here assumes that they are middle-level managers above a certain level and long-term employees who have been in the company for more than a certain number of years. The confidence vote would be formally done at the request of the board of directors which will use the result as a reference opinion. Vote is a secret ballot on the nominee from the management auditing. The voting timing is to coincide with the time when the term of directors is renewed. The result of the vote is reported to the board of directors (and may be publicly announced), and the board takes the result into account in deciding the next board members (including the candidate top managers) to be approved by the general shareholders meeting.

However, it would be appropriate not to make the result of this confidence vote legally binding. Both the board of directors and the general shareholders meeting use the result as a reference, but are not bound by it. Although the vote is used a reference only, depending on the result of the vote, the board of directors can, at its discretion, redo the selection process back from the first step, nomination by the auditing committee.

The purpose of the referential confidence vote by the core employees is to give institutional guarantee of a concrete practice to the principle of employee sovereignty. In short, this aims at institutionalizing the voices of core employees. Since the current system lacks this step, the principle of employee sovereignty remains obscure even though it lies at the tacit foundation of the firm. By not making the voting result legally binding, however, we can avoid legal contradiction with the current corporation law, that is, the legal infringement of shareholders' rights. In that respect, the proposed idea might be termed "soft institutionalization."

The reason why the right to make a confidence vote is confined to representatives of core employees, not employees as a whole, is that their knowledge and ability to evaluate the suitability of the candidate top managers differ considerably among themselves and it would be inappropriate to give all the employees the same voting right.

The third step of the proposed three-layer top management selection is the "approval" at a general shareholders meeting.

The board of directors reports the result of the confidence vote to a general shareholders meeting, calling for approval for a proposed list of new members of the board and the candidate top managers (of course, members of the new board of directors). While the name of the candidate top managers must be clearly stated here, it may be unnecessary to require approval of the meeting for candidate top managers, as under the current system. It may be sufficient for the approved board of directors to make the final decision on who should be the top management of the firm.

If the proposed list of members of the board is rejected, even in part, at the general shareholders meeting, the whole process, in principle, starts from the beginning – nomination. However, in an emergency, it may be possible that the general shareholders meeting determines new members of the board forthwith, and the new board of directors takes responsibility for the selection of the top managers. In other words, in case of emergency, it is permissible to omit steps of the nomination by the management auditing committee and the confidence vote by core employees.

Although the general shareholders meeting is not legally bound by the confidence vote by core employees and the result of the vote is simply passed on to the meeting as information, it is quite naturally expected to have an impact on the decision by the general shareholder meeting. In cases where the general meeting opinion differs from the result of the vote, however, the former should be given priority.

This third step of the process is basically the same as the system under the current corporation law; the only difference lies in the presence of the report on the confidence vote to be used as a reference. This third step being the institutionalization of shareholders' voices, it completes the three-layer structure incorporating the opinions of all three parties (outsiders, employees and shareholders). The first two steps are not institutionalized under the current system.

Why "reference" and "a vote of confidence"?

The most controversial aspect of my proposal would be the vote of confidence by core employees to be used for a reference. I have heard many objections against this proposal, like that its adoption would politicize the workplace, or result in vote-catching populist behavior by the incumbent top management, and so on. However, bearing in mind the magnitude of the faults arising from the current unsatisfactory state of the top management, i.e., the absence of checking mechanisms, I sill maintain that the system, though there are some deficiencies, should be adopted.

But then, why is the vote of confidence used as a "reference"? Why is it a vote of "confidence" instead of a "selection"? And why is the right to vote confined to core employees, rather than employees as a whole?

First, why should core employees take part in the process in the form of a vote of confidence conducted at the request of the board of directors, the result bearing no legal binding?

One reason for this approach is to put the mechanism within the framework of the current corporation law. Another and more important reason is the fact that if the vote had legal binding power, it would immediately mean that core workers had the right to reject candidate top managers. In so far as a joint stock corporation exits as a legal entity as a community of capital, granting employees the right to reject would seem to involve a fundamental problem, not just a problem of legal procedures. The mechanism whereby the vote is one of “confidence” with no binding force, but the result is published in the form of a report to the general shareholders meeting, is intended as a deterrent to top management; if a candidate top manager receives a large amount of non-confidence votes, the announcement of the result will have a considerable negative impact on his governing power and selection prospect.

Second, why is it proposed that a vote conducted after nomination of a particular candidate should express mere “confidence,” rather than direct election with more than one candidate? This is because it is rather doubtful whether core employees have information sufficient to narrow down a wide range of potential candidates to the most appropriate one, or whether they are capable of evaluating the qualification for top manager and selecting a single person via a direct election.

The burden on voters is quite different depending on whether they simply give a yes-no judgment on a nominated candidate, or whether they choose one single person from among an unspecified number of candidates. The suggestion here is to furnish a solution to the above questions of the “information” and “burden” by leaving the actual nomination to the management auditing committee but giving employees the responsibility for giving confidence to the nominee.

And third, why should the representatives to participate in the confidence vote be limited to managers of at least a certain rank or employees with a certain length of tenure? This is because the qualifications of voters should be taken into account.

In order to make a right decision over the suitability of top managers, voters must have pertinent information at hand. The information required is classifiable into two types. One concerns long-term requirements for the management of the firm in question, that is, information concerning what kind of management is needed in the future. This provides important criteria in judging the qualifications and career of a prospective top manager. And the other type of information is related to the personal characteristics of potential candidates, that is, personal information in reference to the suitability of candidates.

In this light, employees who have reached at least at a certain rank of managerial post (e.g., general section chief or higher) are likely to have fuller information than, say, shareholders. They are at the core of practical knowledge of the business management, and posses quite a lot of internal information. What is more, many of them have had potential top managers as their direct superiors and are thus in positions to learn directly the personal characteristics of potential candidates.

What is more, from the standpoint of commitment, they normally have a stake in the long-term prospects of the company. The fact that their number is numerous is a merit. With so many of them, there is little room for the top manager to practice manipulation. This is a marked contrast to the ease of counter-manipulation against the members of the board of directors by top managers under the conventional system, and against the outside directors under the committee system. Voting by secret ballot protects the anonymity of voters and thus also prevents counter-manipulation.

There are three reasons why employees with years of service (for example, 20 years or longer) are added to the representatives of core employees. The first is that they have accumulated a substantial amount of information throughout their long service. The second is their commitment to the company; their opinions do matter, in so far as they have served the company for so many years. And the third reason is that their incorporation among the representatives will enable the opinions of labor union members to be reflected in the opinions of the representatives. Since the labor union system in fact exists, it would seem necessary to reflect the opinions of union members in some form or other.

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